



First QUARTER REPORT Period Ended August 31, 2009

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the first quarter of fiscal year 2010, ended August 31, 2009. The quarterly financial statements constitute an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy International Inc. ("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™, 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.

Discussion of Operations and Financial Conditions

Revenue and Gross Profit

Total sales for the first quarter ended August 31, 2009 were \$1,304,936, compared with \$1,058,318 in 2008 and comprised \$1,300,880 resulting from GEM related sales.

Gross profit for the first quarter ended August 31, 2009 at \$1,014,977 (77.78%) compared with \$528,103 (49.90%) in 2008. The increase in gross profits on a comparative basis from the same period in 2008 was due to better margins on greater revenues associated with the GEM acquisition.

Expenses

Administration expenses in the first quarter ended August 31, 2009 were \$453,284, a decrease of \$74,295 or (14.08)% from the \$527,579 incurred in 2008. The decrease was mainly due to a reallocation of expenses from administration to selling, marketing and business development and cost cutting measures that the Company undertook including the reduction of staff. This was slightly offset with the addition of \$23,380 from GEM related costs.

Selling, marketing and business development expenses in the first quarter ended August 31, 2009 were \$885,664, an increase of \$364,582 or 69.96% over 2008. This



increase included \$159,000 from GEM UK and approximately \$100,000 due to new sales representatives and related expenses in North America.

Legal expenses in the first quarter ended August 31, 2009 were \$84,185, compared to \$9,585 in 2008. The increase in expenses was mainly due to legal support in responding to the TSXV review of the Company's disclosure and compliance to the TSXV Policies.

Audit fee provision in the first quarter ended August 31, 2009 was \$65,533 an increase of \$47,533, compared to \$18,000 incurred in 2008. The increase was due to changes in the accounting rules that requires reporting of the auditing expense upon receipt of the auditors invoice and not accrued as was the process followed in the past.

Insurance costs in the first quarter ended August 31, 2009 were \$37,817 an increase of \$3,569 compared to \$34,248 in 2008.

Amortization of property, plant and equipment was at \$11,613 in the first quarter ended August 31, 2009 compared with \$11,691 in 2008.

Amortization of intangible assets was \$46,625 in the first quarter ended August 31, 2009. The intangible assets were acquired with the purchase of GEM.

Patent and Trademark maintenance costs were \$4,106 in the first quarter ended August 31, 2009, compared to \$2,810 in 2008. All Patent and Trademark costs incurred by the Company are expensed as incurred.

Research and Development costs were \$19,517 in the first quarter ended August 31, 2009, compared to \$71,643 in 2008. The decrease was primarily due to a stoppage of work related to the testing of the THERMALONOX™ technology in China. The costs were mainly for the testing of biomass material pertaining to the development of potential DRY-REX projects. Only a small amount of \$3,721 was related to GEM.

Interest and bank charges were \$19,502 in the first quarter ended August 31, 2009 compared with \$30,894 in 2008. This decrease was due to the significant decline in interest rates and the lower level of bank loans.

Foreign exchange loss on monetary assets and liabilities in the first quarter ended August 31, 2009 was \$16,506 compared with a loss of \$33,312 in 2008.

Interest revenue declined to \$Nil in the quarter ended August 31, 2009, 2009 compared with \$34,021 in 2008. A lower level of short-term investments were the reason.

Finance revenue was \$61,291 in the first quarter ended August 31, 2009 from the THERMAL-AUD™ project in Quebec compared to \$85,052 in 2008.

Net Loss was \$570,530 in the first quarter ended August 31, 2009 compared to a net loss of \$616,086 in 2008. Together with the changes summarized above, insufficient sales volume to cover the current level of fixed costs in the Company to produce a net profit continued. Management continues to work hard to control overhead costs but its main focus at the present time is to leverage the sales of its proprietary technologies worldwide in a cost effective manner by continuing to develop a number of strategic alliances, cooperative partnerships, synergistic sales agencies and agreements with companies in all of its key markets.



