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**U.S. Securities and Exchange Commission**

**Washington, D. C. 20549**

**Form 10-Q**

(Mark One)

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

**For the quarterly period ended October 2, 2010**

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: 000-26226**

**ENERGYCONNECT GROUP, INC.**

(Exact Name of Registrant as Specified in its Charter)

**Oregon**

(State or Other Jurisdiction of Incorporation or Organization)

**93-0935149**

(I.R.S. Employer Identification No.)

**901 Campisi Way, Suite 260, Campbell, CA**

(Address of Principal Executive Offices)

**95008**

(Zip Code)

**(408) 370-3311**

(Registrant's Telephone Number, Including Area Code)

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the registrant's common stock as of November 5, 2010 was 133,102,130 shares.

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**ENERGYCONNECT GROUP, INC.**

**FORM 10-Q**

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**Item 1. Financial Statements****ENERGYCONNECT GROUP, INC. AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**AS OF OCTOBER 2, 2010 AND JANUARY 2, 2010**

	<u>October 2, 2010</u>	<u>January 2, 2010</u>
	(Unaudited)	
Current assets:		
Cash and cash equivalents	\$ 3,513,167	\$ 1,062,306
Accounts receivable, net of zero allowance	20,329,008	6,811,495
Other current assets	374,707	237,242
Total current assets	<u>24,216,882</u>	<u>8,111,043</u>
Property and equipment, net	190,353	187,085
Intangible assets, net (Note 5)	1,219,462	1,398,761
Other assets	236,282	78,035
	<u>\$ 25,862,979</u>	<u>\$ 9,774,924</u>
Current liabilities:		
Accounts payable and accrued expenses	\$ 18,534,355	\$ 7,508,561
Other current liabilities	483,134	324,886
Total current liabilities	<u>19,017,489</u>	<u>7,833,447</u>
Long-term liabilities:		
Note payable, net of debt discount (Note 4)	<u>—</u>	<u>1,912,937</u>
Commitments and contingencies	—	—
Shareholders' equity :		
Common stock, no par value, 225,000,000 shares authorized, 133,102,130 and 95,629,961 shares issued and outstanding at October 2 and January 2, 2010, respectively (Note 2)	126,299,215	121,926,000
Common stock warrants (Note 3)	36,098,289	36,098,289
Accumulated deficit	<u>(155,552,014)</u>	<u>(157,995,749)</u>
Total shareholders' equity	<u>6,845,490</u>	<u>28,540</u>
	<u>\$ 25,862,979</u>	<u>\$ 9,774,924</u>

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**ENERGYCONNECT GROUP, INC. AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<u>October 2, 2010</u>	<u>October 3, 2009</u>	<u>October 2, 2010</u>	<u>October 3, 2009</u>
Revenue	\$ 17,408,942	\$ 10,337,922	\$ 30,874,874	\$ 19,069,889
Cost of revenue	<u>12,100,781</u>	<u>7,221,172</u>	<u>19,253,222</u>	<u>12,160,944</u>
Gross profit	5,308,161	3,116,750	11,621,652	6,908,945
Operating expenses:				
Sales, general and administrative	<u>2,831,997</u>	<u>2,245,933</u>	<u>7,620,803</u>	<u>7,125,821</u>
Income (loss) from operations	2,476,164	870,817	4,000,849	(216,876)
Other income (expense):				
Interest expense, net and other	<u>(1,024,659)</u>	<u>(342,406)</u>	<u>(1,557,114)</u>	<u>(735,237)</u>
Net income (loss) before provision for income taxes	1,451,505	528,411	2,443,735	(952,113)
Provision for income taxes	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net income (loss)	<u>\$ 1,451,505</u>	<u>\$ 528,411</u>	<u>\$ 2,443,735</u>	<u>\$ (952,113)</u>
Net income (loss) per share:				
Basic	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.02</u>	<u>\$ (0.01)</u>
Diluted	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.02</u>	<u>\$ (0.01)</u>
Shares used in per share calculations:				
Basic	<u>106,172,524</u>	<u>95,629,961</u>	<u>99,387,495</u>	<u>95,433,808</u>
Diluted	<u>110,827,379</u>	<u>96,839,705</u>	<u>103,189,930</u>	<u>95,433,808</u>

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**ENERGYCONNECT GROUP, INC. AND SUBSIDIARY**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

	<u>Nine Months Ended</u>	
	<u>October 2, 2010</u>	<u>October 3, 2009</u>
Cash flows from operating activities:		
Net income (loss)	\$ 2,443,735	\$ (952,113)
Reconciling adjustments:		
Depreciation of equipment	105,928	107,709
Amortization of intangible assets	179,299	179,300
Stock-based compensation related to options	345,467	547,225
Stock-based compensation related to restricted stock	97,000	54,000
Amortization and write-off of debt discount	722,821	281,052
Changes in current assets and liabilities:		
Accounts receivable	(13,517,513)	(6,337,981)
Other current assets	(150,965)	144,859
Other assets	(158,247)	27,298
Accounts payable and accrued expenses	11,025,794	5,125,437
Other current liabilities	158,248	232,410
Net cash provided by (used in) operating activities	<u>1,251,567</u>	<u>(590,804)</u>
Cash flows from investing activities:		
Purchases of fixed assets	(109,196)	(94,478)
Capitalized patent costs	—	(38,287)
Net cash used in investing activities	<u>(109,196)</u>	<u>(132,765)</u>
Cash flows from financing activities:		
Repayments on line of credit	—	(117,257)
Proceeds from debt financing, net of repayments	1,257,279	2,050,000
Collection of notes receivable for exercise of stock options	13,786	5,700
Proceeds from exercise of options	37,425	—
Net cash provided by financing activities	<u>1,308,490</u>	<u>1,938,443</u>
Net increase in cash and cash equivalents	2,450,861	1,214,874
Cash and cash equivalents, beginning of the period	<u>1,062,306</u>	<u>410,101</u>
Cash and cash equivalents, end of the period	<u>\$ 3,513,167</u>	<u>\$ 1,624,975</u>
Supplemental disclosures for cash flow information:		
Cash paid during the period for interest (includes \$257,280 paid in conversion shares in the nine months ended October 2, 2010)	\$ 941,925	\$ 300,796
Supplemental schedule of non-cash financing and investing activities:		
Debt discount	\$ 585,758	\$ 452,381
Common stock issued on conversion of debt	\$ 3,307,279	\$ —
Repayment of note receivable via surrender of stock	\$ 13,500	\$ —

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

## ENERGYCONNECT GROUP, INC. AND SUBSIDIARY

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

October 2, 2010

#### 1. Description of the Business

##### General

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all entries considered necessary for a fair presentation have been included. The results from operations for the three and nine month periods ended October 2, 2010 are not necessarily indicative of the results that may be expected for the year ending January 1, 2011. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated January 2, 2010 financial statements and footnotes thereto included in the Company's Form 10-K.

