SECOND QUARTER REPORT
Period Ended November 30, 2009

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 2010, ended November 30, 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" or the "Company") 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 second quarter ended November 30, 2009 were $1,564,527, an increase of 37% compared with $1,140,563 in 2008.

For the six months ended November 30, 2009 sales were $2,869,463, up 30% compared to $2,198,881 in Fiscal Year 2008.

Gross profit for the second quarter ended November 30, 2009 was $854,989 (55%) compared with $822,863 (72%) in 2008. The drop in gross margin on a comparative basis from the same period in 2008 was due to a lesser proportion of revenue coming from GEM sales. Sales of waste energy recovery products amounted to $468,692 in the quarter compared to $33,198 from the same period in 2008. Waste energy recovery products typically have lower gross margins than the GEM related thus reducing gross margin.

For the six months ended November 30, 2009 gross profit was $1,869,966 (65%), up 38% compared to $1,350,966 (61%) from the same period in 2008.

Expenses

Administration and Selling, Marketing and Business Development expenses in the second quarter ended November 30, 2009 totalled $1,472,853, a decrease of $2,536 or 0.1% from the $1,475,389 incurred in 2008. Included in administration costs for the current quarter is a $180,000 provision against the accounts receivable balance related to amounts owing pursuant to the Thermal-AUD™ financed contract, as the customer has filed for protection from its creditors under the Companies' Creditors Arrangement Act and collection of this account receivable is therefore considered doubtful at this time. Also included in administration costs for the current quarter is a $190,000 provision intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the Company. Excluding this $190,000 provision and the $180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, administration, selling, marketing and business developments expenses for the second quarter ended November 30, 2009 decreased $372,536 or 25% compared with the same period last year. This decrease was due to cost cutting measures that the Company undertook.

Legal expenses in the second quarter ended November 30, 2009 were $38,727, compared with $59,797 in 2008. 2008 costs included approximately $22,000 in relation to the dismissal of an underperforming European Sales Person.

Audit fee expense in the second quarter ended November 30, 2009 was $110,067 an increase of $63,599, compared to $46,468 incurred in 2008. The 2008 expense represented accrued costs for that year to date, however recent changes in the accounting rules now require reporting of the auditing expense upon receipt of the auditors invoice and not accrued as was the process followed in the past. The 2009 expense relates to the audit of the Fiscal Year 2009 financial statements which are higher than last year because the Fiscal Year 2009 audit includes a consolidation of Gardner Energy Management Ltd. and Thermal Energy International (Guangzhou) Ltd. and also required a valuation of intangible assets and goodwill as at May 31, 2009.

Insurance costs in the second quarter ended November 30, 2009 were $38,534 an increase of $4,379 compared to $34,155 in 2008.

Amortization of property, plant and equipment was at $11,175 in the second quarter ended November 30, 2009 compared with $15,199 in 2008.

Amortization of intangible assets was $46,625 in the second quarter ended November 30, 2009. The intangible assets were acquired with the purchase of GEM and amortization was first recognised in the Fiscal Year 2009 year-end financial statements.

Patent and Trademark maintenance costs were $nil in the second quarter ended November 30, 2009, compared to $14,730 in 2008. All Patent and Trademark costs incurred by the Company are expensed as incurred.

Research and Development costs were $24,002 in the second quarter ended November 30, 2009, compared to $83,407 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.

Interest and bank charges were $12,363 in the second quarter ended November 30, 2009 compared with $34,868 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 second quarter ended November 30, 2009 was $11,641 compared with a gain of $12,048 in 2008.

Interest revenue of $41 in the quarter ended November 30, 2009 compared with $31,306 in 2008. Declining interest rates and a lower level of short-term investments were the reason.

Finance revenue was $21,535 in the second quarter ended November 30, 2009 from the THERMAL-AUD™ financed project, compared to $64,465 in 2008. Invoicing pursuant to the THERMAL-AUD™ financed project was suspended in October 2009, as the customer has filed for protection from its creditors under the Companies' Creditors Arrangement Act.

Loss before income taxes and non-controlling interest for the second quarter ended November 30, 2009 was $889,422, an increase of $56,091 from the same period last year. Excluding the $190,000 provision intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the company and the $180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, the Loss before income taxes and non-controlling interest for the second quarter ended November 30, 2009 would have been $519,422, an improvement of $313,909 from the same period last year.

