Energy Recovery, Inc.
Form 10-Q
August 04, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to __________

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**01-0616867**
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
1717 Doolittle Drive, San Leandro, CA	**94577**
(Address of Principal Executive Offices)	(Zip Code)

(510) 483-7370

(Registrant's Telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes No

As of August 1, 2016, there were 52,054,700 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED JUNE 30, 2016

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data and par value)

(unaudited)

	June 30, 2016	**December 31, 2015**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 78,987	$ 99,931
Restricted cash	1,058	1,490
Short-term investments	15,095	257
Accounts receivable, net of allowance for doubtful accounts of $168 and $166 at June 30, 2016 and December 31, 2015, respectively	8,242	11,590
Unbilled receivables, current	1,804	1,879
Inventories	6,178	6,503
Deferred tax assets, net	—	938
Prepaid expenses and other current assets	1,272	943
Total current assets	112,636	123,531
Restricted cash, non-current	3,065	2,317
Unbilled receivables, non-current	—	6
Deferred tax assets, non-current	885	—
Property and equipment, net of accumulated depreciation of $19,872 and $18,338 at June 30, 2016 and December 31, 2015, respectively	9,762	10,622
Goodwill	12,790	12,790
Other intangible assets, net	2,216	2,531
Other assets, non-current	2	2
Total assets	$ 141,356	$ 151,799
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,518	$ 1,865
Accrued expenses and other current liabilities	5,233	7,808

Income taxes payable	89	2
Accrued warranty reserve	411	461
Deferred revenue	6,772	5,878
Current portion of long-term debt	10	10
Total current liabilities	14,033	16,024
Long-term debt, net of current portion	33	38
Deferred tax liabilities, non-current	2,109	2,360
Deferred revenue, non-current	66,462	69,000
Other non-current liabilities	637	718
Total liabilities	83,274	88,140
Commitments and Contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.001 par value; 200,000,000 shares authorized; 55,731,277 shares issued and 52,124,021 shares outstanding at June 30, 2016, and 54,948,235 shares issued and 52,468,779 shares outstanding at December 31, 2015	56	55
Additional paid-in capital	134,156	129,809
Accumulated other comprehensive loss	(101)	(64)
Treasury stock at cost, 3,607,256 and 2,479,456 shares repurchased at June 30, 2016 and December 31, 2015, respectively	(15,213)	(6,835)
Accumulated deficit	(60,816)	(59,306)
Total stockholders' equity	58,082	63,659
Total liabilities and stockholders' equity	$ 141,356	$ 151,799

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2016	**2015**	**2016**	**2015**
Product revenue	$11,973	$10,484	$22,024	$16,348
Product cost of revenue	4,236	4,836	7,910	7,367
Product gross profit	7,737	5,648	14,114	8,981
License and development revenue	1,250	—	2,500	—
Operating expenses:				
General and administrative	3,992	5,362	8,876	11,640
Sales and marketing	1,935	1,994	4,005	4,427
Research and development	2,422	1,410	5,087	3,943
Amortization of intangible assets	158	158	315	317
Total operating expenses	8,507	8,924	18,283	20,327
Income (loss) from operations	480	(3,276)	(1,669)	(11,346)
Other expense:				
Interest expense	—	—	(1)	(40)
Other non-operating income (expense)	79	20	58	(82)
Income (loss) before income taxes	559	(3,256)	(1,612)	(11,468)
Provision (benefit) for income taxes	103	71	(102)	142
Net income (loss)	$456	$(3,327)	$(1,510)	$(11,610)
Net income (loss) per share - basic	$0.01	$(0.06)	$(0.03)	$(0.22)
Net income (loss) per share - diluted	$0.01	$(0.06)	$(0.03)	$(0.22)
Weighted average shares outstanding - basic	52,369	52,026	52,288	51,987
Weighted average shares outstanding - diluted	55,698	52,026	52,288	51,987

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(unaudited)

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2016	**2015**	**2016**	**2015**
Net income (loss)	$456	$(3,327)	$(1,510)	$(11,610)
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustments	6	(6)	(6)	25
Unrealized (loss) gain on investments	(32)	(2)	(31)	1
Other comprehensive (loss) income	(26)	(8)	(37)	26
Comprehensive income (loss)	$430	$(3,335)	$(1,547)	$(11,584)

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30, 2016	2015
Cash Flows From Operating Activities		
Net loss	$(1,510)	$(11,610)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	1,865	3,053
Depreciation and amortization	1,851	1,959
Provision for warranty claims	96	15
Unrealized loss on foreign currency transactions	52	21
Amortization of premiums on investments	34	130
Change in fair value of put options	33	—
Provision for doubtful accounts	16	59
Valuation adjustments for excess or obsolete inventory	(42)	21
Other non-cash adjustments	(49)	86
Reversal of accruals related to expired warranties	(146)	—
Deferred income taxes	(199)	131
Changes in operating assets and liabilities:		
Accounts receivable	3,333	3,472
Deferred revenue, product	855	714
Inventories	389	(1,520)
Income taxes payable	89	4
Unbilled receivables	81	60
Litigation settlement	—	(1,700)
Accounts payable	(347)	549
Prepaid and other assets	(384)	239
Deferred revenue, SLB license	(2,500)	—
Accrued expenses and other liabilities	(2,668)	(3,633)
Net cash provided by (used in) operating activities	849	(7,950)
Cash Flows From Investing Activities		
Maturities of marketable securities	—	8,235
Restricted cash	(315)	2,422
Capital expenditures	(613)	(429)
Purchases of marketable securities	(14,903)	—
Net cash (used in) provided by investing activities	(15,831)	10,228

