FIRST QUARTER REPORT
Period ended August 31, 2011

MANAGEMENT'S DISCUSSION & ANALYSIS

This discussion is dated as of November 28, 2011 and explains the material changes in Thermal Energy International Inc.'s ("Thermal Energy" or the "Company") financial condition and results of operations for the first quarter of Fiscal Year 2012, ended August 31, 2011. The condensed consolidated interim financial statements and accompanying notes constitute an integral part of the discussion and should be read in conjunction with these comments. The condensed consolidated interim financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS") and comparative periods have been restated in accordance with IFRS, where applicable. During the period ended August 31, 2011, the Company's critical accounting estimates, significant accounting policies and risk factors have remained substantially unchanged. Unless otherwise indicated, all amounts presented in this discussion are in Canadian dollars. 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. Additional information relating to the Company is available on SEDAR at www.sedar.com.

Description of Business

Thermal Energy is an innovative cleantech company providing a variety of proprietary and proven energy and water efficiency, emission reduction, and bioenergy products and solutions to the industrial, commercial and institutional markets worldwide. Thermal Energy is also a fully accredited professional engineering firm, and can offer advanced process and applications engineering services. By providing a unique mix of proprietary products together with process, energy, environmental, and financial expertise Thermal Energy is able to deliver significant financial and environmental benefits to our customers.

Thermal Energy's products include; **GEM®** - Steam traps and condensate return systems, **FLU-ACE®** - Direct contact condensing heat recovery, and **Dry Rex™** - Low temperature biomass drying systems. These award winning products are effective in a wide range of industries and applications and have an excellent track record of longevity, proven reliability and performance providing significant energy savings, reduced GHG emissions, improved water efficiency, lower maintenance costs, improved product quality and increased production efficiency.

Thermal Energy International Inc. is headquartered in Ottawa, Canada, with offices in the UK and China. More information on Thermal Energy can be found at www.thermalenergy.com. GEM®, FLU-ACE®, THERMALONOx™, and DRY-REX™ are trademarks of Thermal Energy.

Discussion of Operations and Financial Conditions

Revenues and Gross Profits

Revenues were $1,431,686 in the quarter ended August 31, 2011 compared to $2,985,667 in the quarter ended August 31, 2010. Sales of GEM® Condensate return systems increased by $128,758 (16.4%) over the same period in the previous year, while sales of heat recovery systems decreased by $1,682,739 (76.4%).

The first quarter of FY 2012 included GEM® Condensate return systems sales of $248,827 in partial fulfillment of orders from a major food manufacturer, as announced December 23, 2010 and February 18, 2011.

The decrease in heat recovery systems revenue is a result of the completion of the Kruger Products project announced December 23, 2009. $1,827,267 of the heat recovery systems revenues achieved in the first quarter last year related to the contract with Kruger Products while the first quarter of FY 2012 included only $105,357 from the $5.8 million contract with Fibrek, announced June 16, 2011. The Fibrek project is still expected to be significantly completed by the end of this Fiscal year.

The gross profit of $803,012 in the quarter ended August 31, 2011 represented a decrease of $400,648, or 33.3%, on the $1,203,660 achieved in the quarter ended August 31, 2010. These results expressed as a percentage of sales were 56.1% in the first quarter of FY 2012 compared with 40.3% in the first quarter of FY 2011. The increase in gross profit as a percentage of sales is a result of a higher proportion of revenues coming from GEM® Condensate return systems.

Expenses

The consolidated financial statements and notes to the consolidated financial statements which constitute an integral part of this discussion have been prepared in accordance with IFRS. IFRS which requires the presentation of expenses in the statement of operations either by nature of expense or by function. This differs from the Company's previously reported statements in accordance with Canadian GAAP, which allowed a combination of both. It was determined that expenses should be disclosed by function within the condensed consolidated statement of operations, with further analysis being provided within this discussion.

Administration and Selling, Marketing and Business Development expenses in the quarter ended August 31, 2011 totalled $1,150,153 compared with $1,273,393 in the quarter ended August 31, 2010.

Administration and Selling, Marketing and Business Development expenses for the quarters ended August 31, 2011 and 2010 comprise:

	Aug 31, 2011 $	Aug 31, 2010 $
Professional fees	26,248	98,645
Insurance	35,117	33,380
Depreciation of property, plant and equipment	10,508	12,857
Amortization of intangible assets	24,623	36,542
Patent and trademark maintenance	376	4,237
Interest and bank charges	11,649	8,329
Foreign exchange loss (gain)	(10,400)	(1,437)
Other general administration, selling, marketing and business development costs	1,052,032	1,080,840
Total administration, selling, marketing and business development costs	**1,150,153**	**1,273,393**

Professional fees, which comprise legal and audit fees, were $26,248 in the quarter ended August 31, 2011, compared to $98,645 incurred in the quarter ended August 31, 2010. The current period expenditure related entirely to audit fees, mainly for the audit of Gardner Energy Management Limited and its subsidiary GEMchem Limited, in the UK. Audit fees in the same period of the previous year were $48,832, the higher amount being due simply to timing of invoices. There were no legal fees incurred in the first quarter of FY 2012, compared to $49,813 incurred in the quarter ended August 31, 2010, which related to the TSX Venture Exchange review, the ongoing dispute with the former CEO and president of the Company and other sundry matters.

