



SECOND QUARTER REPORT
Period Ended November 30, 2006

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the second quarter of fiscal year 2007, ended November 30, 2006. The Quarterly Report constitutes an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy has established itself since 1987 as a leading provider of cost-effective energy conservation and environmental compliance (air) products and solutions. Thermal Energy is providing its integrated turnkey solutions for customers to economically reduce multiple air pollutant emissions while deriving substantial energy savings benefits through advanced heat recycling. Thermal Energy's innovative abilities and unique technologies have ensured that the implemented solutions met or exceeded the air pollution control performance expectations, while at the same time generated sufficient renewable energy and operating cost savings to produce an attractive return on investment ("ROI"), thereby causing the solution to be self-financing.

Thermal Energy has developed cost-effective energy conservation and air compliance solutions for efficiently removing and reducing multiple air pollutant emissions including: Nitrogen Oxides (NOx) "Smog", Sulfur Oxides (SOx) "Acid Rain", Carbon Dioxide (CO2) "Greenhouse Gas", Fine Particulate Matter (PM2.5) "Lung Irritants", Heavy Metals (HM) including Mercury (Hg) "Carcinogenic Bio-accumulators", Toxic Organic Compounds (TOC) "Poisonous", and Volatile Organic Compounds (VOC) "Odorous or Toxic".

More information on Thermal Energy can be found at www.thermalenergy.com. FLU-ACE®, THERMALONOX™, THERMALOZOMAX™ and DRY-REX™ are registered 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 second quarter ended November 30, 2006 at \$127,987 decreased substantially from \$807,364 in 2005. The decrease in revenues from the previous year was due to a lack of new booked contracts and reflected small residual revenues from completed feasibility studies.

Gross profit (loss) for the second quarter ended November 30, 2006 at \$(38,354) (-29.97%) compared with \$(319,132) (-39.53%) in 2005. While this loss is significantly lower on a comparative basis from the same period in 2005 it was as a



result of small residual costs that were previously underestimated to complete the Minas Basin, Stratford General Hospital, Camco, and CHUQ projects.

Expenses

Administration expenses in the second quarter ended November 30, 2006 were \$316,177 a significant increase of \$169,297 or 115.26% over the \$146,880 incurred in 2005. The main contributing factor to the increase is a one time charge to retire a previous shareholder loan of \$151,500 made to the past President to purchase shares in 1999.

Selling, marketing and business development expenses in the second quarter ended November 30, 2006 were \$259,696 an increase of \$66,498 or 34.42% over \$193,198 in 2005. \$40,000 of the increase was the value of shares issued to Mabarex Inc. as initial payment for the Mabarex rights to their patented DRY-REX™ product.

Legal expenses in the second quarter ended November 30, 2006 were \$(10,603) a decrease over the \$39,950 incurred in 2005. The main contributing factor to the decrease arose from a reversal of a provision for legal costs of \$20,000 following settlement of a claim with Honeywell on a zero cost basis.

Audit fee expenses in the second quarter ended November 30, 2006 were \$15,000, a decrease of \$5,147 or 25.55% from the \$20,147 incurred in 2005.

Insurance costs have been reduced at \$19,827 in the second quarter ended November 30, 2006 compared to \$21,716 in 2005.

Amortization of property, plant and equipment at \$6,335 in the second quarter ended November 30, 2006 compared with \$4,440 in 2005 due primarily to the amortization of leasehold improvements associated with a new office lease and the acquisition of research and development test equipment.

Patent and Trademark maintenance costs were \$3,203 in the second quarter ended November 30, 2006 compared to \$581 in 2005 with respect to countries where patents have been granted. All Patent and Trademark costs incurred by the Company are expensed as incurred. The increase in costs from the previous year was due to new trademark filing charges in Canada and the U.S. for THERMALONox™, OPTINOX™ and THERMALOZOMAX™.

Research and Development costs were \$22,705 in the second quarter ended November 30, 2006 compared to \$22,658 in 2005. The similar results demonstrate the continued laboratory testing following the Company's decision to resume work in developing its patented THERMALONox™ technology through laboratory testing.

Interest and bank charges at \$1,728 in the second quarter ended November 30, 2006 compared with \$3,969 in 2005.