Cash Flows From Financing Activities		
Net proceeds from issuance of common stock	2,511	293
Proceeds from long-term debt	—	55
Repayment of long-term debt	(5)	(2)
Repurchase of common stock	(8,378)	—
Net cash (used in) provided by financing activities	(5,872)	346
Effect of exchange rate differences on cash and cash equivalents	(90)	(18)
Net change in cash and cash equivalents	(20,944)	2,606
Cash and cash equivalents, beginning of period	99,931	15,501
Cash and cash equivalents, end of period	$78,987	$18,107

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (the “Company”, “Energy Recovery”, “Our”, “Us”, and “We”) is an energy solutions provider to industrial fluid flow markets worldwide. We make industrial processes more operating and capital expenditure efficient. Our solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our solutions are marketed and sold in fluid flow markets, such as water, oil & gas, and chemical processing, under the trademarks ERI®, PX®, Pressure Exchanger®, PX Pressure Exchanger®, AT™, AquaBold™, VorTeq™, IsoBoost®, and IsoGen®. Our solutions are developed in whole or in part, in the United States of America (“U.S.”), as well as other locations internationally.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. The accounting policies that reflect our more significant estimates and judgments and that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially from those estimates.

Basis of Presentation

The condensed consolidated financial statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2015 condensed consolidated balance sheet was derived from audited financial statements, and may not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2015 included in our Annual Report on Form 10-K filed with the SEC on March 3, 2016.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments that are necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers.* The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. On July 9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Based on the FASB’s decision, ASU 2014-09 will apply to us for annual reporting periods beginning after December 15, 2017, including interim reporting periods within annual reporting periods beginning after December 15, 2017. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). The FASB issued ASU 2015-14 in August 2015, formally deferring the effective date of ASU 2014-09 by one year. We expect to adopt this guidance as of January 1, 2018. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

In November 2015, the FASB issued ASU No. 2015-17, *Income Taxes (Topic 740) - Balance Sheet Classification of Deferred Taxes*. ASU 2015-17 eliminates the current requirement to present deferred tax assets and liabilities as current and noncurrent in a classified statement of financial position. Instead, ASU 2015-17 requires that deferred tax assets and liabilities be classified as noncurrent in a classified statement of financial position. We early adopted this accounting standard update, on a prospective basis, at the beginning of the second quarter of 2016 to simplify presentation of deferred taxes. The adoption at the beginning of the second quarter resulted in a $1.1 million decrease in current deferred tax assets, a $0.8 million increase in non-current deferred tax assets, and a $0.3 million decrease in non-current deferred tax liabilities. No prior periods were retrospectively adjusted.

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 modifies certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. For public entities, ASU 2016-01 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. We do not expect the adoption of this standard to have a material impact on our financial statements.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842).* ASU 2016-02 impacts any entity that enters into a lease with some specified scope exceptions. The guidance updates and supersedes Topic 840, Leases. For public entities, ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the impact of this guidance on our ongoing financial reporting.

In March and April 2016, the FASB issued ASU No. 2016-08 and ASU No. 2016-10, respectively, *Revenue from Contracts with Customers (Topic 606).* The amendments in the Updates are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations and to clarify two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance, while retaining the related principles for those areas. The effective date and transition requirements for both ASU 2016-08 and ASU 2016-10 are the same as those for ASU 2014-09 as deferred by ASU 2015-14.

In March 2016, the FASB issued ASU No. 2016-09 *Compensation – Stock Compensation (Topic 718).* ASU 2016-09 affects any entity that issues stock-based payment awards to their employees and is intended to simplify several aspects of the accounting for stock-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public entities, ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods with those annual periods. Early adoption is permitted. We have not evaluated the impact of this guidance, but do not expect the adoption of this standard to have a material impact on our financial statements.

Note 2 — Goodwill and Other Intangible Assets

Goodwill as of June 30, 2016 and December 31, 2015 of $12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the three and six months ended June 30, 2016, there were no changes in the recognized amount of goodwill, and there has been no impairment of goodwill to date.

The components of identifiable other intangible assets, all of which are finite-lived, as of the dates indicated were as follows (in thousands):

	June 30, 2016			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed technology	$6,100	$ (4,016)	$ —	$ 2,084
Non-compete agreements	1,310	(1,310)	—	—
Backlog	1,300	(1,300)	—	—
Trademarks	1,200	(180)	(1,020)	—
Customer relationships	990	(990)	—	—
Patents	585	(411)	(42)	132
Total	$11,485	$ (8,207)	$ (1,062)	$ 2,216

	December 31, 2015			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed technology	$6,100	$ (3,711)	$ —	$ 2,389
Non-compete agreements	1,310	(1,310)	—	—
Backlog	1,300	(1,300)	—	—
Trademarks	1,200	(180)	(1,020)	—
Customer relationships	990	(990)	—	—
Patents	585	(401)	(42)	142
Total	$11,485	$ (7,892)	$ (1,062)	$ 2,531

Accumulated impairment losses at June 30, 2016 include impairment charges for trademarks in 2012 and impairment charges for patents in 2007 and 2010.