For the six months ended November 30, 2009 the loss before income taxes and non-controlling interest was $1,457,506, a decrease of $10,507 from the same period last year. Excluding the $190,000 provision of intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the company and the $180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, the loss before income taxes and non-controlling interest for the six months ended November 30, 2009 would have been $1,087,506, an improvement of $359,493 from the same period last year.

Provision for income taxes must be calculated for each Company within the Thermal Energy Group, in accordance with local tax legislation. The provision for the year to date relates to taxes against profits attributable to Gardner Energy Management Limited, based in the UK.

Net Loss was $1,010,630 in the second quarter ended November 30, 2009 compared to a net loss of $834,331 in 2008. 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 November 30, 2009, the Company had working capital of $2,156,069 compared to working capital of $3,791,332 at May 31, 2009. The $1,635,263 decrease in working capital is accounted for by a $1,725,544 decrease in net cash (Cash and cash equivalents less Bank loans) and a $90,281 increase in non-cash working capital (working capital excluding Cash and cash equivalents and Bank loans). Non-cash current assets increased by $455,762, led by a $613,912 increase in accounts receivable. Non-cash current liabilities increased by $365,481. The major changes include a decrease in accounts payable of $122,345, an increase in accrued liabilities of $443,919 and an increase in deferred revenue of $43,907. The large increase in accrued liabilities includes taxation payable for the UK entity of $119,962 on the current year profits, provisions for potential liabilities with former employees totalling $248,050 plus accruals relating to the cost of equipment not yet invoiced by suppliers totalling $209,256. Offsetting these increases was a decrease in GEM earn-outs payable of $253,151.

For the quarter ending November 30, 2009 the Company's net cash (Cash and cash equivalents less Bank loans) position decreased by $619,365 to $970,881.

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, reduce costs and manage working capital.

Related Party Transactions

As at November 30, 2009, loans to Directors and Officers to exercise options and acquire shares were $235,000 ($527,447 as at May 31, 2009) and to Shareholders $592,351 ($299,904 as at May 31, 2009). Accrued interest on these loans stood at $18,459 on loans to Directors and Officers as at November 30, 2009 ($38,652 as at May 31, 2009) and $63,803 on loans to Shareholders ($22,038 as at May 31, 2009)

SEGMENTED INFORMATION

In the quarters ended November 30, 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 two product lines – waste energy recovery solutions and condensate return system solutions. Assets are located in Canada, Europe and China.

The Company operates in three reportable segments, waste energy recovery systems, condensate return systems (GEM™), and Thermal-AUD™ financed projects whereby the Company finances the sale and installation of the product at the customer's facility and then leases the product back to the customer. These three reportable segments are detailed below:

	Waste Energy Recovery Systems		Thermal -AUD™ Financed Projects		GEM™	
	Quarter ended Nov 30		Quarter ended Nov 30		Quarter ended Nov 30	
	2009	2008	**2009**	2008	**2009**	2008
	$	$	**$**	$	**$**	$
Revenue from external customers	**468,692**	33,198	**-**	-	**1,095,835**	1,107,365
Inter-segment revenues	**9,556**	41,067	**-**	-	**102,086**	12,545
Segment loss (profit)	**949,542**	988,518	**173,379**	(14,327)	**(112,291)**	(139,860)
Total assets	**3,915,387**	7,731,770	**1,912,371**	2,134,033	**7,765,181**	6,908,641

Reconciliation of loss to financial statements	**Quarter ended Nov 30, 2009 $**	Quarter ended Nov 30, 2008 $
Total loss for reported segments	**1,010,630**	834,331

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, 2009

	2008		2009				2010	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Sales	509,074	2,750,487	1,058,318	1,140,563	682,341	1,077,700	1,304,936	1,564,527
Net Loss	569,794	521,388	616,086	834,331	1,181,735	573,225	570,530	1,010,630
Net loss per share basic and diluted	0.006	0.005	0.004	0.005	0.007	0.003	0.003	0.006

Trend Analysis:

The losses in Q3 Fiscal Year 2008 were consistent with previous quarters.