Liquidity and Solvency

At August 31, 2009, the Company had a working capital of \$3,170,893 compared to a working capital of \$3,791,332 at May 31, 2009. Current assets of \$5,026,398 decreased by \$798,164 from May 31, 2009. Cash and short-term investments decreased by \$1,238,448, accounts receivable increased by \$560,661 and inventories declined by \$36,649. Current liabilities at \$1,855,505 decreased by \$177,725 from May 31, 2009. The major changes were an increase in deferred revenue of \$149,299, a decrease in accounts payable of \$48,874, a decrease in accrued liabilities of \$145,881 and a decrease in bank loan of \$132,269. The GEM acquisition contributed approximately \$700,000 to working capital.

Management continues to recognize the requirement to maintain 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.

Management's discussions which began in the fourth quarter of FY 2008 to structure a multi-million dollar financing of its new Business Plan involving the acquisition of GEM Ltd., of Bristol, U.K., culminated with the successful completion of a brokered private placement with gross proceeds of \$15,000,000 in the first quarter of fiscal year 2009. The proceeds raised were used for completing the acquisition of GEM, to expand sales and marketing efforts in North America, Europe and China.

Related Party Transactions

In the quarter ended August 31, 2009, Directors fees for services were \$15,750 compared with \$15,750 in 2008. Officers' fees for services were \$33,000 compared with \$33,000. Loans to exercise options and acquire shares by Directors including accrued interest were \$385,849 at August 31, 2009 (2008, \$289,647). Loans to Officers to exercise options and acquire shares including accrued interest were \$187,255 at August 31, 2009 (2008, \$172,800). The shares acquired by exercising options will be held as security by the Company until the loans are repaid.

Management Compensation Disclosure

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Compensation paid to directors and officers was as follows:

Three months ended August 31	Salaries and fees		Commissions		Total	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
<u>Directors</u>						
T. Angus	32,452	43,500	-	-	32,452	43,500
J. Parker	6,375	6,375	-	-	6,375	6,375
M. Williams	1,875	1,875	-	-	1,875	1,875
C. Sharples	1,875	1,875	-	-	1,875	1,875
J. Ansell	1,875	1,875	-	-	1,875	1,875
J. Kelly	1,875	1,875	-	-	1,875	1,875
W. Crossland	16,875	51,875	-	-	16,875	51,875
Total	63,202	109,250	-	-	63,202	109,250



Officers

O. Toffoli	33,000	33,000	-	-	33,000	33,000
A. Pugliese	-	43,000	-	-	-	43,000
G. Pliva	-	13,250	-	-	-	13,250
Total	33,000	89,250	-	-	33,000	89,250

SEGMENTED INFORMATION

In the quarters ended August 31, 2009 and 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe 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 three retrofit technology lines – waste energy recovery solutions, air emission control solutions and condensate return system solutions. Assets are located in Canada and Europe.

The Company operates in three reportable segments. In the waste energy recovery and air emission control business, customers finance these projects entirely from their own resources or through the Company's Thermal-AUD™ system whereby the Company finances the project and leases back the facility to the customer. This gives rise to two reportable segments. The third segment is in the condensate return system solutions business through its subsidiary Gardner Energy Management Limited (GEM™). These three reportable segments are detailed below:

	Customer financed contracts and other		Thermal-AUD™ contract		GEM™	
	Quarter ended Aug 31 2009	2008	Quarter ended Aug 31 2009	2008	Quarter ended Aug 31 2009	2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	4,057	501,824	-	-	1,300,880	556,494
Inter-segment revenues	28,667	28,667	-	-	83,447	2,400
Segment loss (profit)	636,429	650,368	(33,427)	(42,626)	(55,606)	8,344
Total assets	4,789,505	7,791,800	2,065,291	2,182,011	6,741,575	6,874,013
			Quarter ended Aug 31, 2009		Quarter ended August 31, 2008	
Reconciliation of loss to financial statements			\$		\$	
Total loss for reported segments			570,530		616,086	
Net loss			570,530		616,086	

The following table shows selected consolidated financial data for the most recent eight quarters. The quarterly information has been prepared on the same basis as the consolidated financial statements.