Note 3 — Income (loss) per Share

Basic and diluted net income (loss) per share is based on the weighted average number of common shares outstanding during the period. Potential dilutive securities are excluded from the calculation of (loss) per share, as their inclusion would be anti-dilutive.

The following table shows the computation of basic and diluted income (loss) per share (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
Numerator:				
Net income (loss)	$456	$(3,327)	$(1,510)	$(11,610)
Denominator:				
Basic weighted average common shares outstanding	52,369	52,026	52,288	51,987
Weighted average effect of dilutive stock awards	3,329	—	—	—
Diluted weighted average common shares outstanding	55,698	52,026	52,288	51,987

Net income (loss) per share - basic	$0.01	$(0.06)	$(0.03)	$(0.22)
Net income (loss) per share - diluted	$0.01	$(0.06)	$(0.03)	$(0.22)

The following potential common shares were excluded from the computation of diluted income (loss) per share because their effect would have been anti-dilutive (in thousands):

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2016	**2015**	**2016**	**2015**
Stock options	3,937	8,267	7,234	8,267
Warrants	—	200	—	200
Restricted stock units	182	—	214	—

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Note 4 — Other Financial Information

Restricted Cash

We have pledged cash in connection with stand-by letters of credit. We have deposited corresponding amounts into a money market account at a financial institution for these items as follows (in thousands):

	June 30, 2016	**December 31, 2015**
Current collateral for stand-by letters of credit	$1,058	$ 1,490
Non-current collateral for stand-by letters of credit	3,065	2,317
Total restricted cash	$4,123	$ 3,807

Inventories

Our inventories are stated at the lower of cost (using the first-in, first-out “FIFO” method) or market and consisted of the following (in thousands):

	June 30, 2016	**December 31, 2015**
Raw materials	$2,174	$ 2,590
Work in process	1,896	1,689
Finished goods	2,108	2,224
Inventories	$6,178	$ 6,503

Prepaid and Other Current Assets

Prepaid expenses and other current assets consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Foreign currency put option	$—	$ 33
Interest receivable	108	4
Supplier advances	110	171
Prepaid rent	152	7
Other prepaid expenses and current assets	902	728
Total prepaid and other current assets	$1,272	$ 943

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Payroll and commissions payable	$2,478	$ 5,086
Accrued legal expenses	497	217
Other accrued expenses and current liabilities	2,258	2,505
Accrued expenses and other current liabilities	$5,233	$ 7,808

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the six months ended June 30, 2016, were as follows (in thousands):

	Foreign Currency Translation Adjustments Net of Tax Benefit	Unrealized Losses on Investments	Total Accumulated Other Comprehensive Loss
Balance, December 31, 2015	$ (63)	$ (1)	$ (64)
Net other comprehensive loss	(6)	(31)	(37)
Balance, June 30, 2016	$ (69)	$ (32)	$ (101)

There were no reclassifications of amounts out of accumulated other comprehensive loss, as there have been no sales of securities or translation adjustments that impacted other comprehensive loss during the quarter. The tax impact of the changes in accumulated other comprehensive loss were not material.

Note 5 — Investments

Our short-term investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the six months ended June 30, 2016.

Available-for-sale securities as of the dates indicated consisted of the following (in thousands):

June 30, 2016			
Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value

		Holding Gains	Holding Losses	
Corporate notes and bonds	$15,127	$ —	$ (32)	$15,095
Total short-term investments	$15,127	$ —	$ (32)	$15,095

	December 31, 2015			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Corporate notes and bonds	$258	$ —	$ (1)	$ 257
Total short-term investments	$258	$ —	$ (1)	$ 257

Gross unrealized losses and fair values of our investments in an unrealized loss position as of the dates indicated, aggregated by investment category and length of time that the security has been in a continuous loss position, were as follows (in thousands):

	June 30, 2016					
	Less than 12 Months		12 Months or greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate notes and bonds	$14,843	$ (32)	$252	$ —	$15,095	$ (32)
Total	$14,843	$ (32)	$252	$ —	$15,095	$ (32)

	December 31, 2015					
	Less than 12 Months		12 Months or greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate notes and bonds	$—	$ —	$257	$ (1)	$257	$ (1)
Total	$—	$ —	$257	$ (1)	$257	$ (1)

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The amortized cost and fair value of available-for-sale securities that had stated maturities as of June 30, 2016 are shown below by contractual maturity (in thousands):

	June 30, 2016	
	Amortized Cost	Fair Value
Due in one year or less	$15,127	$15,095
Total available-for-sale securities	$15,127	$15,095

Note 6 — Long-Term Debt and Line of Credit

Debt

In March 2015, we entered into a loan agreement with a financial institution for a $55,000 fixed-rate installment loan carrying an annual interest rate of 6.35%. The loan is payable in equal monthly installments and matures on April 2, 2020. The note is secured by the asset purchased.

Long-term debt consisted of the following (in thousands)

	June 30, 2016	December 31, 2015
Loan payable	$43	$ 48
Less: current portion	(10)	(10)
Total long-term debt	$33	$ 38

Future minimum principal payments due under long-term debt arrangements consist of the following (in thousands):

June 30,

	2016
2016 (remaining six months)	$ 5
2017	11
2018	11
2019	12
2020	4
Total debt	$ 43

Line of Credit

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement was amended in June 2015. The 2012 Agreement, as amended, provides for a total available credit line of $16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, $10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement may not exceed the lesser of the $16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of $16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate or a Eurodollar loan that bears interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The 2012 Agreement, as amended, also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement, as amended, matures in June 2018 and is collateralized by substantially all of our assets.