##### Business and Basis of Presentation

EnergyConnect Group, Inc. is a leading provider of demand response services to the electricity grid. Demand response programs provide grid operators with additional electricity generation capacity by encouraging consumers to curtail their electricity usage. Historically, to provide a reliable supply of electricity and to avoid service disruption, grid operators have increased power generation by building additional power plants and transmission infrastructure. However, an alternative approach to increasing the supply side of electricity is to use demand response programs to reduce overall peak demand or shift load from peak to off-peak times, thereby optimizing the balance of demand and supply and reducing the need for additional power generation capacity. Demand response programs fall into two main groups, programs made for participants to stand by and respond to a grid event initiated by the grid operator and programs that rely on participants curtailing their use of electricity based upon price signals.

Through our proprietary software as a service (SaaS) platform, we allow commercial and industrial consumers of electricity to access demand response programs that are offered by the grid and get paid by agreeing to stand by and curtail based upon a grid event or responding to a price signal. Our participants are commercial and industrial consumers of electricity with whom we contract to identify, develop and if necessary implement curtailment strategies. We enroll our participants in demand response programs operated by grid operators, who pay us for standing by or for reducing load by responding to a price signal. We in turn pass on a portion of these payments to our participants in accordance with their contract with us.

The Company was incorporated in August 1986 as an Oregon Corporation, succeeding operations that began in October 1984. In 2009 we moved our corporate headquarters from Lake Oswego, Oregon, to Campbell, California.

##### Going Concern

The accompanying unaudited condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the consolidated financial statements for the year ended January 2, 2010, the Company incurred net losses of \$3,222,021 and generated negative cash flow from operations in the amount of \$1,253,762. In the nine months ended October 2, 2010, the Company had net income of \$2,443,735 and generated positive cash flow from operations in the amount of \$1,251,567, but expects to report a net loss in the three months ending January 1, 2011. These factors among others indicate that the Company may need additional funds to continue as a going concern for a reasonable period of time.

The Company's existence is dependent upon management's ability to develop profitable operations and resolve its liquidity problems. Management anticipates the Company will attain profitable status and improve its liquidity through continued growth, distribution and additional equity investment in the Company. The accompanying condensed consolidated financial statements do not include any adjustments that might result should the Company be unable to continue as a going concern.

In February 2009, and as amended in December 2009, the Company entered into a secured convertible debt facility to supplement the Company's cash needs for 2010 and beyond. The net balance outstanding on the facility on September 8, 2010 of \$3,307,279 was converted into common stock, which eliminated all of our long term debt. The Company has arranged a new facility which allows for borrowing of up to \$4 million, which is presently unused. While we believe our cash availability under this debt facility, along with cash generated by operations, will be adequate for the next twelve months, we may need to obtain additional capital in order to sustain and expand operations and become profitable. In order to obtain capital, we may need to sell additional shares of our common stock or borrow funds from private lenders while remaining in compliance with the terms of our debt facility. There can be no assurance that we will be successful in obtaining additional funding.

We may still need additional investments in order to continue operations to cash flow break even. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock, the downturn in the U.S. stock and debt markets and the first priority lien on all of our assets granted to our secured lender could make it more difficult to obtain financing through the issuance of equity or debt securities. Even if we are able to raise the funds required, it is possible that we could incur unexpected costs and expenses, fail to collect significant amounts owed to us, or experience unexpected cash requirements that would force us to seek alternative financing. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, we may have to curtail our operations.

By adjusting the Company's operations and development to the level of capitalization, management believes it has sufficient capital resources to meet projected cash flow deficits. However, if the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on acceptable terms, or is no longer in compliance with the terms of its debt facility, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition. If operations and cash flows continue to improve through these efforts, management believes that the Company can continue to operate. However, no assurance can be given that management's actions will result in profitable operations or the resolution of its liquidity problems.

#### Fiscal Year

The Company's fiscal year is the 52- or 53-week period ending on the Saturday closest to the last day of December. The Company's current fiscal year is the 52-week period ending January 1, 2011. The Company's last fiscal year was the 52-week period ended January 2, 2010. The Company's third fiscal quarters in fiscal 2010 and 2009 were the 13-week periods ended October 2, 2010 and October 3, 2009, respectively.

#### Revenue Recognition

We provide grid operators with products similar to those the grid operator purchases from electric power generators. Our products can be grouped into two main categories: "Capacity" and "Economic".

The Capacity programs are designed to curtail usage during times when an electrical grid approaches its capacity limits of electrical generation just before a blackout or brownout. Participants in the capacity program are generally paid a fee to be on standby to respond on several hours' notice to a request from the grid to reduce electrical usage for a specified period.

The Economic programs differ from the capacity programs as they allow commercial and industrial consumers of electricity to curtail usage at their discretion based on price signals from the grid. Participants in such programs are paid for their discretionary performance rather than being paid to standby and curtail based on a request from the grid.

Under the Capacity programs grid operators pay us an annual fee in weekly installments to stand by and provide demand response resources to the grid when the grid calls an event. We record these payments as revenue over the time when we are required to perform under these capacity programs. For some programs our obligation to perform does not match the period over which we are paid by the grid in which case we recognize revenues over the mandatory performance period.

Under the Economic programs we are paid by the grid for our commercial and industrial participants' ability to reduce electricity usage in response to a price signal from the grid. Through our software we summarize price responsive activity and submit to the grid for payment. At the end of each monthly period the power grid approves the payments, and we in turn recognize revenue based upon the grid approval.

An additional source of our revenue is derived from agreements with the power grid operators whereby a monthly reserve fee is paid for our agreement to be available to provide relief in the form of curtailment of energy usage in times of high energy demand. We record these payments as revenue over the period during which we are required to perform under these programs. Under certain programs, our obligation to perform may not coincide with the period over which we receive payments under that program. In these cases we record revenue over the mandatory performance obligation period and record a receivable for the amount of payments that will be received after that period has been completed.

The vast majority of our revenue in 2009, and in the first nine months of 2010, was processed through the Pennsylvania, New Jersey, Maryland Interconnection, LLC ("PJM"). PJM serves as the market for electrical transactions in a specific region in the United States. Our agreement with PJM is an ongoing one as we are members of PJM. These transactions are initiated by building owners, who are our participants. The transactions form the basis for our revenue.

### New Accounting Pronouncements

In April 2010, the FASB issued ASC Update No. 2010-17, *Milestone Method of Revenue Recognition* (ASU 2010-17). ASU 2010-17 provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. ASU 2010-17 is effective for interim and annual reporting periods beginning after June 15, 2010, with early adoption permitted. We adopted this standard effective July 4, 2010, and its adoption did not have a material impact on our consolidated financial position or results of operations.

In January 2010, the FASB issued ASC Update No. 2010-06, *Improving Disclosure about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 requires additional disclosures regarding fair value measurements, amends disclosures about post-retirement benefit plan assets and provides clarification regarding the level of disaggregation of fair value disclosures by investment class. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for certain Level 3 activity disclosure requirements that will be effective for reporting periods beginning after December 15, 2010. The adoption of this standard did not and will not have a material impact on our consolidated financial position or results of operations.

