KPMG

# NORESCO HOLDINGS, INC. AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

**NORESCO HOLDINGS, INC. AND SUBSIDIARIES**

**Table of Contents**

**KPMG LLP**
Suite 2500
One Mellon Center
Pittsburgh, PA 15219-2598

# Independent Auditors' Report

The Board of Directors
NORESCO HOLDINGS, INC. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of NORESCO HOLDINGS, INC. and Subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of NORESCO HOLDINGS, INC. and Subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

KPMG LLP

March 28, 2008

**NORESCO HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Balance Sheets

December 31, 2007 and 2006

(In thousands except per share amounts)

| **Assets** | | **2007** | **2006** |
|---|---|---|---|
| Current assets: | | | |
| Cash and cash equivalents | $ | 25,102 | 8,635 |
| Accounts receivable (less provision for doubtful accounts of $851 and $719, respectively, in 2007 and 2006) | | 22,484 | 21,350 |
| Unbilled revenues | | 43,921 | 56,561 |
| Inventory | | 211 | 155 |
| Restricted cash | | — | 2,190 |
| Debt service reserve | | — | 377 |
| Deferred income tax (note 8) | | 388 | 601 |
| Prepaid expenses and other current assets (note 4) | | 7,469 | 4,993 |
| Total current assets | | 99,575 | 94,862 |
| Equity in nonconsolidated investment | | 98 | 142 |
| Property, plant, and equipment, net (note 2) | | 4,310 | 4,586 |
| Long-term unbilled revenues | | 101,008 | 42,718 |
| Goodwill (note 3) | | 48,161 | 49,822 |
| Other intangible assets, net (note 3) | | 2,701 | 4,398 |
| Deferred income tax (note 8) | | 1,120 | — |
| Other assets (note 5) | | 10,060 | 11,195 |
| Total assets | $ | 267,033 | 207,723 |
| **Liabilities and Stockholders' Equity** | | | |
| Current liabilities: | | | |
| Current portion of long-term debt (note 9) | $ | 7,293 | 6,918 |
| Accounts payable | | 28,717 | 12,435 |
| Accrued income taxes (note 8) | | 1,972 | 2,819 |
| Current portion of project financing obligations (note 1) | | 31,911 | 44,318 |
| Other current liabilities (note 6) | | 12,847 | 11,133 |
| Total current liabilities | | 82,740 | 77,623 |
| Long-term debt (note 9) | | 25,148 | 32,500 |
| Asset retirement obligation (note 15) | | 124 | 114 |
| Project financing obligations (note 1) | | 92,295 | 41,925 |
| Deferred income tax (note 8) | | — | 66 |
| Other liabilities (note 7) | | 19,174 | 13,424 |
| Total liabilities | | 219,481 | 165,652 |
| Minority interest in Hunterdon | | 2,150 | 2,222 |
| Common stockholders' equity: | | | |
| Common stock (41,000 shares authorized at $0.01 par value; 36,500 shares issued and outstanding) | | 365 | 365 |
| Retained earnings | | 9,135 | 2,915 |
| Additional paid-in capital | | 35,902 | 36,569 |
| Total common stockholders' equity | | 45,402 | 39,849 |
| Total liabilities and stockholders' equity | $ | 267,033 | 207,723 |

See accompanying notes to consolidated financial statements.

**NORESCO HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Statements of Income

Years ended December 31, 2007 and 2006

(In thousands)

| | | 2007 | 2006 |
|---|---|---|---|
| Energy service contract revenues | $ | 190,948 | 138,372 |
| Energy service contract cost | | 141,725 | 103,020 |
| Net operating revenues | | 49,223 | 35,352 |
| Operating expenses: | | | |
| Selling, general, and administrative | | 25,995 | 20,617 |
| Depreciation and amortization | | 3,034 | 2,759 |
| Total operating expenses | | 29,029 | 23,376 |
| Operating income | | 20,194 | 11,976 |
| Equity earnings from nonconsolidated investment | | 95 | 54 |
| Minority interest expense | | 1,128 | 557 |
| Interest income | | (859) | (475) |
| Interest expense | | 10,339 | 7,204 |
| Income before income tax expense | | 9,681 | 4,744 |
| Income tax expense (note 8) | | 3,461 | 1,829 |
| Net income | $ | 6,220 | 2,915 |

See accompanying notes to consolidated financial statements.

**NORESCO HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Statements of Stockholders' Equity

Years ended December 31, 2007 and 2006

(Thousands)

| | Common stock | | | Additional | |
|---|---|---|---|---|---|
| | Shares outstanding | Par value | Retained earnings | paid in capital | Stockholders' equity |
| Balance, December 31, 2005 | 36,500 | $ 365 | — | 36,569 | 36,934 |
| Net income | — | — | 2,915 | — | 2,915 |
| Balance, December 31, 2006 | 36,500 | 365 | 2,915 | 36,569 | 39,849 |
| Purchase price adjustment | — | — | — | (667) | (667) |
| Net income | — | — | 6,220 | — | 6,220 |
| Balance, December 31, 2007 | 36,500 | $ 365 | 9,135 | 35,902 | 45,402 |

See accompanying notes to consolidated financial statements.

