MANAGEMENT'S DISCUSSION & ANALYSIS – 2008

Overview

This discussion explains the material changes in the Company's financial condition and results of operations for the fiscal year ended May 31, 2008 (or FY 2008), and compares the FY 2008 financial results to the previous year ended May 31, 2007 (or FY 2007). The consolidated financial statements, and notes to the consolidated financial statements constitute an integral part of the discussion and should be read in conjunction with these comments. This discussion and analysis of the financial condition and results of operations may contain forward-looking statements. These statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

Thermal Energy has established itself since 1991 as an innovative technology company providing custom energy and emission reduction solutions. Our award winning energy recovery, conservation and bioenergy solutions provide significant financial and environmental benefits to our customers.

Thermal Energy engages clients through a unique mix of process, energy, environmental, financial and other expertise combined with the best technology solutions and financial offerings. The Company's client can expect compelling returns and solutions with an excellent track record of longevity, proven reliability and performance.

More information on Thermal Energy can be found at www.thermalenergy.com. FLU-ACE®, THERMALONOx™, THERMALOZOMAx™, GEM® and DRY-REX™ are trademarks of Thermal Energy. Common shares of Thermal Energy are traded on the TSX Venture Exchange under the symbol TMG.

Environmental Compliance and Energy Conservation Market Trends

World market demand is increasing for innovative environmental protection and renewable energy solutions for sustainable economic growth. North America today is faced with the growing challenge of reducing and controlling air pollution emissions that cause serious health risk to human beings, cross international borders, and impact the environment. Furthermore, as the USA, Europe ("EU"), and Canada strive to grow their economies and increase their economic outputs, this causes increased demand and consumption of fossil fuels. Therefore, the more successful a country becomes, the larger the task and costs are for the reduction and the control of multiple air pollutant emissions from fossil fuel consumption. In addition, the costs of oil and natural gas fossil fuel energy sources have been rising substantially both due to the increasing demand for their utilization, and due to the decreasing fossil fuel reserves and sources which are available for consumption. Thermal Energy has developed and commercialized proprietary air compliance and waste heat recovery technologies and solutions, designed specifically to cost-effectively meet or exceed both the current and future anticipated US and EU air pollution emissions regulations.

Thermal Energy is well positioned to provide the US, EU, and Canada with the best available products, technologies, and solutions to most economically meet both the medium-term and longer-term air compliance and energy conservation objectives. In addition to having cost effective environmental compliance and energy conservation solutions, Thermal Energy continues to grow and work through strategic alliances,

cooperative partnerships, and synergistic sales development associations with US and Canadian companies in order to sell, market, and implement retrofit solutions in North America. Recently, the Corporation established new strategic alliances and cooperative relationships with companies in China to further improve the Corporation's competitive access to global markets.

Through unique energy conservation and self-financing solutions, Thermal Energy is economically assisting in meeting Canadian, and soon US, and EU environment protection policies, strategies and goals to achieve cost effective environmental compliance.

Energy Conservation and Environmental Compliance Solutions Business

Thermal's technologies have widespread industrial, utility, commercial and institutional applications for environmental compliance, self-funding energy retrofits and infrastructure upgrades to plant operations. Specifically the technologies can be applied to process modifications and retrofit solutions for primary metal processing, automotive manufacturing, coal-fired power utility, petrochemical, pulp & paper, and food processing industries as well as for sewage treatment, central or district heating, commercial building, and institutional facilities. In addition, Thermal Energy has developed leading edge energy-from-waste solutions for combustion of solid and liquid waste via incineration and thermal destruction facilities.

The Corporation delivers superior proprietary and patented environmental compliance and energy conservation technologies coupled with comprehensive engineering and implementation services.

Thermal Energy's core business provides three primary client benefits:

1. Energy consumption & cost reduction;
2. Commensurate greenhouse gas and emission reductions;
3. Excellent financial returns.

The Company provides this through two core focus areas:

1. Energy Solutions
2. Environmental research and development

Energy Solutions: The Companies energy solutions portfolio comprises three primary technologies:

- **FLU-ACE® waste heat recovery:** This proprietary technology was developed by Thermal Energy to recover 75% or more of the heat wasted through exhausts. FLU-ACE® systems are designed to process exhaust gas from combustion of all fuel types, plus process exhaust from dryers such as from pulp and paper, and food and beverage industries. This waste heat is captured as condense hot water and returned to process which displaces the use of fossil fuel and reduces energy costs with commensurate emission reductions.

- **DRY-REX™ low temperature biomass dryer:** This patented technology was acquired in 2006. DRY-REX™ dries large quantities of biomass and biowaste at relatively low temperature. It can recovered energy from "waste" heat sources and reduces air quality concerns. It turns waste such as bark and sludge into high quality biofuels.

- **GEM® Condensate Return System:** Offered by Thermal Energy under exclusive licence in Canada, China and key U.S. markets since 2006, the GEM® Condensate return System is a permanent replacement for traditional, mechanical steam traps. GEM® results in lower steam production costs, lower greenhouse gas emissions and improved steam efficiency. Thermal Energy acquired GEM in June 2008.