Insurance expenses were $35,117 in the quarter ended August 31, 2011 compared with $33,380 in the quarter ended August 31, 2010.

Depreciation of property, plant and equipment was $10,508 in the quarter ended August 31, 2011, compared with $12,857 in the corresponding quarter of the previous year.

Amortization of intangible assets was $24,623 in the quarter ended August 31, 2011 compared to $36,542 in the quarter ended August 31, 2010. These assets were acquired on the purchase of Gardner Energy Management Ltd. and represent the amortization of the estimated useful life of these assets since the acquisition. Of the reduction in charge for the quarter ended August 31, 2011 over the same period for the previous year, $3,965 relates to the full amortization of the non-compete agreement with the former owner of Gardner Energy Management Ltd. The remaining difference arose from the revaluation of intangible assets, which is now performed on a quarterly basis. Management did not consider it material to retrospectively adjust comparatives for the period when revaluation of intangible assets was not performed.

Patent and trademark maintenance costs were $376 in the quarter ended August 31, 2011 compared to $4,237 in the quarter ended August 31, 2010. Patent and trademark maintenance costs are expensed as incurred.

Interest and bank charges were $11,649 in the quarter ended August 31, 2011 compared to $8,329 in the quarter ended August 31, 2010. The higher amount in the current period reflects the timing of charges relating to the borrowing facility within the UK.

Other general administration, selling, marketing and business development costs for the quarter ended August 31, 2011 were $1,052,032, compared to $1,080,840 for the quarter ended August 31, 2010, a decrease of $28,808.

Other general administration, selling, marketing and business development costs within the statement of operations include salaries not directly attributable to cost of sales, staff incentives, stock based compensation, sales commissions, advertising and promotional costs, staff training, motoring and travelling costs, plus costs of running the Company's offices, as well as bad debts and corporate costs.

Savings included the lack of incentive accrual in the current year to date, lower commissions and stock based compensation. These savings were partially offset by additional training of distributors in North America in the first quarter of the current year.

Research and development costs of $120 in the first quarter of FY 2012 compared to $1,913 in the first quarter of FY 2011. Current focus is on increasing revenues from existing product lines, rather than developing new products.

Finance revenue in the first quarter of FY 2012 of $31,079 was $19,836 less than the $50,915 recognized in the first quarter of FY 2011. The interest rate implicit in the lease of 14% is applied against the reducing net investment in the lease, hence lower finance revenues as the term of the agreement progresses.

Loss before income taxes for the quarter ended August 31, 2011 was $316,182 compared to a loss of $20,731 in the same quarter of the previous year. The main reason behind the poorer results for the current quarter was the lack of revenue in the heat recovery segment, compared with the Kruger project generating significant revenue in the previous year.

Income taxes for the first quarter of FY 2012 represent a credit of $653, compared to a cost of $8,360 as reported in the first quarter of FY 2011. A charge of $6,448 in respect of taxes payable in the United Kingdom by the Company's wholly owned subsidiary Gardner Energy Management Ltd was offset by a credit of $7,101 reflecting the reduction in the future tax liability related to intangible assets.

Net loss for the period was $315,529 compared to a loss of $29,091 in the same quarter of the previous year. The main reason behind the poorer results for the current quarter was the lack of revenue in the heat recovery segment due to the timing of the Kruger and Fibrek projects.

Comprehensive loss was $319,966 for the first quarter of FY 2012 compared to comprehensive income of $319,169 for the first quarter of FY 2011. The Sterling exchange rate strengthened over the Canadian dollar in the first quarter of FY 2011, giving rise to unrealized gains on translating the goodwill and intangible assets acquired as part of the acquisition of Gardner Energy Management Limited. Exchange rates over the current quarter have remained more constant, hence no similar gains in the first quarter of FY 2012.

Liquidity & Capital Resources

The working capital was $1,666,232 at August 31, 2011 compared to working capital of $1,870,934 at May 31, 2011 - a decrease of $204,702, while the Company's net cash position (Cash and cash equivalents less Bank loans) decreased by $147,198 from $972,163 at May 31, 2011 to $824,965 as at August 31, 2011. These decreases run counter to the trend of steady increases up until the end of the previous quarter, however this is mainly due to the timing of the start on the Fibrek project.

The Company's working capital position since the start of the previous fiscal year can be summarized as follows:

	May 31, 2010 $	Aug 31, 2010 $	Nov 30, 2010 $	Feb 28, 2011 $	May 31, 2011 $	Aug 31, 2011 $
Current Assets	3,281,721	3,491,058	3,955,487	3,717,578	3,898,346	4,371,855
Current Liabilities	2,132,235	2,092,165	2,344,370	1,943,063	2,027,408	2,705,623
Working Capital	1,149,486	1,398,893	1,611,117	1,774,515	1,870,938	1,666,232

Current assets increased by $473,509 to $4,371,855. This was mainly due to an increase in Trade receivables of $577,177, representing invoices to Fibrek at the end of the quarter, less the decrease in cash balances of $147,198. Current liabilities meanwhile increased by $678,211 to $2,705,623. Accounts payable increased by $49,820 and deferred revenue by $541,700 due to progress billings raised to Fibrek for which the revenue is yet to be recognized.