**NORESCO HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Statements of Cash Flows

Years ended December 31, 2007 and 2006

(Thousands)

| | | 2007 | 2006 |
|---|---|---|---|
| Cash flows provided by (used in) operating activities: | | | |
| Net income | $ | 6,220 | 2,915 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | | 3,034 | 2,759 |
| Amortization of construction contract costs | | 461 | 838 |
| Accretion of project financing interest, net | | 7,332 | 3,922 |
| Provision for losses on accounts receivable | | 132 | 106 |
| Gain on sale of fixed asset | | (12) | — |
| Minority interest expense | | 1,128 | 557 |
| Equity earnings from nonconsolidated investments | | (95) | (54) |
| Distributions from nonconsolidated investments | | 139 | — |
| Deferred income taxes | | (973) | (967) |
| Payments from (to) restricted cash | | 1,525 | (1,044) |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable and unbilled revenues including derecognitions | | (46,991) | (18,965) |
| Inventory | | (56) | 6 |
| Prepaid expenses and other | | (2,476) | (43) |
| Accounts payable | | 16,282 | 3,355 |
| Other current liabilities | | 1,350 | 4,666 |
| Other – net | | 8,408 | 2,146 |
| Net cash provided by (used in) operating activities | | (4,592) | 197 |
| Cash flows used in investing activities: | | | |
| Capital expenditures | | (812) | (1,344) |
| Proceeds from sale of fixed assets | | 16 | — |
| Net cash used in investing activities | | (796) | (1,344) |
| Cash flows from financing activities: | | | |
| Project financing obligations, net of derecognitions | | 28,990 | 13,219 |
| Repayments of long-term debt | | (6,977) | (1,917) |
| Repayment of revolver | | — | (963) |
| Distributions to minority owners | | (1,200) | (625) |
| Payments from (to) restricted cash | | 665 | (480) |
| Payments from (to) debt service reserve | | 377 | (5) |
| Net cash provided by financing activities | | 21,855 | 9,229 |
| Net change in cash and cash equivalents | | 16,467 | 8,082 |
| Cash and cash equivalents, beginning of period | | 8,635 | 553 |
| Cash and cash equivalents, end of period | $ | 25,102 | 8,635 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during the period for: | | | |
| Interest | $ | 2,946 | 2,480 |
| Income taxes, net of refunds | | 4,268 | 213 |

See accompanying notes to consolidated financial statements.

## (1) Summary of Significant Accounting Policies

### *(a) Business*

NORESCO HOLDINGS, INC. and Subsidiaries (the Company or NORESCO) provides an integrated group of energy-related products and services that are designed to reduce its customers' operating costs and improve their energy efficiency. The Company's activities comprise performance contracting, energy efficiency programs, combined heat and power and central boiler/chiller plant development, design, construction, ownership, and operation. The Company's customers include governmental, military, institutional, commercial, and industrial end-users.

On December 30, 2005, the Company was acquired by a fund managed by GFI Energy Ventures LLC (GFI) from Equitable Resources, Inc. (Equitable). The Company was sold (GFI Transaction) for $82 million before adjustments to reduce the purchase price by $5.8 million. The effect of GFI's acquisition of the Company is recognized in the accompanying consolidated financial statements.

On May 2, 2007, pursuant to the settlement agreement between Equitable and GFI, $0.7 million was paid directly to GFI for indemnifications as defined in the sellers' agreement. This settlement was considered to be a reduction of the purchase price and is reflected as a reduction of $0.7 million in equity and goodwill.

The Company, as general partner, holds a 50% controlling equity interest in the Hunterdon Cogeneration Limited Partnership (Hunterdon). As part of an energy services agreement entered into with the State of New Jersey, on behalf of the New Jersey Department of Corrections and the New Jersey Department of Human Services, the cogeneration facility produces and sells electricity and steam to the Hunterdon Developmental Center and Edna Mahan Correctional Facility for Women. The agreement is set to expire in 2013.

### *(b) Principles of Consolidation*

The consolidated financial statements include the accounts of NORESCO HOLDINGS, INC. and all subsidiaries and a partnership (Hunterdon Cogeneration Limited Partnership) in which a controlling equity interest is held. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company utilizes the equity method of accounting for one partnership (Plymouth Cogeneration Limited Partnership) in which its ownership is less than 50% and significant influence exists.

### *(c) Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

### *(d) Cash and Cash Equivalents*

The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. These investments are accounted for at cost, which



(Continued)

approximates fair value due to the short maturity of the investments. Interest earned on cash equivalents is included as interest income.