Environmental Research and Development: Thermal Energy is currently engaged in research and development of the THERMALONOx™ technology for reducing nitrogen oxide emissions (NOx) from coal-fired power plants and other industrial sources. This is a process for which patent applications have been filed. THERMALONOx™ utilizes phosphorous to create a chemical reaction to remove the NOx. Research is under way at the Company's laboratory facilities in Cranbrook, B.C. where initial tests show a better than 98% rate of NOx reduction. Current best available commercial technology known as Selective Catalytic Reduction (SCR) and Selective Non-Catalytic Reduction (SNCR) is considered problematic, costly and has a lower rate of NOx removal that is projected for THERMALONOx™. A joint venture is under way at the South China University of Technology (SCUT), supported by Chinese government agencies, to establish a pilot demonstration facility which is expected to lead to the eventual commercialization of THERMALONOx™.

More information may be found on the Corporation's products, technologies and solutions by visiting the website at www.thermalenergy.com.

Throughout FY 2008 the Corporation maintained its close working relationship with Johnson Controls L.P. ("JCI") for developing combined energy conservation and air pollution control solutions for their selected Canadian and U.S. customers.

The Thermal Energy mission statement can be summarized as follows: to increase sales through existing (JCI) customer relationships by targeting energy solutions sales opportunities which will result in a faster sales cycle for both companies, while targeting niche industrial and commercial market sectors where Thermal Energy solutions provides a strong competitive advantage.

Although JCI accounted for nearly all of the sales in FY 2004, FY 2005, FY 2006, FY 2007 and approximately 50% of all sales in FY 2008, the Corporation continues to work aggressively with other new and potential partners to attract new customers. An example of such a new arrangement was the creation of a joint venture named Thermal Energy International (Guangzhou) Ltd in China with Oriental-Unicorn Sales and Marketing Company, Ltd. located in Guangzhou, China and E5 Enterprises, LLC located in Toronto, Canada in Q2 FY 2008 to deploy the Corporation's energy recovery products and solutions in key Chinese markets. Inc. As a result, management is confident that the Corporation would continue in the absence of contracts with JCI

The Corporation completed its first recovery/energy cost reduction project at a major food and beverage facility in the U.S. for an estimated value in excess of $1.4 million. Its second commercial contract in the U.S. market which was also the first to use both the Company's FLU-ACE® waste heat recovery solutions and its new state-of-the-art GEM® Condensate Return System was approximately 95% complete at year end. Throughout the year the Corporation continued to receive small purchase orders to install its newly acquired energy saving, GEM® condensate return technology at a Global 500 company's facilility in the U.S. as well as purchase orders for trial testing of the GEM® condensate return technology at various industrial sites throughout Canada and China. In addition, the Corporation through its wholly-owned

subsidiary, ForEverGreen Energy Inc. (FEI) implemented a contract valued at $2,209,842 Fraser Paper Inc.'s Thurso mill. FEI began monthly invoicing to the customer in March, 2008 for the supply of green energy. In addition, the Corporation completed a feasibility study for a fine paper mill in the north eastern United States for the installation of a FLU-ACE® condensing heat recovery system to recover waste heat from the mill's Recovery Boiler dissolving tank exhaust. The value of the first of a two phase contract was US$130,000.

In addition the Corporation successfully diversified its business development model using its THERMAL-AUD program to initiate direct sales of proven FLU-ACE® and DRY-REX® solutions to established Fortune 500 customers, while continuing to develop new non-exclusive strategic alliances under a new more cooperative joint venture alliance model.

During FY 2008, the Corporation cooperated with JCI to develop and propose many industrial and institutional FLU-ACE® Energy Recovery Solutions to establish a growing multimillion dollar potential sales pipeline in Canada and the US. While the Corporation was successful in generating $4,926,208 in sales during FY 2008, it also developed a large project in excess of $20M with a North American integrated paper company located in north eastern United States which led to the signing of an LOI on June 2, 2008. Notwithstanding the final value of this project which is currently being finalized, there is approximately $524,000 in carry-forward revenues from the Fraser-Thurso project and the Phillips project in FY 2009. However, the potential sales pipeline of qualified bids significantly increased to an amount in excess of $200,000,000 and these will carry-over to FY 2009.

During FY 2008 the Corporation remained committed to the future product development and commercialization of the patented THERMALONOx™ technology with the design and procurement of equipment for the further testing of its THERMALONOx™ solution, planned for Q2 and Q3 FY 2009. Over the past year, the Corporation's chief scientist, Dr. Raymond Belanger, continued to conduct further laboratory testing of ozone generation, which is fundamental to the chemical reaction required to remove NOx from flue gas streams and one of several components required for a complete emission reduction solution. Additionally, the Corporation continued to evaluate potential partners in the medium and large electric utility market who could sponsor a large scale demonstration of the technology now that it has successfully completed its laboratory testing. Finally it reached an agreement with the South China University of Technology (SCUT), with Chinese government backing, on the division of work related to the joint research and developmental testing of industrial applications for the Company's THERMALONOx™ technology on a coal-fired power plant slip stream in Guangdong province, which has been indentified by SCUT as a suitable test site.