In September 2009, the FASB ratified ASC Update No. 2009-13, *Multiple-Deliverable Revenue Arrangements* (ASU 2009-13). ASU 2009-13 amends existing revenue recognition accounting pronouncements that are currently within the scope of FASB ASC Subtopic 605-25. This consensus provides for two significant changes to the existing multiple element revenue recognition guidance. First, this guidance deletes the requirement to have objective and reliable evidence of fair value for undelivered elements in an arrangement and will result in more deliverables being treated as separate units of accounting. The second change modifies the manner in which the transaction consideration is allocated across the separately identified deliverables. These changes may result in entities recognizing more revenue up-front, and entities will no longer be able to apply the residual method and defer the fair value of undelivered elements. Upon adoption of these new rules, each separate unit of accounting must have a selling price, which can be based on management's estimate when there is no other means to determine the fair value of that undelivered item, and the arrangement consideration is allocated based on the relative selling price. This accounting guidance is effective no later than fiscal years beginning on or after June 15, 2010 but may be adopted early as of the first quarter of an entity's fiscal year. Entities may elect to adopt this accounting guidance either through prospective application to all revenue arrangements entered into or materially modified after the date of adoption or through a retrospective application to all revenue arrangements for all periods presented in the financial statements. We adopted this standard effective April 4, 2010, and its adoption did not have a material impact on our consolidated financial position or results of operations.

## **2. Capital Stock**

The Company has authorized 10,000,000 shares of Preferred Stock, no par value. As of October 2, 2010 and January 2, 2010, there were no preferred shares outstanding. The Company has authorized 225,000,000 shares of Common Stock, no par value. The Company had 133,102,130 and 95,629,961 shares of common stock issued and outstanding as of October 2, 2010 and January 2, 2010, respectively. During the nine months ended October 2, 2010, the Company issued 36,504,180 shares due to the conversion of debt of \$3,307,279 at \$0.0906 per share (see Note 4). The Company also issued 517,989 shares of common stock due to the exercise of options, and retired 100,000 shares as partial repayment of a note receivable from an employee. No options were exercised or shares retired in the nine months ended October 3, 2009. In addition, the Company issued an aggregate of 550,000 and 450,000 shares of common stock during the nine month periods ended October 2, 2010, and October 3, 2009, respectively, all of which were issued to directors for their services on the Company's board (see Note 3).

### 3. Stock Options and Warrants

#### Stock Incentive Plan

The Company presently grants awards under the 2004 Stock Incentive Plan, as amended (the “Plan”). The purpose of the Plan is to enable the Company to attract and retain the services of (1) selected employees, officers and directors of the Company or of any subsidiary of the Company and (2) selected nonemployee agents, consultants, advisors, persons involved in the sale or distribution of the Company’s products and independent contractors of the Company or any subsidiary. The Plan is administered by the Compensation Committee of the Board of Directors, who may grant various awards, including Incentive Stock Options (“ISOs”), Non-Statutory Stock Options (“NSOs”), Stock Appreciation Rights and Restricted Shares.

The Company has issued both options and restricted stock under the Plan. Restricted stock grants afford the recipient the opportunity to receive shares of common stock, subject to certain terms, whereas options give them the right to purchase common stock at a set price. The Company’s options generally have vesting restrictions that are eliminated over a four-year period, although vesting may be over a shorter period, or may occur on the grant date, depending on the terms of each individual award.

A summary of stock option and restricted stock transactions in the nine months ended October 2, 2010 is as follows:

	Shares Available for Grant	Stock Options		Restricted Stock	
		Number of Options Outstanding	Weighted Average Exercise Price	Number of Shares Outstanding	Weighted Average Grant-Date Fair Value
Balance at January 3, 2010	1,626,444	14,509,530	\$ 0.29	—	\$ —
Granted	(1,385,000)	1,385,000	\$ 0.15	—	\$ —
Granted – restricted stock	(550,000)	—	\$ —	550,000	\$ 0.18
Exercised	—	(517,989)	\$ 0.07	—	\$ —
Vested – restricted stock	—	—	\$ —	(550,000)	\$ 0.18
Cancelled or expired	2,958,534	(2,958,534)	\$ 0.60	—	\$ —
Balance at October 2, 2010	2,649,978	12,418,007	\$ 0.21	—	\$ —

The Company received \$37,425 for the 517,989 options exercised during the nine months ended October 2, 2010, which had an intrinsic value of \$33,699. There were no options exercised during the nine months ended October 3, 2009.

The following table summarizes information concerning options outstanding and exercisable as of October 2, 2010, with the first line showing options that were in-the-money:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding as of October 2, 2010	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable as of October 2, 2010	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price
\$0.050 - \$0.159	9,876,396	6.47	\$0.09	3,982,893	6.31	\$0.08
\$0.160 - \$2.702	2,541,611	3.40	\$0.70	1,668,416	1.48	\$0.84
	12,418,007	5.84	\$0.21	5,651,309	4.88	\$0.31

The aggregate intrinsic value of options outstanding and exercisable at October 2, 2010 was \$693,834 and \$300,667, respectively. Aggregate intrinsic value is the total pretax amount (i.e., the difference between the Company’s stock price and the exercise price) that would have been received by the option holders had all their in-the-money options been exercised.

The fair value of stock options vested in the nine months ended October 2, 2010 and October 3, 2009 was \$483,520 and \$421,066, respectively. The weighted average grant date fair value of all options granted in the nine months ended October 2, 2010 and October 3, 2009 was \$0.10 and \$0.08, respectively, computed using the Black-Scholes pricing model and the following assumptions:

	<u>2010</u>	<u>2009</u>
Risk-free interest rate	1.64 – 2.60%	1.80 – 2.75%
Expected dividend yield	0%	0%
Expected term	5 years	5 years
Expected volatility	83%	118%

The amounts expensed for stock-based compensation related to options totaled \$111,687 and \$186,787 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$345,467 and \$547,225 for the nine months ended October 2, 2010 and October 3, 2009, respectively. Amounts expensed for stock-based compensation related to restricted stock awards totaled \$16,000 for the three months ended October 2, 2010. No restricted stock was awarded in the three months ended October 3, 2009. The amounts expensed for stock-based compensation related to restricted stock awards totaled \$97,000 and \$54,000 for the nine months ended October 2, 2010 and October 3, 2009, respectively. All of these expenses relate to awards to five independent directors of the Company (including one who was elected in the three months ended October 2, 2010) in connection with their services as directors. These awards granted the directors a total of 550,000 and 450,000 shares of the Company’s common stock in 2010 and 2009, respectively (Note 2). These shares are fully vested on the award date, but are restricted from transfer, except as permitted for estate planning purposes, until January 15 of the year following the award.

At October 2, 2010, the total stock-based compensation cost not yet recognized was \$739,344. This cost is expected to be recognized over an estimated weighted average amortization period of 2.21 years. No amounts related to stock-based compensation costs have been capitalized. The tax benefit and the resulting effect on cash flows from operating and financing activities related to stock-based compensation costs were not recognized as the Company currently provides a full valuation allowance for all of its deferred taxes.

#### *Common Stock Warrants*

The Company has various warrants to purchase shares of its common stock outstanding, which were issued in conjunction with private placements, acquisitions and debt issuance, or in exchange for services received. All warrants contain standard anti-dilution clauses in the event of recapitalization, stock splits or combinations, merger or reorganization, dividends or distributions and similar equity adjustments, but none of the warrants presently outstanding contain anti-dilution provisions that would prevent them from being considered indexed to the Company’s own stock, so they are all accounted for within Stockholders’ Equity.