***(e) Restricted Cash and Debt Service Reserve***

Restricted cash as of December 31, 2006 consisted of cash held in trust for annual installment principal payments on long-term debt, payments to partners, and certain operating expenses of Hunterdon. Debt service reserve as of December 31, 2006 consisted of cash held in trust to maintain a minimum balance of two quarterly debt payments of Hunterdon's debt. On April 12, 2007, the outstanding Hunterdon debt was paid in full; therefore, any restricted cash and debt service reserves were no longer required.

***(f) Inventory***

Inventory consists of fuel, oil, and other supplies and is valued at the lower of cost or market, with cost being determined using the average cost method.

***(g) Property, Plant, and Equipment***

Property, plant, and equipment is carried at cost and depreciation is calculated using the straight-line method based on estimated service lives. This property consists largely of the Hunterdon Cogeneration Facility as well as improvements to the Facility (3-20 year estimated service life based on asset type), office equipment (3-7 year estimated service life), leasehold improvements (5 year estimated service life), vehicles (5 year estimated service life), and computer and telecommunications equipment and systems (3-7 year estimated service life).

Planned major maintenance projects that do not increase the overall life of the related assets are expensed. When the major maintenance materially increases the life or value of the underlying asset, the cost is capitalized.

***(h) Goodwill***

Goodwill is the excess of the acquisition cost of businesses over the fair value of the identifiable net assets (tangible and intangible) acquired. Goodwill is required to be evaluated for impairment on an annual basis according to Statement of Financial Accounting Standard (SFAS) No. 142 (Statement No. 142), *Goodwill and Other Intangible Assets*. Statement No. 142 requires that a two-step process be performed to analyze whether or not goodwill has been impaired. Step one requires that the fair value be compared with book value. If the fair value is higher than the book value, no impairment is indicated and there is no need to perform the second step of the process. If the fair value is lower than the book value, step two must be evaluated. Step two requires that a hypothetical purchase price allocation analysis be done to determine the implied fair value of goodwill. This implied fair value of goodwill is then compared with its carrying value. If the implied fair value is lower than the carrying value, an impairment must be recorded. There were no impairments identified in 2007 or 2006.

***(i) Impairment of Long-Lived Assets***

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, whenever events or changes in circumstances indicate that the carrying amount of long-lived assets may not be recoverable, the Company reviews its long-lived assets for impairment by first comparing the carrying value of the assets with the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the assets. If the carrying value exceeds the sum of the assets' undiscounted cash flows, the Company determines the impairment loss as the difference between the carrying value and fair value of the assets.

### *(j) Revenue Recognition*

The Company recognizes revenue and profit from long-term contracts using the percentage of completion method of accounting. The percentage of completion method measures the percentage of contract costs incurred to date to the estimated total contract costs for each contract. Contract costs include all direct material, labor, subcontract costs, and those indirect costs related to contract performance. Selling, general, and administrative costs are charged to expense as incurred. Revenue from contract change orders and claims is recognized when settlement is probable and the amount can be reasonably estimated. Costs and estimated profits in excess of billings are classified as unbilled revenues on the consolidated balance sheets. Amounts billed in excess of costs and estimated profits are classified as other current liabilities on the consolidated balance sheets. The Company follows this method since reasonably dependable estimates of the revenue and costs applicable to various stages of a contract can be made. However, due to uncertainties inherent in the estimation process, actual results could differ from those estimates. Since the financial reporting of these contracts depends on estimates, which are assessed continually during the term of the contract, recognized revenues and profit are subject to revisions as the contract progresses to completion. The revenue recognized on contracts is not related to progress billings to customers. Revisions in profit estimates, including revisions relating to events that occurred after the balance sheet date but before issuance of the financial statements, are reflected in the consolidated financial statements. Accordingly, favorable changes in estimates result in additional profit recognition, and unfavorable changes in estimates result in the reduction of previously recognized revenue and profits. The accuracy of the gross margins the Company reports for contracts is dependent upon various judgments it makes with respect to its contract performance, its cost estimates, and its ability to recover additional contract costs through change orders or claims. When estimates indicate a loss under a contract, energy service contract cost is charged with a provision for such loss in the period in which such losses are identified. As work progresses under a loss contract, revenues continue to be recognized, and a portion of the contract costs incurred in each period is charged to the contract loss reserve. The Company has determined that there are no loss contracts as of December 31, 2007 and 2006.

With certain projects, the Company enters into shared energy savings contracts to provide sustained levels of energy savings to its customers. The terms of the project are defined by an energy services agreement between the Company and the customer. Once completed, these projects will earn revenue from the customer based on the measurement formulas established in the energy services agreement. The Company recognizes revenue from shared energy savings contracts as energy savings are measured and verified, in accordance with the established measurement formulas.