During the early part of FY 2007 the Corporation expanded its suite of energy savings solutions by acquiring the award-winning, patented DRY-REX™ bioenergy technology from Mabarex Inc., of Montreal (www.mabarex.com). With this agreement, the Corporation took immediate ownership of the exclusive worldwide license to the DRY-REX™ technology and the transfer of all intellectual property (patent) rights on an earn-out basis over five years. While no contracts have been realized to date, there has been favourable reaction to this technology that has resulted in the submission of several proposals to potential customers. The Corporation's Chilliwack laboratory was converted to test for the drying of sludge materials that can abet in the development of a DRY-REX® solution.

The total value of the Mabarex technology acquisition was $3.25 million. This included the issuance of 500,000 common shares of the Corporation at a deemed

price of $0.16 per share. The remainder of the acquisition price is to be retired through royalty payments on the Corporation's sales of DRY-REX™ solutions.

The Corporation was successful in financing its working capital requirements to support its business development efforts, by raising capital through the completion of a non-brokered private placement. The private placement with gross proceeds of $999,000 closed on January 21, 2008. The financing consisted of the issuance of 1,455,000 Units at $0.30 per unit with each unit comprising one common share and one non-transferable share purchase warrant entitling the holder to acquire one additional common share at any time within two years of issuance at a price of $0.50 per share. It also consisted of an issuance of 1,875,000 flow-through shares at a deemed price of $0.30 per share.

The Corporation also secured a five-year, $2.5M line of credit with the Toronto Dominion Bank to finance its THERMAL-AUD Program, through its wholly owned subsidiary, FEI.

The Corporation incurred a net loss during the year of $2,372,508 compared to $2,443,265 during the previous year and has an accumulated deficit at year-end of $21,086,582. The Company's ability to continue as a going concern has improved by obtaining a significant level of financing in the amount of $15M through a brokered private placement in Q1 FY2009 and will continue to improve by achieving or exceeding targeted gross margins. In addition the Company anticipates further funds will become available in the approximate amount of $3,000,000 from the exercising of options and warrants later in the second half of FY 2009. Together, this will satisfy the planned expansion of its R&D work in China on its new THERMALONOx™ technology solution and significantly expand sales and marketing capabilities throughout North America and China.

Revenues and Gross Profits

Revenues were $4,926,208 in FY 2008 compared to $821,024 in FY 2007. Revenues increased significantly in FY 2008 compared to FY 2007 due to more secured and significantly larger sized contracts from the previous year, primarily from its completed contract at Fraser's Thurso mill and two US contracts at Kelloggs and Phillips Lighting.

The gross profit of $608,024 in FY 2008 improved substantially from a gross loss of $53,491 in FY 2007. These results expressed as a percentage of sales were 12.34% in FY 2008 compared with (6.51%) in FY 2007. The current year profit was due to the completion of the Fraser Thurso project ahead of schedule and below budget, despite the combination of increased cost over-runs and foreign exchange losses of $380,163 at the Phillips project and warranty related costs of $122,793 incurred at the Valley Regional Hospital, associated with the remedy of previous design deficiencies, Camco and Minas Basin. Additionally, $25,000 was accrued as a warranty provision.

Expenses

Administration expenses in FY 2008 were $1,228,984 compared with $880,331 in FY 2007. The increase in costs was due mainly to increases in stock-based compensation of $262,000, directors' fees (full year in FY 2008 as opposed to partial in the previous year) of $30,000, combined UIC, EHT and WSIB of $38,000,

consultant's due diligence costs to acquire GEM Ltd of $50,000 and a provision of $30,000 for doubtful accounts.

Selling, marketing and business development expenses were $1,314,208 in FY 2008 compared to $1,266,359 in FY 2007. The major changes were increases in sales salaries of $92,500, commissions of $109,800, business development pursuing FLU-ACE heat recovery work and GEM sales in China of $66,000 and $72,000 respectively, and business development pursuing GEM sales in Canada of $63,000. These were offset by declines of $144,400 in stock-based compensation and of $230,700 in other business development costs.

Legal expenses in FY 2008 were $331,836, a significant increase compared to the amount of $18,850 incurred in FY 2007. Approximately $93,500, represents the increase in preparatory work for discoveries related to the litigation by the past President and CEO against the Company and $120,000 represents partial legal costs by U.K. lawyers in assisting with the acquisition of GEM Ltd.

Audit expenses in FY 2008 were $72,839 compared to $77,500 in FY 2007.

Insurance expenses increased significantly to $127,993 in FY 2008 compared with $78,498 in FY 2007 due to new premiums of $69,500 for professional liability (errors & omissions).

Patent and trademark maintenance costs were $13,587 in FY 2008 compared to $23,715 in FY 2007 with respect to countries where patents have been granted. Patent and trademark maintenance costs are expensed as incurred. The decrease in costs year over year was due to a lessening of reporting requirements pending the testing of the Company's THERMALONOx™ technology planned for the second quarter of FY 2009.

Research and Development costs decreased slightly in FY 2008 to $87,572 compared to $99,875 in FY 2007 as a result of completion of the laboratory testing program together with a lessening of consumable costs associated with the testing.

