

MANAGEMENT'S DISCUSSION & ANALYSIS – 2007

Overview

This discussion explains the material changes in the Company's financial condition and results of operations for the fiscal year ended May 31, 2007 (or FY 2007), and compares the FY 2007 financial results to the previous year ended May 31, 2006 (or FY 2006). 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 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.

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. The Corporation has two main product lines, the first of which is the proven FLU-ACE® condensing reactive exhaust gas scrubbing technology, and the second is the patent pending THERMALONox™ technology under development to reduce nitrogen oxide emissions for coal-fired utilities and heavy industry. Hybrid Multi-Air Pollutant FLU-ACE® is the only known multi-air pollutant removal system on the market to effectively combine efficient energy recovery with air pollution control into one easy solution. The unique benefits of combined energy savings and air pollution control give the FLU-ACE® family of products and integrated systems solutions a large competitive advantage in the marketplace. More information may be found on the Corporation's products, technologies and solutions by visiting the website at www.thermalenergy.com.

Throughout FY 2007 the Corporation maintained its strategic cooperation agreement with Johnson Controls L.P. ("JCLP") for developing combined energy conservation and air pollution control solutions for their selected Canadian and U.S. customers. However, although JCLP accounted for nearly all of the sales in FY 2004, FY 2005, FY 2006 and FY 2007, 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 signing of a Memorandum of Understanding in Q1 FY 2008 to develop a joint venture with the Jiangnan Boilers and Pressure Vessels Company, Ltd. (JBPV), to deploy the Corporation'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. As a result, management is confident that the Corporation would continue in the absence of contracts with JCLP

During the past year, the Corporation completed the implementation of its second Hybrid FLU-ACE® solution for JCLP at the Minas Basin Pulp and Power Co.'s facility in Nova Scotia, Canada. In addition it was successful in signing and starting work on two heat recovery projects for JCLP's US-based clients, (the first such contracts in the U.S.). The first involved the implementation of a heat 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. The second commercial contract in the U.S. market is 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. The Corporation also successfully completed the engineering design and supply of its FLU-ACE® Condensing Heat Recovery Major Equipment Package at Mere-Enfant for the Centre Hospitalier Universitaire de Quebec and later successfully commissioned and started up the system in the first quarter FY 2008. Late in the year the Corporation received a purchase order valued at approximately \$250,000 to install its newly acquired energy saving, GEM® condensate return technology at a Global 500 company's facility in the U.S.

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 2007, the Corporation cooperated with JCLP to develop and propose many industrial and institutional Standard and Hybrid 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 only \$821,024 in sales during FY 2007, it secured approximately \$3.9 million with approximately \$3 million in carry-forward revenues. However, the potential sales pipeline of qualified bids significantly increased to an amount in excess of \$70,000,000 and these will carry-over to FY 2008.

The Thermal Energy and JCLP cooperative mission statement can be summarized as follows: to increase sales through existing (JCLP) 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.

During FY 2007 the Corporation remained committed to the future product development and commercialization of the patented THERMALONOX™ technology with the filing of a patent on new technology at the core of its THERMALONOX™ solution. Over the past year, the Corporation's chief scientist, Dr. Raymond Belanger, has conducted numerous 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, to jointly research and develop industrial applications for the Company's THERMALONOX™ 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.

