



FIRST QUARTER REPORT Period Ended August 31, 2006

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 2007, ended August 31, 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 first quarter ended August 31, 2006 at \$102,659 decreased substantially from \$382,180 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 the completion of the Minas Basin project together with small revenues from performed feasibility studies.

Gross profit (loss) for the first quarter ended August 31, 2006 at \$(47,463) (-46.23%) compared with \$52,825 (13.82%) in 2005. This decrease in profitability was as a result of small increased costs that were previously



underestimated to complete the Minas Basin and Stratford General Hospital projects. Both contracts are now fully completed.

Expenses

Administration expenses in the first quarter ended August 31, 2006 were \$118,544 an increase of \$12,150 or 11.42% over the \$106,394 incurred in 2005. Administration expenses are trending higher with additional services required to meet the demands of increased business activity of the Company.

Selling, marketing and business development expenses in the first quarter ended August 31, 2006 were \$237,599 an increase of \$36,787 or 18.32% over \$200,812 in 2005. Due to the need to increase sales revenue, there has been an increase in selling and marketing efforts.

Stock based compensation expenses continues to trend down and at \$8,550 in the first quarter ended August 31, 2006 compared with \$288,189 in 2005. This expense is incurred over the vesting period of options awarded and valued using the Black-Scholes statistical model. There were no options awarded in the first quarter of 2006 and the vesting value of previously awarded options was minimal.

Legal expenses in the first quarter ended August 31, 2006 were \$12,670 a decrease over the \$17,094 incurred in 2005. The main contributing factor to the legal costs arises from the Company's litigation against the past President and CEO.

Audit fee expenses in the first quarter ended August 31, 2006 at \$15,000 compared with \$11,250 in 2005 reflect the increase in audit fees.

Insurance costs have been reduced and at \$18,828 in the first quarter ended August 31, 2006 they were \$1,809 or 8.76% lower than 2005.

Amortization of property, plant and equipment at \$6,413 in the first quarter ended August 31, 2006 compared with \$2,991 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 \$4,932 in the first quarter ended August 31, 2006 compared to \$6,355 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 decrease in costs from the previous year was due to the Company's decision not to renew the original THERMALONox™ licences.

Research and Development costs were \$24,659 in the first quarter ended August 31, 2006 compared to \$9,853 in 2005. The increase results from 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 \$1,201 in the first quarter ended August 31, 2006 compared with \$739 in 2005.

Foreign exchange loss on US dollar transactions in the first quarter ended August 31, 2006 of \$1,591 compared with a gain of \$4,555 in 2005.



Other revenue at \$nil in the first quarter ended August 31, 2006 compared with \$221,286 in 2005.

All of the other revenue in the first quarter ended August 31, 2006 resulted from an agreement for a reduction in obligations due to the past President.

Interest revenue of \$123 in the first quarter ended August 31, 2006 compared with \$5,037 in 2005 which included interest from short term investments.

Other Costs were \$14,684 in the first quarter ended August 31, 2006. 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 \$512,011 in the first quarter ended August 31, 2006 compared to a net loss of \$435,216 in 2005. Contributing factors resulting in the loss in 2006 were the additional costs required to complete the Minas Basin and Stratford General Hospital, the continuing legal fees arising from litigation against the past President 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 August 31, 2006, the Company had a working capital deficiency of \$884,486 compared to a deficiency of \$414,337 at May 31, 2006. This resulted mainly from a decrease in accounts receivable of \$418,088 and contracts in progress of \$89,000 following collection of completed contract accounts. Accounts payable and accrued liabilities declined by \$26,653 while other net changes of \$10,286 had a negative impact on working capital. Cash requirements have been adversely affected by increased costs to complete at the Minas Basin and Stratford General Hospital projects and the continued costs of litigation to defend and counterclaim against the past President and to pursue an insurance claim.

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 committed. The proceeds raised would be used for expanded sales and marketing efforts, strategic acquisitions and R&D activities with THERMALONOX™.

Related Party Transactions

In the quarter ended August 31, 2006, officers were paid fees for services of \$48,000 and 200,000 flow-through shares were issued to the President in accordance with his employment agreement.



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 August 31, 2006

| | 2005 | | | 2006 | | | | 2007 |
|---|-----------|-----------|-----------|-----------|-------------|-----------|-----------|-----------|
| | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 |
| Sales | 223,824 | 35,604 | 252,211 | 382,180 | 807,364 | 655,010 | 1,000,787 | 102,659 |
| Net loss | (242,283) | (527,001) | (434,242) | (380,611) | (1,008,669) | (402,164) | (425,289) | (512,011) |
| Net loss per Share basic And diluted | (0.01) | (0.01) | (0.01) | (0.01) | (0.02) | (0.00) | (0.00) | (0.01) |

Trend Analysis:

The losses incurred in each quarter from Q2 FY 2005 through to Q1 FY 2007 are consistent in magnitude with exception of Q2 FY 2005, Q3 FY 2005, Q2 FY 2006 and Q1 FY 2007. The losses incurred in Q2 FY 2005 were lower primarily due to the departure of four (4) employees from the Company. The increase in losses in Q3 FY 2005 from Q2 FY 2005 was a result of the substantial decrease in sales from \$223,824 in Q2 FY 2005 to \$35,604 in Q3 FY 2005.

The losses in Q2 FY 2006 increased to \$954,064 from \$435,216 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.

Without the exceptions noted above, the net losses remained in a fairly constant range throughout the eight quarters summarized from Q2 FY 2005 through Q1 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 August 31, 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 August 31, 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 this 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 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 and with gross proceeds of \$734,900 in Q3 FY 2006. 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 late Q2 2007 or early 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.

Subsequent Events

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.

Signed in Ottawa, Ontario on this 31st day of October 2006.

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