Amortization of property, plant and equipment was $31,314 in FY 2008 compared to $24,828 in FY 2007. The increased costs were due primarily to the amortization of new equipment associated with the R&D laboratory in the Company's offices in Chilliwack, B.C. and new computer equipment in the Company's head office.

Other revenues

Other revenue was $Nil in FY 2008 compared with $5,240 in FY 2007.

Interest revenue

Interest revenue was $32,098 in FY 2008 compared to $562 in FY 2007 because of increased balances in investment accounts.

Finance revenue

The Fraser Paper contract in Thurso, Quebec, which was delivered through the THERMAL-AUD program, was accounted for as a sales-type lease and, accordingly finance revenue of $56,201 was recognized in relation with this contract.

Other costs

Other costs were $Nil in FY 2008 compared to $36,001 in FY 2007.

Net Loss

Net Loss was $2,372,508 in FY 2008 compared to a net loss of $2,443,265 in FY 2007. Contributing factors resulting in the loss in 2008 were the cost over-runs and foreign exchange losses at the Phillips project in the amount of $380,163 and warranty related costs of $122,793 at Valley Regional Hospital, Minas Basin and Camco, increased administration, selling, marketing and business development and legal costs referred to earlier, and insufficient sales volume to cover the current level of fixed costs of the Company required to produce a net profit. Management continues to work hard to control overhead costs but its main focus at the present time is a dedicated effort to secure much improved sales results.

Liquidity

The working capital deficiency of $2,093,061 at the end of FY 2008 increased significantly compared to the working capital of $559,350 at the end of FY 2007. Current assets decreased by $383,522 to $1,680,029. The major changes in current assets were decreases in cash of $464,479 and short-term investments of $468,107 offset to a lesser extent by increases of $198,990 in accounts receivable, $152,000 in contracts in progress and the current portion of the net investment lease of $227,034. Current liabilities increased by $2,268,889 to $3,773,090. The changes were the result of increases in the bank loan of $908,667, accounts payable of $1,673,619 and accrued liabilities of $301,695, partly offset by a decrease in deferred revenue of $615,092.

Other cash requirements in FY 2008 were met by the issue of common shares with a value of $999,000 from private placements. This was in excess of current requirements and $552,773 was invested in short-term securities. Cash requirements continued to be adversely affected by insufficient sales volume to cover the current level of fixed and variable costs.

Management continues to recognize the requirement to further improve liquidity in order to continue as a going concern, and as a result is aggressively working to increase sales and is continuing to develop new cooperative business relationships and exclusive sales distributorships in different, but complementary, product lines. In addition, the Company has completed one (1) non-brokered private placement in the third quarter of FY 2008 with gross proceeds of $999,000.

Additionally, during the fourth quarter of FY 2008 the Company actively explored opportunities to further structure a multi-million dollar financing of its new Business Plan, which involved the acquisition of GEM Ltd., of Bristol, U.K. This culminated with the Company's successful completion of a brokered private placement at the beginning of Q1 FY 2009 with gross proceeds of $15,000,000, which would be used for completing the acquisition of GEM, to expand sales and marketing efforts in North America, Europe and China, to assist in project financing and for R&D testing activities of THERMALONOx™ in China.

Related Party Transactions

In FY 2008 Directors were paid fees for services of $48,750 and Officers were paid $188,000. The Chairman of the Board of Directors was paid an annual fee of $18,000. Additionally, one other Director was paid $50,000 for consulting services pertaining to the GEM acquisition.

2,366,667 common shares were issued to Directors and 1,843,000 shares were issued to Officers in 2008.

Options outstanding for Directors as at May 31, 2008 were 3,500,000 of which 2,461,000 were exercisable. There were 37,500 warrants outstanding for Directors.

Loans to enable the exercise of options in the amount of $265,000 for Directors and $312,300 for Officers were outstanding at May 31, 2008.

Segmented Information

In FY2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and was also engaged in the start-up phase of similar operations in China. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports two retrofit technology lines – waste energy recovery solutions and air pollution control solutions. In FY2008 revenue was derived mainly from engineering and constructing the complete retrofit energy recovery and air pollution control solution, with some revenue derived from the custom fabrication and assembly of the proprietary hardware components and the core major equipment package of the technologies. All assets are located in Canada.

Prior to fiscal 2008, customers financed these projects entirely from their own resources and accordingly, the Company operated in only one segment. However in 2008 the Company introduced its Thermal-AUD™ product whereby it finances the project, recovers and obtains a return on its investment by entering in an energy purchase agreement with its customer. Construction of the first Thermal-AUD™ project was completed in late fiscal 2008. This gave rise to two reportable segments which are detailed below:

	May 31, 2008	
	Customer financed contracts and other $	Thermal-AUD™ contract $
Revenue from external customers	2,716,365	2,209,842
Inter-segment revenues	19,111	-
Interest and finance revenue	32,098	56,201

	Customer financed contracts and other $	Thermal-AUD™ contract $
Interest expense and bank charges	13,503	6,914
Stock-based compensation charge	495,786	-
Amortization of capital assets	31,314	
Segment loss (profit)	2,391,014	(18,506)
Segment assets	2,755,526	2,225,562
Expenditures for capital assets	28,768	

