FIRST QUARTER REPORT
Period ended August 31, 2012

MANAGEMENT'S DISCUSSION & ANALYSIS

This discussion is dated as of October 30, 2012 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 2013, ended August 31, 2012. 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. During the period ended August 31, 2012, the Company's critical accounting estimates, significant accounting policies and risk factors have remained substantially unchanged. 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. All financial information in this report is stated in Canadian Dollars, which is both the presentation and functional currency of the Company.

Description of Business

Thermal Energy, established in 1991, 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. Thermal Energy International Inc. is headquartered in Ottawa, Canada, with offices in the UK and China and sales worldwide.

Thermal Energy engages clients through a unique mix of process, energy, environmental, and financial expertise to deliver significant financial and environmental benefits to our customers. The Company's award winning products have an excellent track record of longevity, proven reliability and performance and have been shown to provide: significant energy savings; improved water efficiency; reduced greenhouse gas emissions; lower maintenance costs; improved product quality; and increased production efficiency. Thermal Energy's products are effective in a wide range of industries and applications.

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 $862,077 in the quarter ended August 31, 2012 compared to $1,431,686 in the quarter ended August 31, 2011. Sales of GEM® Condensate return systems decreased by $192,827 (21.1%) over the same period in the previous year, while sales of heat recovery systems decreased by $376,782 (72.7%).

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, compared with $34,326 in the current period. An increase in revenue within North America of $147,896 was offset by decreases in revenues to a major pharmaceutical company and to the rest of the world.

The low heat recovery systems revenue in the first quarter ended August 31, 2012 was the result of a lack of project activity, pending the arrival of equipment in the UK for four ordered systems, due to arrive in the beginning of the third quarter of FY 2013.

The gross profit of $524,963 in the quarter ended August 31, 2012 represented a decrease of $278,049, or 34.6%, on the $803,012 achieved in the quarter ended August 31, 2011. These results expressed as a percentage of sales were 60.9% in the first quarter of FY 2013 compared with 56.1% in the first quarter of FY 2012. 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

Administration and Selling, Marketing and Business Development expenses in the quarter ended August 31, 2012 totalled $1,507,917 compared with $1,150,153 in the quarter ended August 31, 2011.
The increase is primarily due to staff costs related to six additional sales staff, three additional technical staff, one additional finance staff and a marketing and sales co-ordinator, all hired since May 2011. Other increases relate to enhanced staff and distributor training, audit fees for IFRS reporting, plus the addition of two directors as well as the retainer paid to the investor relations firm, as announced April 19, 2012.

Research and development costs of $nil in the first quarter of FY 2013 compared to $120 in the first quarter of FY 2012. Current focus is on increasing revenues from existing product lines, rather than developing new products.

Finance revenue

Finance revenue was $11,033 in the quarter ended August 31, 2012 compared to $31,079 in the quarter ended August 31, 2011. The interest rate implicit in the lease of 14% is applied against the reducing finance lease receivable balance, hence lower finance revenues as the term of the agreement progresses.

Loss before income taxes for the quarter ended August 31, 2012 was $971,921 compared to a loss of $316,182 in the same quarter of the previous year. The increased loss is mainly the result of the reduced revenues plus increased staff numbers.

Income taxes recovery for the first quarter of FY 2013 of $124,594 compared to $653 as reported in the first quarter of FY 2012. Losses made by the Company's wholly owned UK subsidiary Gardner Energy Management Ltd generated a tax credit in the first quarter of FY 2013. In the prior period, 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 $847,327 compared to a loss of $315,529 in the same quarter of the previous year.

Comprehensive loss attributable to Owners of the Parent was $913,232 for the first quarter of FY 2013 compared to comprehensive loss of $312,933 for the first quarter of FY 2012. The Sterling exchange rate weakened over the Canadian dollar in the first quarter of FY 2013, giving rise to unrealized losses on translating the goodwill and intangible assets acquired as part of the acquisition of Gardner Energy Management Limited.

Liquidity & Capital Resources

The working capital was $1,733,904 at August 31, 2012 compared to working capital of $2,567,447 at May 31, 2012 - a decrease of $833,543, while the Company's net cash position (Cash and cash equivalents less Bank loans) decreased by $777,618 from $1,371,951 at May 31, 2012 to $594,333 as at August 31, 2012.