The total value of the 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 five (5) non-brokered private placements. The first closed on December 29, 2006 for gross proceeds of \$778,638. The financing consisted of an issuance of 1,862,162 Units at \$0.16 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 one year of issuance at a price of \$0.30 per share. It also consisted of an issuance of 3,004,334 flow-through shares at a deemed price of \$0.16 per share. The second placement closed on March 31, 2007 and consisted in the issuance of 1,350,000 common shares at a deemed price of \$0.14 per share for gross proceeds of \$189,000. The third private placement closed on April 27, 2007 with the issuance of 4,100,000 shares of the Corporation at the deemed price of \$0.16 per share with gross proceeds of \$656,000. The fourth private placement with gross proceeds of \$1,000,000 closed on May 16, 2007 with the issuance of 4,166,666 Units, each unit comprising one common share of the Corporation at the deemed priced of \$0.24 per share and one warrant to purchase a common share at the deemed price of \$0.40 per share for a period of up to 2 years. And finally the fifth private placement with gross proceeds of \$312,500 closed on May 25, 2007 with the issuance of 1,250,000 Units, each unit comprising one common share of the Corporation at the deemed priced of \$0.25 per share and one warrant to purchase a common share at the deemed price of \$0.40 per share for a period of up to 2 years.

The Corporation incurred a net loss during the year of \$2,443,265 compared to \$2,216,733 during the previous year and has an accumulated deficit at year-end of \$18,714,074. The Company's ability to continue as a going concern has improved by obtaining an appropriate level of financing and will continue to improve by achieving or exceeding targeted gross margins as was the case in the recently completed work at Minas Basin Pulp and Power Co. 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 2008 and early part of FY 2009. Together this will satisfy the planned expansion of its R&D work on its new THERMALONox™ technology solution and significantly expand sales and marketing throughout North America and China.

Revenues and Gross Profits

Revenues were \$821,024 in FY 2007 compared to \$2,845,341 in FY 2006. Revenues decreased significantly in FY 2007 compared to FY 2006 due primarily to a three to four month delay encountered in signing its first two US contracts. As a result approximately 50% of \$1,000,000 of revenue received but yet unearned has been deferred to the first quarter of FY 2008.

The gross loss of \$53,491 in FY 2007 decreased from a gross loss of \$126,815 in FY 2006. These results expressed as a percentage of sales were (6.51%) in FY 2007 compared with (4.45%) in FY 2006. The lower gross loss in FY 2007 compared to the gross loss in FY 2006 was due to a combination of reduced cost over-runs and warranty related costs incurred compared to the previous year's costs incurred to remedy the design deficiencies at the Valley Regional Hospital and at the Stratford General Hospital as well as the cost over-runs at the Camco project.

Expenses

Administration expenses in FY 2007 were \$880,331 compared with \$841,737 in FY 2006. The increase in costs was due to additional services required to meet the demands of the increased business activity of the Company.

Selling, marketing and business development expenses were \$1,266,359 in FY 2007 which increased significantly compared to \$883,461 in FY 2006 due mainly to increases in salaries of \$78,980, commissions of \$83,820, stock-based compensation of \$150,904 and travel, living, auto expenses of \$57,504 for a total of \$371,208.

Legal expenses in FY 2007 were \$18,850, a significant decrease compared to the amount of \$155,950 incurred in FY 2006. The decrease arose from the relative inactivity, changes and prosecutorial delays by the past President and CEO in his litigation against the Company.

Audit expenses in FY 2007 were \$77,500 compared to \$68,797 in FY 2006. The increase in fees arose due to increase costs of providing assurances services, a cost of living increase and reflects the complex transactions with shareholders and employees, including the use of non-monetary compensation such as stock options and other financial instruments.

Insurance expenses decreased slightly to \$78,498 in FY 2007 compared with \$82,166 in FY 2006 due to a reduction in premiums.

Patent and trademark maintenance costs were \$23,715 in FY 2007 compared to \$16,059 in FY 2006 with respect to countries where patents have been granted. Patent and trademark maintenance costs are expensed as incurred. The increase in costs year over year was due the Company's filing of the final patent application of its THERMALONOX™ technology in the last quarter of FY 2007.

Research and Development costs increased slightly in FY 2007 to \$99,875 compared to \$89,880 in FY 2006 and resulted from increased labour charges.

Amortization of property, plant and equipment was \$24,828 in FY 2007 compared to \$18,518 in FY 2006. 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.