Reconciliation to financial statements

	May 31, 2008 $
Revenues	
Total revenues for reporting segments	4,945,319
Elimination of inter-segment revenues	(19,111)
Total company revenues	4,926,208
Loss	
Total loss for reported segments	2,572,508
Income tax recovery	(200,000)
Net loss	2,372,508
Assets	
Total assets for reported segments	4,981,088
Elimination of inter-segment receivables	(1,287,087)
Total assets	3,694,001

Geographic Segments

	May 31, 2008	
	Revenues $	Capital Assets $
Canada	2,382,444	2,013,972
United States	2,507,137	-
China	36,627	-
Total	4,926,208	2,013,972

Supplementary Financial Information

The following table shows selected consolidated financial data for the three most recently completed financial years.

Financial information for the years ending
May 31, 2006, May 31, 2007 and May 31, 2008

	2006 $	2007 $	2008 $
Sales	2,845,341	821,024	4,926,208
Net loss	(2,216,733)	(2,443,265)	(2,372,508)
Net loss per share – basic and diluted	(0.033)	(0.031)	(0.025)
Total assets	931,430	2,131,163	3,694,001

The earned revenue from sales in FY 2006, FY 2007 and FY 2008 are inconsistent in magnitude. In FY 2007, while secured sales increased to approximately $3.9 million year-over-year because of long delays in the awarding of two contracts, the earned revenue from sales fell significantly.

The net losses in FY 2006 were partly due to the extra cost over-runs of the Camco project, the costs to remedy design flaws at the Valley Regional Hospital and Stratford General Hospital projects and the litigation costs to defend against the past President.

The net losses further increased in FY 2007 due to a significant drop in earned revenue from sales as a result of a three to four month delay encountered in signing its first two U.S. contracts.

While the net losses decreased slightly in FY 2008 compared to FY 2007, they remained consistent in magnitude due to cost over-runs and foreign exchange losses at the Phillips project in the amount of $380,163 and warranty related costs of $122,793 at Valley Regional Hospital, Minas Basin and Camco. Increased administration, selling, marketing and business development costs of $396,500, increased legal and insurance costs of $313,000 and $49,500 respectively all contributed to the loss.

The variations in assets from FY 2006 through to FY 2008 were affected primarily by an investment of $800,263 in short term investments in FY 2005 following the closing of a private placement in the amount of $1,100,100 late in the fourth quarter of FY 2005. This investment was drawn down in FY 2006 to meet cash requirements. A further closing of a private placement in the amount of $734,900 which was drawn down in FY 2006 was followed with five private placements in the amount of $2,747,138 in FY 2007. The increase in assets for FY 2008 was primarily due to the accounting treatment of the Fraser Paper contract as a sales-type lease.

Disclaimer

The information provided in this document is not intended to be a comprehensive review of all matters concerning the Company. It should be read in conjunction with all other disclosure documents provided. No securities commission or regulatory authority has reviewed the accuracy or adequacy of the information presented herein and, as noted in the financial statements ended May 31, 2008, these statements were subject to an audit by our independent public accountants.

Business Risks

Management is confident about our long-term prospects, but we recognize that we are exposed to a number of risks in the normal course of business that could negatively impact the financial condition of the Company.

The Company is engaged in the development, engineering and supply of pollution control and heat recovery systems. Operational risks of the company include the ability to continue to secure and implement multiple sales contracts each year for its FLU-ACE® technology solutions. In addition, the Company had not yet been able to finance and complete the development and commercialization of its patented THERMALONOX™ technology at year end. However, with the successful completion of it brokered private placement in Q1 FY 2009, the Company began the design work in earnest to be in a position to test the THERMALONOx™ patented technology by Q2-Q3 FY 2009. The Cost Effective Energy Conservation and Environmental Compliance Solutions sales through the close working relationship with JCI has not limited the size of the market but has increased the market potential.

Financial risks and uncertainties of the Corporation include:

- The Company's history of operating losses and uncertainty of future profitability;
- The ability to continue to grow quicker sales through its working relationship with JCI;
- The ability to grow sales through the establishment of new cooperative partnerships and strategic alliances;
- The ability to grow sales through the licensing of the corporation's technologies;
- The ability to secure and maintain the required outside working capital financing;
- The ability to achieve profitable operations through increased sales,
- Reliance on third party collaborations and license arrangements;
- Reliance on proprietary technology;
- Competition in the energy conservation and environmental compliance solutions;
- Product liability claims and insurance;
- Reliance on key personnel;
- The ongoing litigation with its former President & CEO; and,
- The ability to control costs and achieve a positive gross margin on projects.

Management's addressing of the risks:

The management of the Company realizes that the increased operating losses in FY 2008, while displaying a consistent pattern of losses as in previous years were primarily due to the unexpected cost over-runs with the Phillips project (using non-core Company technologies), increase in warranty related costs on three previously

completed projects and increase spending in selling and maketing of its product lines in China. Additionally, while the sales funnel increased significantly year-over-year it demonstrates the Company's inability to close the "deal" in a timely fashion and the need to improve its efforts to shorten the sales cycle.

