

ENVIRONMENTAL POWER CORP

Form 10-K/A

November 15, 2004

[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K/A

(Mark one)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2003

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number 0-15472

Environmental Power Corporation

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction
of incorporation or organization)

75-3117389
(IRS Employer
Identification No.)

One Cate Street, Fourth Floor, Portsmouth, New Hampshire 03801

(Address of principal executive offices)

(Zip code)

Registrant's telephone number, including area code: (603) 431-1780

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$.01 par value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to the Form 10-K. Yes ☐ No ☒

The aggregate market value of voting stock (common stock, \$.01 par value) held by non-affiliates, computed by reference to the closing price of such stock, was \$5,229,907 on June 30, 2003.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the last practicable date: On March 12, 2004 there were 26,741,734 outstanding shares of Common Stock, \$.01 par value, of the registrant.

Table of Contents

EXPLANATORY NOTE

This Annual Report on Form 10-K/A of Environmental Power Corporation (the Company or EPC) for the year ended December 31, 2004, is filed solely for the purposes of (1) integrating, but not amending (other than to delete the reference to Section 21E of the Securities Exchange Act in the section entitled Forward-looking Information), the information set forth in both the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the Original Report) and the information set forth in the Company's Annual Report on Form 10-K/A as filed on April 30, 2004 with the Securities and Exchange Commission (the Amendment), (2) conforming the signature of Deloitte & Touche LLP on the filed version of its Independent Auditors' Report and (3) filing updated certifications pursuant to Item 601(b)(31) of Regulation S-K, which certifications appear as Exhibits 31.01 and 31.02 to this report. Except as described above, no other changes are being made to the Original Report or the Amendment. This Form 10-K/A does not reflect events occurring after the March 30, 2004 filing of the Original Report or modify or update the disclosure contained in the Original Report in any way other than as required to reflect the foregoing.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be filed with the Securities and Exchange Commission and delivered to shareholders in connection with the 2004 Annual Meeting of Shareholders are incorporated by reference into Part III of this Annual Report filed on Form 10-K. The portions of the Proxy Statement under the headings Audit Committee Report, Report of the Compensation Committee and the Stock Performance Graph are not incorporated by reference and are not a part of this Annual Report on Form 10-K.

TABLE OF CONTENTS

PART I

| | |
|--|----|
| <u>Item 1. Business</u> | 4 |
| <u>Item 2. Properties</u> | 15 |
| <u>Item 3. Legal Proceedings</u> | 15 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 15 |

PART II

| | |
|--|----|
| <u>Item 5. Market for Registrant's Common Equity and Related Shareholder Matters</u> | 15 |
| <u>Item 6. Selected Financial Data</u> | 16 |
| <u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17 |
| <u>Item 7A. Quantitative and Qualitative Disclosures about Market Risk</u> | 33 |
| <u>Item 8. Financial Statements and Supplementary Data</u> | 33 |
| <u>Item 9. Disagreements on Accounting and Financial Disclosure</u> | 33 |
| <u>Item 9A. Controls and Procedures</u> | 33 |

PART III

| | |
|--|----|
| <u>Item 10. Directors and Executive Officers</u> | 34 |
| <u>Item 11. Executive Compensation</u> | 35 |
| <u>Item 12. Security Ownership of Certain Beneficial Owners and Management</u> | 40 |
| <u>Item 13. Certain Relationships and Related Transactions</u> | 42 |
| <u>Item 14. Principal Accountant Fees and Services</u> | 42 |

PART IV

| | |
|--|----|
| <u>Item 15. Index to Financial Statements, Exhibits, and Reports on Form 8-K</u> | 43 |
| <u>Signature Page</u> | 48 |

Table of Contents

CERTAIN DEFINITIONS

All references in this Annual Report on Form 10-K to EPC , Company , we , us and our refer to Environmental Power Corporation and its consolidated subsidiaries (unless the context otherwise requires).

FORWARD-LOOKING INFORMATION

This Annual Report on Form 10-K contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact, including without limitation, certain statements under Item 1. Business and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and located elsewhere herein regarding industry prospects and our results of operations or financial position, may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects, and similar expressions are intended to identify forward-looking statements. The important factors discussed below under the caption Certain Factors That May Affect Future Results, among others, could cause actual results to differ materially from those indicated by forward-looking statements made herein and presented elsewhere by management from time to time. Such forward-looking statements represent management's current expectations and are inherently uncertain. Investors are warned that actual results may differ from management's expectations.

Table of Contents

PART I

Item 1. Business

Environmental Power Corporation was incorporated in May 2003 and is the successor holding company to our subsidiary, EPC Corporation, which was originally incorporated in Delaware in 1982. EPC Corporation became a publicly traded company in 1986, and, as its successor, Environmental Power Corporation is currently quoted on the OTC Bulletin Board market (symbol: POWR.OB). The address of our principal executive offices is One Cate Street, Fourth Floor, Portsmouth, New Hampshire 03801 and our telephone number is (603) 431-1780.

The following table outlines the corporate structure of Environmental Power Corporation and its subsidiaries:

| <u>Entity</u> | <u>Relationship</u> |
|---------------------------------|--|
| Environmental Power Corporation | Ultimate parent |
| EPC Corporation | Wholly-owned subsidiary of Environmental Power Corporation |
| Buzzard Power Corporation | Wholly-owned subsidiary of EPC Corporation |
| Microgy Cogeneration Systems | Wholly-owned subsidiary of Environmental Power Corporation |
| Coal Dynamics Corporation | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Kaiser Power of Sunnyside, Inc | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Kaiser Systems, Inc. | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Milesburg Energy, Inc | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Sunnyside Power Corporation | Wholly-owned subsidiary of Environmental Power Corporation, inactive |

EPC is an independent developer and owner of electrical generating facilities powered by non-commodity fuels and renewable energy sources. Our power generating facilities use alternative fuels, most of which are wastes, which are generally not subject to the same cost fluctuations as traditional fuels. Our power generating facilities have also been able to exceed air quality emission standards and to assist with the clean-up of wastes that are sources of water pollution. Accordingly, we have realized financial benefits, such as tax-exempt financing and sales of pollution allowances from the pollution control benefits of our facilities.