The Company's working capital position over the last eight quarters can be summarized as follows:

	Nov 30, 2010 $	Feb 28, 2011 $	May 31, 2011 $	Aug 31, 2011 $	Nov 30, 2011 $	Feb 29, 2012 $	May 31, 2012 $	Aug 31, 2012 $
Current Assets	3,955,487	3,717,578	3,898,346	4,371,855	5,813,077	5,345,538	5,758,086	4,534,637
Current Liabilities	2,331,863	1,930,687	2,017,259	2,695,481	3,500,526	2,942,432	3,190,639	2,800,733
Working Capital	1,623,624	1,786,891	1,881,087	1,676,374	2,312,551	2,403,106	2,567,447	1,733,904

Q1 FY 2013 Changes

Current assets decreased in the current quarter by $1,223,449 to $4,534,637. This was mainly due to a decrease in Trade receivables of $325,157, a decrease in cash balances of $777,618 and a decrease in the finance lease receivable of $132,959. Current liabilities meanwhile also decreased by $389,906 to $2,800,733. Trade payables decreased by $171,692, current tax liabilities were erased by the losses incurred in the first quarter and other liabilities decreased by $333,993 due mainly to May accruals relating to the Fibrek project of $152,742 now being billed and sales taxes as at May 2012 being settled of $124,080. Deferred revenue, meanwhile, increased by $209,015 due to initial deposits paid by customers for heat recovery projects in the UK.

As at August 31, 2012, $1,698,138 (66.4%) of the Company's trade receivables balance was over 90 days past due. Of this balance, $1,231,364 has subsequently been received by the Company, and a further $284,462 is receivable from Fibrek upon final commissioning, all of which is expected to be received over the next two months. None of this overdue balance is considered impaired as at August 31, 2012.

Operating cash outflow (defined as net loss for the period, plus items not involving cash, plus lease payments received) for the quarter ended August 31, 2012 was $668,914. After adjusting this for $89,165 of negative changes in non-cash working capital items and foreign exchange adjustments and deducting $20,178 to acquire fixed assets and adding a positive $639 to allow for the effect of exchange rate fluctuations on cash and cash equivalents, the net cash outflow was $777,618, decreasing the net cash balance as at August 31, 2012 to $594,333 from $1,371,951 as at May 31, 2012.

In addition to its net cash balance of $594,333 as at August 31, 2012 the Company also had an estimated $100,000 of unused borrowing capacity under its bank loans.

With cash balances and unused borrowing capacity of approximately $694,333, management believes that it has sufficient capital resources to fund existing operations and anticipated capital requirements in the remainder of FY 2013. Order backlog as at August 31, 2012 was approximately $1.9 million compared to $8.6 million at the same time last year, which included $5.6 million regarding Fibrek and $2.0 million for the St. George NHS Trust project in the UK. As at October 30, 2012 the Company had $2.5 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, 2012	May 31, 2012
	$	$
Total estimated minimum lease payments receivable	386,788	530,779
Less: unearned income	(7,251)	(18,283)
	379,537	512,496
Less: current portion	(379,537)	(512,496)
	-	-

The estimated minimum lease payments receivable in this 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 2013	247,258
Residual value of equipment	139,530
	386,788

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.

Related Party Transactions

Options outstanding for Directors (excluding the CEO) as at August 31, 2012 were 1,250,000 of which 166,666 were exercisable. There were no warrants outstanding for Directors.

Options outstanding for Officers (including the CEO) as at August 31, 2012 were 4,140,000 of which 1,900,000 were exercisable. There were no warrants outstanding for Officers.

Officer and Director Compensation

During the first quarter ended August 31, 2012 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, 2012 Directors fees paid were $25,000. 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 $5,000 was paid for in-person meetings.

Compensation paid to directors and officers during the first quarter ended August 31, 2012 (inclusive of the amounts described above) was as follows:

	Salaries and fees		**Commissions / incentives**		**Total**	
	2012	2011	**2012**	2011	**2012**	2011
	$	$	**$**	$	**$**	$
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	**6,000**	4,333	**-**	-	**6,000**	4,333
W. Ollerhead	**6,000**	-	**-**	-	**6,000**	-
Total	**37,000**	29,333	**-**	-	**37,000**	29,333
Officers						
W. Crossland	**60,000**	60,000	**-**	-	**60,000**	60,000
J. Flynn	**31,732**	30,779	**-**	-	**30,779**	30,779
R. Triebe	**33,750**	33,750	**-**	-	**33,750**	33,750
Total	**124,529**	124,529	**-**	-	**124,529**	124,529

Segmented Information

In the three months ended August 31, 2012 and 2011, the Company operated in the energy efficiency industry in North America, Europe, China and Rest of the World. The Company markets, sells, engineers, fabricates, constructs, installs and supports two technology lines – heat recovery solutions and condensate return system solutions. The Company is also developing a third technology line - 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 Bristol, United Kingdom, covering Europe and the rest of the world. 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. The chief operating decision maker focuses on revenues and costs by geographical segments, but manages assets and liabilities on a global basis.