Foreign exchange loss on US dollar transactions in the second quarter ended November 30, 2006 of \$792 compared \$9,121 in 2005.



Other revenue was \$5,240 in the second quarter ended November 30, 2006 and arose from the settlement with Honeywell. This compared with \$32,380 in the second quarter ended November 30, 2005 which resulted from the extinguishment of a liability.

Interest revenue amounted to \$141 in the second quarter ended November 30, 2006 compared with \$4,527 in 2005 which included interest from short term investments.

Other Costs were \$21,317 in the second quarter ended November 30, 2006 compared to \$263,784 in 2005. These were additional and final costs to those incurred in the prior fiscal year to remedy the design deficiencies at the Valley Regional Hospital. Remedies are being sought through the courts to recover some or all of these costs. However the Company considered it prudent to expense them at this time.

Net Loss was \$689,150 in the second quarter ended November 30, 2006 compared to a net loss of \$1,008,669 in 2005. Contributing factors resulting in the loss in 2006 were the one time charge in the amount of \$151,500 to retire the previous loan made to the past President, the initial payment of \$40,000 for the Mabarex rights to their patented DRY-REX™ product and insufficient sales volume to cover the current level of fixed costs in the Company and 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. This is discussed more fully elsewhere in this report.

Liquidity and Solvency

At November 30, 2006, the Company had a working capital deficiency of \$906,410 compared to a deficiency of \$414,337 at May 31, 2006. Current assets at \$95,486 declined by \$720,905 from May 31, 2006 caused mainly by a fall in accounts receivable of \$585,128 due to low sales volume. Contracts in progress of \$89,000 at May 31, 2006 were invoiced and collected and there was a decrease in cash of \$35,064. Current liabilities at \$1,001,896 decreased by \$228,832 from May 31, 2006 caused mainly by a reduction in accounts payable of \$179,280. A reduction of \$55,000 in deferred revenue also contributed to the overall decrease in current liabilities.

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.

Additionally the Company is actively exploring opportunities to structure a multi-million dollar financing arrangement. Partial funding has already been secured with the closing of a non-brokered private placement on December 29, 2006 with gross proceeds of \$778,639. The proceeds raised would be used for expanded sales and marketing efforts and R&D activities with THERMALONox™.

Related Party Transactions

In the quarter ended November 30, 2006, officers were paid fees for services of \$48,000. This compared with \$46,500 in the second quarter ended November 30,



2005. In the second quarter ended November 30, 2006 a total of 204,956 flow-through shares were issued from which 61,875 shares were issued to a director and 143,081 shares were issued to officers.

Supplementary Financial Information

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 November 30, 2006

	2005		2006				2007	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Sales	35,604	252,211	382,180	807,364	655,010	1,000,787	102,659	127,987
Net loss	(527,001)	(434,242)	(380,611)	(1,008,669)	(402,164)	(425,289)	(512,011)	(689,150)
Net loss per Share basic And diluted	(0.01)	(0.01)	(0.01)	(0.02)	(0.00)	0.00)	(0.01)	(0.01)

Trend Analysis:

The losses incurred in each quarter from Q3 FY 2005 through to Q2 FY 2007 are consistent in magnitude with exception of Q3 FY 2005, Q2 FY 2006, Q1 FY 2007 and Q2 FY 2007.

The losses in Q2 FY 2006 increased to \$1,008,669 from \$380,611 in Q1 FY 2006 and \$402,164 in Q3 FY 2006 due to operational losses of \$549,009 on the Camco, Valley Regional Hospital and Stratford General Hospital projects.

The losses in Q1 FY 2007 increased to \$512,011 from \$425,289 in Q4 FY 2006 due to additional operational costs to complete the Minas Basin and Stratford General Hospital projects.

The losses in Q2 FY 2007 increased to \$689,150 from \$512,011 in Q1 FY 2007 due to a one time charge to retire a previous shareholder loan of \$151,500 made to the past President to purchase shares in 1999 and due to the initial payment of \$40,000 for the Mabarex rights to their patented DRY-REX™ product.

Without the exceptions noted above, the net losses remained in a fairly constant range throughout the eight quarters summarized from Q3 FY 2005 through Q2 FY 2007, demonstrating the need to significantly increase sales to cover and exceed the amount of fixed costs in order to overcome the consistent pattern of losses.