As of June 30, 2016 and December 31, 2015, there were no advances drawn under the 2012 Agreement. Stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled $4.1 million and $3.8 million as of June 30, 2016 and December 31, 2015, respectively. Total cash restricted related to these stand-by letters of credit totaled $4.1 million and $3.8 million as of June 30, 2016 and December 31, 2015, respectively.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of June 30, 2016, we were in compliance with these covenants.

Note 7 — Equity

Stock Repurchase Program

In January 2016, the Board of Directors authorized a stock repurchase program under which shares, not to exceed $6.0 million in aggregate cost, of our outstanding common stock can be repurchased through June 30, 2016 at the discretion of management. We account for stock repurchases using the cost method. Cost includes fees charged in connection with acquiring the treasury stock. As of June 30, 2016, 673,700 shares, at an aggregate cost of $4.1 million, had been repurchased under this authorization. This authorization was replaced with a new authorization in May 2016.

In May 2016, the Board of Directors authorized a stock repurchase plan under which shares, not to exceed $10.0 million in aggregate cost, of our outstanding common stock could be repurchased through October 31, 2016 at the discretion of management. As of June 30, 2016, 454,100 shares, at an aggregate cost of $4.3 million, had been repurchased under this authorization.

Stock-based Compensation Expense

For the three and six months ended June 30, 2016 and 2015, we recognized stock-based compensation expense related to employees and consultants as follows (in thousands):

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2016	**2015**	**2016**	**2015**
Cost of revenue	$24	$37	$62	$72
General and administrative	373	1,679	1,257	2,576
Sales and marketing	125	106	284	207
Research and development	155	91	262	198
Total stock-based compensation expense	$677	$1,913	$1,865	$3,053

Stock-based compensation in the three and six months ended June 30, 2015 included modification expenses in connection with the resignation of the former Chief Executive Officer related to the accelerated vesting, extended vesting, and extended exercise period of options previously granted of approximately $1.3 million.

In connection with the resignation of the former General Counsel, Chief Compliance Officer, and Secretary, additional stock based compensation of approximately $0.5 million was recorded in the first quarter of 2016 related to the continued vesting of awards granted prior to the resignation.

Stock Option Plan

On June 23, 2016, our stockholders approved the 2016 Incentive Plan (the “Plan”). Prior to June 23, 2016, we maintained an equity incentive plan, the Amended and Restated 2008 Equity Incentive Plan (the “Prior Plan”). Stock-based awards granted under the Plan generally vest over four years and expire no more than ten years after the date of grant. Subject to adjustments as provided in the Plan, the number of shares of common stock initially authorized for issuance under the Plan is 4,441,083, plus up to 7,635,410 shares subject to outstanding awards under the Prior Plan that subsequently cease to be subject to such awards (other than by reason of exercise or settlement of the awards in shares). On July 27, 2016, we filed a registration statement on Form S-8 with respect to 4,441,083 shares issuable under the Plan. The Plan supersedes all previously issued stock incentive plans and will be the only available plan from which stock related awards may be granted.

Stock Option Activity

The following table summarizes the stock option activity under the Plan and includes options granted under all previous plans:

	Options Outstanding			
	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in Years)	Aggregate Intrinsic Value [2]
Balance December 31, 2015	7,198,479	$ 3.97	7.0	$22,875,000
Granted	872,017	$ 8.49	—	—
Exercised	(783,042)	$ 3.21	—	—
Forfeited	(53,316)	$ 5.44	—	—
Balance June 30, 2016	7,234,138	$ 4.58	7.2	$31,185,000
Vested and exercisable as of June 30, 2016	4,439,757	$ 4.20	6.1	$20,838,000
Vested and exercisable as of June 30, 2016 and expected to vest thereafter[1]	6,780,263	$ 4.53	7.0	$29,888,000

[1] Options that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of ASC 718, *"Compensation — Stock Compensation."*

[2] The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of our common stock as of June 30, 2016 of $8.89 per share

As of June 30, 2016, total unrecognized compensation cost related to non-vested options, net of estimated forfeitures, was $6.8 million, which is expected to be recognized as an expense over a weighted average period of approximately 2.74 years.

Restricted Stock Unit Activity

The following table summarizes the restricted stock unit activity under the Plan and includes restricted stock units granted under all previous plans:

	Units	**Weighted Average Grant-Date Fair Value (Per unit)**
Outstanding at December 31, 2015	—	$ —
Awarded	213,514	$ 8.65
Vested	—	$ —
Forfeited	—	$ —
Outstanding at June 30, 2016	213,514	$ 8.65

As of June 30, 2016, total unrecognized compensation cost related to non-vested restricted stock units, net of estimated forfeitures, was $1.3 million, which is expected to be recognized as an expense over a weighted average period of approximately 3.7 years.

Note 8 — Income Taxes

The effective tax rate for the six months ended June 30, 2016 and 2015 was 6.3% and (1.23%), respectively. As of December 31, 2015, a valuation allowance of approximately $21.4 million had been established to reduce our deferred income tax assets to the amount expected to be realized. The tax expense recognized for the six months ended June 30, 2016, was primarily related to the tax basis amortization of goodwill and federal, state, and other taxes. The tax expenses were offset by a tax benefit related to losses in our Ireland subsidiary.