Segment information for the three months ended August 31 is detailed in the table below.

	North America and China		Europe and Rest of World		Reconciling items		Total	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	$	$	**$**	$	**$**	$	**$**	$
Total revenue	**321,410**	300,854	**540,667**	1,130,832	**-**	-	**862,077**	1,431,686
Cost of sales	**(94,484)**	(142,896)	**(242,630)**	(485,778)	**-**	-	**(337,114)**	(628,674)
Gross profit	**226,926**	157,958	**298,037**	645,054	**-**	-	**524,963**	803,012
Amortization of intangible assets	**-**	-	**(24,646)**	(24,623)	**-**	-	**(24,646)**	(24,623)
Other expenses	**(574,996)**	(388,294)	**(583,230)**	(520,511)	**(325,045)**	(216,845)	**(1,483,273)**	(1,125,650)
Finance revenue	**11,033**	31,079	**-**	-	**-**	-	**11,033**	31,079
Profit (loss) before taxation	**(337,037)**	(199,257)	**(309,839)**	99,920	**(325,045)**	(216,845)	**(971,922)**	(316,182)
Taxation	**-**	-	**89,803**	(19,481)	**34,791**	20,134	**124,594**	653
Profit (loss) after taxation	**(337,037)**	(199,257)	**(220,036)**	80,439	**(290,254)**	(196,711)	**(847,328)**	(315,529)
Attributable to:								
Owners of the parent	**(326,957)**	(189,066)	**(221,188)**	77,281	**(290,254)**	(196,711)	**(838,399)**	(308,496)
Non-controlling interest	**(10,080)**	(10,191)	**1,152**	3,158	**-**	-	**(8,928)**	(7,033)

Other expenses within reconciling items comprise the following:

	Quarter ended Aug 31	
	2012	2011
	$	$
Corporate admin costs	**199,116**	168,754
Stock-based compensation	**34,393**	10,108
Professional fees	**53,522**	26,248
Depreciation of property, plant and equipment	**10,627**	10,508
Bank charges and interest	**10,306**	11,627
Foreign exchange differences	**17,081**	(10,400)
Total	**325,045**	216,845

During the quarter ended August 31, 2012 the company had no individual customer who accounted for more than 10% of total revenue for the period.

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

Further geographical analysis:

	Revenue for the three months ended		Property, Plant and Equipment as at		Goodwill and other Intangible assets as at		Finance Lease Receivable as at	
	August 31, 2012	May 31, 2012	**August 31, 2012**	May 31, 2012	**August 31, 2012**	May 31, 2012	**August 31, 2012**	May 31, 2012
	$	$	**$**	$	**$**	$	**$**	$
Canada	**115,636**	157,155	**41,591**	28,448	**-**	-	**379,537**	512,496
U.S.A.	**205,062**	134,611	**-**	-	**-**	-	**-**	-
U.K.	**405,053**	840,086	**36,687**	40,512	**4,057,936**	4,145,745	**-**	-
Italy	**42,534**	150,221	**-**	-	**-**	-	**-**	-
Netherlands	**38,237**	25,603	**-**	-	**-**	-	**-**	-
Eire	**32,357**	13,721	**-**	-	**-**	-	**-**	-
Rest of Europe	**6,485**	24,807	**-**	-	**-**	-	**-**	-
Singapore	**-**	51,904	**-**	-	**-**	-	**-**	-
China	**712**	9,245	**958**	1,364	**-**	-	**-**	-
Rest of world	**16,001**	24,333	**-**	-	**-**	-	**-**	-
Total	**862,077**	1,431,686	**79,236**	70,324	**4,057,936**	4,145,745	**379,537**	512,496

Material Segmentation Variances

Revenue

North America and China: total revenue for this segment in the quarter ended August 31, 2012 was $321,410, representing an increase of $20,556 over the quarter ended August 31, 2011. A decrease in heat recovery revenue of $120,343, due to the completion of the Fibrek project in FY 2012 was more than offset by an increase in GEM® revenues of $140,899 in the quarter ended August 31, 2012 over the same period in the previous year. The increased GEM® revenues are the result of increased sales staff across the region.