Cash flow from operations (defined as net loss attributable to the owners of the parent, plus items not involving cash, plus lease payments received) for the quarter ended August 31, 2011 was ($158,988). After adjusting this for $52,923 of positive changes in non-cash working capital items; and deducting $26,290 to acquire fixed assets, $15,501 in final settlement to the former owners of Gardner Energy Management Limited and $658 to allow for the effect of exchange rate fluctuations on cash and cash equivalents, the net cash flow was ($147,198), decreasing the net cash balance as at August 31, 2011 to $824,965 from $972,163 as at May 31, 2011.

In addition to its net cash balance of $824,965 as at August 31, 2011 the Company also had an estimated $130,000 of unused borrowing capacity under its bank loans.

With cash balances and unused borrowing capacity of approximately $954,965, management believes that it has sufficient capital resources to fund existing operations and anticipated capital requirements in the remainder of FY 2012. Of the orders totaling approximately $8,731,000 disclosed in the previous Management Discussion and Analysis, dated September 28, 2011, only $449,414 was recognized as revenue as at August 31, 2011, leaving approximately $8,281,500 yet to be recognized as revenue from these orders. Order backlog as at August 31, 2011 was approximately $8.6 million compared to $2.7 million at the same time last year. As at November 25, 2011 the Company had $9.2 million in purchase orders that had not yet been reflected as revenue in the Company's published quarterly financial statements.

Net Investment In Lease

The Company's net investment in lease includes the following:

	August 31, 2011 $	May 31, 2011 $
Total estimated minimum lease payments receivable	1,071,772	1,215,814
Less: unearned income	(63,405)	(94,484)
	1,008,367	1,121,330
Less: current portion	(668,534)	(653,807)
	339,833	467,523

The previous lease for this facility, entered into in August 2007 for a period of six years, was suspended in 2009 following the bankruptcy of the customer and the lease was renegotiated with the new owners of the facility, Fortress Paper Ltd. As at the suspension date, the net investment in lease was included in the financial statements of the Company at $1,886,721.

The new lease was signed on June 29, 2010 with an effective date of May 1, 2010. Based on estimated minimum lease payments expected over the thirty month term of the agreement, the revised net investment in lease was calculated at $1,693,341, resulting in a write down of $193,380 in the financial statements for the year ended May 31, 2010. In connection with the renegotiation of the agreement, an additional net charge to earnings of $97,638 was recorded in the year ended May 31, 2010 as a result of the bankruptcy of the previous customer.

The estimated minimum lease payments receivable in this new lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. The lease expires December 31, 2012, at which time the customer has the option to purchase the asset for $1,000,000 or extend the lease term for a further 24 months with a 15% reduction in the purchase price of the asset to $850,000 at the end of the extended term.

Future estimated minimum lease payments receivable, and expected residual value of equipment at the end of the lease, under the sales-type lease are as follows:

	$
FY 2012	605,107
FY 2013	327,135
	932,242
Residual value of equipment	139,530
	1,071,772

The estimated residual value of the equipment at the end of the new lease has been determined by assigning depreciation rates to various pieces of the equipment in order to derive a reasonable expected selling price or re-use value for the equipment upon the termination of the agreement. The residual value of the equipment is not guaranteed.

Dry-Rex™ Agreement

Subsequent to the quarter end, the Company amended and extended its licensing and patent purchase agreement with Mabarex Inc. related to the Dry-Rex™ technology. In exchange for minimum annual royalty payments of $5,000 the agreement provides the Company with a sole and exclusive worldwide license to the Dry-Rex™ technology. The agreement also provides the Company the option to purchase the Dry-Rex™ technology at any time during the term of the agreement.

Related Party Transactions

Options outstanding for Directors (excluding the CEO) as at August 31, 2011 were 750,000 of which 250,000 were exercisable. There were no warrants outstanding for Directors.

Options outstanding for Officers (including the CEO) as at August 31, 2011 were 2,850,000 of which 1,283,333 were exercisable. There were no warrants outstanding for Officers.

Loans outstanding to shareholders, including accrued interest, to enable the exercise of options and purchase of shares at August 31, 2011 totalled $nil ($122,275 at May 31, 2011).

Officer and Director Compensation

During the first quarter ended August 31, 2011 compensation arrangements for directors was as follows:

$20,000 per annum per Director plus an additional $12,000 per annum payable to the Chairman of the Board, $8,000 per annum payable to individual committee chairpersons of the Audit Committee and the Ethics, Governance and Compliance Committee, and $1,000 payable for each in-person meeting.

During the first quarter ended August 31, 2011 Directors fees paid were $18,333. Fees to the Chairperson of the Audit Committee were $2,000; fees to the Chairperson of the Ethics, Governance and Compliance Committee were $2,000; fees paid to the Chairman were $3,000; and a total of $4,000 was paid for in-person meetings.