With the addition of a new Vice President of Sales in FY 2008 to fully focus on sales and marketing and with new proven sales personnel to be added in Q1-Q2 FY 2009, the Company believes that it will be more productive in future quarters of FY 2009 in its pursuit and closing of sales opportunities.

Management believes that it can continue to grow sales by working closely with JCI as evidenced by the two recently awarded contracts to perform work for its clients in the U.S. In addition there are numerous projects that it is presently jointly pursuing with JCI both in Canada and the U.S and abroad.

In addition management has signed an agreement with the South China University of Technology (SCUT), with Chinese government backing, to jointly research and develop industrial applications for the Company's THERMALONOx™ nitrogen oxides (NOx) removal technology. The R&D program envisions demonstrating THERMALONOx™ on a coal-fired power plant slip stream in Guangdong province which has been tentatively identified by SCUT as a suitable test site. The Company believes that this cooperative partnership could help to grow its sales and possibly lead to licensing agreements after successful trials of the Corporation's technologies.

The current management has demonstrated that it can secure outside working capital when required, as evidenced by the successful closings of its five Private Placements with gross proceeds of $2,936,138 in the second half of FY 2007, its closing of a non-brokered private placement with gross proceeds of $999,000 in Q3 FY 2008 and followed by a brokered private placement of $15,000,000 in Q1 FY 2009.

Management believes that by maintaining its small core of personnel and high margins on more secured contracts that it will achieve profitable operations. Small incremental staffing increases will be introduced from time to time depending on the demand arising from increased sales volumes.

Management has expanded its suite of energy savings solutions by acquiring the award-winning, patented DRY-REX™ bioenergy technology from Mabarex Inc., of Montreal (www.mabarex.com). With this agreement, the Company took immediate ownership of the exclusive worldwide license to the DRY-REX™ technology and the transfer of all intellectual property (patent) rights on an earn-out basis over five years. This adds to the Company's previous acquisition of new licenses and distributorship rights to GEM®, a leading European (Great Britain) line of industrial/commercial steam traps and THERMALOZOMAx™, an ozone generation technology. This was followed in Q1 FY 2009 with the Company entering into an agreement to acquire Bristol-based Gardner Energy Management Ltd. (GEM) (www.gemtrap.com)

The Company is protecting its proprietary technology through registered trademarks and confidentiality agreements. It has recently filed a new provisional patent for THERMALONOx™, a technology which is currently undergoing laboratory testing.

Management believes that competition against its core technologies of FLU-ACE™ and DRY-REX® is limited at this time and in any event believes that the market place is sufficiently large enough to permit stronger competition in the future and firmly believes that the Company is in a better position now with a significantly

enhanced arsenal of building blocks to draw on in presenting a more comprehensive solution to customers.

Highlights

On June 15, 2007 the Company announced the appointment of Anthony J. Pugliese as Vice President, Sales. Mr. Pugliese came from Direct Energy Business Services where he was Manager, Business Development, Health Care Sector, responsible for leading the development and implementation of market strategies in the Canadian healthcare and public sector markets. Prior to his tenure at Direct Energy, Mr. Pugliese was Account Manager, Healthcare Solutions with Johnson Controls, Inc. in eastern Canada.

On June 19, 2007 the Company announced that it had signed a Memorandum of Understanding to develop a joint venture with the Jiangnan Boilers and Pressure Vessels Company, Ltd. (JBPV), to deploy the Company's energy recovery solutions in key Chinese markets. JBPV, with revenues of $90 million annually, serves the chemical fertilizer, medical, oil and chemical industries in China and works with a number of international companies such as York International, BASF, SECCO, Inc., and SPX Corp.

On June 21, 2007 the Company announced that it had formalized a research and development agreement with South China University of Technology (SCUT) focused on the commercialization of the Company's THERMALONOx™ nitrogen oxides (NOx) removal technology for China's coal-fired power market. The formal agreement opened the door for the initial Chinese investment in the research of $1 million RMB (the lawful currency of the People's Republic of China) or (CAD$140,000) by the Guangzhou Municipal Science and Technology Bureau for SCUT's project resources commitment to the Company. The funding was secured in Q1 FY 2008.

On June 26, 2007 the Company announced that it had signed a letter of intent to enter its first long-term energy services agreement with one of the largest North American forest products pulp and paper process, which has a wide-spread, repeatable, application for the industry. The agreement envisages an initial five-year solution to provide the customer with approximately $2.5 M in positive cash flow and to cut greenhouse gas emissions by 50,000 tons of CO_2.

On June 28, 2007 the Company announced that it reached an agreement with Gardner Energy Management of Bristol, UK, to market its GEM® Condensate Return System in China. China represents a multi billion dollar market for condensate return systems and is the fastest growing steam systems market in the world.

On July 11, 2007 the Company announced that one of the largest pulp and paper manufacturers in China was commencing a trial installation of the GEM® Condensate Return System.

On August 7, 2007 the Company announced that it had received its first order in China for GEM® Steam Traps from Lee and Man Paper Manufacturing Co. to be installed on one of its paper machines in one of their massive plants that produces over 1.5 million tons of containerboard annually. Lee and Man will monitor the results as a basis for considering other conversions of their large condensate systems at their various plants.