Since our founding in 1982, we have partially or fully developed seven hydroelectric plants, two municipal waste projects and three waste-coal fired generating facilities. We sold all but one of these projects as follows:

We sold four hydropower projects during their development phases;

We transferred rights to two municipal waste projects during their development phases;

We sold three hydropower facilities after completion;

We sold, during development, a 43 megawatt (net) waste-coal fired facility located in Pennsylvania known as the Milesburg Project;

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We sold, after completion in 1994, a 51 megawatt (net) waste-coal fired facility located in Utah known as the Sunnyside Project; and

We sold, during development, an approximate 83 megawatt (net) waste-coal fired facility located in Pennsylvania known as the Scrubgrass plant. Buzzard Power Corporation, referred to as Buzzard, currently owns a 22-year leasehold interest in this project.

In 2001, we acquired all of the common stock of Microgy Cogeneration Systems Inc., a privately held Colorado company, referred to as Microgy. We operate Microgy as a subsidiary. Microgy holds an exclusive license in North America for development and deployment of a proprietary technology for extraction of methane gas from animal wastes and its use to fuel generation of energy. EPC is currently in the process of marketing and developing opportunities for sale and development of this technology.

Our ongoing business activities are discussed further in the following sections.

Buzzard Power Corporation

Buzzard is a subsidiary of our wholly owned subsidiary, EPC Corporation. Buzzard leases the Scrubgrass plant from Scrubgrass Generating Company, L.P. The Scrubgrass plant, located on a 600-acre site in Venango County,

Table of Contents

Pennsylvania, is an approximate 83 megawatt waste coal-fired electric generating station. The following table describes the key participants in the Buzzard plant and their relationship and responsibilities:

| <u>Entity</u> | <u>Relationship</u> |
|--|---|
| EPC Corporation | Owns Buzzard Power Corporation |
| Buzzard Power Corporation | Holds the lease rights to the Scrubgrass plant and all principal project agreements |
| U.S. Operating Services Company | Operates the Scrubgrass plant |
| Pennsylvania Electric Company or Penelec | Purchases energy from Scrubgrass |
| FirstEnergy Group | Parent of Penelec |
| NEGT, Inc | Parent of U.S. Operating Services Company |

Buzzard's lease commenced on June 30, 1994 and provides for a term of 22 years with a renewal option for up to 3 years. Under the lease, Scrubgrass Generating Company assigned to Buzzard all principal project agreements and its rights and obligations under such contracts including the following:

power purchase agreement;

management services agreement;

operating and maintenance agreement;

limestone supply agreements;

ground lease agreements;

fuel agreements;

transportation; and

materials handling agreements.

We have pledged Buzzard's common stock to the Scrubgrass Generating Company as security for Buzzard's performance of its obligations as lessee. PG&E National Energy Group, a wholly owned indirect subsidiary of NEG, Inc., which in turn is a wholly owned indirect subsidiary of PG&E Corporation, manages the Scrubgrass plant under a Management Services Agreement.

U.S. Operating Services Company (formerly PG&E Operating Services Company) (the "Operator"), a wholly owned, indirect subsidiary of NEG, Inc., operates the Facility pursuant to a 15-year operating and maintenance agreement (the "O&M"). Under the terms of the O&M, the Operator can incur a liability not to exceed its management fee if the Operator does not achieve certain targeted output performance levels.

Buzzard sells all of its electric output to Pennsylvania Electric Company, known as Penelec, a subsidiary of FirstEnergy Group, under a 25-year power sales agreement, which commenced in June 1993. Under this contract, except for amounts sold above certain hourly and annual limits, all power is sold at fixed rates which initially averaged 4.68 cents per kilowatt hour and escalate by 5% annually through 2004. For years 2005 through 2012, the agreement provides for a rate equal to the greater of a scheduled rate, as adjusted to reflect actual inflation during the contract term compared to the prior 5% annual adjustment, or a rate based on the PJM Billing Rate. The PJM Billing Rate is the monthly average of the hourly rates for purchases by the FirstEnergy Group from, or sale to, the Pennsylvania-New Jersey-Maryland Interconnection. For years 2013 through 2015 and 2016 through 2018, if Buzzard exercises the renewal term option, terms of the power purchase agreement applicable during these prospective periods will apply. The agreement provides for a rate equal to the lower of the average monthly PJM Billing Rate or the rate paid for calendar year 2012 adjusted annually by the percentage change in the Gross National Product Deflator less one percent.

Buzzard deposits all revenues earned under the power sales agreement into an account administered by a disbursement agent. Before Buzzard can receive cash from the operation of the Scrubgrass plant, Buzzard must first satisfy all operating expenses, base lease payments, restricted cash deposits, and other subordinated obligations. Buzzard's base lease payments consist of Scrubgrass Generating Company's debt service, equity repayment, base return on equity and related expenses. Buzzard must also pay to Scrubgrass Generating Company additional rent of 50 percent of the net cash flows Buzzard receives from the operation of the Scrubgrass plant. We are not required to fund Buzzard's operating losses, or otherwise invest further from sources outside of the Scrubgrass plant.