Compensation paid to directors and officers during the first quarter ended August 31, 2011 (inclusive of the amounts described above) was as follows:

	Salaries and fees		Commissions / incentives		Total	
	2011 **$**	2010 $	**2011** **$**	2010 $	**2011** **$**	2010 $
Directors						
M. Williams	**8,000**	8,000	**-**	-	**8,000**	8,000
J. Ansell	**8,000**	8,000	**-**	-	**8,000**	8,000
J. Kelly	**9,000**	9,000	**-**	-	**9,000**	9,000
D. Gibbs	**4,333**	-	**-**	-	**4,333**	-
Total	**29,333**	25,000	**-**	-	**29,333**	25,000
Officers						
W. Crossland	**60,000**	60,000	**-**	10,100	**60,000**	70,100
J. Flynn	**30,779**	29,732	**-**	4,927	**30,779**	34,659
R. Triebe	**33,750**	33,750	**-**	4,927	**33,750**	38,677
Total	**124,529**	123,482	**-**	19,954	**124,529**	143,436

Chinese Joint Venture

In 2007, the Company entered into a joint venture agreement with two partners under the laws of the Peoples Republic of China to establish a new company with the name of Thermal Energy International (Guangzhou) Ltd ("TEIG"). The Company owned a 55% interest of the joint venture, a Chinese based operating partner owned 40% and a Chinese consultant that assisted with the Company's activities in China owned 5%. The joint venture was set up to market, sell and install Thermal Energy International Inc.'s suite of products in China. The start-up capital required was $200,000 CDN and each partner contributed their respective share during the year ended May 31, 2009.

Initially, the management of TEIG was conducted by the Chinese based operating partner, with minimum input from the Company who had one board member out of a total of three. As a result, the financial results of TEIG were included in the consolidated financial statements of the Company on a proportionate share basis. That is, 55% of the operating results plus 55% of all assets and liabilities of the TEIG were included on a line by line basis in the consolidated financial statements of the Company. On September 6, 2010 however, the Chinese based operating partner resigned from management of the joint venture and as a board member and Thermal Energy added a board member. The retiring Director agreed to hand over the company seals and bank control to Thermal Energy. Thermal Energy International Inc assumed management control of TEIG. It was consequently determined that, from Q2 2011 onwards, the results of TEIG should be included in the group financial statements on a consolidated basis, i.e. 100% of the operating results plus 100% of all assets and liabilities of the joint venture to be included on a line by line basis in the consolidated financial statements of the Company with the 45% minority interest recorded accordingly.

The reported consolidated financial statements of the Company for the year ended May 31, 2011 therefore included the first quarter ended August 31, 2010 on a proportionate basis with the quarters ended November 30, 2010, February 28, 2011 and May 31, 2011 being included on a full consolidation basis.

There are no significant differences in the accounting policies of the Chinese entity and the Company.

The results of the joint venture for the first quarter of FY 2011, as included in the consolidated financial statements of Thermal Energy International Inc. were as follows:

	Quarter ended Aug 31, 2010 $
Current Assets	**122,235**
Current Liabilities	**109,056**
Sales	**1,419**
Cost of sales	**(2,705)**
Other expenses	**(19,112)**
Net profit (loss)	**(20,398)**
Cash flows provided (used in) operating activities	**1,272**
Cash flows used in investing activities	

The above figures represent the Company's 55% share in the joint venture.
The results of the Chinese entity for the remaining three quarters of FY 2011 were fully consolidated within the financial statements of Thermal Energy International Inc. The impact of the change to full consolidation from the second quarter of FY 2011 onwards for the year ended May 31, 2011 was as follows:

	Proportionate consolidation @ 55% $	As reported $	Difference $
Total Assets	**39,848**	**72,450**	32,602
Current Liabilities	**(2,502)**	**(4,548)**	(2,046)
Non-controlling interest	**-**	**(30,556)**	(30,556)
Net difference to balance sheet			-
Sales	**19,857**	**34,922**	15,065
Cost of sales	**(13,137)**	**(21,633)**	(8,496)
Other expenses	**(2,916)**	**9,441**	12,357
Non-controlling interest		**(18,926)**	(18,926)
Net profit (loss)	**3,804**	**3,804**	-

Sales in China through TEI (Guangzhou) Ltd came to a virtual halt during the last three quarters of FY 2011, pending resolution of management and staffing changes. Expenses incurred are related to the maintenance of the office plus technical and administrative staff. Management has now established a stable team to recommence the distribution of the Company's range of products in China. There was no revenue from the Chinese operation in the first quarter of FY 2012, with expenses relating to office rental and three employees of $22,646.

Segmented Information

In the quarters ended August 31, 2011 and 2010, the Company operated in the energy conservation industry in North America, Europe, China and Rest of the World. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports three technology lines – heat recovery solutions, condensate return system solutions and low temperature biomass drying systems. Assets are located in Canada, Europe and China.

Management reporting comprises analysis of revenue and gross profit by product segment within two distinct geographical areas. All other items of revenue and expenses are considered on a geographical and/or global basis in making strategic decisions regarding the Company's future. The Company has two operational bases ("reporting units"), one in Canada covering North America and China, and the other in the United Kingdom, covering Europe and the rest of the world. The chief operating decision maker focuses on revenues and costs by product and geographical segments, but manages assets and liabilities on a global basis. Segmented information was previously reported on a product line basis, rather than the geographical basis set out below. As a result the Company has restated the corresponding items of segment information for earlier periods.

Product segments:
In the heat recovery business, customers typically finance these projects entirely from their own resources and occasionally through the Company's Thermal-AUD™ system whereby the Company finances the project and leases the facility to the customer thereby giving rise to finance revenue and financial lease payments received. The second product segment is in the condensate return system solutions business which was acquired through via the Company's acquisition of Gardner Energy Management Limited (GEM™) on July 1, 2008. Costs of sale identifiable as attributable to each segment are recorded within each segment.