A summary of changes in the number of outstanding common stock warrants in the nine months ended October 2, 2010 is as follows:

<u>Balance on January 3, 2010</u>	<u>During the Nine Months Ended October 2, 2010</u>			<u>Balance on October 2, 2010</u>	<u>Exercise Price</u>	<u>Expiration Date</u>
	<u>Granted</u>	<u>Exercised</u>	<u>Forfeited</u>			
316,425	—	—	(316,425)	—	\$0.38	March to July 2010
100,000	—	—	—	100,000	\$0.40	May 2013
4,565,874	—	—	—	4,565,874	\$0.60	May 2013
2,752,323	—	—	(2,395,180)	357,143	\$0.90	September to October 2010
19,695,433	—	—	—	19,695,433	\$2.58	October 2010
5,625,000	—	—	—	5,625,000	\$3.00	June 2011
<u>33,055,055</u>	<u>—</u>	<u>—</u>	<u>(2,711,605)</u>	<u>30,343,450</u>		

#### **4. Debt**

On February 26, 2009, the Company entered into a \$5 million loan agreement with Aequitas Commercial Finance, LLC (“Aequitas”, see also Note 9). On December 23, 2009, the Company entered into an amendment of the convertible debt agreement. This loan agreement, as amended, provided us with a debt facility that enabled us to borrow money in a maximum principal amount

not to exceed \$5 million. The interest rate for funds borrowed by us in the first 12 month term was 23% payable monthly in arrears, with an additional 7% deferred interest per annum. For the balance of the term, and for all amounts borrowed under the amendment, the interest rate was 22% payable monthly in arrears, with an additional 3% deferred interest per annum. The accrued deferred interest at 7% was added to the current principal balance of the loan at the end of the first twelve-month term. The accrued deferred interest at 3% was added to the current principal balance of the loan prior to conversion. The lender was granted a first priority security interest in all of our assets, and had the right to convert up to 100% of unpaid principal and interest into shares of our common stock at an exercise price of \$0.0906 per share, either on the planned maturity date of February 24, 2012, or to the extent the Company gave notice of its intent to pay down the principal balance outstanding.

On September 8, 2010, following notice that the Company intended to repay the balance of the facility, the lender opted to convert all but \$1 of the remaining principal plus accrued interest, totaling \$3,307,280, into 36,504,180 shares of common stock. The Company repaid the remaining \$1 on September 24, 2010.

The balance of this debt facility comprises the following at October 2, 2010 and January 2, 2010:

	<u>October 2, 2010</u>	<u>January 2, 2010</u>
Convertible note payable:		
Draw-down of principal, net	\$ 3,049,999	\$ 2,050,000
Deferred interest added to principal	257,280	—
Conversion to common stock	<u>(3,307,279)</u>	<u>—</u>
Net principal balance	—	2,050,000
Debt discount – beneficial conversion feature, net of accumulated amortization of \$1,038,139 and \$315,318 at October 2, 2010, and January 2, 2010, respectively.	—	(137,063)
Note payable, net of debt discount	<u>\$ —</u>	<u>\$ 1,912,937</u>

In 2009, the Company recognized an imbedded conversion feature present in the convertible note (which equaled the intrinsic value of the conversion option on each date funds were drawn down from the facility) as additional paid-in capital and as a discount against the convertible note. The intrinsic value recognized was \$452,381 in the year ended January 2, 2010, which was recorded as both additional paid-in capital and as a discount against the convertible note. In the three months ended April 3, 2010, the Company's share price was below the conversion price on each date that the principal balance outstanding on the facility increased, and thus no beneficial conversion option was recognized. In the six months ended October 2, 2010, the Company recognized a further \$585,758 as additional paid-in capital and as a discount against the convertible note, which arose both when funds were drawn down, and when deferred and accrued interest was added to principal prior to conversion.

This debt discount attributed to the beneficial conversion feature was amortized over the convertible note's maturity period as interest expense. In addition, an accelerated charge of the unamortized expense, based on the proportion of debt repaid to debt outstanding prior to repayment, was recorded whenever principal was either paid down or converted to common stock. We amortized the convertible note debt discount attributed to the beneficial conversion feature and recorded non-cash interest expense in the amount of \$655,529 and \$159,540 for the three month periods ended October 2, 2010 and October 3, 2009, respectively, and \$722,821 and \$281,052 for the nine month periods ended October 2, 2010 and October 3, 2009, respectively. The balance of unamortized debt discount that was expensed on conversion to common stock on September 8, 2010, including the debt discount that arose when accrued interest was transferred to principal immediately prior to conversion, amounted to \$516,845.

Interest paid to Aequitas totaled \$562,394 and \$146,066 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$941,840 and \$340,841 for the nine months ended October 2, 2010 and October 3, 2009, respectively. Interest payments in the three and nine months ended October 2, 2010, include \$150,000 in minimum interest charges of \$50,000 per month for the remaining contract term of ninety days after the balance of principal was repaid, and \$257,280 in deferred and accrued interest charges paid in common stock, following conversion on September 8, 2010. In addition, the Company paid Aequitas fees of \$3,000 per month from March 2009 until August 2010. Aequitas agreed to release its liens on the Company's assets and waive all covenants and loan fees during the termination period following receipt of the \$150,000 minimum interest charges, which the Company paid on October 1, 2010.

The balance owed on the debt facility (including deferred interest) was recorded as long-term debt. We remained current with our obligations under this agreement, and were in compliance with all covenants, up to the date of conversion. There were no interest-bearing debts due by us at October 2, 2010.

## 5. Intangible Assets

Intangible assets currently consist of the following:

	<u>October 2, 2010</u>	<u>January 2, 2010</u>
Developed technology	\$ 2,394,873	\$ 2,394,873
Less: accumulated amortization	<u>(1,175,411)</u>	<u>(996,112)</u>
Net Intangible Assets	<u>\$ 1,219,462</u>	<u>\$ 1,398,761</u>

Amortization of intangible assets included as a charge to income was \$179,299 and \$179,300 for the nine month periods ended October 2, 2010 and October 3, 2009 respectively.

Based on the Company's current intangible assets, amortization expense for the next five years will be as follows:

<u>Year</u>	<u>Amortization Expense</u>
Twelve months ended September 2011	\$ 239,067
Twelve months ended September 2012	239,067
Twelve months ended September 2013	239,067
Twelve months ended September 2014	239,067
Twelve months ended September 2015 and beyond	263,194
Total	<u>\$ 1,219,462</u>

## 6. Business Concentrations

We record revenue and therefore accounts receivable through agreements with both building owners and the power grid operators. Under our agreements with facilities owners, we use electrical and energy related products that help energy consumers control energy use in their buildings. In conjunction with this agreement we are members of the power grid operators and have agreed to provide the grids with energy, capacity, and related ancillary services during specified times and under specified conditions. These transactions are summarized at the end of each monthly period and submitted to the power grids for settlement and approval. While the power grids are our customers, they are primarily a conduit through which these electrical curtailment transactions are processed. The vast majority of our revenues each year are processed through PJM, which serves as the market for electrical transactions in a specific region in the United States. Our agreement with PJM is an ongoing one as we are members of PJM. Transactions are initiated by building owners, who are our participants. These transactions form the basis for our revenue.