Other revenues

Other revenue was \$5,240 in FY 2007 resulting from a gain on the extinguishment of a liability and compared with \$290,214 in FY 2006 which was due primarily to an adjustment to the past President's account.

Other costs

Other costs were \$36,001 in FY 2007 compared to \$310,096 in FY 2006. These were the final additional costs incurred to remedy a design deficiency for the Valley Regional Hospital project and were summarily classified to monitor against a potential insurance recovery claim.

Net Loss

Net Loss was \$2,443,265 in FY 2007 compared to a net loss of \$2,216,733 in FY 2006. Contributing factors resulting in the greater loss in 2007 were the cost overruns at the Centre Hospitalier Universitaire de Quebec and Minas Basin and warranty related costs at Minas Basin and Camco, increased selling, marketing and business development costs, delays in the award of two U.S. contracts which deferred the recognition of \$1,000,000 of revenue into FY 2008 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 of \$559,350 at the end of FY 2007 increased significantly compared to the working capital deficiency of \$414,337 at the end of FY 2006. Current assets increased by \$1,247,160 to \$2,063,551. The major changes were a decrease in accounts receivable of \$197,914 more than offset by an increase of \$490,077 in cash and \$1,020,880 in short term investments. Current liabilities increased by \$273,473 to \$1,504,201. The changes were a decrease in accounts payable of \$618,881 and accrued liabilities of \$8,646 and offset by an increase in deferred revenue of \$901,000. Other cash requirements in FY 2007 were met by the issue of common shares with a value of \$2,840,846 primarily from private placements. This was in excess of current requirements and \$1,020,880 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 five (5) non-brokered private placements in the third and fourth quarters of FY 2007 with gross proceeds of \$2,936,138. All this had been preceded with the completion of a non-brokered private placement in the fourth quarter of FY 2006 with gross proceeds of \$734,900.

Additionally the Company is actively exploring opportunities to further structure a multi-million dollar financing of its new Business Plan. The proceeds raised would be used for expanded sales and marketing efforts, strategic acquisitions and R&D activities with THERMALONOX™.

Related Party Transactions

In FY 2007 Directors were paid fees for services of \$18,750, officers were paid \$192,000. Additionally, the Chairman was paid a fee of \$18,000 for consulting services.

In addition, 3,233,000 common share options issued to Directors became exercisable, 1,434,000 common share options issued to officers became exercisable.

Loans in the amount of \$54,469 in the form of advances against pending sales commissions (\$46,969 from the President and \$7,500 from an Officer) were outstanding at May 31, 2007.

Supplementary Financial Information

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

	2005 \$	2006 \$	2007 \$
Sales	668,204	2,845,341	821,024
Net loss	(1,421,589)	(2,216,733)	(2,443,265)
Net loss per share – basic and diluted	(0.026)	(0.033)	(0.031)
Total assets	1,314,129	931,430	2,131,163

Trend Analysis:

The earned revenue from sales in FY 2005, FY 2006 and FY 2007 are inconsistent in magnitude. The increased sales funnel and resultant earned revenue from sales in FY 2006 increased due to the efforts of a new and more vigorous sales team which accompanied the newly placed management team in the Company. 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 increased from those reported in FY 2005 due to a decrease in gross profits from 27.34% in FY 2005 to (4.45%) in FY 2006 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.

The variations in assets from FY 2005 through to FY 2007 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 \$2,936,138 in FY 2007.

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, 2007, 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 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 JCLP cooperation 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 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 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 and;
- The ongoing litigation with its former President & CEO.

Management's addressing of the risks:

The management of the Company realizes that the increased operating losses in FY 2007, while displaying a consistent pattern of losses as in previous years were primarily due to the unexpected delays in the awarding of two projects and their revenue streams to offset some of the Company's fixed and variable costs. In short,

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 Q1 FY 2008 to fully focus on sales and marketing, the Company believes that it will be more productive in future quarters in its pursuit and closing of sales opportunities.