Geographical areas:
Below the gross profit line, management considers the results analyzed by geographical area. Management does not consider assets and liabilities on a geographical basis, but instead on a global basis. The two geographical areas are North America and China, which are managed from the Ottawa office, and Europe and Rest of world, which are managed from the UK office. These areas are determined by proximity of the region to the reporting unit, plus the location of the contracts in existence with agents and distributors in the respective areas and the historical relationships with those agents and distributors. Corporate costs that cannot easily be attributed to either of the two reporting units are included in reconciling items.

Segment information for the quarter ended August 31, 2011 and the comparative period are detailed in the table below.

	North America and China		**Europe and Rest of world**		**Reconciling items**		**Total**	
	2011	2010	2011	2010	2011	2010	**2011**	2010
	$	$	$	$	$	$	**$**	$
Revenue from heat recovery systems	**157,394**	1,835,267	**360,627**	365,493	-	-	**518,021**	2,200,760
Revenue from GEM	**143,460**	134,001	**770,205**	650,906	-	-	**913,665**	784,907
Total revenue	**300,854**	1,969,268	**1,130,832**	1,016,399			**1,431,686**	2,985,667
Cost of sales	**142,896**	1,430,921	**485,778**	351,086	-	-	**628,674**	1,782,007
Gross profit	**157,958**	538,347	**645,054**	665,313	-	-	**803,012**	1,203,660
Amortization of intangible assets			**24,623**	36,542			**24,623**	36,542
Other expenses	**398,402**	412,662	**520,511**	507,986	**206,737**	318,116	**1,125,650**	1,238,764
Finance revenue	**31,079**	50,915					**31,079**	50,915
Profit (loss) before taxation	**(209,365)**	176,600	**99,920**	120,785	**(206,737)**	(318,116)	**(316,182)**	(20,731)
Taxation	**-**	-	**(19,481)**	(29,137)	**20,134**	20,777	**653**	(8,360)
Profit (loss) after taxation	**(209,365)**	176,600	**80,439**	91,648	**(186,603)**	(297,339)	**(315,529)**	(29,091)
Attributable to:								
Owners of the parent	**(199,174)**	176,600	**77,281**	85,979	**(186,603)**	(297,339)	**(308,496)**	(34,760)
Non-controlling interests	(10,191)	-	3,158	5,669	-	-	(7,033)	5,669

During the quarter ended August 31, 2011 the company had one customer in the heat recovery systems segment that accounted for 23%, and one customer in the GEM segment that accounted for 17% of total revenue for the period. Both customers were within Europe and rest of world.

For the quarter ended August 31, 2010 the company had one customer in the heat recovery systems segment that accounted for 61% of total revenue for the period. This customer was based in the North America and China geographical segment.

Further geographical analysis:

	Revenues for the 3 months ended Aug 31		**Property, plant and equipment**		**Goodwill and intangibles**		**Sales-type lease**	
	2011	2010	Aug 31, 2011	May 31, 2011	Aug 31, 2011	May 31, 2011	Aug 31, 2011	May 31, 2011
	$	$	$	$	$	$	$	$
Canada	**157,155**	1,862,799	36,015	20,115	-	-	1,008,367	1,121,330
U.S.A.	**134,611**	52,664	-	-	-	-	-	-
U.K.	**840,086**	679,593	51,993	51,824	4,227,281	4,258,567		
Italy	**150,221**	104,620	-	-	-	-	-	-
Germany	**13,112**	73,388	-	-	-	-	-	-
Rest of Europe	**51,019**	33,352	-	-	-	-	-	-
China	**9,245**	53,806	2,313	2,588	-	-	-	-
Malaysia	**-**	47,544	-	-	-	-	-	-
Singapore	**51,904**	-	-	-	-	-	-	-
Rest of World	**24,333**	77,901	-	-	-	-	-	-
Total	**1,431,686**	2,985,667	90,321	74,527	4,227,281	4,258,567	1,008,367	1,121,330

Supplementary financial information

Quarterly financial information (unaudited)
For the eight quarters ended August 31, 2011

	2010			2011				2012
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Sales	1,564,527	1,306,548	1,636,644	2,985,667	2,938,131	1,863,635	1,913,163	1,431,686
Net profit (loss)	(1,010,630)	(646,842)	(843,849)	(34,760)	(3,186)	(53,842)	(50,794)	(308,496)
Net profit (loss) per share basic and diluted	(0.006)	(0.004)	(0.005)	(0.000)	(0.000)	(0.000)	(0.000)	(0.002)

Material Segmentation Variances

Revenue

Revenue from heat recovery systems decreased by $1,682,739 in the quarter ended August 31, 2011 over the same quarter of the previous year. This decrease was mainly the result of the Kruger project, in Canada, which provided $1,827,267 in the quarter ended August 31, 2010 ($nil in the quarter ended August 31, 2011). Revenue from the Fibrek project was $105,357 in the first quarter of FY 2012.

Thermal-AUD finance revenue in the quarter ended August 31, 2011 was $31,079, compared with $50,915 in the quarter ended August 31, 2010.

GEM revenues increased in the quarter ended August 31, 2011 over the same period in the prior year by $128,758. Revenues from the major food manufacturer in the UK, the orders for which were announced on December 23, 2010 and February 18, 2011 totalled $248,827 in the first quarter of this year ($nil I the same period of last year). This increase was partially offset by a general reduction in sales to other customers in the UK.