Revenue received from customer contract termination payments is recognized when received. Any maintenance revenues are recognized as related services are performed.

***(k) Sales of Receivables***

The Company enters into construction contracts with governmental customers and accrues unbilled revenue on these contracts under percentage of completion accounting for revenue earned but not yet billed. The Company sells the rights to these unbilled revenues, which represent unbilled receivables from governmental customers, to institutional counterparties in an effort to accelerate cash collection. The Company records an increase to project financing obligations and accrues interest expense for the cash received from the institutional counterparty over the construction period. Interest expense represents the difference between the carrying value of the receivable sold (unbilled revenues) and the selling price. The sale of the receivables is accounted for under SFAS No. 140 (Statement No. 140), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Company derecognized unbilled revenues and project financing obligations of $36.9 million and $38.0 million in 2007 and 2006, respectively, and have recorded this in the consolidated statements of cash flows. The receivables that have not yet met the criteria of sales treatment under Statement No. 140 are recorded in unbilled revenues and project financing obligations on the consolidated balance sheets.

***(l) Investments***

Investments in companies in which the Company has the ability to exert significant influence over operating and financial policies are accounted for using the equity method. Under the equity method, investments are initially recorded at cost and adjusted for dividends and undistributed earnings and losses. A loss in the value of an equity method investment is recognized when the loss is determined to be other than temporary in accordance with Accounting Principles Board No. 18 (APB No. 18), *The Equity Method of Accounting for Investments in Common Stock*. The Company has one investment (Plymouth Cogeneration Limited Partnership), which is classified as equity in nonconsolidated investment on the consolidated balance sheets. The Company analyzes its equity method investment based on its share of estimated future cash flows from the investment to determine whether the carrying amount will be recoverable.

***(m) Income Taxes***

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

***(n) Allowance for Doubtful Accounts***

Judgment is required to assess the ultimate realization of the Company's accounts receivable, including assessing the probability of collection and the creditworthiness of certain customers. Reserves for uncollectible accounts are recorded as part of selling, general, and administrative expense on the consolidated statements of income. The reserve is based on historical experience, current and expected economic trends, and specific information about customer accounts.



(Continued)

Accordingly, actual results may differ from these estimates under different assumptions or conditions.

***(o) Stock-Based Compensation***

Effective January 1, 2006, the Company adopted SFAS No. 123(R) (Statement No. 123(R)), *Share-Based Payment*. This statement replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Statement No. 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the prospective method of application, which requires the Company to recognize compensation cost on a prospective basis. For stock-based awards granted after January 1, 2006, the Company recognizes compensation expense based on estimated grant date fair value using the Black-Scholes option-pricing model. During 2006, the Company established the NORESCO Acquisition, Inc. 2006 Stock Incentive Plan (the Plan). The purpose of the Plan is to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to selected key employees, consultants, and directors, and to promote the success of the Company's business. The Plan provides for the issuance of up to 4,055,556 shares. The exercise price of the options may not be less than the fair market value of the common stock at the date of grant. NORESCO Acquisition, Inc. is the parent company of NORESCO Holdings, Inc. There was no compensation expense relating to these options for the years ended December 31, 2007 or 2006.

***(p) Fair Value of Financial Instruments***

The carrying value of all financial instruments approximates fair value.

***(q) Concentrations of Credit Risk***

The Company's operating revenues and related accounts receivable are generated from performance contracts with federal, state, and local governments; institutional customers throughout the United States; and cogeneration and power plant facilities in several U.S. markets.

The Company has one energy savings performance contracting project with the federal government that accounted for 19% of revenue in 2007 and 22% of revenue in 2006, respectively, and represents 45% and 31% of unbilled revenues, respectively, as of December 31, 2007 and 2006.

***(r) Warranty Reserve***

The Company provides a reserve for warranty expenses to account for potential savings shortfalls related to performance contracts sold by the Company. The warranty reserve is calculated based on the total amount of savings warranted to the customers for the remaining contract years of all projects in the service phase period. A factor based on historical savings warranty shortfalls as a percentage of savings is then applied against the total savings warranted for all projects.

The aggregate reductions in the warranty reserve for payments under the warranties was $0.1 million in 2007. There were no payments made in 2006. The aggregate changes in the liability for accruals related to new product warranties issued during 2007 and 2006, and changes in estimates related to existing warranties, were $0.7 million and $0.2 million, respectively.



(Continued)

### *(s) Reclassification*

Certain previously reported amounts have been reclassified to conform to the 2007 presentation. These reclassifications did not affect reported net income.