Europe and Rest of World: total revenue for this segment in the quarter ended August 31, 2012 was $540,667, representing a decrease of $590,165 from the quarter ended August 31, 2011. Heat recovery revenue fell by $256,439, as there were no NHS projects in the current period, compared with one UK hospital project in the first quarter of the preceding year. GEM® revenues, meanwhile, decreased by $333,726, resulting mainly from reduced revenues from orders received from the major food manufacturer in the previous year and reduced revenues from the major pharmaceutical company with whom a key supplier agreement was signed in 2008.

Segment loss before tax:

North America and China realized a pre-tax loss of $337,037 in the quarter ended August 31, 2012, compared to a loss of $199,257 in the same quarter of the preceding year, despite an increase in gross profit of $68,968. Increased staff numbers served to increase costs, including recruitment and training, alongside additional commission payable on the GEM® sales.

Europe and rest of the world loss before tax of $309,839 in the quarter ended August 31, 2012 compared to pre-tax income of $99,920 in the same quarter of the previous year. The net decrease of $409,759 was a combination of a reduction in gross profit of $347,107 and an increase in other expenses of $62,719. Additional other expenses came from an increase in staff numbers in the first quarter of FY 2013 compared with the same period last year.

Other expenses within Reconciling items, which incorporates all costs not specifically attributable to the either regional operational center, increased in the first quarter of FY 2013 over the first quarter of FY 2012 by $108,200. This increase was due to the two directors added during the year, fees relating to the investor relations firm appointed in the final quarter of FY 2012, stock based compensation, and the timing of invoices for audit services.

Supplementary financial information

Quarterly financial information (unaudited)
For the eight quarters ended August 31, 2012

Quarter ended	30-Nov-11 $	29-Feb-12 $	31-May-12 $	31-Aug-12 $
Revenue	4,676,322	3,583,801	3,460,878	862,077
Gross Profit	2,123,687	1,413,265	1,308,407	524,963
Gross Profit Percentage	45.4%	39.4%	37.8%	60.9%
EBITDAS(1)	731,191	44,242	(61,525)	(901,104)
Total net income (loss)	459,779	(28,913)	(20,941)	(838,399)
Income (loss) per share, basic and diluted	0.003	0.000	0.000	(0.005)
Net operating cash flow(2)	609,587	236,363	216,353	(668,914)

Quarter ended	30-Nov-10 $	28-Feb-11 $	31-May-11 $	31-Aug-11 $
Revenue	2,938,131	1,863,635	1,913,163	1,431,686
Gross Profit	1,275,844	1,140,077	1,055,037	803,012
Gross Profit Percentage	43.4%	61.2%	55.1%	56.1%
EBITDAS(1)	46,178	78,638	(79,562)	(264,766)
Total net income (loss)	(3,186)	(53,842)	(50,794)	(308,496)
Income (loss) per share, basic and diluted	0.000	0.000	0.000	(0.002)
Net operating cash flow(2)	183,724	167,807	86,776	(158,988)

(1) EBITDAS represents earnings before interest, taxation, depreciation, amortization, share-based compensation expense and net write down of lease.

(2) Net operating cash flow represents net income (loss) plus items not involving cash, plus lease payments received.

Trend Analysis:

In the first quarter of FY 2013, revenues fell from the last quarter of FY 2012 by $2,598,801, representing mainly heat recovery revenue from Fibrek and GEM revenues from UK sites of a major food manufacturer realized in the quarter ended May 31, 2012. The consequent reduction in gross profit of $783,444 along with a slight increase in other expenses net of finance revenue of $34,014, resulted in an increased loss of $817,458 over the previous quarter. Historically, the first quarter of the year has relatively lower GEM sales than in other quarters due to summer vacations, and management had forecast a significant loss in this quarter.

Revenues in the quarter ended May 31, 2012 decreased again from the quarter ended February 29, 2012 by $122,923. 74% of the revenue in this quarter came from heat recovery systems sales; mainly Fibrek and two UK sites of a major food manufacturer. GEM® revenues increased by $71,065 over the previous quarter. Although expenses remained fairly constant from the third to the fourth quarter, due to less revenue being generated in the UK entity, there was a reversal of tax charge. In addition, a reduction in the UK rate of tax served to reduce the value of the future tax liability against intangible assets, thus creating a credit to the tax charge on the fourth quarter, and reducing the effect of the reduction in revenue.