Geographical segment profit (loss) before tax:

North America and China suffered a pre-tax loss of $209,365 in the first quarter of FY 2012, compared with a profit of $176,600 in the same period of the preceding year. This was due almost entirely to the Kruger project in the quarter ended August 31, 2010, with no equivalent heat recovery revenue in the current period. Costs decreased by $14,260 in the quarter ended August 31, 2011 compared to the quarter ended August 31, 2010, mainly due to the lack of commissions due on the Kruger project in the current period.

Europe and rest of the world profits fell to $99,920 in the quarter ended August 31, 2011 from $120,785 in the same period of the previous year, despite an increase in revenue. The main reasons for this decrease are twofold: firstly the proportion of revenue coming from the installation of GEM traps at the major food manufacturer in the UK in the first quarter of 2012, much of which was at little or no margin: secondly the main heat recovery project in the UK in the first quarter of 2012 had much lower margins than the equivalent project in the preceding year. Other expenses increased by $12,525 (2.5%) over the same period in FY 2011. There were no significant changes.

Trend Analysis:

Sales increased in Q2 2010 over the previous quarter by $259,591 to $1,564,527. Sales of heat recovery systems of $468,692 included $299,161 for a system sold to Belfast City Hospital in Northern Ireland, while GEM® product sales of $1,095,835 included $289,984 from the major pharmaceutical company and $291,314 from Kings College Hospital in the UK. The losses in the quarter increased to $1,010,630, despite an increase in revenue. A greater percentage of revenue originated from sales of heat recovery systems, which generate lower a lower gross profit than GEM® products. In addition, provisions for potential liabilities with the former employees totaling $248,050 were made in the second quarter, as well as a $180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract.

Q3 Fiscal Year 2010 saw a decrease in net loss to $646,842. Despite the revenue matching that of Q1 2010, the loss was higher due to a higher percentage of the revenue in Q3 being generated from heat recovery systems, hence a lower gross margin. Of the $1,306,548 revenue in the quarter, $254,326 derived from sales of heat recovery systems, including $145,524 from the Kruger project, announced December 23, 2009. GEM® sales of $1,052,222 included $136,062 from the major pharmaceutical company, as well as two individual orders from the US for $85,214 and $90,183 respectively and one in Ireland for $105,710. The lower gross margins were offset by cost reductions within Administration and Selling, Marketing and Business Development.

In Q4 Fiscal Year 2010, revenues increased by $330,096, mainly due to the recognition of revenues from the Kruger project of $330,067. This, plus a small heat recovery project in the UK of $203,640 helped to bring sales of waste heat recovery systems in the quarter to $595,279. GEM® product sales of $1,041,365 were held at previous levels thanks to a smaller order from Kuwait National Petroleum Company of $149,336, plus the first order from the National Health Service (NHS) in the UK of $89,546 following a targeted drive towards this sector. In addition, Q4 saw a flurry of orders from the US and Canada. Despite this increased revenue, the loss incurred in the quarter was $843,849 due to $593,213 of provisions and write offs at year end.

The first quarter of Fiscal Year 2011 produced revenues of $2,985,667 and a net loss of $34,760. The increase in revenues came mainly from heat recovery products, which increased gross profit by $328,641 over the previous quarter. The majority of the revenue from this segment was generated from the Kruger Products contract at $1,827,267, with $296,689 coming from the partial recognition of a project at Kings College hospital in London for the installation of a waste heat recovery solution. Total revenue from heat recovery projects for the quarter was $2,200,760. GEM® product sales were $784,907, with no particularly large individual orders, but with $52,388 coming in from a new distributor in China. Continuing cost management ensured expenses were kept low, thus resulting in a relatively small loss in the quarter.

Q2 Fiscal Year 2011 produced revenues on a similar scale to Q1. With a higher level of GEM® sales than the prior quarter, gross profit was increased. Revenue from heat recovery systems for the quarter was $1,890,302, of which $1,614,754 related to the Kruger contract and $186,818 from the project at Kings College Hospital. GEM® product sales increased up to $1,047,829 for the quarter, due partly to sales to the major pharmaceutical company of $306,892. This higher level of sales combined with continued cost management generated a net loss of $3,186, an improvement of $31,574 over the first quarter.

Total sales in Q3 2011 of $1,863,635 were lower than the previous two quarters due to the stage of completion of the Kruger project, which generated $57,220 in the quarter. The installation of a heat recovery system at the Royal National Orthopaedic Hospital (RNOH) contributed $397,678 towards the total heat recovery systems sales of $607,056. Sales of GEM® products in the third quarter were $1,256,579, of which $317,925 related to orders received from a major food manufacturer in the UK, as announced December 23, 2010, and $87,810 from another hospital within the NHS in the UK. Resulting net loss for the quarter was $53,842, due in part to the provision for taxes generated from profits made in the UK entity of $100,156.

Q4 Fiscal Year 2011 saw revenues at a level similar to the previous quarter. Sales of GEM product were higher at $1,487,753, of which $558,016 related to the major food manufacturer in the UK and $220,448 related to sales within the NHS in the UK. At $425,410, revenues from heat recovery systems were less than Q3 which, as stated above, included the majority of the RNOH project. At $50,794, the net loss for the fourth quarter was a slight improvement on Q3, due mainly to the recovery of future taxes relating to intangible assets, which cancelled the effect of higher costs on a smaller heat recovery project plus higher cost of sales on GEM product due to more revenue coming from installation of traps in the quarter, which attract a lower margin that the product itself.