## (2) Property, Plant, and Equipment

The Company's property, plant, and equipment consists of the following:

| | | 2007 | 2006 |
|---|---|---|---|
| | | (In thousands) | |
| Plant and equipment – Hunterdon, net | $ | 2,394 | 2,759 |
| Office equipment | | 2,854 | 2,058 |
| Leasehold improvements | | 249 | 249 |
| Other equipment | | 110 | 123 |
| Accumulated depreciation | | (1,297) | (603) |
| Property, plant, and equipment, net | $ | 4,310 | 4,586 |

Depreciation expense for property, plant, and equipment totaled $1.1 million and $0.8 million, respectively, for the years ended December 31, 2007 and 2006.

## (3) Goodwill and Other Intangible Assets, Net

The table below reflects changes or activity in the balances related to goodwill for the years ended December 31, 2007 and 2006, respectively, including adjustments to the allocation of the purchase:

| | | Net carrying amount |
|---|---|---|
| | | (In thousands) |
| Goodwill balance as of January 1, 2006 | $ | 49,231 |
| Less: Goodwill adjustments | | 591 |
| Goodwill balance as of December 31, 2006 | | 49,822 |
| Purchase price adjustment | | (667) |
| Increase in purchased deferred taxes | | (994) |
| Goodwill balance as of December 31, 2007 | $ | 48,161 |

The following is a list of other intangible assets and the remaining amortization period as of December 31, 2007 and 2006.

| | | 2007 | 2006 | Total amortization period |
|---|---|---|---|---|
| | | (In thousands) | (In thousands) | |
| Trademark | $ | 382 | 382 | Indefinite |
| Construction customer backlog, net of accumulated amortization of $2,622 and $1,311, respectively | | — | 1,311 | 24 months |
| Operations contract backlog, net of accumulated amortization of $772 and $386, respectively | | 2,319 | 2,705 | 96 months |
| Total | $ | 2,701 | 4,398 | |

Amortization, which is recorded on a straight-line basis, was $1.7 million for the years ended December 31, 2007 and 2006. Amortization expense is expected to be $0.4 million in 2008 through 2012 and $0.3 million in 2013.

**(4) Other Current Assets**

The Company's other current assets consist of the following as of December 31, 2007 and 2006:

| | | 2007 | 2006 |
|---|---|---|---|
| | | (In thousands) | |
| Project development costs | $ | 5,398 | 4,320 |
| Prepaid insurance | | 1,403 | 61 |
| Other | | 668 | 612 |
| Total other current assets | $ | 7,469 | 4,993 |

Project development costs are precontract costs whose recovery is probable. These deferred costs are transferred to contract costs when a contract is awarded or expensed as an energy service contract costs when recovery is no longer probable.

## (5) Other Assets

The Company's other assets consist of the following as of December 31, 2007 and 2006:

| | | 2007 | 2006 |
|---|---|---|---|
| | | (In thousands) | |
| Lease receivable, net of deferred interest | $ | 6,432 | 6,577 |
| Capitalized project costs | | 1,215 | 1,532 |
| Deferred emission reduction credits | | 474 | 949 |
| Deferred financing costs, net of amortization | | 463 | 694 |
| Deferred costs | | 726 | 870 |
| Other | | 750 | 573 |
| Total other assets | $ | 10,060 | 11,195 |

In June 2001, the Company entered into an agreement to construct and lease a chiller water plant for a customer and oversee its operations for the next 20 years. The lease is set up with a fixed capacity payment that covers capital recovery of the chilled water plant equipment plus the operations and maintenance costs. At the end of the term, the ownership of the chilled water plant transfers to the customer. Due to the fact that the assets are transferred at the end of the lease, the collectability of the fixed payments can be reasonably predicted, and that there are no uncertainties regarding unreimbursable costs yet to be incurred by the Company, in accordance with SFAS No. 13, *Accounting for Leases*, the Company is treating this lease as a sales-type lease. The repayment of this lease receivable will be complete in December 2021.

The Company has recorded a lease receivable in the amount of $11.4 million and $12.0 million as of December 31, 2007 and 2006, respectively, that represents the future minimum lease payments to be received through the term of the lease. The current portion of the lease receivable, $0.7 million and $0.6 million as of December 31, 2007 and 2006, respectively, is included in the accounts receivable line on the consolidated balance sheets. The long-term portion of $10.7 million and $11.4 million as of December 31, 2007 and 2006, respectively, is included in the lease receivable line in other assets.

The Company has recorded deferred interest in the amount of $4.8 million and $5.3 million as of December 31, 2007 and 2006, respectively, related to the lease. The current portion of the deferred interest, $0.5 million, is included as a reduction in accounts receivable on the consolidated balance sheet. The long-term portion, $4.3 million and $4.8 million as of December 31, 2007 and 2006, respectively, is included as a reduction in lease receivable in other assets.