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 and year to date ended November 30, 2006, these statements were not 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 standard, hybrid, and multi-air pollutant FLU-ACE® 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 THERMALONOX™ patented technology is yet to be tested and the Company will be seeking potential partners and investors to sponsor the costs associated with the implementation of a THERMALONOX™ demonstration pilot project. This will occur upon the successful completion of new, ongoing and promising laboratory testing. Cost Effective Energy Conservation and Environmental Compliance Solutions Sales through the Johnson Controls L.P. ("JCLP") cooperation has not limited the size of the market but has 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 through the existing JCLP cooperation agreement;
- 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 Company'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 and;
- The ongoing litigation with its former President & CEO.

Management's addressing of the risks:

The management of the Company realizes that the operating losses of the period ended November 30, 2006, 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 behind it, the Company is now fully focused on sales and marketing and is expanding its drive towards that purpose with the addition of new regional sales associates in Canada, the U.S. and Mexico and the possible addition of new internal sales professionals.

The costs in the second 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 continue to grow sales through the existing JCLP cooperation agreement as evidenced by the recent award of a feasibility study for one of its clients in the U.S. In addition there are numerous projects that it is jointly pursuing with JCLP both in Canada and the U.S and abroad.

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.

The new Management has demonstrated that it can secure outside working capital as evidenced by the successful closings of its Private Placement with gross proceeds of \$1,000,100 in Q4 FY 2005, with gross proceeds of \$734,900 in Q3 FY 2006 and with gross proceeds of \$778,639, in Q3 FY 2007. In addition it has realized in excess of \$600,000 in the same period of time through the closing of smaller private placements and the exercise of options and warrants.

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 recently acquired new licenses and distributorship rights to GEM®, a leading European (Great Britain) line of industrial/commercial steam traps; THERMALOZOMax™, an ozone generation technology 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. Recently, the Company has received its first purchase order for a trial of the GEM® at the site of one the "Big Three" Automakers in Detroit, Michigan and has conducted audits for its implementation at other industrial sites and awaits new trial orders. The Company is presently working through its JCLP alliance and has provided proposals to implement its THERMALOZOMax™ technology at several of JCLP's clients in the hospitality industry. It has scheduled a pilot demonstration at one site in Q3 2007.

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 technology of FLU-ACE™ 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 July 10, 2006 the Company announced that it had significantly expanded its sales capacity with the appointments of six experienced representatives from North to South America.

On September 7, 2006 the Company announced that together with Johnson Controls it had commenced the initial phase of a heat recovery/energy cost reduction project in the US for one of the world's largest producers of consumer foods.

On September 11, 2006 the Company announced that it had acquired the sole and exclusive worldwide license to the award winning Dry-Rex™ system from Mabarex Inc., of Montreal, Quebec. The terms of the deal also include the transfer of all intellectual property rights to the patented Dry-Rex™ technology on an earn-out basis over five years. The value of the acquisition over time is \$3,250,000 and includes an initial sum of \$80,000 in the form of an issuance of 500,000 common shares of the Company at a deemed price of \$0.16 per share. Dry-Rex™ uses waste heat to turn bark, sludge and other biomass into high-efficiency bio-energy fuel for pulp mills and other industrial applications.

Subsequent Events

On December 1, 2006 the Company announced that it would be implementing a heat recovery/energy cost reduction project in the U.S. in the food and beverage sector for an estimated value in excess of \$1.4 million.

On December 29, 2006 the Company announced that it had closed a non-brokered private placement with gross proceeds of \$778,639. The financing consisted of the issuance of 4,866,495 share units at a deemed price of \$0.16 per share. Insiders participating in the private placement subscribed for a total of 874,334 share units resulting in proceeds of \$139,893.

On December 29, 2006 the Company announced that it issued 3,500,000 stock options to certain directors, officers, employees and consultants to acquire common shares of the Company at a deemed price of \$0.16 per share and up to three years from the date of grant. 2,500,000 of these options will be earned on a performance basis.

Signed in Ottawa, Ontario on this 29th day of January, 2007.

A handwritten signature in black ink that reads "Tim Angus".

Tim K. Angus
President and CEO

A handwritten signature in black ink that reads "Oliver Toffoli".

Oliver Toffoli, P.Eng
General Manager & CFO