Note 9 — Commitments and Contingencies

Operating Lease Obligations

We lease facilities under fixed non-cancellable operating leases that expire on various dates through November 2019. Future minimum lease payments consist of the following (in thousands):

	June 30, 2016
2016 (remaining six months)	838
2017	1,642
2018	1,603
2019	1,402
Total future minimum lease payments	$5,485

Product Warranty

The following table summarizes the activity related to the product warranty liability during the three and six months ended June 30, 2016 and 2015 (in thousands):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2016	**2015**	**2016**	**2015**
Balance, beginning of period	$428	$756	$461	$755
Warranty costs charged to cost of revenue	54	(6)	96	15
Release of accrual for expired warranties	(71)	—	(146)	—
Utilization of warranty	—	(3)	—	(23)
Balance, end of period	$411	$747	$411	$747

Purchase Obligations

We enter into purchase order arrangements with our vendors. As of June 30, 2016, there were open purchase orders for which we had not yet received the related goods or services. These arrangements are subject to change based on our sales demand forecasts, and we have the right to cancel the arrangements prior to the date of delivery. As of June 30, 2016, we had approximately $1.4 million of cancellable open purchase order arrangements related primarily to materials and parts.

Guarantees

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by our general liability insurance to the extent provided by the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, we have no liabilities recorded for these agreements as of June 30, 2016 and December 31, 2015.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 5% to 15% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance. These guarantees, generally in the form of stand-by letters of credit or bank guarantees secured by stand-by letters of credit, typically remain in place for periods ranging up to 24 months and in some cases up to 68 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash and our credit facility. The $4.1 million in stand-by letters of credit outstanding at June 30, 2016 were collateralized by restricted cash of $4.1 million.

Litigation

The Company is named in and subject to various proceedings and claims in connection with our business. We are contesting the allegations in these claims, and we believe that there are meritorious defenses in each of these matters. The outcome of matters we have been and currently are involved in cannot be determined at this time, and the results cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on our results of operations in any future period and a significant judgment could have a material adverse impact on our financial condition, results of operations and cash flows. We may in the future become involved in additional litigation in the ordinary course of our business, including litigation that could be material to our business. Based on currently available information and review with outside counsel, management does not believe that the currently known actions or threats against the Company will result in any material adverse effect on our financial condition, results of operations, or cash flows.

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On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 24, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain, challenging the fairness of his dismissal and seeking compensation ("Case 1"). A hearing was held on November 13, 2015, after which the labor court ruled that it did not have jurisdiction over the matter. Mr. Blanco has appealed. Based on currently available information and review with outside counsel, at this time, the Company has not determined that an award to Mr. Blanco is probable.

On November 24, 2014, Mr. Blanco filed a second action based on breach of contract theories in the same court as Case 1, but the cases are separate. In Case 2, Mr. Blanco seeks payment of an unpaid bonus, stock options, and non-compete compensation. The court ruled that this case is stayed until a final ruling is issued in Case 1. Based on currently available information and review with outside counsel, at this time, the Company has not determined that an award to Mr. Blanco is probable.

On January 20 and 27, 2015, two stockholder class action complaints were filed against the Company in the United States District Court of the Northern District of California, on behalf of Energy Recovery stockholders under the captions, *Joseph Sabatino v. Energy Recovery, Inc. et al.*, Case No. 3:15-cv-00265 EMC*,* and *Thomas C. Mowdy v. Energy Recovery, Inc, et al.*, Case No. 3:15-cv-00374 EMC. The complaints have now been consolidated under the caption, *In Re Energy Recovery Inc. Securities Litigation*, Case No. 3:15-cv-00265 EMC. The complaint alleges violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 based upon alleged public misrepresentations and seeks the recovery of unspecified monetary damages. Based on currently available information and review with outside counsel, the Company is not able to estimate the possible loss, if any, due to the early stage of this matter.

On January 27, 2016, a complaint was filed by the Company's Former Chief Sales Officer, David Barnes, in the United States District Court for the Northern District of California under the caption, *David Barnes v. Energy Recovery, Inc.,* et al. Case No. 3:16-cv-00477 EMC, related to his separation from the Company and alleging numerous legal claims including, but not limited to, wrongful termination, breach of contracts and negligent and/or intentional misrepresentations to induce Mr. Barnes to join the Company. Mr. Barnes is seeking to recover, among other things, relocation and business expenses, back pay, front pay, lost equity, contractual severance, emotional distress damages, punitive damages, damages under the California Private Attorneys General Act, attorneys' fees, costs, and interest. Based on currently available information and review with outside counsel, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

On February 18, 2016, a complaint captioned *Goldberg v. Rooney, et al.*, HG 16804359, was filed in the Superior Court for the State of California, County of Alameda, naming as defendants Thomas Rooney, Alexander J. Buehler, Joel Gay, Ole Peter Lorentzen, Audrey Bold, Arve Hanstveit, Fred Olav Johannessen, Robert Yu Lang Mao, Hans Peter Michelet, Maria Elisabeth Pate-Cornell, Paul Cook, Olav Fjell, and Dominique Trempont ("Individual Defendants") and naming the Company as a nominal defendant. The complaint is styled as a derivative action being brought on behalf of the Company and generally alleges breach of fiduciary duty, abuse of control, gross mismanagement, and unjust enrichment causes of action against the Individual Defendants. Based on currently available information and review with outside counsel, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

Note 10 — Business Segment and Geographic Information

We are an energy solutions provider to industrial fluid flow markets worldwide. We make industrial processes more operating and capital expenditure efficient. Our chief operating decision-maker ("CODM") is the chief executive officer ("CEO").