On August 9, 2007 the Company announced that it had ventured into Alberta's oil, gas and petrochemical sector with a contract from an Edmonton-area petrochemical

manufacturer, to begin retrofitting approximately one-third of its mid-size facility with GEM® steam traps.

On August 15, 2007 the Company announced the establishment of ForEverGreen Energy Inc., a wholly-owned green energy services subsidiary. The subsidiary will own and operate the Company's assets to be used under the THERMAL-AUD™ (Alternate Utility Delivery) program, that will allow the Company's customers to benefit from energy savings without capital investments.

On August 27, 2007 the Company announced that its wholly-owned energy services subsidiary, ForEverGreen Energy Inc. (FEI) signed an agreement for up to $3.75M with Fraser Paper Inc. to recover waste heat at its Thurso Mill. The green power agreement using THERMAL-AUD™'s program is for a term of six years. The Company will enter into a contract with FEI to supply, install and manage performance of its FLU-ACE® system at the Thurso pulp mill.

On September 18, 2007 the Company announced that it had signed a Letter of Intent with an Eastern Canada pulp and paper mill for a DRY-REX® biomass drying system to dry the mill's biomass waste stream including paper sludge for use as biofuel. The feasibility study will be completed in December, 2007 and if accepted by the mill, would lead to a contract to implement the DRY-REX® system using the THERMAL- AUD™ program through Thermal's energy services subsidiary (FEI).

On October 3, 2007, the Company announced that it had received three new initial orders for the "no fail" GEM® steam traps and an engineering contract from an existing customer involving the optimization of an older FLU-ACE® waste heat recovery system and steam system. The total value of the contracts is in excess of $125,000.

On October 29, 2007, the Company announced that it had completed its first waste heat recovery project in the U.S., valued at $1.4 M.

On November 1, 2007, the Company announced that it had received a second order for 39 GEM® steam traps at the Jiangsu Huachang Chemical Co.'s plant in China. The order was secured by Jiangnan Boilers and Pressure Vessels Company Ltd. (JBPV), in advance of completing a joint venture agreement under development between the Company and JBPV, a multi-billion dollar, national large scale chemical enterprise.

On November 20, 2007, the Company announced that it was being honoured by the Ottawa Section of the Institute of Electrical and Electronics Engineers (IEEE) with an award for its innovative technology and success in providing custom energy and emission reduction solutions.

On November 28, 2007, the Company announced that it was entering as majority owner through its wholly-owned subsidiary (Thermal Energy International (Guangzhou) Ltd.) into a joint venture with Oriental-Unicorn Sales and Marketing Co., of Guanzhou, China and E5 Enterprises LLC, of Markham, Ontario. Oriental-Unicorn was instrumental in the Company's first sale of GEM® steam traps to Lee & Man Paper Co.

On December 13, 2007, the Company announced that it had secured a five-year, $2.5 million line of credit with the Toronto-Dominion Bank to facilitate the Company's co-investment in assets such as FLU-ACE® and DRY-REX™ systems using its THERMAL-AUD Program through its wholly owned subsidiary, ForEverGreen Energy Inc. The Company's first commercial line of credit with a leading financial institution

was partially supported by guarantees by Export Development Corporation because it was deemed to contribute to export-related sales.

On January 21, 2008, the Company announced that it had closed a non-brokered private placement with gross proceeds of $999,000. The financing consisted of the issuance of 1,455,000 units, with each unit comprising one common share and one non-transferable share purchase warrant entitling the holder to acquire one additional common share at an issuance price of $0.50 per warrant any time within two years of issuance, and, 1,875,000 units, each unit comprising one "flow-through" common share. A total of 3,300,000 units were sold at the deemed price of $0.30 per share. The proceeds of the private placement will be used to support on-going sales and marketing.

On February 20, 2008, the Company announced that Natural Resources Canada (NRCan) had committed $900,000 in funding toward the development of a green energy power facility proposed for an eastern Canada pulp and paper mill. The funding will be provided under a repayable contribution agreement from NRCan's Climate Change Interim Strategy Technology Early Action Measures (TEAM) Fund to demonstrate the performance and energy efficiency improvements of a combined biomass dryer/energy recovery system in order to reduce emissions and fossil fuel use at a Canadian pulp and paper mill.

On March 4, 2008, the Company announced that it had received a new initial order for the GEM Condensate Return System from one of Canada's largest energy-related companies.

On March 6, 2008, the Company announced that it had established a DRY-REX™ test facility to handle funded research projects on drying different sources of biomass for use as biofuels. The laboratory has already received its first contract from an Italian firm to conduct drying tests on grape pressings and orange pressings. This represents one of several requests from potential customers in Europe's bioenergy sector.

On March 27, 2008, the Company announced that an alliance of international leaders in energy efficiency and energy financing will launch a new energy saving services program early next month targeting energy intensive industries in China. The consortium is led by Honeywell Building Solutions and Asia Clean Capital Limited and includes Solar Turbines Inc. and the Company. The energy savings solutions will offer state-of-the-art energy savings technologies focusing on energy recovery, steam system efficiency, co-generation and tri-generation solutions.