Financial transactions and instruments that potentially subject us to concentrations of credit risk consist primarily of revenue generating transactions and the resultant accounts receivable.

During the three months ended October 2, 2010, and October 3, 2009, sales to one customer, PJM, accounted for \$16,558,000, or 95% of revenue, and \$9,479,000, or 92% of revenue, respectively. Our sales to PJM are made up of a number of transactions with participants. No single participant accounted for 10% or more of our revenue in either period.

During the nine months ended October 2, 2010, and October 3, 2009, sales to PJM accounted for \$28,811,000, or 93% of revenue, and \$17,342,000, or 91% of revenue, respectively, with no single participant accounting for 10% or more of our revenue in either period.

We do have a concentration of revenue with PJM, however, we do not believe there is a significant risk arising from this concentration.

## 7. Net Income (loss) per Share

The following table presents the calculation of basic and diluted net income (loss) per share:

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Net income (loss)	\$ 1,451,505	\$ 528,411	\$ 2,443,735	\$ (952,113)
Interest charges applicable to convertible debt	—	—	—	—
Net income (loss) used for net income per share—diluted calculation	<u>\$ 1,451,505</u>	<u>\$ 528,411</u>	<u>2,443,735</u>	<u>\$ (952,113)</u>
Weighted-average shares—basic	106,172,524	95,629,961	99,387,495	95,433,808
Common share equivalents from exercise of stock options	<u>4,654,855</u>	<u>1,209,744</u>	<u>3,802,435</u>	<u>—</u>
Weighted-average shares—diluted	<u>110,827,379</u>	<u>96,839,705</u>	<u>103,189,930</u>	<u>95,433,808</u>
Net income per share—basic	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.02</u>	<u>\$ (0.01)</u>
Net income per share—diluted	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.02</u>	<u>\$ (0.01)</u>

Interest charges applicable to convertible debt and the shares that were issuable prior to conversion were not reflected the calculation of diluted EPS in the three or nine months ended October 2, 2010, or in the three months ended October 3, 2009, as the effect would be anti-dilutive. The following potential common shares arising from stock options, warrants, and convertible debt were excluded from the computation of diluted net loss per share attributable to holders of common stock as they had antidilutive effects for the periods indicated:

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Shares issuable upon exercise of outstanding options	2,894,138	11,172,370	3,207,816	14,323,440
Shares issuable upon exercise of outstanding warrants	32,337,328	33,055,055	32,793,662	33,055,055
Shares issuable upon conversion of convertible note	42,148,222	28,448,924	36,856,476	23,170,722
Total common share equivalents excluded from denominator for diluted EPS computation	<u>77,379,688</u>	<u>72,676,349</u>	<u>72,857,954</u>	<u>70,549,217</u>

Employee share options, unvested shares, warrants and similar equity instruments granted by the Company, as well as convertible debt, are treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options and warrants, which are calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

## **8. Fair Value Measurement**

Fair value measurements are determined under a three-level hierarchy for fair value measurements that prioritizes the inputs to valuation techniques used to measure fair value, distinguishing between market participant assumptions developed based on market data obtained from sources independent of the reporting entity (“observable inputs”) and the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (“unobservable inputs”).

Fair value is the price that would be received to sell an asset or would be paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets (“market approach”). We also consider the impact of a significant decrease in volume and level of activity for an asset or liability when compared with normal activity to identify transactions that are not orderly.

The highest priority is given to unadjusted quoted prices in active markets for identical assets (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Securities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

The three hierarchy levels are defined as follows:

*Level 1 inputs* are observable inputs and use quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date and are deemed to be most reliable measure of fair value.

*Level 2 inputs* are observable inputs and reflect assumptions that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Level 2 inputs include 1) quoted prices for similar assets or liabilities in active markets, 2) quoted prices for identical or similar assets or liabilities in markets that are not active, 3) observable inputs such as interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, credit risks, default rates, and 4) market-corroborated inputs.

*Level 3 inputs* are unobservable inputs and reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available under the circumstances.

The carrying value of the Company’s cash and cash equivalents, accounts receivable, accounts payable and other current assets and liabilities approximate fair value because of their short-term maturity. The carrying value of the Company’s long term debt approximates fair value.

## **9. Related party and related party transactions**

The Company had a convertible debt facility with Aequitas Commercial Finance LLC, an affiliate of Aequitas Management LLC which, with its associates, had beneficial ownership of more than 10% of the Company at October 2, 2010, following conversion of principal outstanding on the debt facility into 36,504,180 shares of our common stock. Aequitas has disclosed in its most recent 13D filing with the SEC that it has approximately a 30% ownership position. One of the Company’s directors (until his resignation, effective September 17, 2010), William McCormick, is also an advisor of Aequitas Management LLC. Interest paid to Aequitas totaled \$562,394 and \$146,066 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$941,840 and \$340,841 for the nine months ended October 2, 2010 and October 3, 2009, respectively. Interest payments in the three and nine months ended October 2, 2010, include \$150,000 in minimum interest charges of \$50,000 per month for the remaining contract term of ninety days after the balance of principal was repaid, and \$257,280 in accrued interest charges that were added to the principal balance of the note, and thus paid in common stock as part of the conversion on September 8, 2010. In addition, the Company paid Aequitas fees of \$3,000 per month from March 2009 until August 2010. See also Notes 2 and 4 above.

## **10. Subsequent events**

On November 5, 2010, we entered into a \$4,000,000 revolving line of credit with Silicon Valley Bank and Partners for Growth. Borrowings under the agreement are at an interest rate of 12.5%. The facility matures on September 30, 2011. We granted the lender a first priority security interest in all of our assets. We issued a total of 3.75 million warrants to Silicon Valley Bank and Partners for Growth in connection with the agreement. These warrants have a term of seven years, and an exercise price of \$0.15.

Effective November 5, 2010, we appointed Andrew N. MacRitchie and Thomas Reiter to our board of directors, increasing the total number of directors from six to eight.

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion of the financial condition and results of operations of EnergyConnect Group, Inc. should be read in conjunction with the Management’s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements and the Notes thereto included in the Company’s Annual Report on Form 10-K for the year ended January 2, 2010.

### **Forward-Looking Statements**

Certain statements contained in this Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements which are other than statements of historical facts are “forward-looking statements” within the meaning of the federal securities laws. Although the Company believes that the expectations and assumptions reflected in these statements are reasonable, there can be no assurance that these expectations will prove to be correct. These forward-looking statements involve a number of risks and uncertainties, and actual results may differ materially from the results discussed in the forward-looking statements. Any such forward-looking statements should be considered in light of such important factors and in conjunction with other documents of the Company on file with the Securities and Exchange Commission.

New factors that could cause actual results to differ materially from those described in forward-looking statements emerge from time to time, and it is not possible for the Company to predict all of such factors, or the extent to which any such factor or combination of factors may cause actual results to differ from those contained in any forward-looking statement. Any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligations to update the information contained in such statement to reflect subsequent developments or information.