Following the appointment of a new CEO in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period amounts have been adjusted retrospectively to reflect this new internal reporting structure.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas Segment consists of product revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing and license and development revenue associated with hydraulic fracturing, as well as related identifiable expenses. Operating income for each segment excludes other income and expenses and certain expenses managed outside the operating segment. Costs excluded from operating income include various corporate expenses such as certain stock-based compensation expenses, income taxes, and other separately managed general and administrative expenses not related to the identified segments. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The following summarizes financial information by segment for the periods presented (in thousands):

	Three Months Ended June 30, 2016			**Three Months Ended June 30, 2015**		
	Water	**Oil &Gas**	**Total**	**Water**	**Oil &Gas**	**Total**
Product revenue	$11,973	$—	$11,973	$10,484	$—	$10,484
Product cost of revenue	4,236	—	4,236	4,836	—	4,836
Product gross profit	7,737	—	7,737	5,648	—	5,648
License and development revenue	—	1,250	1,250	—	—	—
Operating expenses:						
General and administrative	263	184	447	(17)	391	374
Sales and marketing	1,100	576	1,676	931	949	1,880
Research and development	333	2,074	2,407	201	1,299	1,500
Amortization of intangibles	158	—	158	158	—	158
Operating expenses	1,854	2,834	4,688	1,273	2,639	3,912
Operating income (loss)	$5,883	$(1,584)	4,299	$4,375	$(2,639)	1,736
Less:						
Corporate operating expenses			3,819			5,012
Consolidated operating income (loss)			480			(3,276)
Non-operating income			79			20
Income (loss) before income taxes			$559			$(3,256)

	Six Months Ended June 30, 2016			Six Months Ended June 30, 2015		
	Water	**Oil &Gas**	**Total**	**Water**	**Oil &Gas**	**Total**
Product revenue	$22,024	$—	$22,024	$16,207	$141	$16,348
Product cost of revenue	7,910	—	7,910	7,339	28	7,367
Product gross profit	14,114	—	14,114	8,868	113	8,981
License and development revenue	—	2,500	2,500	—	—	—
Operating expenses:						
General and administrative	482	372	854	587	723	1,310
Sales and marketing	2,229	1,383	3,612	2,101	2,069	4,170
Research and development	692	4,371	5,063	546	3,459	4,005
Amortization of intangibles	315	—	315	317	—	317
Operating expenses	3,718	6,126	9,844	3,551	6,251	9,802
Operating income (loss)	$10,396	$(3,626)	6,770	$5,317	$(6,138)	(821)
Less:						
Corporate operating expenses			8,439			10,525
Consolidated operating loss			(1,669)			(11,346)
Non-operating income (expenses)			57			(122)
Loss before income taxes			$(1,612)			$(11,468)

The following geographic information includes net revenue to our domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	**2015**	**2016**	**2015**
Domestic product revenue	$219	$922	$404	$1,186
International product revenue	11,754	9,562	21,620	15,162
Total product revenue	$11,973	$10,484	$22,024	$16,348
Product revenue by country:				
China	25 %	4 %	15 %	4 %
Egypt	19 %	3 %	11 %	9 %

United States	2	%	9	%	2	%	7	%
UAE	1	%	35	%	2	%	23	%
Qatar	*	%	0	%	18	%	0	%
Others **	53	%	49	%	52	%	57	%
Total	100	%	100	%	100	%	100	%

* Less than 1%.

** Includes remaining countries not separately disclosed. No country in this line item accounted for more than 10% of our product revenue during the periods presented.

All of our long-lived assets were located in the United States at June 30, 2016 and December 31, 2015.

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Note 11 — Concentrations

Customers accounting for 10% or more of our accounts receivable and unbilled receivables were as follows:

	June 30, 2016	December 31, 2015
Customer A	24%	8 %
Customer B	13%	2 %
Customer C	6 %	18 %
Customer D	4 %	26 %

Revenue from customers representing 10% or more of product revenue varies from period to period. For the periods indicated, customers representing 10% or more of product revenue were:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Customer A	20%	* %	12%	* %
Customer B	11%	6 %	6 %	4 %
Customer E	4 %	9 %	4 %	10%
Customer C	1 %	1 %	19%	1 %
Customer F	* %	30%	1 %	22%

*Less than 1%.

A single customer, Customer G, represents 100% of our license and development revenue for the three and six months ended June 30, 2016. There was no license and development revenue recognized for the three or six months ended June 30, 2015.

Vendors accounting for 10% or more of our accounts payable were as follows:

	June 30, 2016	December 31, 2015
Vendor A	26%	0 %
Vendor B	19%	0 %

Note 12 — Fair Value Measurements

The authoritative guidance for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows:

Level 1 — Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 — Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 — Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions that market participants would use in pricing.

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, unbilled receivables, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For our investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then we use quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist of corporate agency obligations and the premium paid for foreign currency put options.