Future annual minimum lease payments and earned deferred interest are as follows as of December 31, 2007 and 2006:

| | | Lease payments (In thousands) | Deferred interest earned (In thousands) |
|---|---|---|---|
| 2008 | $ | 666 | 521 |
| 2009 | | 686 | 508 |
| 2010 | | 706 | 493 |
| 2011 | | 728 | 474 |
| 2012 | | 749 | 452 |
| Thereafter | | 7,841 | 2,351 |
| | $ | 11,376 | 4,799 |

In connection with the financing of the GFI transaction, the Company paid $1.2 million of legal and financing costs, which the Company has capitalized. These financing costs are to be amortized using the straight-line method over the life of the debt.

## (6) Other Current Liabilities

The Company's other current liabilities consist of the following as of December 31, 2007 and 2006:

| | | 2007 | 2006 |
|---|---|---|---|
| | | (In thousands) | |
| Accrued payroll and related costs | $ | 4,770 | 3,528 |
| Warranty reserve | | 335 | 86 |
| Funds held for distribution to finance companies | | 1,513 | 2,457 |
| Retainage of completed subcontractor work | | 4,460 | 3,265 |
| Other | | 1,769 | 1,797 |
| Total other current liabilities | $ | 12,847 | 11,133 |

## (7) Other Liabilities

The Company's other liabilities consist of the following as of December 31, 2007:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Deferred revenue | $ 6,299 | 4,044 |
| Deferred termination | 3,983 | 4,876 |
| Retainage of completed subcontractor work | 7,618 | 2,470 |
| Warranty reserve | 1,173 | 844 |
| Other | 101 | 1,190 |
| Total | $ 19,174 | 13,424 |

The Company has recorded a $4.0 million and $4.9 million deferred termination liability, respectively, as of December 31, 2007 and 2006. This liability represents the amount owed to institutional counterparties should the Company's governmental customers decide to prepay their permanent financing, which is with the Company's institutional counterparties. The Company accrues this liability over the construction period as interest expense. If the Company has to pay the institutional counterparty as a result of prepayment by their governmental customers, the liability is relieved. Otherwise this liability is amortized as a reduction to interest expense as the Company's exposure is reduced due to payments made by the Company's governmental customers to their institutional counterparties. The Company's exposure is over their governmental customer's permanent financing period which ranges up to a maximum of 20 years.

## (8) Income Taxes

The components of income tax expense (benefit) for the year ended December 31, 2007 and 2006 are as follows:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Current: | | |
| Federal | $ 3,724 | 2,272 |
| State | 710 | 524 |
| | 4,434 | 2,796 |
| Deferred: | | |
| Federal | (868) | (849) |
| State | (105) | (118) |
| | (973) | (967) |
| Total | $ 3,461 | 1,829 |

Income tax expense was different from the amounts computed by applying the statutory federal income tax rate of 34% to income before income taxes due to the following items as of December 31, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Tax at statutory rate | $ 3,292 | 1,613 |
| State income taxes, net of federal benefit | 366 | 232 |
| Research and development credits | (374) | (50) |
| Nondeductible business expense and other | 177 | 34 |
| Income tax expense | $ 3,461 | 1,829 |
| Effective income tax rate | 35.8% | 38.6% |

The components of the deferred tax assets (liabilities) as of December 31, 2007 and 2006 are as follows:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Deferred tax assets: | | |
| Project development cost reserve | $ 573 | 1,506 |
| Uncollectible accounts | 326 | 278 |
| Deferred revenues | 2,021 | 263 |
| Other | 64 | 116 |
| Total deferred tax assets | 2,984 | 2,163 |
| Deferred tax liabilities: | | |
| Intangible amortization | (888) | (1,554) |
| Prepaid insurance | (536) | (24) |
| Tax depreciation in excess of book depreciation | (52) | (50) |
| Total deferred tax liabilities | (1,476) | (1,628) |
| Net deferred tax asset | $ 1,508 | 535 |

In assessing whether a valuation allowance for the deferred tax assets should be recorded, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.



(Continued)

## (9) Long-Term Debt

| | | 2007 | 2006 |
|---|---|---|---|
| | | (In thousands) | |
| Hunterdon short-term debt | $ | — | 698 |
| Term loans | | 32,441 | 38,720 |
| | | 32,441 | 39,418 |
| Less current portion of long-term debt | | 7,293 | 6,918 |
| Total long-term debt | $ | 25,148 | 32,500 |

Interest expense on outstanding debt amounted to $3.2 million in 2007 and $3.5 million in 2006, respectively. Interest expense also includes net interest expense of $7.3 million and $3.9 million related to project financing obligations and deferred termination liabilities for the years 2007 and 2006, respectively. Aggregate scheduled maturities of outstanding debt are $3.9 million in 2008, $3.9 million in 2009, and $24.6 million in 2010.