Q4 2008 saw losses of $521,388. This level of losses was consistent with previous quarters, but was based on a higher level of revenue. Revenue of $2,750,487 included the recognition of the Fraser Papers Canada Thurso mill sale. Although this sale generated a profit, losses were suffered on the Philips project, resulting in a gross profit of just 13%. In addition, legal costs of $262k relating to the purchase of GEM and litigation with the former CEO inflated SGA costs.

The losses in Q1 Fiscal Year 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 on 1st July 2008.

The losses in Q2 Fiscal Year 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.

Q3 Fiscal Year 2009 illustrated the impact of the global recession, with revenue down significantly on prior quarters. As a result, despite cost reductions elsewhere, losses increased to $1,181,735.

Q4 Fiscal Year 2009 saw an improvement in sales despite the continuing recession. This, combined with further reduced costs, brought the losses back down to $573,225 for the quarter.

Despite a further increase in sales in Q1 Fiscal Year 2010, at $570,530 losses barely changed from the previous quarter. The additional $297,987 gross profit was offset mainly by legal fees relating to the TSXV review and new distributor agreement with Kemco Systems ($84,185), four additional staff in the UK office (three from European Kemco operations plus a new sales person for the UK) plus an increase in travel costs within US.

The losses in Q2 2010 increased to $1,010,630, again despite an increase in revenue. The increase in revenue resulted from sales of Kemco products, which attract lower margins than GEM Traps. In addition, provisions for potential liabilities with the former employees totalling $248,050 were made in the current quarter, as well as a $180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract.

In summary, other than Q3 and Q4 2009, in which the effects of the poor economic climate were most greatly felt, revenue has been steadily climbing. Losses, however, have fluctuated inconsistently, as detailed above. This demonstrates the need to significantly increase sales to cover and exceed the amount of fixed costs in order to overcome the consistent pattern of losses.

Outlook

On December 22, 2009, the Corporation announced the receipt of a Statement of Claim filed by former acting CFO, Mr. Oliver Toffoli in the amount of approximately $350,000 for wrongful dismissal and other damages related to Mr. Toffoli's services with the company. Thermal Energy believes it has acted reasonably to date and intends to vigorously defend the claim.

On December 23, the Corporation announced the receipt of a non-binding purchase order for approximately $4 million from Kruger Products Limited, a subsidiary of Kruger Inc., to provide a FLU-ACE® heat recovery solution for its tissue mill operations located in Gatineau, Quebec

Critical Accounting Estimates

As previously announced, the Company is defending a lawsuit brought by a former president. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the amount of $4 million, plus an as yet undetermined value of share options, interest and legal costs. The Company has filed a statement of defence in response and has counterclaimed for $5.4 million in damages plus interest and costs. Two attempts have been made at a mediated settlement. Neither attempt has been successful. Although the lawsuit was commenced in October, 2005, the plaintiff has yet to take the proceeding to the point of oral examinations for discovery. As a result, there is much that is still unknown about the former president's case. Following the latest unsuccessful mediation in November, 2009, the Company has recorded a charge of $190,000 in its financial statements. This charge is intended to account for possible net liabilities resulting from the claim and the counterclaim.

As at November 30, 2009, the financial statements of the Company are showing total assets of $1,886,721 as Net Investment in Lease with a party that has filed for protection from its creditors under the Companies' Creditors Arrangement Act. Although the Company has taken a $180,000 provision against the accounts receivable balance related to this lease, it has made no provision against the Net Investment in Lease, as it is expected that a new lease agreement will be negotiated during the restructuring process.

Changes in Accounting Policies

On February 13, 2008, the Accounting Standards Board confirmed that the use of International Financial Reporting Standards ("IFRS") will be required for Fiscal Years beginning on or after January 1, 2011 for publicly accountable profit-oriented enterprises. After that date, IFRS will replace Canadian GAAP for those enterprises. While IFRS is based on a conceptual framework similar to Canadian GAAP, there are significant differences with respect to recognition, measurement and disclosures. The Company is in the process of developing a plan for the implementation of IFRS and will assess the impact of the differences in accounting standards on the Company's consolidated financial statements. It is not possible to quantify the impact of these differences at this time. The Company expects to make changes to processes and systems before the 2012 Fiscal Year, in time to enable the Company to record transactions under IFRS. Training and additional resources will be utilized to ensure timely conversion to IFRS.

Summary of Outstanding Shares

The Company currently has 167,533,922 common shares issued and outstanding.