The fair value of financial assets and liabilities measured on a recurring basis for the indicated periods was as follows (in thousands):

	June 30, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
Assets:				
Available-for-sale securities	$15,095	$ —	$15,095	$ —
Total assets	$15,095	$ —	$15,095	$ —

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	December 31, 2015	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
Assets:				
Available-for-sale securities	$ 257	$ —	$ 257	$ —
Foreign currency put options	33	—	33	—
Total assets	$ 290	$ —	$ 290	$ —

Note 13 — Related Party Transactions

In January 2016, the Company entered into a lease agreement with EMS USA, Inc. for the use of office space. The President and Chief Executive Officer of EMS USA, Inc. is also a member of the Board of Directors of the Company. The lease is for a term of ninety (90) days with continuation on a month-to-month basis thereafter, with each month being an “Additional Term.” The Company paid EMS USA, Inc. $2,502 and $4,170, respectively, related to this agreement during the three and six months ended June 30, 2016.

In March 2016, the Company extended an employee loan to one of its employees for $21,786. The loan is repayable to the Company monthly over six months and is non-interest bearing. At June 30, 2016, $10,893 was outstanding under this loan.

Note 14 - Subsequent Events

On July 18, 2016, we finalized a purchase order associated with a previously announced letter of award totaling up to $11 million to provide our IsoBoost technology for integration into a major gas processing plant to be constructed in the Middle East. The contract is for approximately $7 million worth of equipment and services, with an option for an additional $4 million to be determined at a later date.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion in this item and in other items of this Form 10-Q contains forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions, or strategies regarding the future.

Forward-looking statements that represent our current expectations about future events are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events. These forward-looking statements are based on information currently available to us and on management's beliefs, assumptions, estimates, or projections and are not guarantees of future events or results. We may not actually achieve the plans, intentions, or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements.

Words such as "expects," "anticipates," "believes," "estimates," "assumes," "intends," " projects," " predicts," "plans," "forecasts," "outlook," "sustain," "could," "may," "strategy," "will," "would be," "seek," "target," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Forward-looking statements in this report include, without limitation, statements about the following:

- *our expectation that sales outside of the United States will remain a significant portion of our product revenue;*
- *our expectation that we will meet the two key milestones associated with our VorTeq™ licensing agreement with Schlumberger Technology Corporation and will receive annual royalties under said agreement;*
- *our expectation that oil price fluctuations may impact the acceptance or rate of adoption of our oil & gas and hydraulic fracturing products;*
- *our belief that levels of gross profit margin for our Water Segment are likely sustainable to the extent that volume grows, we experience a favorable product mix, pricing remains stable, and we continue to realize cost savings through production efficiencies and enhanced yields;*
-

- *our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies;*
- *our expectation that our expenses for research and development may increase as a result of our continuing to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for existing and new products; and*
- *our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in newly developed technologies or product offerings arising from rapid market adoption that could require us to seek additional equity or debt financing.*

You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, including those risks and uncertainties, as disclosed from time to time in our reports on Forms 10-K under Part I, Item 1A, Risk Factors, as my be updated from time to time in our Forms 10-Q, and/or 8-K. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.

Overview

We are an energy solutions provider to industrial fluid flow markets worldwide. We make industrial processes more operating and capital expenditure efficient. Our solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our core competencies are fluid dynamics and advanced material science. Our company was founded in 1992, and we introduced the initial version of our Pressure Exchanger® energy recovery device in early 1997 for sea water reverse osmosis desalination. Share of our common stock began trading publicly in July 2008. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers as well as high-pressure pumps. In 2012, we introduced the IsoBoost and IsoGen branded products for use in the oil & gas industry. In 2015, we conducted field trials for the VorTeq hydraulic fracturing system, also for use in the oil & gas industry for oil field hydraulic fracturing operations and entered into a fifteen year license agreement with Schlumberger Technology Corporation.

Following the appointment of a new Chief Executive Officer in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period segment results have been adjusted retrospectively to reflect this new internal reporting structure.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold and the related solutions and services.

At June 30, 2016, two vendors accounted for 26% and 19%, respectively, of our accounts payable balance. At December 31, 2015, no customer accounted for more than 10% of our accounts payable balance.

Water Segment

The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. Our Water Segment revenue is principally derived from the sale of our energy recovery devices for use in water desalination plants worldwide. We also derive product revenue from the sale of our high-pressure and circulation pumps which we manufacture and sell both separately and in connection with our energy recovery devices for use in water desalination plants. Additionally, we receive product revenue from the sale of spare parts and services, including start-up and commissioning services that we provide to our customers.

With respect to product revenue from our energy recovery devices in our Water Segment, a significant portion of our revenue typically has been generated from sales to a limited number of large engineering, procurement, and construction, or EPC, firms that are involved with the design and construction of large desalination plants. Sales to these firms often involve a long sales cycle that can range from 16 to 36 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents a significant revenue opportunity. We also sell our devices to many small- to medium-sized original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant, and have shorter sales cycles.

We often experience substantial fluctuations in our Water Segment net revenue from quarter to quarter and from year to year because a single order for our energy recovery devices by a large EPC firm for a particular plant may represent significant revenue. In addition, historically our EPC customers tend to order a significant amount of equipment for delivery in the fourth quarter, and as a consequence, a significant portion of our annual sales typically occurs during that quarter. This historical trend has been reflected in the fourth quarter of the last several years. Normal seasonality trends also generally show our lowest revenue in the first quarter of the year.