To finance the acquisition, the Company obtained financing from General Electric Capital Corporation (GECC) in the form of two term loan notes. The first being a $20 million note with an interest rate based on prime rate plus 175 basis points or LIBOR plus 250 basis points. The rate is selected by the Company and fixed for a specified period of time, and reset at the end of that period. As of December 31, 2007 and 2006, the rate was 7.81% and 7.87%, respectively, based upon LIBOR plus 250 basis points. The Company shall repay the note by making quarterly installments in the amount of $930,000 through September 30, 2010. A final installment in the amount of $4,970,000, or the remaining principal balance, is due on December 31, 2010. The second is a $20 million note with an interest rate based on prime rate plus 325 basis points or LIBOR plus 400 basis points. The rate is selected by the Company and fixed for a specified period of time, and reset at the end of that period. As of December 31, 2007 and 2006, the rate was 9.31% and 9.37%, respectively, based upon LIBOR plus 400 basis points. The Company shall repay the note by making quarterly installments in the amount of $50,000 through September 30, 2010. A final installment in the amount of $19,050,000, or the remaining principal balance, is due on December 31, 2010. Both term loans are due in full on December 31, 2010. In addition to the scheduled installments, within 100 days after the end of each fiscal year, the Company shall prepay the loans in an amount equal to an excess cash flow as defined in the credit agreement with GECC. The amount of prepayment debt due within 100 days was $3.4 million and $2.4 million, respectively, as of December 31, 2007 and 2006. The prepayment amount of $3.4 million plus the normal scheduled payments due in 2008 and $2.4 million plus the normal scheduled payments due in 2007 are recorded as current portion of long-term debt as of December 31, 2007 and 2006. As part of the financing arrangement, the Company has pledged a substantial amount of its assets. The Company was in compliance with all debt covenants pertaining to both term loan notes as of December 31, 2007.

During the year ended December 31, 2005, the Company entered into a secured revolving credit facility agreement with a maximum borrowing capacity of $15.0 million. As of December 31, 2007 and 2006, there was no balance outstanding with the revolver. The interest rate for the revolving credit facility was 9.75% and 10.75% as of December 31, 2007 and 2006, respectively, based upon prime rate plus 250 basis points. Under the revolving credit facility, the Company has issued a $2.0 million letter of credit, which reduced the availability of the facility to $13.0 million. The Company pays a fee at a rate of 3.25% calculated based on the total outstanding letter of credits. The Company was in compliance with all debt covenants pertaining to the revolving credit facility as of December 31, 2007.

### (10) Employee Benefit Plans

Effective January 1, 2006, the NORESCO, LLC 401(k) Plan (the Plan), which is a defined contribution plan, was established. All employees of the Company may become participants of the Plan on the first day of the month coinciding with or immediately following their date of employment. Participants may contribute up to 25% of total compensation. The Company matches contributions based on years of service as follows: 50% in the first year of service, 75% in the second year of service, and 100% after three years of service, all subject to a maximum match of 6% of eligible compensation. Participants are vested immediately in their contributions plus actual earnings. Vesting in the Company's contribution portion is based on years of continuous service. A participant is 100% vested after three years of credited service.

Expense recognized by the Company related to its 401(k) employee savings plans totalled $0.9 million in 2007 and $0.7 million in 2006.

### (11) Commitments and Contingencies

There are various claims and legal proceedings against the Company arising from the normal course of business. Although counsel is unable to predict with certainty the ultimate outcome, management and counsel believe that the Company has significant and meritorious defenses to pending claims and intends to pursue them vigorously.

### (12) Stock-Based Compensation

As discussed in note 1, the Company adopted Statement No. 123(R) on January 1, 2006. Statement SFAS No. 123(R) was adopted prospectively by the Company, which requires the Company to recognize compensation cost on a prospective basis. The following table represents a rollforward of stock options from December 31, 2005 to December 31, 2007:

| | Non Vested Shares | Weighted average exercise price |
|---|---|---|
| | (In thousands) | |
| Outstanding at December 31, 2005 | — | $ — |
| Options granted | 3,359 | 1.00 |
| Options forfeited | (215) | 1.00 |
| Outstanding at December 31, 2006 | 3,144 | 1.00 |
| Options granted | 483 | 1.23 |
| Options forfeited | (85) | 1.00 |
| Outstanding at December 31, 2007 | 3,542 | 1.00 – 1.23 |

The calculated fair value of each option granted is estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants:

| | | 2007 | 2006 |
|---|---|---|---|
| Expected dividend yield | | —% | —% |
| Expected volatility of Company's stock | | 40.10% | 52.68% |
| Risk-free interest rate | | 4.29% | 5.03% |
| Expected life in years | | 3.66 | 4.62 |
| Weighted average calculated fair value of options granted per share | $ | 0.43 | 0.50 |

Because the Company is a privately owned, closely held corporation, there is not sufficient empirical data associated with prior transactions involving the Company's common stock to determine the volatility of the common stock. In accordance with Statement No. 123(R), expected volatility was based upon comparable guideline companies whose historical volatilities provided a better indication of the future volatility of NORESCO's stock. The risk-free interest rate is based upon a zero coupon treasury rate. The term of each option shall commence on the date of the Grant Notice and expire on the tenth anniversary of the grant date. However, while the options may be exercised from the time that the vesting requirements have been met until the expiration of the Options on the tenth anniversary of being granted, the restrictions on the transferability of the options and the Option shares effectively prevent the Option Shares from being convertible into value until a merger, sale, or change of control of the Company occurs. Most of the options vest over four years with 25% vesting on each 1 year anniversary of the grant date. The remainder of the options vest monthly over the four years.