Table of Contents

The debt obligations for Scrubgrass Generating Company and Buzzard are described below:

| | Balance at December 31, 2003 | Balance at December 31, 2002 | Interest Rate |
|--|---------------------------------|---------------------------------|-------------------|
| Buzzard's lease obligations (maturity): | | | |
| Tax-exempt bonds (2012) | 135,600,000 | 135,600,000 | Quoted Bond Rates |
| Swap rate term loan (2005) | 6,268,163 | 8,700,913 | 7.6725% |
| Variable rate term loan (2004) | 3,687,000 | 7,089,016 | LIBOR + 1.250% |
| Buzzard's debt obligations (maturity): | | | |
| Variable rate term loan (2004) | 389,535 | 837,437 | LIBOR + 1.250% |
| Working capital loan (2008) | 2,433,261 | 517,112 | LIBOR + 1.250% |

Scrubgrass Generating Company or Buzzard pays interest on these obligations at either quoted rates for tax-exempt debt, rates fixed by swap agreements for taxable debt, or rates for taxable debt which are based on the London Interbank Offering Rate, or LIBOR. On December 22, 1995, Scrubgrass Generating Company entered into an interest rate swap arrangement that fixed the LIBOR component for the life of its swap rate term loan at 6.4225%. As a result, the interest rate for the swap rate term loan was fixed at 7.5475% through 2001 and at 7.6725% for its remaining term. This swap rate term loan and the other lease obligations of Buzzard are not debt obligations of Buzzard and are not recorded on our balance sheets.

Under the terms of the loan agreements, Buzzard is subject to various customary financial and operating covenants with the most critical being debt service coverage. It is required to maintain a 1.20 coverage ratio defined as all cash from revenues minus all operating expenses divided by principal and interest payments. As of December 31, 2003 and 2002, we were in compliance with all such covenants.

The Environmental Protection Agency and the Pennsylvania Department of Environmental Protection granted Nitrogen Oxide Ozone Transport Region Budget Allowances, or NOx Credits, to Buzzard based on factors that primarily pertain to the design and operation of the Scrubgrass plant. Buzzard is required annually to maintain NOx Credits that equal or exceed the quantity of its nitrogen oxide emissions during a seasonal period known as an ozone season. If the Scrubgrass plant's nitrogen oxide emissions exceed its available NOx Credits, Buzzard would be subject to fines by such agencies. During 1999, Buzzard installed machinery, costing \$811,568, which has significantly reduced its nitrogen oxide emissions. Accordingly, we anticipate that Buzzard may not require a portion of its future NOx Credits to comply with the applicable regulations. NOx Credits are transferable and marketable. Buzzard has sold and may sell, from time to time, its projected excess NOx Credits or purchase additional NOx credits that are necessary to meet the applicable regulations. To date, we have entered into several agreements to sell and purchase, when necessary, NOx credits. We received net proceeds from these NOx Credit transactions of \$0 in 2003, \$2,428,200 in 2002, and \$0 in 2001, which were reported as other income in our accompanying consolidated financial statements. The sale in 2002 was for NOx emission credits for the 2002 through 2007 ozone seasons.

Our wholly owned subsidiary, EPC Corporation, holds our investment in Buzzard as its sole asset. In September 2003, EPC Corporation obtained a \$3,700,000 loan from ArcLight Capital Partners. This debt is secured by the stock of EPC Corporation. This loan incurs a 20% interest rate. All distributions from Buzzard are required to be used to repay this note. As an incentive fee for providing this note, we have also granted ArcLight a participation right in a portion of the future distributions of Buzzard after the note has been repaid. ArcLight will receive half of the distributions after the note has been repaid in full and after EPC alone receives a total of \$1,400,000 of distributions. This participation right will end on December 31, 2012. We are required to make payments only when we receive distributions. Any unpaid interest by the 15th of any month will be accrued and rolled into the principal. Nevertheless, we are required to make at least one payment of any amount within a 24 month period. As of the date of this filing, we have satisfied this requirement for the next 22 months.

Microgy Cogeneration Systems

Overview

In 2001, we acquired all of the common stock of Microgy Cogeneration Systems Inc., a privately held development-stage company based in Colorado. Microgy holds an exclusive license in North America for the development and deployment of a proprietary technology for the extraction of methane gas from animal wastes and its use to fuel generation of energy. Microgy's product is expected to provide certain farms, known as concentrated animal feeding operations, or CAFO's, with a potentially profitable means of mitigating an existing waste management problem

Table of Contents

that affects both water and air quality. Federal and State agencies either have or may be in the process of passing regulations that require CAFOs to implement changes to their current waste management practices.

While Microgy is seeking to help farmers meet their waste management needs, we are also seeking to produce renewable energy. Many states have either passed or may be in the process of promulgating legislation requiring utilities to obtain a certain percentage of their power from renewable sources. This positions Microgy as a potentially profitable solution to farmers' waste management problems, while at the same time providing a new renewable energy source for utilities. We believe that Microgy represents a substantial portion of the future potential growth of Environmental Power and, as such, we are investing substantially all our available resources, both financial and human capital, to take advantage of these opportunities.

Anaerobic Digester License Agreement

The licensor of Microgy's anaerobic digester technology is Danish Biogas Technology A/S (DBT). Anaerobic digestion is a process whereby animal wastes are broken down into different chemical components in an oxygen-free environment. One of the critical components is methane that has fuel value. DBT is 50% owned by Schouw & Co., a Danish public company and 50% by DDH Contractors A/S, a Danish engineering firm. On May 12, 2000, Microgy entered into a revised licensing agreement with DBT which granted Microgy a perpetual and exclusive license in certain territories, specifically North America, for use of certain proprietary technologies, including the anaerobic digestion technology. This agreement superseded previous license agreements. As part of the agreement renegotiated in 2003, DBT will receive fixed payments for engineering work and construction drawings and a licensing fee that is based on a percentage of the total cost for each project facility where the licensed technology is installed and operating.

Proposed Projects

Microgy plans to develop projects based upon the anaerobic digestion technology license. Our present business strategy anticipates the outright sale of facilities; however, we expect that, in some circumstances, we may own some or even a majority of projects. In addition to any ownership position Microgy may have, it presently plans to manage and may operate any such proposed facilities. We anticipate that most of these facilities will deliver renewable energy for supply to the utility grid and will provide certain pollution control benefits to the agricultural markets. In addition, certain facilities may supply biogas for other applications, such as the operation of feed production and drying equipment as contemplated by projects proposed to be developed under Microgy's Project Development Agreement with The Scoular Company. The ultimate opportunity to develop such projects and/or to sell these facilities to others, as well as to manage and/or operate them profitably, depends on factors including the value which can be derived from the energy and agricultural markets discussed below.