### **Overview**

EnergyConnect Group, Inc. is a leading provider of demand response services to the electricity grid. Demand response programs provide grid operators with additional electricity generation capacity by encouraging consumers to curtail their electricity usage. Historically, to provide a reliable supply of electricity and to avoid service disruption, grid operators have increased power generation by building additional power plants and transmission infrastructure. However, an alternative approach to increasing the supply side of electricity is to use demand response programs to reduce overall peak demand or shift load from peak to off-peak times, thereby optimizing the balance of demand and supply and reducing the need for additional power generation capacity. Demand response programs fall into two main groups: programs made for participants to stand by and respond to a grid event initiated by the grid operator, and programs that rely on participants curtailing their use of electricity based upon price signals.

Through our proprietary software as a service (SaaS) platform, we allow commercial and industrial consumers of electricity to access demand response programs that are offered by the grid and get paid by agreeing to stand by and curtail based upon a grid event or responding to a price signal. Our participants are commercial and industrial consumers of electricity with whom we contract to identify, develop and if necessary implement curtailment strategies. We enroll our participants in demand response programs operated by grid operators, who pay us for standing by or by reducing load by responding to a price signal. We make payments to our participants based on the terms and conditions of their contract with us.

The Company was incorporated in August 1986 as an Oregon Corporation, succeeding operations that began in October 1984. The Company’s headquarters are located in Campbell, California.

### **Description of Market**

In a wholesale electricity market, such as the energy market operated by Pennsylvania, New Jersey, Maryland Interconnection, LLC (“PJM”), the market operator is responsible for buying, selling and delivering wholesale electricity thereby balancing the needs of suppliers, wholesale customers and other market participants. These markets operate like a stock exchange, with the price of electricity resulting from matching supply, for example power supplied by the generators, with demand, consisting of the retail, industrial and commercial consumers of electricity. The PJM market uses locational marginal pricing (“LMP”) that reflects the value of electricity at a specific time and location. If the lowest-priced electricity can reach all locations, prices are the same across the entire grid. If there is congestion and energy cannot flow to all locations, more expensive electricity is ordered to meet that

demand. As a result, the LMP is higher in those locations of constraint. Wholesale electricity prices fluctuate based on five-minute intervals across the grid, however most consumers of electricity pay rates that are based on an average price of electricity that includes a hedge premium. This means that most consumers do not see wholesale prices and have no way of reacting to them. We have developed and deployed a software solution that allows our participants to transact in the wholesale market.

The energy market consists of Day-Ahead and Real-Time, or Day-Of, markets. The Day-Ahead market is a forward market in which hourly LMPs are calculated for the next operating day based on generation offers, demand bids and scheduled bilateral transactions. The Real-Time market is a spot market in which LMPs are calculated at five-minute intervals based on actual grid operating conditions.

### **Real-Time Response**

Our participants reduce their usage of electricity based on a pre-determined curtailment strategy they have developed and estimated prices for wholesale electricity that we provide. EnergyConnect is paid for the actual measured reduction in electricity usage expressed either in kilowatts per hour (KW) or megawatts per hour (MW) at the actual LMP less the participant's retail rate. We in turn pay our participants a percentage of the payment we receive based upon our individual contracts with them.

### **Real-Time Dispatch**

Our participants reduce their usage of electricity in response to requests by the grid operator. The grid operator notifies us of an emergency event, we in turn notify our participants of their need to reduce demand. EnergyConnect is paid for our participants standing by to respond to the grid operator's request to curtail. We in turn pay our participants a percentage of the payment we receive based upon our individual contracts with them.

### **Day-Ahead**

Some grid operators establish Day-Ahead economic markets with forward hourly electricity prices. The price certainty of the Day-Ahead market provides a known return for a specific curtailment strategy, for example, by pre-cooling buildings in early morning hours to create subsequent reductions of energy use in the peak afternoon hours. We provide our participants with all the information and support required to participate in the Day-Ahead electrical energy market. EnergyConnect is paid for the reduction in usage. Reductions in excess of the amount committed to the Day-Ahead market are generally paid at the prevailing Real-Time rate. Under-delivery generally must be made up by our participants buying energy at the Real-Time rate.

## **Critical Accounting Policies**

The discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We continuously evaluate our estimates and judgments, including those related to revenue recognition, sales returns, bad debts, excess inventory, impairment of intangible assets, income taxes, contingencies and litigation. Our estimates are based on historical experience and assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Form 10-Q.

We believe the following critical accounting policies, among others, affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

### **Revenue Recognition**

We provide grid operators with products similar to those the grid operator purchases from electric power generators. Our products can be grouped into two main categories: "Capacity" and "Economic".

The Capacity programs are designed to curtail usage during times when an electrical grid approaches its capacity limits of electrical generation just before a blackout or brownout. Participants in the capacity program are generally paid a fee to be on standby to respond on several hours' notice to a request from the grid to reduce electrical usage for a specified period.

The Economic programs differ from the capacity programs as they allow commercial and industrial consumers of electricity to curtail usage at their discretion based on price signals from the grid. Participants in such programs are paid for their discretionary performance rather than being paid to standby and curtail based on a request from the grid.

Under the Capacity programs grid operators pay us an annual fee in weekly installments to stand by and provide demand response resources to the grid when the grid calls an event. We record these payments as revenue over the time when we are required to perform under these capacity programs. For some programs our obligation to perform does not match the period over which we are paid by the grid in which case we recognize revenues over the mandatory performance period.

Under the Economic programs we are paid by the grid for our commercial and industrial participants' ability to reduce electricity usage in response to a price signal from the grid. Through our software we summarize price responsive activity and submit to the grid for payment. At the end of each monthly period the power grid approves the payments, and, we in turn recognize revenue based upon the grid approval.

An additional source of our revenue is derived from agreements with the power grid operators whereby a monthly reserve fee is paid for our agreement to be available to provide relief in the form of curtailment of energy usage in times of high energy demand. We record these payments as revenue over the period during which we are required to perform under these programs. Under certain programs, our obligation to perform may not coincide with the period over which we receive payments under that program. In these cases we record revenue over the mandatory performance obligation period and record a receivable for the amount of payments that will be received after that period has been completed.

Some of our contracts with our participants are multi-year contracts for their participation in capacity markets where both the pricing and the participant's commitment are known. Contracts signed for delivery in future years form the basis of our backlog. As of October 2, 2010, we had approximately 118 MW of capacity backlog with our participants, compared to no backlog in 2009.

#### **Accruals for Contingent Liabilities**

We make estimates of liabilities that arise from various contingencies for which values are not fully known at the date of the accrual. These contingencies may include accruals for reserves for costs and awards involving legal settlements, costs associated with vacating leased premises or abandoning leased equipment, and costs involved with the discontinuance of a segment of a business. Events may occur that are resolved over a period of time or on a specific future date. Management makes estimates of the potential cost of these occurrences, and charges them to expense in the appropriate periods. If the ultimate resolution of any event is different than management's estimate, compensating entries to earnings may be required.

#### **Impairment of Intangible and Long-Lived Assets**

In accordance with ASC 360, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we assess the impairment of long-lived assets whenever events or changes in circumstances indicate that their carrying value may not be recoverable from the estimated future cash flows expected to result from their use and eventual disposition. Our long-lived assets subject to this evaluation include property and equipment and amortizable intangible assets. If our estimate of future undiscounted net cash flows is insufficient to recover the carrying value of the assets, we will record an impairment loss in the amount by which the carrying value of the assets exceeds the fair value. If assets are determined to be recoverable but the useful lives are shorter than originally estimated, we depreciate or amortize the net book value of the asset over the newly determined remaining useful lives.