The quarter ended February 29, 2012 experienced a decrease in revenues of $1,092,521 over the previous quarter, represented by a decrease in heat recovery revenues of $1,168,074 and a small increase in GEM® revenues of $75,553. The majority of the heat recovery decrease related to the St. George’s project in the UK, which was substantially completed in the second quarter. The majority of the GEM related increase came from general UK and Rest of World sales. Expenses decreased in the third quarter from the previous quarter by $59,606, mostly the result of reduced incentive related to the reduced net income for the period.

The second quarter of FY 2012 saw an increase in revenues of $3,244,636 over the previous quarter, resulting from an increase in heat recovery revenues of $3,395,794 and a reduction in GEM® revenues of $151,158. GEM® revenues relating to the orders from the major food manufacturer and the global pharmaceutical company were $227,730 and $74,711 respectively less in the second quarter than the quarter ended August 31, 2011, while revenues from the NHS and other general sales were up $74,607 and $47,860 respectively over the prior quarter. The increase in heat recovery revenues over the first quarter came predominantly from St. Georges Healthcare NHS Trust in the U.K. contributing $1,607,234, and Fibrek, which generated an extra $1,775,452 over the previous quarter. Resulting gross profit represented an increase of $1,320,675 over the $803,012 generated in the first quarter. Net profit before tax for the second quarter of FY 2012 was $622,412 – an improvement of $938,594 over the net loss before tax in the first quarter of $316,182. Costs increased by $382,081 over the prior quarter, mainly the result of increased commissions on the increased revenues, incentive accrued on the profit made in the year to date, audit bills, legal fees relating to the dispute with a former president of the company and other issues, the write off of the finance lease receivable of approximately $54,758 and the recruitment of two new heat recovery sales people; one based in North America and the other covering the U.K. and Europe. These increases were partially offset by a tax credit of around $52,000 relating to historical research and development expenditure.

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 November 30, 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 November 30, 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 $252,025. 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 first quarter. There were no other large fluctuations in costs during the quarter.

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.

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.

Q2 Fiscal Year 2011 produced revenues on a similar scale to the previous quarter, which showed an increase on prior quarters. 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.

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, 2012, 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 continuing 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:

FY 2012 saw the Company's first ever net profit, which was the result of increased revenues and strict cost control. The first quarter of FY 2013, however, has produced a loss before tax of $971,921, resulting from diminished revenues and increasing costs. The increased costs predominantly relate to increased staff numbers, which management believes are vital to maintain and build on the record revenues of FY2012. A dip in profitability was expected while new staff additions become accustomed to their roles and the strategy of the Company.

As reported last year, 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 waste energy expected to be recovered, this agreement was expected to provide the Company approximately $720,000 of additional cash flow per year between now and December 31, 2012. To date, it has delivered just that. It is anticipated that the agreement may be extended for a number of months beyond December 31, 2012, while a decision is made regarding the termination or contractual extension of the lease. Management is scheduled to meet with the customer within the next two weeks to determine a way forward.

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.

Business Update:

1. On April 20, 2012, the Company received an order for the value of £316,844 (approximately $500,000) from St. Bartholomew's Hospital in the UK for its heat recovery solutions. This order is expected to be substantially completed by the end of the third quarter of FY 2013.

2. On May 10, 2012, the Company announced it had received a further purchase order for approximately $467 thousand from the major food manufacturer in the U.K. for a heat recovery solution. This order is expected to be completed in FY 2013.

3. On October 16, 2012, the Company announced it had appointed Tim Gardner as Director of Business Development. The inventor of the GEM® steam trap, Mr. Gardner will be responsible for driving sales in the UK, Ireland and Italy. He will be working out of the Bristol office in the UK.

4. The Company's order backlog as at August 31, 2012 was approximately $1.9 million. As at October 30, 2012 the Company had approximately $2.5 million in purchase orders that had not yet been reflected as revenue in the Company's published quarterly financial statements.

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	2,166,667	0.10	May 4,2015
2,562,500	854,167	0.10	May 10, 2016
500,000	166,667	0.10	July 12, 2016
5,190,000	-	0.10	December 1, 2016
11,002,500	3,187,501		

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, 2012 in accordance with IFRS, 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, 2012, prepared in accordance with IFRS, have not been audited.