The following table provides information about unvested options for the years ended December 31, 2007 and 2006:

| | Shares (Thousands) | | Weighted average grant date fair value per share |
|---|---|---|---|
| Unvested options at December 31, 2005 | — | $ | — |
| Granted | 3,359 | | 0.50 |
| Vested | — | | — |
| Forfeited | (215) | | 0.50 |
| Unvested options at December 31, 2006 | 3,144 | | 0.50 |
| Granted | 483 | | 0.43 |
| Vested | (1,011) | | 0.49 |
| Forfeited | (85) | | 0.50 |
| Unvested options at December 31, 2007 | 2,531 | | 0.49 |

The total compensation cost related to unvested and vested awards not yet recognized was $1.8 million as of December 31, 2007 and $1.6 million as of December 31, 2006. There is a performance condition in the awards that precludes the options from being exercised until a merger, sale, or change of control of the Company occurs. As the Company does not know when the condition will be met, it cannot determine when the unvested stock compensation expense will be recorded.

As of December 31, 2007 and December 31, 2006, there were no options outstanding that were exercisable due to the performance condition in the award.

## (13) Operating Leases

The Company leases substantially all of its office facilities under noncancelable operating leases that expire at various dates through 2012. Certain agreements contain renewal options for additional periods and contain certain rent escalation clauses. The lease agreements provide primarily for payment of minimum annual rentals, costs of utilities, and maintenance. Rent expense under these operating leases was approximately $1.5 million for 2007 and $1.6 million for 2006.

Future annual minimum lease payments under noncancelable operating leases are as follows (in thousands) as of December 31, 2007:

| | | |
|---|---|---|
| 2008 | $ | 1,011 |
| 2009 | | 853 |
| 2010 | | 695 |
| 2011 | | 543 |
| 2012 | | 437 |
| | $ | 3,539 |

**(14) Noncash Activities**

As discussed in note 3, purchase accounting adjustments were made in 2007 and 2006 that had a noncash impact on goodwill as well as various other balance sheet captions. For 2007, the only noncash items were the indemnification payment made directly to GFI of \$0.7 million and an increase in deferred taxes of \$1.0 million. The indemnification payment is reflected as a reduction in equity and goodwill, and the increase in deferred taxes is reflected as a reduction in goodwill and accrued income taxes. The noncash impact to goodwill and other balance sheet captions for 2006 are as follows (in thousands):

| | | 2006 |
|---|---|---|
| Increase in accounts receivable | $ | (145) |
| Increase in unbilled revenues | | (766) |
| Decrease in deferred income tax | | 1,456 |
| Increase in property, plant and equipment | | (10) |
| Decrease in other assets | | 310 |
| Decrease in accounts payable | | (53) |
| Decrease in accrued income taxes | | (486) |
| Decrease in project financing obligations | | (803) |
| Increase in other current liabilities | | 765 |
| Increase in other liabilities | | 323 |
| | $ | 591 |

The impact of these adjustments on the consolidated balance sheets as of December 31, 2007 and 2006 has been properly excluded from the consolidated statements of cash flows.

**(15) Asset Retirement Obligation**

The Company determined that the Hunterdon Partnership has an asset retirement obligation (ARO) in accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations*, and Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which require that the estimated fair value of the ARO be capitalized as part of the cost of the related long-lived asset and subsequently allocated to deprecation expense using a systematic and rational method. In addition, the fair value of the retirement obligation is accreted over time.

The Company has an ARO arising from a contractual requirement to remove the Facility from the current site within 120 days of the Energy Services Agreement (ESA) termination date and return the site to its original condition. The liability was initially measured at fair value and subsequently is adjusted for accretion expense and changes in the amount or timing of the estimated cash flows. The corresponding ARO costs are capitalized as part of the carrying amount of the related long-lived asset and depreciated over the asset's useful life. The following table presents the activity for the ARO for the years ended December 31, 2007 and 2006:

| | | |
|---|---|---|
| Balance at December 31, 2005 | $ | 105 |
| Accretion expense | | 9 |
| Balance at December 31, 2006 | | 114 |
| Accretion expense | | 10 |
| Balance at December 31, 2007 | $ | 124 |