Quarterly financial information (unaudited)
For the eight quarters ended August 31, 2009



	2008			2009				2010
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Sales	618,200	509,074	2,750,577	1,058,318	1,140,563	682,341	1,077,700	1,304,936
Net loss	863,431	569,794	521,388	616,086	834,331	1,181,735	544,125	570,530
Net loss per Share basic And diluted	0.009	0.006	0.005	0.004	0.005	0.007	0.003	0.003

Trend Analysis:

The losses in Q2 FY 2008 increased to \$863,431 partly due to lower recognized revenues from sales. The Company's work at Fraser Papers Canada (FPS's) Thurso mill could not be recognized until the construction asset was complete and generating revenue from monthly billings to FPS.

The losses in Q3 FY 2008 decreased to \$569,794 despite a further reduction in revenue. This was partly due to an entry for the future income tax recovery of \$200,000 in 2008. The Company's work at FPS's Thurso mill was completed on time and although not impacting the third quarter, began generating revenue in the fourth quarter with the first monthly billing to FPS on March 31, 2008.

The losses in Q4 FY 2008 were fairly consistent with the previous quarter despite a significant increase in recognized revenues from sales, due mainly to slightly increased costs and the absence of a future income tax recovery. .

The losses in Q1 FY 2009 increased to \$616,086. Gross margins were much improved but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures for equipment related to testing the THERMALONox® technology. Expenses were impacted on a comparative basis by the acquisition of GEM.

The losses in Q2 FY 2009 increased to \$834,331. Gross margins were improved from the previous quarter but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures related to testing the THERMALONox® technology in China. Expenses were impacted to a greater degree from the first quarter on a comparative basis by the acquisition of GEM.

The losses in Q3 FY 2009 increased to \$1,181,735 due to a significant reduction in revenues from the previous two quarters and increase in the areas of administration and sales and marketing.

The losses in Q4 FY 2009 and Q1 FY 2010 decreased to \$544,125 and \$570,530 respectively due to improved revenues.

All the above clearly demonstrate the need to significantly increase sales to cover and exceed the amount of fixed costs in order to overcome the consistent pattern of losses.



Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide assurance that all relevant information is gathered and reported to senior management, including the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), on a timely basis so that appropriate decisions can be made regarding public disclosure. Management of the Company, with the participation of the CEO and the CFO, has evaluated the effectiveness of the Company's disclosure controls and procedures as at August 31, 2009 as required by Canadian securities laws. Based on that evaluation, the CEO and CFO have concluded that, as of August 31, 2009, the disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the Company's interim filings (as such terms are defined under National Instrument 52-109 Certification of Disclosure in Issuer's Annual and Interim Filings) and other reports filed or submitted under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified by those laws and that material information is accumulated and communicated to management of the Company, including the CEO and CFO, as appropriate to allow for accurate disclosure to be made on a timely basis.

Changes in Internal Control over Financial Reporting

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. The CEO and CFO have concluded that there has been no change in the Company's internal control over financial reporting at August 31, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company has recognized the need to improve internal control by a better segregation of duties in the accounting and finance area. An Administrative assistant/accounting clerk has been added to relieve the current accountant of bookkeeping duties and enable the Company to devote more resources to the controllership function.

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 for the quarter ended August 31, 2009, these statements were not subject to an audit or a review 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 FLU-ACE® Dry-Rex™ and



GEM technology solutions. In addition, the Company has not yet been able to finance and complete the development and commercialization of its patented THERMALONOX™ technology.