### Stock-Based Compensation

We account for stock-based compensation under the provisions of ASC 718-10 and ASC 505-50, "Stock Compensation and Equity Based Payments to Non-Employees". ASC 718 requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statement of Operations.

The weighted average grant date fair value of all options granted in the nine months ended October 2, 2010 and October 3, 2009 was \$0.10 and \$0.08, respectively. These fair values were computed using the Black-Scholes pricing model and the following assumptions:

	<u>2010</u>	<u>2009</u>
Risk-free interest rate	1.64 – 2.60%	1.80 – 2.75%
Expected dividend yield	0%	0%
Expected term	5 years	5 years
Expected volatility	83%	118%

The amounts expensed for stock-based compensation related to options totaled \$111,687 and \$186,787 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$345,467 and \$547,225 for the nine months ended October 2, 2010 and October 3, 2009, respectively.

### **Results of Operations**

The financial information presented for the three and nine months ended October 2, 2010 and October 3, 2009 represents activity in EnergyConnect Group, Inc. and its wholly-owned operating subsidiary, EnergyConnect, Inc (ECI).

*Revenue.* The Company generates revenue mainly from demand response transactions regulated by a Federal Energy Regulatory Commission (FERC) tariff. These transactions include economic or price-based programs and capacity programs. Economic or price-based programs entail voluntary, daily opportunities to enter into transactions in the energy markets based on our participants' responses to fluctuations in hourly energy prices.

Capacity programs allow for payments to partners such as ECI based on energy availability and curtailment when required by an electric grid to stabilize the supply and demand of electricity on the grid. Also included in the FERC tariff are rules under which we recognize revenue in capacity-based energy programs.

The FERC tariff also allows for other revenue opportunities in helping to meet various needs of electric grids. We recognize revenue from these programs ratably over the months during which our response is required.

Revenue for the three months ended October 2, 2010 was \$17,409,000 compared to \$10,338,000 for the three months ended October 3, 2009, an increase of 68.4%. This increase in year-over-year quarterly revenue in ECI is due primarily to an increase in PJM capacity revenues from the annual program from \$9,205,000 to \$15,548,000, or 68.9%.

Revenue for the nine months ended October 2, 2010 was \$30,875,000 compared to \$19,070,000 for the nine months ended October 3, 2009, an increase of 61.9%. The increase was primarily due to increased revenues from capacity transactions of \$2,493,000 and increased revenues from the annual program of \$8,457,000.

*Gross Profit.* Gross profit for the three months ended October 2, 2010 was \$5,308,000 (or 30.5% of revenue) compared to \$3,117,000 (or 30.2% of revenue) for the same period in 2009, an increase of 70.3%. This increase in gross profit is due to the higher volume of the annual capacity program in 2010, on which approximately the same gross margin was achieved.

Gross profit for the nine months ended October 2, 2010 was \$11,622,000 (or 37.6% of revenue) compared to \$6,909,000 (or 36.2% of revenue) for the same period in 2009, an increase of 68.2%. This increase is attributable to the \$4,691,000 gross profit generated by the high margin capacity transaction completed in the first quarter of 2010 compared to the \$3,023,000 generated by capacity transactions in the first six months of 2009, and also an increase in the profit generated by the annual program from \$3,675,000 to \$6,616,000, the increase being primarily attributable to the \$8,457,000 increase in revenue from the annual program.

Gross profit comprises revenue, less the related amounts due to our participants for capacity commitments made by them, and for transactions initiated by them, and various costs required to do business in the grids in which we operate. Future gross profit margins will depend on the Company's ability to sign contracts with participants for appropriate percentages for the duration of the contract term.

*Operating Expenses.* Operating expenses were \$2,832,000 (16.3% of revenue) for the three months ended October 2, 2010, compared to \$2,246,000 (21.7% of revenue) for the three months ended October 3, 2009, an increase of 26.1%. This increase in expenses is primarily due to increases of \$403,000 in legal and professional fees, and \$238,000 in employee costs, including salaries, offset by a reduction in non-cash stock-based compensation of \$59,000.

Operating expenses were \$7,621,000 (24.7% of revenue) for the nine months ended October 2, 2010, compared to \$7,126,000 (37.4% of revenue) for the nine months ended October 3, 2009, an increase of 6.9%. The increase in expenses is primarily due to increases of \$273,000 in legal and professional fees, \$334,000 in employee costs, including salaries, and \$67,000 in occupancy costs, offset by a decrease in non-cash stock-based compensation of \$159,000.

*Interest expense, net and other.* Net interest expense was \$1,024,000 for the three months ended October 2, 2010, compared to \$343,000 for the three months ended October 3, 2009. Net interest expense was \$1,557,000 for the nine months ended October 2, 2010 compared to \$735,000 for the nine months ended October 3, 2009. Net interest expense in both 2010 and 2009 comprised mainly interest expense incurred under the Company's debt facility and amortization of debt discount associated with the beneficial conversion feature of the debt facility. Net interest expense increased in the quarterly period in 2010 due to an acceleration of the charge against debt discount and the \$150,000 in minimum interest charges incurred when the loan was repaid, and in both periods in 2010 due to higher average aggregate borrowings, offset by a reduction in interest rates. Following conversion of the principal balance of the Aequitas loan into common stock in September 2010, interest expenses are expected to be significantly lower in the future.

*Taxation.* We have provided a full valuation allowance on our net deferred tax asset.

## **Liquidity and Capital Resources**

Since inception, we have financed our operations and capital expenditures through public and private sales of equity securities, cash from operations, and borrowings under operating and revolving lines of credit.

At October 2, 2010, the Company had positive working capital of approximately \$5,199,000, compared to approximately \$278,000 at January 2, 2010. The increase is primarily due to receivables under the 2010-2011 PJM capacity program being fully booked by the end of September, offset by corresponding payables to participants in lower amounts. The Company derived significant liquidity in the three months ended October 2, 2010, as the balance on its convertible note was repaid in common stock.

Accounts receivable increased to \$20,329,000 at October 2, 2010 from \$6,811,000 at January 2, 2010. The increase was primarily due to the creation of a receivable of approximately \$6.5 million following the recognition of revenue from a capacity transaction in the three months ended April 3, 2010, and the recognition of revenue and receivables from the entire 2010-2011 PJM capacity program, offset by the receipt of remaining monies due under the 2009-2010 PJM capacity program. We receive funds from this capacity transaction over the PJM program year on a weekly basis starting each June. Our remaining receivables will increase and decrease in accordance with the revenue recognized in each quarter. The large majority of our revenue, and therefore cash and receivables, is generated through PJM, which serves as the market for electrical transactions in a specific region in the United States. We are members of PJM, and our relationship with this power grid is perpetual. We do have a concentration of receivables from PJM, however, we do not believe there is a significant risk arising from this concentration.