The first quarter of Fiscal Year 2012 experienced a drop in revenue of $481,477 over the previous quarter to $1,431,686. Of this revenue, $913,665 related to sales of GEM product, representing a decrease from the previous quarter of $574,088.

$309,189 of this decrease was due to a significant proportion of the sales to the major food manufacturer in the UK being recognized in Q4 of Fiscal 2011, $191,246 related to sales to the NHS in the UK, with one hospital order in the quarter ended August 31, 2011 compared with three in the quarter ended May 31, 2011, and other general sales worldwide being down $103,675, except for sales to the major pharmaceutical company which increased by $30,022 over the previous quarter. Revenue from sales of heat recovery solutions in the quarter ended August 31, 2011 increased by $92,611 over the previous quarter. Of the order from Salisbury District Hospital Trust, announced April 11, 2011, $321,752 was recognized as revenue in the first quarter of FY 2012. This more than replaced the revenue from Qincunbao of $159,972 in the previous quarter, but the decrease of other smaller projects served to reduce the overall increase. These reductions in overall revenue of $481,477 resulted in a decreased gross profit from the previous quarter of $229,452. Net loss increased in the first quarter of FY 2012 over the previous quarter by $257,702, due to the decrease in gross profit, plus $26,248 audit fees paid in the current quarter. There were no other large fluctuations in costs during the quarter.

Business Update:

1. On December 23, 2010 and February 18, 2011 the Company announced it had received purchase orders totalling approximately $1.3 million from a major food manufacturer based in the UK, to provide GEM® condensate return systems for use at twelve of its manufacturing sites. Sales for the year ending May 31, 2011 included approximately $0.9 million related to these orders with a further $0.25 million earned in the first quarter of fiscal 2012.

2. On April 11, 2011 the Company announced it had received a purchase order for approximately £246 thousand (approximately CDN $386 thousand) from Salisbury District Hospital Trust, a major hospital in South West England, to install a heat recovery system for use on its heating and hot water system. This system was largely completed in the first quarter of fiscal 2012.

3. On May 6, 2011 the Company received a purchase orders for approximately £208 thousand (approximately $334 thousand) from Frimley Park Hospital NHS Trust in the UK to provide to provide GEM® condensate return products and a heat recovery solution for use on its heating and hot water system. This project is now underway and is expected to be substantially completed over the next two quarters.

4. On June 16, 2011 the Company announced it had signed a contract valued at approximately $5.8 million with Fibrek to provide a heat recovery solution for its pulp mill located in Saint-Félicien, Québec. This project is now underway and is expected to be substantially completed this fiscal year.

5. On July 21, 2011 the Company received a purchase order for approximately $340 thousand from a major multi-national bakery company to provide a heat recovery solution for one of its United States based manufacturing facilities. This project is now underway and is expected to be substantially completed over the next two quarters.

6. On August 5, 2011 the Company announced it had received a purchase order for approximately £1.29 million (approximately CDN $2.06 million) from St Georges Healthcare NHS Trust, a major hospital in London, UK to provide a heat recovery solution for use on its heating and hot water system. This project is now underway and is expected to be substantially completed this fiscal year.

7. Subsequent to quarter end the Company amended and extended its distributor, licensing and patent purchase agreement with Mabarex Inc. related to the Dry-Rex™ technology. In exchange for minimum annual royalty payments of approximately $5,000, the agreement provides the Company with a sole and exclusive worldwide licence to the Dry-Rex™ technology for the next 10 years. The agreement also provides the Company the option to purchase the Dry-Rex™ technology at any time during the term of the agreement.

8. The Company's order backlog as at August 31, 2011 was approximately $8.6 million compared to $2.7 million at the same time last year. As at November 28, 2011 the Company had $9.2 million in purchase orders that had not yet been reflected as revenue in the Company's published quarterly financial statements.

Critical Accounting Estimates

On October 25, 2005, the Company was served with a statement of claim from its past President. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the approximate 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 approximately $5 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. In May, 2010, the plaintiff brought a motion for summary judgment, seeking judgment on part of the claim. In the motion, the plaintiff seeks damages in the amount of $1,105,047 plus interest and costs. This amount is comprised of: i) $398,737 allegedly owing as a result of wrongful dismissal and calculated as 24 months of salary, commissions, and related benefits; ii) $618,810 in alleged unpaid loans and advances; and iii) $87,500 in stock options which are alleged to have vested. The motion was heard on September 6 and 7, 2011 and on October 18, 2011 a decision was rendered. In its decision on the motion for summary judgment the court:

i) Allowed the plaintiff's claim for wrongful dismissal assessing the damages for the plaintiff's wrongful dismissal at the equivalent of 18 months of pay in lieu of notice of termination;
ii) Dismissed the plaintiff's claim for alleged unpaid loans and advances;
iii) Permitted the remainder of the parties' claims and counterclaims to proceed to trial;
iv) Declined to fix the amount of the damages, suggesting instead that the parties try to agree on the amount;
v) Stated that in the absence of the parties' agreement on the amount of damages, the quantification of damages is to be referred to a Master;
vi) Stayed the execution of the partial summary judgment pending the determination of the outstanding claims at trial;
vii) Reserved the matter of costs on the motion pending either an agreement between the parties or the receipt of written submissions on costs.