A limited number of our customers account for a substantial portion of our product revenue and of our accounts receivable and unbilled receivables. Product revenue from customers representing 10% or more of product revenue varies from period to period. For the three months ended June 30, 2016, two customers accounted for 20% and 11%, respectively, of our product revenue. For the three months ended June 30, 2015, one customer accounted for 30% of our product revenue. For the six months ended June 30, 2016, two customers accounted for 19% and 12%, respectively, of our product revenue. For the six months ended June 30, 2015, two customers accounted for 22% and 10%, respectively, of our product revenue. No other customer accounted for more than 10% of our product revenue during any of these periods.

At June 30, 2016, two customers accounted for 24% and 13%, respectively, of our accounts receivable and unbilled receivables balance. At December 31, 2015, two customers accounted for 26% and 18%, respectively, of our accounts receivable and unbilled receivables balance.

At June 30, 2016, two vendors accounted for 26% and 19%, respectively, of our accounts payable balance. At December 31, 2015, no customer accounted for more than 10% of our accounts payable balance.

During the three and six months ended June 30, 2016 and 2015, most of our product revenue and accounts receivable were attributable to sales outside of the United States. We expect sales and accounts receivable outside of the United States to remain a significant portion of our Water Segment product revenue and accounts receivable for the next few years.

Oil &Gas Segment

The Oil & Gas Segment consists of revenue associated with products sold or licensed for use in gas processing, chemical processing, and hydraulic fracturing, as well as related identifiable expenses. In the past several years, we have invested significant research and development costs to expand our business into pressurized fluid flow industries within the oil & gas industry. In 2014, we announced a new product for the hydraulic fracturing industry, the VorTeq hydraulic fracturing system. Field trials were initiated for the VorTeq in the second quarter of 2015 and successfully completed in December 2015.

No oil & gas product revenue was recognized during the three and six months ended June 30, 2016. In the first quarter of 2015, we recognized oil & gas product revenue of $0.1 million from oil & gas commissioning services and fees related to the cancellation of a sales order.

On October 14, 2015, the Company, through our Ireland subsidiary ERI Energy Recovery Ireland Ltd., entered into a Licensing Agreement (the “Agreement”) with Schlumberger Technology Corporation, a subsidiary of Schlumberger Limited (NYSE:SLB). The Agreement has a term of fifteen years for the exclusive right to use certain intellectual property related to our VorTeq hydraulic fracturing system technology. The Agreement provided for a $75 million exclusivity payment in connection with the execution of the Agreement, two separate $25 million payments upon the meeting of two milestones, and recurring royalty payments throughout the term of the Agreement. License and development revenue related to the exclusivity payment is recognized over the term of the agreement with $1.3 million of license and development revenue recognized in the three months ended June 30, 2016 and $2.5 million recognized in the six months ended June 30, 2016.

During the three and six months ended June 30, 2016 all of our license and development revenue is attributable to the Agreement. There was no license and development revenue in the three and six months ended June 30, 2015. At June 30, 2016 and December 31, 2015, there were no accounts receivable associated with our Oil & Gas Segment.

Results of Operations

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets.

Three Months Ended June 30, 2016 Compared to Three Months Ended June 30, 2015

Total Revenue

	Three Months Ended June 30,				**Change**	
	2016		**2015**		**Increase / (Decrease)**	
Product revenue	$11,973	91 %	$10,484	100%	$1,489	14 %
License and development revenue	1,250	9 %	—	—	1,250	100%
Total revenue	$13,223	100%	$10,484	100%	$2,739	26 %

Product Revenue

Segment	Three Months Ended June 30, 2016	2015	$ Change	% Change
Water	$11,973	$10,484	$1,489	14 %
Oil & Gas	—	—	—	—
Product revenue	$11,973	$10,484	$1,489	14 %

Product revenue in the Water Segment increased by $1.5 million, or 14%, to $12.0 million for the three months ended June 30, 2016 from $10.5 million for the three months ended June 30, 2015. The increase was primarily due to increased OEM shipments of $2.0 million and higher aftermarket shipments of $1.0 million. These increases were offset by lower mega project ("MPD") shipments of $1.5 million in the three months ended June 30, 2016 compared to MPD shipments in the three months ended June 30, 2015.

No product revenue in the Oil & Gas Segment was recognized in either the three month period ended June 30, 2016 or the three month period ended June 30, 2015.

During the three months ended June 30, 2016 and 2015, a significant portion of our product revenue was attributable to sales outside of the United States. Product revenue attributable to domestic and international sales as a percentage of product revenue was as follows:

	Three Months Ended June 30, 2016	2015
Domestic revenue	2 %	9 %
International revenue	98 %	91 %
Product revenue	100%	100%

License and Development Revenue

Segment	Three Months Ended June 30, 2016	2015	$ Change	% Change
Water	$—	$ —	$ —	—
Oil & Gas	1,250	—	1,250	100 %
License and development revenue	$1,250	$ —	$ 1,250	100 %

The increase in license and development revenue during the three months ended June 30, 2016, was due to the recognition of $1.3 million in revenue associated with the licensing agreement with Schlumberger. The $1.3 million is representative of the straight-line basis of revenue recognition of the $75 million initial payment over the fifteen-year term of the agreement.

License and development revenue attributable to domestic and international sales as a percentage of license and development revenue was as follows:

	Three Months Ended June 30, 2016	2015
Domestic revenue	—	—
International revenue	100%	—
License and development revenue	100%	