Microgy has executed agreements with affiliates of five farms: Wild Rose Dairy, Five Star Dairy, Norswiss Dairy, Daley Farms Dairy, and Bach Farms, LLC. These farms will purchase a Microgy digester system to process manure produced by their dairy operations in Wisconsin and Minnesota. These five farms represent a backlog of over \$12 million in sales from documented transactions to be developed under the agreement with Dairyland Power Cooperative described below.

Microgy will act as the general contractor in these projects and pay for licensing fees, construction, permitting, engineering, and other general expenses related to the projects.

Power Sales Agreements

Microgy and/or EPC have also signed memoranda of understanding with Dairyland Power Cooperative, or DPC, Vermont Public Power Supply Authority, or VPPSA, Lodi Electric Utility, or Lodi, and Merced Irrigation District and Gallo Farms to develop projects based on Microgy's proprietary anaerobic digestion technology. The following table outlines these agreements and the associated generating capacity:

| Power Sales Agreement | Location | Generating Capacity (MW) |
|--|----------------------|---------------------------------|
| Dairyland | La Crosse, Wisconsin | 25 |
| Vermont VPSA | Waterbury, Vermont | 15 |
| New York NYSERTA | New York | 5 |
| Lodi Electric Utility | California | 20 |
| Merced Irrigation District and Gallo Farms | California | 4 |
| TOTAL | | 69 |

Table of Contents

All of these agreements are non-binding and the actual completion of any projects under these agreements may not occur.

Commodity Electricity

We expect the near-term market for commodity electricity to remain very price competitive with upward pressure on prices dependent upon increased costs of fuels used for electric generation. If and when the economy becomes more robust and consumption of energy increases, there are likely to be increases in conventional fuel prices as well as geographical areas within the United States that will need increased capacity to service demand. Therefore, we believe prices will likely increase accordingly. If such projections prove to be accurate and commodity electricity prices do increase, the output from any facilities developed by Microgy will be increasingly price competitive and potentially more profitable. Such factors should also make it easier for us to attract and execute new opportunities to develop these projects.

Renewable Peak Period Electricity

Among the facilities that we plan to develop, some will serve the market for renewable energy delivered during peak usage periods. We intend this combination of renewable energy and peak period delivery to position our output into the highest priced segments of the electricity markets. The greatest use and demand for electricity occurs during peak periods. Natural gas is the principal fuel source for generating commodity electricity on a peaking basis. Except for oil, which is now seldom used, generation from most other fuels is not readily adaptable to peak period operation. Microgy's anaerobic digestion technology produces biogas from the processed manure that, like natural gas, can be stored and used to generate power during peak periods. We believe that Microgy's technology offers us a valuable generating capability, namely, the ability to produce renewable, peak energy.

The demand for renewable power in the energy markets is driven largely by consumer desire for such power and by state legislation. These preferences have resulted in green pricing programs in many local energy markets. Many states and local governments have further encouraged the growth of renewables through tax incentives and by requiring utilities to offer customers electricity derived from renewable sources and/or to generate or purchase a small portion of their electricity from renewable energy providers. Presently, the United States Congress is considering proposed legislation that would add significant tax benefits to the generation of electricity produced from biomass involving animal waste. Further, many states and the Federal government require a portion of the power consumed in their own facilities to be provided from renewable generating sources.

Green Tags and Pollution Offset Credits

As a potential producer of renewable energy, we expect to be able to sell separately electricity and green energy credits, also called green tags. Green tags can be defined in many ways. We define them as the marketable bundle of benefits derived from the environmentally friendly generation of power. In many instances, we may include all or some portion of the green tags in wholesale electricity purchase agreements. However, we may also separately trade these green tags or some of their unbundled components in a separate trading market.

Buzzard has been able to sell pollution-offset credits based upon NOx emissions which were discussed previously. We may derive future demand, or increased opportunities, for facility sales by Microgy if our future facilities are able to sell greenhouse gases, and other pollution offset credits in addition to electricity and other green credits. We hope that the market for these and similar credits will grow over the long term, as stricter environmental regulations and emission standards are adopted.

Agricultural Markets

We plan to provide anaerobic digester equipment and services to help control pollution in agricultural markets, specifically concentrated animal feeding operations or CAFOs. Runoff from animal wastes presents significant water pollution problems.

On December 16, 2002, the Environmental Protection Agency issued new rules to regulate manure run-off on farms, one of the nation's leading causes of water pollution. The new rules apply to about 15,500 livestock operations across the country. These CAFOs will need to obtain permits, submit an annual report, and develop and follow a plan that will ensure that measures are instituted to protect America's waters from wastewater and manure. The EPA

Table of Contents

is working with the United States Department of Agriculture to help the agricultural community find solutions to this environmental problem. Effective manure management practices required by the rules will maximize the use of manure as a resource for agriculture while reducing adverse impacts on the environment. The effective date of the rules was April 14, 2003, but the compliance deadlines vary depending upon the classification of a company's operations. For operations that are defined as CAFOs under regulations that were in effect prior to April 14, 2003, the owner or operator was requested to have or seek to obtain coverage under an NPDES permit by April 14, 2003, and comply with all applicable NPDES requirements, including the duty to maintain permit coverage. The compliance deadlines for other operations are phased in over periods ranging from 90 days to three years. In addition, permitted CAFOs must have their nutrient management plans developed and implemented by December 31, 2006.