To date, the parties have not yet discussed or agreed on the amount of the damages for wrongful dismissal and have not agreed on an award of costs. There has, as yet, been no reference to a Master. Written submissions on costs have been provided to the court. Until the remaining issues are determined, it is unclear what the net balance payable between the parties will be and to which party it is to be paid and the ultimate net impact of the partial judgment on Thermal Energy remains unknown at present.

While the Company is confident in the merits of its own case, there is much that is still unknown about the former president's case. In November 2009, the Company 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.

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 condensed consolidated interim financial statements for the quarter ended August 31, 2011, these statements were not subject to an audit.

Business Risks

Management is confident about our long-term prospects, but does recognize that the company is exposed to a number of risks in the normal course of business that could negatively impact the financial condition of the Company.

Operational risks of the company include the ability to continue to secure and implement sales contracts for its GEM® and FLU-ACE® technology solutions.
Financial risks and uncertainties of the Corporation include:

- The Company's history of operating losses and uncertainty of future profitability;
- 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;
- The ongoing litigation with its former President & CEO;
- The ability to control costs and achieve a positive gross margin on projects; and,
- The effect of a prolonged recession in Canada, USA and Europe to the financial markets in securing project financing and in particular to industrial and commercial customers in committing capital to projects.

Management's addressing of the risks:

The management of the Company realizes that the operating losses in FY 2010, FY 2011 and the first quarter of FY 2012 display a consistent pattern of losses as in previous years. However the operating losses in FY 2010 were partly attributed to $963,213 in one-time provisions and write-offs. FY 2011 also resulted in a loss, however this was much reduced from previous years' losses due to achieving a larger number of both heat recovery projects and GEM sales, along with improved cost controls. The loss suffered in the first quarter of FY 2012 was due to the lack of revenue from heat recovery projects, which is expected to be recovered as both the Fibrek project and St. Georges Healthcare NHS Trust project, announced August 5, 2011, progress.

In addition on June 29th, 2010 the Company signed an arm's length Greenpower Purchase Agreement with Fortress Specialty Cellulose Inc. ("Fortress Specialty"). The agreement is to supply recovered energy to the Fortress Specialty mill in Thurso, Quebec from a FLU-ACE® Waste Heat Recovery System installed at the site. Based on the amount of heat expected to be recovered, this agreement is expected to provide the Company approximately $720,000 of additional cash flow per year between now and December 31, 2012.

The Company actively protects its proprietary technology through registered trademarks and confidentiality agreements.

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

Management believes that competition against its core technology of GEM®, FLU-ACE® and DRY-REX™ is limited at this time and believes that the market place is sufficiently large enough to mitigate the risk of stronger competition in the future.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

In February 2008, the Canadian Institute of Chartered Accountants (CICA) announced that Canadian GAAP for publicly accountable enterprises will be replaced by IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The standard also requires that comparative figures for 2010 be based on IFRS. Accordingly, the Company has adopted IFRS on June 1, 2011, with restatement for comparative purposes of amounts reported by the Company for the fiscal year beginning June 1, 2010. The unaudited condensed consolidated interim financial statements, which should be read in conjunction with this discussion, have been prepared in accordance with International Accounting Standard 34, Interim Financial Reporting.

The significant accounting policies adopted under IFRS are included in note 3 to the unaudited condensed consolidated interim financial statements for the quarter ended August 31, 2011. These accounting policies have been applied consistently to all periods presented in the financial statements. They also have been applied in preparing an opening IFRS statement of financial position as at June 1, 2010, the Company’s transition date, as required by IFRS 1. The accounting policies have been selected to be consistent with IFRS as is expected to be effective on May 31, 2012, the Company’s first annual IFRS reporting date. The standards and interpretations within IFRS are subject to change and accordingly, the accounting policies for the annual period that are relevant to these unaudited condensed consolidated interim financial statements will be finalized only when the first full IFRS financial statements are prepared for the year ending May 31, 2012.

Reconciliations and descriptions of the effect of the transition from Canadian GAAP to IFRS are included in note 27 to the unaudited condensed consolidated interim financial statements for the quarter ended August 31, 2011.

The transition from Canadian GAAP to IFRS had no impact on total comprehensive income (loss).

Summary of Outstanding Shares and Dilutive Instruments

The Company currently has the following shares and dilutive instruments outstanding:

Shares

163,336,616 class A common shares.

Options

Number of options outstanding	Number of options exercisable	Exercise price per share $	Expiry date
2,750,000	1,583,333	0.10	May 4, 2015
2,656,250	-	0.10	May 10, 2016
500,000	-	0.10	July 12, 2016
5,906,250	1,583,333		

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The unaudited condensed consolidated interim financial statements of Thermal Energy and all the information in this interim 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 unaudited condensed consolidated interim financial statements conform to IFRS. Financial information presented throughout this report is consistent with that in the unaudited condensed consolidated interim financial statements.

Thermal Energy 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's external auditors, Raymond Chabot Grant Thornton LLP, conducted an independent audit of the consolidated financial statements for the year ended May 31, 2011 in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an audit opinion. The condensed consolidated financial statements for the quarter ended August 31, 2011, prepared in accordance with IFRS, have not been audited.