The Cost Effective Energy Conservation and Environmental Compliance Solutions sales through the close working relationship with partner companies Johnson Controls (JCI) and Honeywell China has not limited the size of the market but has actually increased the market potential.

Financial risks and uncertainties of the Company include:

- The Company's history of operating losses and uncertainty of future profitability;
- The ability to continue to grow sales by maintaining its close working relationship with JCI and Honeywell China;
- The ability to grow sales through the establishment of new cooperative partnerships and strategic alliances;
- 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;
- The ability to control costs and achieve a positive gross margin on projects; and
- The effect of a prolonged recession in Canada, USA and Europe to the financial markets in securing project financing and in particular to industrial and commercial customers in committing capital to projects.
- The effect of a temporary or permanent plant shutdown at Fraser Paper Inc.'s Thurso plant.

Management's addressing of the risks:

The management of the Company realizes that the operating losses of the period ended August 31, 2009, display a consistent pattern of losses as in previous years. However with the previous fiscal year's losses partly attributed to new management transition costs and to remedial costs on past projects, the Company is now fully focused on sales and marketing and is expanding its drive towards that purpose with the addition of a number of sales staff, sales agents, strategic alliances and cooperative partnerships to promote the Company's solutions in the United States, Canada, Europe and China.

The costs in the first quarter associated with administration and sales, marketing and business development were necessary to advance the sales cycle forward which will become evident in future quarters.

Management believes that it can leverage off of its wholly-owned subsidiary's (ForEverGreen Energy Inc.) successful signing of an agreement of up to \$3.75M with Fraser Paper Inc. to recover waste heat using the THERMAL-AUD™ program and use the same process in other mills.

Management is presently in late discussions with several large companies that it believes will result in the signing of new cooperative partnership agreements that could help to grow



its sales and possibly lead to licensing agreements after successful trials of the Company's technologies.

Management is also increasing focus on key institutional markets which are anticipated to receive significant investment from the federal governments both in the US and Canada. This includes a focus on hospitals, universities and government facilities. In line with the strategy, the Company is focused on leveraging the current relationship with JCI and building new relationships with other Energy Service Companies which are expected to benefit greatly in the US by the new administration's spending plans and loan guarantees to increase energy efficiency of institutional facilities.

Management has demonstrated that it can secure outside working capital as evidenced by the successful closings of its private placement with gross proceeds of \$778,639, in Q3 FY 2007, with gross proceeds of \$1,968,500 in Q4 FY 2007 and with gross proceeds of \$1,017,750 in Q3 FY 2008. In addition, during this period, it has realized \$200,000 through the closing of smaller private placements and the exercise of options and warrants. Finally, in Q1 FY 2009, management closed an oversubscribed brokered private placement of common shares with gross proceeds of \$15,000,000.

Management believes that by maintaining its small core of personnel, reducing non-essential employee costs and miscellaneous overhead and achieving higher margins on more secured contracts, it will achieve profitable operations. Small incremental staffing increases will be introduced from time to time as evidenced in FY 2009 depending on the demand arising from increased sales volumes, however management has also been aggressively implementing measures to reduce total SG&A costs as evidenced by the reduction of five (5) employees in Q3 and Q4 FY 2009 due to deteriorating economic conditions.

Management has acquired GEM®, a leading European (Great Britain) line of industrial/commercial steam traps; and DRY-REX™, a technology that uses waste heat to turn bark, sludge and other biomass into high-efficiency bio-energy fuel for the pulp & paper and other industrial applications. In connection with these technologies, the Company has received multiple purchase orders from Dow Corning in Kentucky, Hemlock Semiconductor Corporation in Michigan, Anheuser-Busch, Inc. in Colorado, GlaxoSmithKline in North Carolina, Greenfield Ethanol in Chatham, Ontario, Alberta Envirofuels Inc., Rogers Sugar in B.C., CFB Kingston, CFB Trenton, Fraser Papers at Thurso, Catalyst Paper in B.C., Lee & Man Paper Manufacturing Co. and Jiangsu Huachang Chemical Co., Coca Cola, BASF, all located in China, and has conducted audits for its implementation at other industrial sites and awaits new trial orders.