We believe that the waste management benefits of Microgy's technologies should help CAFOs meet the stricter guidelines and permitting requirements, and, as a result, many farms would be able to address existing pollution problems over time and to increase land application of less-pollutant manure and, in some instances, support a larger herd on the same amount of land. Alternatively, in critical pollution areas, or where uses for residual products can be identified, the land application of manure could be substantially curtailed.

Thermal Energy

We believe that Microgy's technology is readily adaptable to applications other than electric generation and can address markets requiring a reliable supply of high quality biogas for use in producing thermal energy. We believe that this adaptability allows us to operate to economic advantage in markets that do not have favorable power pricing or power marketing dynamics. An example of such an alternative are the projects Microgy intends to develop with The Scoular Company, referred to as Scoular, where biogas produced by Microgy digesters will be used to operate feed production systems, which include a dryer and are dependent upon a reliable, cost-effective, high-quality gas supply. We believe that the application contemplated by the agreement with Scoular is only the first of many possible opportunities to leverage Microgy's technology into diverse applications dependent upon thermal energy. We believe that the volatility of, and general increases in, natural gas prices are propelling this market. Heavy users of thermal energy not only suffer generally when fuel costs increase, but often are unable to protect their profitability from fuel cost volatility when prices for their products are referenced to different market forces. Our biogas prices are expected to be essentially constant.

Other Expected Benefits

While digesting the raw manure and burning the resulting biogas to make electricity does not eliminate the nutrients from the manure slurry, the process does change their chemical makeup. In the anaerobic digestion process, many of the nutrients that were previously bound in organic molecules are mineralized, or reduced to the inorganic forms of the nutrients. These are the forms that are usable by crops. The organic forms in undigested manure must first be broken down before they can be used. Because this usually takes an extended period of time, there are residual nutrients in the soil left over from previous years' manure applications. These residuals must be taken into account when calculating current manure application rates, resulting in less manure being spread on the same amount of cropland. By providing the nutrients in readily usable forms, digested manure has lower potential to produce a residual accumulation of minerals on the land. Therefore, more of it can be spread on an acre of cropland, thus reducing manure-spreading costs.

In addition, further environmental benefits are expected to be achievable by subjecting the digested manure slurry to other nutrient extraction techniques, such as chemical precipitation. By digesting the manure, these nutrients will be in a form that is more easily extracted in such techniques. Digested manure can also be put to other beneficial uses, such as bedding for the animals, and, therefore, would not need to be applied to the land.

Competition

The following sections describe the competition facing our subsidiaries.

Buzzard Power Corporation

Buzzard generates electricity using waste coal, an alternative energy source. Buzzard sells all of its electricity at rates established under a long-term power purchase agreement. With the exception of the risk that Penelec would seek and achieve judicial determination that it has a right to renegotiate the terms of the power purchase agreement,

Table of Contents

the sale of power from our existing facility is not subject to competition during the term of the power purchase agreement.

However, because our contracted rates in the later years of the agreement are determined with reference to the Gross National Product Deflator, or GNPD, and future market conditions at the PJM western hub, the rate at which such power is sold after 2004 is influenced by competitive power rates in the region. Therefore, low wholesale energy rates during the later years of the power purchase agreement would adversely affect our profitability and could affect our results of operations and financial position.

Microgy Cogeneration Systems

Microgy plans to generate revenue from the development, sale, and/or ownership of facilities that market renewable, green energy in addition to providing pollution control features to the agricultural markets. In the energy market, its competitors include traditional regulated utilities, unregulated subsidiaries of regulated utilities, energy brokers and traders, energy service companies in the development and operation of energy-producing projects as well as the marketers of electric energy, equipment suppliers, providers of pollution control products or services, and other non-utility generators like EPC.

Microgy's green competitors include other energy producers using biomass combustion, biomass anaerobic digestion, geothermal, solar, wind, new hydro, and other renewable sources. These companies represent a significant class of competitors because they will compete with Microgy not only for electricity sales but also for sale of green tags and participation in various renewable portfolios and other programs.

In the agricultural markets, Microgy faces many forms of competition from other providers of pollution control. The most significant among these entities may include environmental engineers, providers of pollution control systems, and other developers of anaerobic digesters or plug-flow digesters. Competition includes private companies, public companies, associations, cooperatives, government programs, such as AgStar, foreign companies, and educational pilot programs.

There are many companies that offer anaerobic digester systems. We believe that at least 60 companies offer complete systems or components to these systems in the U.S. market. Although we are unaware of any competitors pursuing a business strategy similar to Microgy's, a number of competitors have more mature businesses and have successfully installed anaerobic digester systems.

Environmental Regulation

Our present and any future projects are and will be subject to various federal, state and local regulations pertaining to the protection of the environment, primarily in the areas of water and air pollution. Microgy intends to build plants in various states. These facilities will be subject to federal, state and local regulatory requirements in all the locations where they may operate.

In many cases, these regulations require a lengthy and complex process of obtaining and maintaining licenses, permits and approvals from federal, state and local agencies. We also have and will have significant administrative responsibilities to monitor our compliance with the regulations. As regulations are enacted or adopted in any of these jurisdictions, we cannot predict the effect of compliance therewith on our

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business. Our failure to comply with all the applicable requirements could require modifications to operating facilities. During periods of non-compliance, our operating facilities may be forced to shutdown until the compliance issues are resolved. EPC is responsible for ensuring the compliance of its facilities with all the applicable requirements and, accordingly, attempts to minimize these risks by dealing with reputable contractors and using appropriate technology to measure compliance with the applicable standards. The cost of environmental regulation does and will continue to affect our profitability.