Management believes that it can continue to grow sales through the existing JCLP cooperation agreement 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 JCLP 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 indentified 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 and which had been preceded with the completion of a non-brokered private placement in the fourth quarter of FY 2006 with gross proceeds of \$734,900.

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. In Q3 FY 2007 the Company received a major order valued at approximately \$250,000 under its exclusive license for the GEM® Condensate Return System FROM A Global 500 company at a U.S. location.

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 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.

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 \$778,638. The financing consisted of the issuance of 4,866,496 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.

On January 31, 2007 the Company announced that it had received a \$2.5 million-plus energy efficiency contract at a major industrial facility in the U.S. making this the second commercial contract in the U.S. market and 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.

On March 1, 2007 the Company announced that it had received a major order valued at approximately \$250,000 under its exclusive license for the GEM® Condensate Return System FROM A Global 500 company at a U.S. location.

On March 31, 2007 the Company announced that it had closed a non-brokered private placement with gross proceeds of \$189,000. The financing consisted of an issuance of 1,350,000 common shares at the deemed price of \$0.14 per share.

On April 3, 2007 the Company announced that it had completed filing the final patent applications of technology at the core of its THERMALONox™ nitrogen oxides (NOx)

reduction solution. A patent application was filed with the United States and Trademark Office and another application was filed with the Canadian Receiving Office for the Patent Cooperation Treaty to simultaneously start patenting the new technology in 137 countries across Europe, South America and China – the world's largest coal-fired power market. The laboratory tests repeatedly demonstrated consistent results of more than 98% removal of nitrogen oxides from simulated flue gas streams.

On April 10, 2007 the Company announced that it had 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 indentified by SCUT as a suitable test site.

On April 27, 2007 the Company announced that it had closed a non-brokered private placement with gross proceeds of \$656,000. The financing consisted of an issuance of 4,100,000 common shares at the deemed price of \$0.16 per share. Thirty non-insiders participated in this financing.

On May 16, 2007 the Company announced that it had completed an institutional private placement with a syndicate of investment firms including Whitebox Advisors LLC, an SEC-registered investment advisor with over \$2 billion in assets, headquartered in Minneapolis, and a Toronto investment firm. The Company received gross proceeds of \$1 million from the issuance of 4,166,666 units, each comprising one common share of the Company at a deemed price of \$0.24 per share and one warrant to purchase a common share of the Company at a deemed price of \$0.40 per share for a period of up to two years. Under the terms of the private placement, the syndicate participants had an option to increase the size of the placement by up to 30% at a 10% discount to market price for a period of 60 days from the date of closing.

On May 25, 2007 the Company announced that Whitebox Advisors LLC had exercised its option from the previously announced institutional financing to increase the total gross proceeds from the private placements to \$1,312,500. The Company issued an additional 1,250,000 units each comprising one common share of the Company at a deemed price of \$0.25 per share and one warrant to purchase an additional share of the Company at an exercise price of \$0.40 per share for a period of up to two years.

On May 31, 2007 the Company announced that William M. Crossland had been appointed to the Board of Directors. Mr. Crossland spent over 18 years with the National Bank of Canada's Corporate and Investment Banking Group most recently as Managing Director, Investment Banking.

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 2008, 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 industrial 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 second quarter FY 2008 (ending November 30, 2007) but become a harbinger for continued improvement to the Consolidated Balance Sheet that began in the fourth quarter of FY 2007.

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 (\$140,000) by the Guangzhou Municipal Science and Technology Bureau for SCUT's project resources commitment to the Company. The funding is to be in place within 90 days.

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 CO₂.

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 broken 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. The Company will derive its revenues from the sale of assets to, and investments in the subsidiary.

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 (Alternative Utility Delivery) Program is for a term of six years. The Company will enter into a contract with FEI to supply, install and performance manage its FLU-ACE® system at the Thurso pulp mill.

On September 18, 2007 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).

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
General Manager & CFO