On April 7, 2008, the Company announced that it had entered into an agreement to acquire Bristol based Gardner Energy Management Ltd. The contemplated transaction consists of a base price of Pounds Sterling 2.7 million (approximately $5.4 million CAD) payable upon closing, and an amount of Pounds Sterling 1.3 million (approximately $2.6 million CAD) payable in a combination of cash and shares on an earn-out basis over a three year period based on the future performance of the GEM business line. The transaction is expected to close on or before July 4, 2008, subject to financing and to regulatory approvals.

On April 11, 2008, the Company gave an update on the successful launch of the new energy savings program by an alliance of international leaders in energy savings and energy financing. The launch event was attended by senior executives of major companies from the textile, pulp and paper and other energy-intensive industries as well as local and foreign government representatives and key industry associations.

On April 17, 2008, the Company announced that its new energy services subsidiary ForEverGreen Energy Inc. has commenced delivery of a "green" energy supply contract to provide Fraser Papers Inc.'s Thurso pulp mill with recovered waste heat. The green power purchase agreement is for six years and is worth up to $3.75M based on the estimated amount of heat from waste heat.

On April 23, 2008, the Company announced that it had been engaged to commence work for a major FLU-ACE® energy recovery system at a fine paper mill in the north eastern United States. The first phase of the project for the client, a multinational forest products company, is the detailed design and engineering work which serves to confirm the implementation costs and financial benefits from the energy savings generated through waste heat recovery to offset fossil fuel use. The initial study for the customer in 2007 estimated the capital investment of a FLU-ACE® energy recovery solution at approximately $3 million with a simple payback of less than 3 years.

Outlook

Statements in this discussion are forward-looking and as such, are subject to various risks and uncertainties concerning a variety of factors. Such information contained herein represents management's best judgment as of the date hereof based on the information currently available.

During Q1 of FY 2009, the Corporation has been focused equally on direct sales and cooperative sales development activities in Canada, USA and China. The majority of the Corporations' sales, marketing, and business development resources have been utilized equally in support of the Johnson Controls' cooperative energy solutions sales development activities; as well as in support of some direct sales development activities through independent sales agents in Michigan, Maine, Ontario, Quebec, British Columbia, Alberta, Mexico and China to selected industrial process facilities where existing customer relationships are already in place. This has led to the submission of several proposals currently including the Company's THERMAL-AUD™ program with clients for approval and several invitations to other client sites for submission of other proposals.

The Corporation anticipates that these initiatives will not only produce increased sales revenues and gross profit in the third quarter FY 2009 (ending February 28, 2009) but become a harbinger for continued improvement to the Consolidated Balance Sheet.

On June 3, 2008, the Corporation announced that it had entered into an agreement with a North American integrated paper company for the delivery of a green energy supply program worth in excess of $20M, using recovered waste heat at one of its facilities in the north eastern United States.

On June 23, 2008, the Corporation announced that it had closed an oversubscribed brokered private placement of common shares with gross proceeds of $15,000,000. The placement was subscribed by a number of the most recognized renewable energy and sustainability focused funds in Toronto, New York and London (U.K.), The funds raised were to complete the acquisition of Gardner Energy Management Ltd. in the U.K. (requiring approximately CAD$5.4 M) and to provide the Corporation a funding base for future investment in its product line of assets under THERMAL-AUD™ green energy supply contracts. The financing which was handled by agents Max Capital Markets Ltd. and Jacob and Company Securities Inc. (both

headquartered in Toronto) consisted of an issuance of 68,181,818 commons shares of the Corporation at a price of $0.22 per share.

On July 2, 2008, the Corporation announced that it had completed the acquisition of Gardner Energy Management Ltd. ("GEM") of Bristol, U.K. Under the terms of the transaction, the Corporation made a base payment of 2.7 M British Pounds Sterling (or CAD $5.4M) upon closing on July 1, 2008. An additional payment of up to 1.3 M British Pounds Sterling (or CAD $2.6M) may be made on an earn-out basis in a combination of cash and shares over a three-year period subject to defined future growth targets of the GEM® business unit.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements of Thermal Energy International Inc. and all the information in this annual financial report have been prepared by management, which is solely responsible for the integrity and fairness of the data presented, including the many amounts, which due to necessity, are based on estimates and judgments. The accounting policies followed in the preparation of these consolidated financial statements conform with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those that it deems most appropriate in the circumstances. Financial information presented throughout this report is consistent with that in the consolidated financial statements.

Thermal Energy International Inc. maintains systems of internal accounting and administrative controls to provide reasonable assurance that the financial information is relevant, reliable and accurate and that transactions are authorized, assets are safeguarded and proper records are maintained.

The Board of Directors is responsible for ensuring that management fulfills its responsibility principally through its Audit Committee.

Thermal Energy International Inc.'s external auditors, Raymond Chabot Grant Thornton LLP ("RCGT"), have conducted an independent audit of the consolidated financial statements in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an audit opinion. The external auditors have full and unrestricted access to the Audit Committee to discuss their audit and related findings.

Tim Angus
President & CEO

Oliver Toffoli
Chief Operating Officer & CFO