Buzzard Power Corporation

We believe the Scrubgrass plant, our only currently operating project, is currently in compliance with all material applicable environmental regulations. Our Scrubgrass plant is most notably affected by the following environmental regulations:

Table of Contents

Air Quality The Scrubgrass plant is subject to air quality regulations under the federal Clean Air Act of 1970. This Act established National Ambient Air Quality Standards for certain pollutants including ozone, sulfur dioxide, nitrogen dioxide, particulate matter, carbon monoxide and lead. In particular, Title I of the Clean Air Act established the Northeast Ozone Transport Region, which includes 12 northeast states and the District of Columbia, to address the transport of these pollutants which may lead to the non-attainment of the ozone standards in the Northeast. Ozone control is facilitated by the control of pollutant precursors, which are nitrogen oxides, or NOx, and volatile organic compounds. Electric generating facilities that use fossil fuels, including the Scrubgrass plant, are considered major sources of NOx emissions.

In recent years, the Pennsylvania Department of Environmental Protection established regulations that required companies with stationary sources of NOx emissions to establish plans to reduce their NOx emissions. To administer these regulations, the Department began allocating Nitrogen Oxide Ozone Transport Region Budget Allowances, or NOx Credits, to facilities based on numerous factors including the design and operation of each facility. A market-based trading system was established to allow companies with excess NOx Credits to trade with companies that required additional NOx Credits to meet the stricter requirements. More recently, an Ozone Transport Commission established certain inner and outer zones with seasonal NOx emission reductions that required the Scrubgrass plant to achieve certain targeted NOx emission levels beginning on May 1, 1999. Under such requirements, the Scrubgrass plant was also required to achieve reduced emission standards by May 2003. Due to the efficient design of the Scrubgrass plant, the Scrubgrass plant met the new 1999 requirements without any modifications to the facility. However, we made capital improvements of \$811,568 in 1999 to the Scrubgrass plant, which enabled the Scrubgrass plant to meet the stricter standards in 2003. To date, we have sold credits through 2007 in anticipation of meeting the air quality standards for sulfur dioxide, nitrogen dioxide, particulate matter, carbon monoxide and lead during this period. We do not anticipate needing any additional material modifications to the Scrubgrass plant during this time.

Waste Disposal The Scrubgrass plant must also comply with various environmental regulations pertaining to water discharge as well as the handling and disposal of hazardous and non-hazardous wastes. The Pennsylvania Department of Environmental Protection establishes classifications for wastes and requires companies to follow certain handling and disposal procedures for each waste classification. Currently, the Scrubgrass plant employs special handling procedures for the transportation of its fuel, which is classified as a waste, from the waste sites to the Scrubgrass plant. The fuel is burned in the Scrubgrass facility where it is treated with various substances such as limestone during the electric generation process. Ash, which is a byproduct of the waste-coal combustion process, is removed from the Scrubgrass facility and returned to the original waste site, which is reclaimed in part by deposit of the ash along with the soil. Under existing regulations, ash is not classified as a hazardous waste. However, various environmental organizations have recently been lobbying for changes to the applicable regulations for the classification of ash. If there are changes to the waste classification of ash, our ash disposal costs may significantly increase which could have material adverse affect on our results of operations and financial position.

Microgy Cogeneration Systems

Microgy has no projects currently in operation. Depending on the location of each individual plant, state implementation plans of the Clean Air Act and Clean Water Act as described above may apply. The state permitting process could involve lengthy delays and the purchase of offsets in order to counter-balance emissions. Microgy's projects may be subject to the following additional regulations:

Current Regulations The primary Federal law affecting manure management on animal operations is the Clean Water Act, under which the National Pollutant Discharge Elimination System, or NPDES, program covers Concentrated Animal Feeding Operations, or CAFOs. Federal NPDES permits may be issued by EPA or any state authorized by EPA to implement the NPDES program. Forty-three states are certified by the EPA to issue their own NPDES permits. Of note, EPA materials published in 1999 indicated that 32 states have a requirement covering application rates of manure on the land, and 27 states require at least some animal operations to develop and use waste management plans.

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In addition, each distributed generation site with an installed reciprocating engine and generator is regulated under a state implementation plan (SIP) developed in accordance with the federal Clean Air Act. The engine emissions at each site will be covered under a general statewide permit or a point source permit. The engine emissions are

Table of Contents

considered a minor point source for both the general and specific permit, and no other emission control devices are required.

New Regulations On December 16, 2002, the Environmental Protection Agency issued new rules to regulate manure run-off on farms, one of the nation's leading causes of water pollution. The new rules apply to about 15,500 livestock operations across the country. These CAFOs will need to obtain permits, submit an annual report, and develop and follow a plan which will ensure that measures are instituted to protect America's waters from wastewater and manure. The EPA is working with the United States Department of Agriculture (USDA) to help the agricultural community find solutions to this environmental problem. Effective manure management practices required by the rules are intended to maximize the use of manure as a resource for agriculture while reducing adverse impacts on the environment.

Energy Regulation

PURPA The Public Utility Regulatory Policies Act of 1978, or PURPA, and the regulations under PURPA by the Federal Energy Regulatory Commission, or FERC, have provided incentives for the development of cogeneration facilities and small power production facilities, which are power projects that use renewable fuels and generally have a capacity of less than 80 megawatts. In general, PURPA requires utilities to purchase electricity produced by facilities using alternative fuels or from cogeneration facilities that meet the FERC's requirements for certification as qualifying facilities, or QFs.

In order to obtain QF status under PURPA, any facilities that we might acquire or develop will be required to meet certain size, fuel and ownership requirements and/or co-generate. Specifically, a cogeneration facility must produce not only electricity, but also useful thermal energy for use in an industrial or commercial process for heating or cooling applications in certain proportions to the facility's total energy output and must meet certain energy efficiency standards. A geothermal facility may qualify as a QF if it produces less than 80 megawatts of electricity. With respect to small power production facilities, there is generally no size limit for qualifying solar, wind, or waste facilities. For small power production facilities, the primary energy source of the facility must be biomass; waste, renewable resources, geothermal resources, or any combination thereof, and 75 percent or more of the total energy input must be from these sources. Any primary energy source which, on the basis of its energy content, is 50 percent or more biomass is considered to be biomass. Finally, a QF must not be controlled or more than 50 percent owned by an electric utility or by an electric utility holding company, or a subsidiary of such a utility or holding company or any combination thereof.