Property and equipment, net of depreciation increased to \$190,000 at October 2, 2010, compared to \$187,000 at January 2, 2010. This increase was due to approximately \$109,000 in additions to fixed assets offset by normal depreciation charges of \$106,000 during the period. We may capitalize purchased software in the coming quarters, but do not anticipate spending significant amounts to acquire other fixed assets for the foreseeable future.

Accounts payable and accrued expenses increased to \$18,534,000 at October 2, 2010 from \$7,509,000 at January 2, 2010. The increase was primarily due to incurring liabilities to participants under the entire 2010-2011 PJM capacity program. At October 2,

2010, other than normal obligations to vendors, payables consist primarily of payment obligations to participants in our capacity programs, not currently due, and to normal monthly obligations in our economic programs.

The Company had no commitments for capital expenditures in material amounts at October 2, 2010.

As a result of our history of losses and our experiencing difficulty in generating sufficient cash flow to meet our obligations and sustain our operations, our independent registered public accounting firm, in its report included in our January 2, 2010 Form 10-K, expressed substantial doubt about our ability to continue as going concern.

We may still need additional investments in order to continue operations to cash flow break even. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock, the downturn in the U.S. stock and debt markets and the first priority lien on all of our assets granted to our secured lender could make it more difficult to obtain financing through the issuance of equity or debt securities. Even if we are able to raise the funds required, it is possible that we could incur unexpected costs and expenses, fail to collect significant amounts owed to us, or experience unexpected cash requirements that would force us to seek alternative financing. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, we may have to curtail our operations.

By adjusting the Company's operations and development to the level of capitalization, management believes it has sufficient capital resources to meet projected cash flow deficits. However, if the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on acceptable terms, or is no longer in compliance with the terms of its debt facility, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition. If operations and cash flows continue to improve through these efforts, management believes that the Company can continue to operate. However, no assurance can be given that management's actions will result in profitable operations or the resolution of its liquidity problems.

## **Concentrations**

We record revenue and therefore accounts receivable through agreements with both building owners and the power grid operators. Under our agreements with facilities owners, we use electrical and energy related products that help energy consumers control energy use in their buildings. In conjunction with this agreement we are members of the power grid operators and have agreed to provide the grids with energy, capacity, and related ancillary services during specified times and under specified conditions. These transactions are summarized at the end of each monthly period and submitted to the power grids for settlement and approval. While the power grids are our customers, they are primarily a conduit through which these electrical curtailment transactions are processed. The vast majority of our revenues each year are processed through PJM, which serves as the market for electrical transactions in a specific region in the United States. Our agreement with PJM is an ongoing one as we are members of PJM. These transactions are initiated by building owners, who are our participants. These transactions form the basis for our revenue.

Financial transactions and instruments that potentially subject us to concentrations of credit risk consist primarily of revenue generating transactions and the resultant accounts receivable.

During the three months ended October 2, 2010, and October 3, 2009, sales to one customer, PJM, accounted for \$16,558,000, or 95% of revenue, and \$9,479,000, or 92% of revenue, respectively. Our sales to PJM are made up of a number of transactions with participants. No single participant accounted for 10% or more of our revenue in either period.

During the nine months ended October 2, 2010, and October 3, 2009, sales to PJM accounted for \$28,811,000, or 93% of revenue, and \$17,342,000, or 91% of revenue, respectively, with no single participant accounting for 10% or more of our revenue in either period.

We do have a concentration of revenue with PJM, however, we do not believe there is a significant risk arising from this concentration.

## **Recent Accounting Pronouncements**

See the “New Accounting Pronouncements” in Note 1 to the Condensed Consolidated Financial Statements in Part I, Item 1 for information related to the adoption of new accounting standards in the third quarter of 2010, none of which had a material impact on our financial statements, and the future adoption of recently issued accounting pronouncements, which we do not expect will have a material impact on our financial statements.

## **Inflation**

In the opinion of management, inflation will not have an impact on the Company’s financial condition and results of its operations.

## **Off-Balance Sheet Arrangements**

The Company does not maintain off-balance sheet arrangements nor does it participate in any non-exchange traded contracts requiring fair value accounting treatment.

## **Item 3. Quantitative and Qualitative Disclosures About Market Risks**

The Company does not own or trade any financial instruments about which disclosure of quantitative and qualitative market risks are required to be disclosed.

## **Item 4. Controls and Procedures**

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

## **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this Quarterly Report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on that evaluation, our CEO and CFO concluded, as of the end of such period, our disclosure controls and procedures were effective.

## **Changes in Internal Control over Financial Reporting**

There were no changes in internal controls over financial reporting that occurred during the period covered by this report that have affected, or are reasonably likely to affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Company is subject to legal proceedings and claims, which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters should not have a material adverse effect on its financial position, results of operations or liquidity.

### **Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A “Risk Factors” in our Annual Report on Form 10-K for the year ended January 2, 2010 (the “Annual Report”), which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors disclosed in the Annual Report, except as follows:

#### ***Risks concerning Aequitas Ownership position***

Aequitas has disclosed in its most recent 13D filing with the SEC that it has approximately a 30% ownership position, but in conversations between representatives of Aequitas and members of the Company’s Board of Directors and management team, Aequitas has indicated verbally that the ownership position of their “group” may be closer to 37% or even as much as 50%. The Company is not currently in a position to reconcile the Aequitas ownership position.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. [Removed and Reserved]**

### **Item 5. Other Information**

None.

### **Item 6. Exhibits**

(a) The exhibits filed as part of this report are listed below:

#### Exhibit No.

- |      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

## **SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: November 9, 2010

ENERGYCONNECT GROUP, INC.

By: /s/ Kevin R. Evans  
Kevin R. Evans  
Chief Executive Officer  
(Principal Executive Officer)

## EXHIBIT INDEX

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## CERTIFICATIONS

Exhibit 31.1

I, Kevin R. Evans, certify that:

1. I have reviewed this quarterly report on Form 10-Q of EnergyConnect Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. I have disclosed, based on my most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of my most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 9, 2010

/s/ Kevin R. Evans  
Kevin R. Evans  
Chief Executive Officer

## CERTIFICATIONS

Exhibit 31.2

I, Andrew C. Warner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of EnergyConnect Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. I have disclosed, based on my most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of my most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 9, 2010

/s/ Andrew C. Warner  
Andrew C. Warner  
Chief Financial Officer

**CERTIFICATION PURSUANT TO SECTION 906  
OF  
THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report on Form 10-Q of EnergyConnect Group, Inc. (the "Company") for the period ended October 2, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Covered Report"), I, Kevin R. Evans, the principal executive officer of the Company, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that:

The Covered Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

The information contained in the Covered Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

IN WITNESS WHEREOF, I have executed this certificate as of this 9th day of November 2010.

/s/ Kevin R. Evans  
Kevin R. Evans  
Chief Executive Officer

**CERTIFICATION PURSUANT TO SECTION 906  
OF  
THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report on Form 10-Q of EnergyConnect Group, Inc. (the "Company") for the period ended October 2, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Covered Report"), I, Andrew C. Warner, the principal financial officer of the Company, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that:

The Covered Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

The information contained in the Covered Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

IN WITNESS WHEREOF, I have executed this certificate as of this 9th day of November 2010.

/s/ Andrew C. Warner  
Andrew C. Warner  
Chief Financial Officer