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.

The Company maintains adequate forms of general liability insurance including product liability and errors and omission coverage.

Management believes that competition against its core technology of FLU-ACE™ and DRY-REX® is limited at this time and believes that the market place is sufficiently large enough to permit stronger competition in the future. Management also believes that while there is greater competition to its newly acquired GEM® product line, the Company is well positioned to penetrate the market with a far superior product. It is the opinion of management 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.

The Company is adequately protected in its contract with Fraser Paper Inc. for payments arising from a temporary shutdown of the mill on an established per diem rate. If the temporary shutdown becomes a permanent shutdown, Fraser Paper is obligated to pay a lump sum payment and the Company is required to remove the equipment within six months of such notification. However, the Company has no control or ability to recoup any receivables in the event of a declared bankruptcy by Fraser Papers Inc.

Highlights

On June 8, 2009, the Corporation announced that it had concluded an agreement with Kemco Systems Inc. (Kemco) of Clearwater, Florida to become the exclusive distributor of Kemco products in all areas globally except in North and South America. Kemco is a recognized leader in providing high efficiency, environmentally friendly water heaters, heat recovery, and water treatment systems that guarantee performance to save water, labor, energy, sewer and chemical costs.

On June 9, 2009, the Corporation announced new GEM Condensate Return System Contracts in the Middle East and China. One order in the amount of CAD\$450,000 was with the Kuwait National Petroleum Corp as part of a conversion to GEM trap technology. The other two orders totalling approximately CAD\$200,000 were with a European based global pharmaceutical corporation in two of its plants in North East China.

On July 22, 2009, the Corporation announced that it had received its first order under the recently announced Kemco exclusive distributorship deal for an amount of British Pound Sterling (GBP) 215,000 (approximately CAD\$393,000) from a hospital located in Belfast, Northern Ireland to install a condensing heat recovery system which will capture and recycle heat from the hospital's boilers.

On August 7, 2009, the Corporation provided an update on the halt trading status of its securities. The Corporation's securities were halt traded by the TSX Venture Exchange on July 22, 2009, pending clarification of its affairs.

On August 7, 2009, the Corporation announced that Tim Angus resigned his position as President and CEO and from the Corporation's board of directors for personal reasons. William Crossland, a board member of the Corporation was appointed as President and CEO to fill the vacancy left by Mr. Angus' resignation. Mr. Angus committed to work with Mr. Crossland to ensure an orderly transition and to continue to assist the Corporation with a number of sales initiatives and strategic priorities going forward.

On August 21, 2009, the Corporation announced that Clint Sharples resigned from the Corporation's board of directors in order to pursue other business opportunities.

Outlook

On September 15, 2009, the Corporation announced Board of Director and Officer changes. John Parker resigned as Chairman of the Board and Director of the Corporation to focus greater attention on his numerous other business interests. John Kelly, a sitting member of the Board was appointed Chairman of the Board. Oliver Toffoli resigned as Chief Financial



Officer but will remain working for the Corporation in areas of operations and project management. Michael Williams, a sitting member of the Board has assumed the role of Chief Financial Officer on an interim basis until such time as a permanent replacement can be appointed.

On October 13, 2009, the Corporation announced that its shares would resume trading on the TSX Venture Exchange (Exchange) effective October 15, 2009. It also noted that the Exchange's review of the Corporation's affairs remained ongoing and that the Corporation continues to work with the Exchange.

Signed in Ottawa, Ontario on this 29th day of October, 2009.

A handwritten signature in blue ink, appearing to read "W Crossland".

William Crossland
President and CEO

A handwritten signature in blue ink, appearing to read "Michael H. Williams".

Michael Williams
Chief Financial Officer