PURPA provides two primary benefits to QFs. First, QFs generally are relieved of compliance with extensive federal and state regulations that control the financial structure of an electric generating plant and the prices and terms on which electricity may be sold by the plant. Such regulations include the Public Utility Holding Company Act of 1935, or PUHCA, and the Federal Power Act, or FPA. Second, electric utilities are required to purchase electricity generated by QFs at a price based on the purchasing utility's avoided cost and to sell back-up power to the QFs on a non-discriminatory basis. The term "avoided cost" is defined generally as the price at which the utility could purchase or produce the same amount of power from sources other than the QF. The FERC regulations also permit QFs and utilities to negotiate agreements for utility purchases of power at rates other than the utilities' avoided costs. While public utilities are not explicitly required by PURPA to enter into long-term power sales agreements, PURPA helped to create a regulatory environment in which it has been common for long-term agreements to be negotiated.

Our Scrubgrass plant is certified as a QF by the FERC. We believe that the facilities we would build or develop using Microgy's licensed technology would also meet the qualifications required to be a QF. We endeavor to develop our projects and monitor compliance of existing projects with applicable regulations in a manner which minimizes the risks of any project losing its QF status. Certain factors necessary to maintain QF status are, however, subject to the risk of events which may be outside our control. Upon the occurrence of such an event, we would seek to correct any non-compliance in order to meet PURPA's requirements, but we cannot assure you that such correction would be possible in all instances.

If a facility in which we have an interest should lose its status as a QF, the project would no longer be entitled to the exemptions from PUHCA and the FPA. This could also trigger certain rights of termination under the facility's power sales agreement, could subject the facility to rate regulation as a public utility under the FPA and state law

Table of Contents

and could result in EPC inadvertently becoming an electric utility holding company that would not be exempt under PUHCA. Loss of QF status may also trigger defaults under covenants to maintain QF status in the project's power sales agreement and potentially result in termination, penalties or acceleration of indebtedness under such agreements.

Under the Energy Policy Act of 1992, if a facility can be qualified as an exempt wholesale generator, or EWG, it will be exempt from PUHCA even if it does not qualify as a QF. Generally, an EWG is defined as any person who receives a determination from the FERC that it is engaged directly, or indirectly through one or more affiliates, and exclusively in the business of owning or operating, or both owning and operating, all or part of one or more eligible facilities and selling electric energy at wholesale. As such, another response to the loss or potential loss of QF status would be to apply to have the project qualified as an EWG. However, assuming this changed status would be permissible under the terms of the applicable power sales agreement, rate approval from FERC would be required. To the extent applicable, the facility would also be required to cease selling electricity to any retail customers.

Presently, there are various pending legislative proposals which would amend or comprehensively restructure PURPA and the electric utility industry. If PURPA is amended or repealed, the statutory requirement that electric utilities purchase electricity from QFs at full-avoided cost could be repealed or modified. While existing contracts are expected to be honored, the repeal or modification of these statutory purchase requirements under PURPA in the future could, among other things, increase pressure from electric utilities to renegotiate existing contracts. Should there be changes in statutory purchase requirements under PURPA, and should these changes result in amendments to our current power purchase agreement for Scrubgrass which reduce the contract rates, our results of operations and financial position could be negatively impacted.

Public Utility Holding Company Act Under PUHCA, any legal entity which owns or controls ten percent or more of the outstanding voting securities of a public utility company or a company which is a holding company for a public utility company is subject to registration with the Securities and Exchange Commission, or SEC, and regulation under PUHCA, unless eligible for an exemption. Generally, a holding company of a public utility company that is subject to registration is required by PUHCA to limit its utility operations to a single integrated utility system and to divest any other operations not functionally related to the operation of that utility system. Approval by the SEC is required for nearly all important financial and business dealings of a registered holding company. Under PURPA, most QFs are not public utility companies under PUHCA.

The Energy Policy Act of 1992, among other things, amends PUHCA to allow electric wholesale generators, or EWGs, under certain circumstances, to own and operate non-QF electric generating facilities without subjecting those producers to registration or regulation under PUHCA. The effect of such amendments has been to enhance the development of non-QFs which do not have to meet the fuel, production and ownership requirements of PURPA. We believe that these amendments benefit us by expanding our ability to own and operate facilities that do not qualify for QF status. However, they have also resulted in increased competition by allowing utilities to develop such facilities which are not subject to the constraints of PUHCA.

Federal Power Act Regulation Under the FPA, FERC is authorized to regulate the transmission of electric energy and the sale of electric energy at wholesale in interstate commerce. Unless otherwise exempt, any person that owns or operates facilities used for such purposes is considered a public utility subject to FERC jurisdiction. FERC regulation under the FPA includes approval of the disposition of utility property, authorization of the issuance of securities by public utilities, regulation of the rates, terms and conditions for the transmission or sale of electric energy at wholesale in interstate commerce, the regulation of interlocking corporate directors, officers, and officials, and a uniform system of accounts and reporting requirements for public utilities.

FERC regulations provide that a QF is exempt from regulation under the foregoing provisions of the FPA. However, QFs remain subject to limited FPA regulation concerning interconnection authority, transmission authority, information requirements, and emergency provisions. An EWG is not exempt from the FPA and therefore an EWG that makes sales of electric energy at wholesale in interstate commerce is subject to

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FERC regulation as a public utility. However, many of the regulations that customarily apply to traditional public utilities have been waived or relaxed for power marketers, EWGs and other non-traditional public utilities that have demonstrated that they lack market power in the region in which they are located. EWGs that have demonstrated such a lack of market power are regularly granted authorization to charge market-based rates, blanket authority to issue securities, and waivers of

Table of Contents

FERC's requirements pertaining to accounts, reports and interlocking corporate directors, officers, and officials. Such action is intended to implement FERC's policy to foster a more competitive wholesale power market.

Wholesale Electricity Market Restructuring On July 31, 2002, FERC issued a notice of proposed rulemaking which is intended to substantially restructure the nation's wholesale electricity transmission and sales markets. FERC's objectives in this proposed rule are to remedy various discriminatory aspects of the industry and establish a standardized transmission service and wholesale electric market design that will provide a level playing field for all entities that seek to participate in wholesale electric markets. FERC is also seeking in this rulemaking to establish regulatory measures to protect customers against the exercise of market power when structures do not support a competitive market. We do not know when a final FERC rule in this matter will be issued or what changes will be made to the proposed rule once it is issued in final form. We will continue to monitor these regulatory activities to evaluate any impact on the Scrubgrass plant and/or business opportunities for Microgy.

State Regulation State public utility commissions, or PUCs, have historically had broad authority to regulate both the rates charged by, and the financial activities of, electric utilities operating in their states and to promulgate regulations for implementing PURPA. Because a power sales agreement generally is incorporated into a utility's cost structure and its retail rates, power sales agreements with power producers, such as EWGs and QFs, are potentially subject to state regulatory scrutiny, including the process in which the utility has entered into the power sales agreement. Where the state regulatory authority has authorized a utility's process for securing its electric power supply, the regulatory agency is generally inclined to permit the utility to pass through the costs associated with power purchase agreement to its retail customers. However, under certain circumstances, PUCs could disallow full cost recovery for the expenses associated with a power purchase agreement. Independent power producers that are not QFs or EWGs are considered to be public utilities in many states. As such, these entities would be subject to broad regulation by a PUC, ranging from certificates of public convenience and necessity to regulation of organizational structure, accounting, and financial and other matters. States may also assert jurisdiction over the siting and construction of electric generating facilities including that associated with QFs and EWGs. States may further assert jurisdiction, with the exception of QFs, over the issuance of securities and the disposition, sale, or transfer of assets by these electric generation facilities. PUCs, pursuant to state legislative authority, may also have jurisdiction over how new federal initiatives associated with power production are implemented in each state.

The actual scope of jurisdiction over independent power projects by state public utility regulatory commissions varies from state to state. Presently, through its power purchase agreement with Penelec, the Scrubgrass plant is affected by state legislation in Pennsylvania.

On December 3, 1996, in response to changes in the electric industry, Pennsylvania passed legislation known as the Electricity Generation Customer Choice & Competition Act, or Customer Choice Act, which became effective on January 1, 1997. The Customer Choice Act regulates the generation portion of the electric business by permitting all Pennsylvania retail electric customers to choose their electric generation supplier over a phase-in period which expired December 1, 2000. The Customer Choice Act required that all electric utilities file restructuring plans with the PUC. Penelec filed its proposed restructuring plan during 1997. The plan was subsequently litigated by numerous parties, and later settled by an agreement which was approved by the PUC on October 20, 1998. The settlement agreement set forth a comprehensive plan for restructuring Penelec's service and for ensuring there would be competition for electric generation for all of Penelec's customers beginning on January 1, 1999. The approved restructuring plan provided for Penelec to maintain a separate non-utility generator cost recovery mechanism for accounting purposes. The restructuring plan is designed to enable Penelec to recover all of its costs from non-utility generators, such as the Scrubgrass facility, and should serve to decrease the pressure on Penelec to renegotiate existing power contracts with non-utility generators.

Presently, except as discussed above, neither the Customer Choice Act nor Penelec's restructuring plan directly impacts Environmental Power, since the legislation and restructuring plan pertain to the retail market or new contracts in the wholesale market. Nevertheless, we continue to monitor regulatory developments in order to evaluate any impact on the Scrubgrass plant and possible new business opportunities for Microgy.

Table of Contents

Employees

At the time of this filing, we have thirteen employees, including executive officers and other marketing, finance, engineering and administrative personnel. Our employees are not represented by a collective bargaining agreement and we consider relations with our employees to be good.

Item 2. Properties

Buzzard leases the Scrubgrass facility, which is an approximately 83 megawatt waste coal-fired electric generating facility located on approximately 600 acres in Venango County, Pennsylvania. The payment terms of the lease are described in Item 1.

We lease 2,818 square feet of office space for our corporate headquarters in Portsmouth, New Hampshire under a five-year lease with monthly payments of \$5,520.

Microgy is a tenant-at-will for office space located in Colorado and Wisconsin with aggregate rents of \$1,545 per month.

Item 3. Legal Proceedings

We are currently not involved in any legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of our stockholders during the fourth quarter of 2003.

PART II

Item 5. Market for Registrant's Common Equity and Related Shareholder Matters

Stock Market Trading:

Our common stock trades on the OTC Bulletin Board under the symbol **POWR**. As of March 3, 2004 there were approximately 231 record holders and approximately 900 beneficial holders of our common stock.

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The following table shows the quarterly high and low bid prices during 2003 and 2002 as reported by the OTC Bulletin Board:

| Year | Period | High | Low | Year | Period | High | Low |
|------|----------------|--------|--------|------|----------------|--------|--------|
| 2003 | First Quarter | \$0.30 | \$0.19 | 2002 | First Quarter | \$0.60 | \$0.45 |
| | Second Quarter | \$0.28 | \$0.17 | | Second Quarter | \$0.90 | \$0.40 |
| | Third Quarter | \$1.15 | \$0.18 | | Third Quarter | \$0.62 | \$0.35 |
| | Fourth Quarter | \$1.08 | \$0.80 | | Fourth Quarter | \$0.43 | \$0.15 |

These over-the-counter quotations reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

Dividends:

The Board of Directors has not declared any dividends on our common stock since the last quarter of 2000. Due to the acquisition of Microgy in 2001 and anticipated expansion of our business, the Board of Directors has concluded that available cash flows should be used for operating and investing activities for the foreseeable future.