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# Echelon's 2008 Annual Report

Letter to Shareholders

Notice of 2009  
Annual Meeting  
and Proxy Statement

2008 Annual Report  
to Shareholders

– Management's Discussion  
and Analysis

– Consolidated Financial  
Statements

Other Shareholder  
Information

Dear Shareholder,

The year 2008 was a challenging one for businesses worldwide, and Echelon was no exception. Our revenues for the year were \$134 million compared to \$137.6 million in 2007. In the final weeks of the year, we saw our customers abruptly curtail spending to preserve cash and reduce inventories in response to the worldwide financial and economic crisis.

I believe that 2009 will be an even more challenging year than 2008, filled with uncertainty about the extent and timing of an economic recovery. Nonetheless, I believe 2009 and beyond hold significant opportunities for Echelon. While our markets and customers may be temporarily under severe pressure, I am quite optimistic about the future of Echelon and its market drivers. If there is any silver lining in today's dour economic climate it is the increased focus that governments, businesses, and individuals worldwide are now placing on the importance of monitoring, managing, and controlling energy. Everyone is looking for ways to conserve energy, save money, reduce the impact of carbon emissions on the environment, and provide alternatives to fossil fuels. Saving energy through smart monitoring and control systems is the least costly, most available, and greatest potential source of clean energy for the next decade. With buildings alone consuming about 50 percent of the electrical energy in the United States, simply reducing the energy use of those buildings by 20 percent would produce the equivalent of all the electrical generating capacity that is forecast for the combination of wind and solar power over the next decade! And this is just one of the many benefits that our products make possible.

Our two product lines, LONWORKS® Infrastructure (LWI) and Networked Energy Services (NES), complement each other and provide a rich platform for energy monitoring, management, and control. After years of innovation and product development, our LONWORKS products provide the building blocks that allow thousands of companies to create products and services that let devices with an electrical heartbeat interoperate openly and communicate over the Internet. The

result is networks of intelligent devices that can save energy in a myriad of diverse applications — from controlling the kitchens and lighting and air conditioning of McDonald's restaurants, to saving energy and reducing the maintenance costs of streetlights, to optimizing the use of a solar panel array, to reducing a building's electricity demand for a few hours to ensure that enough will be available during peak energy periods without the need to build another peaking power plant, to turning on the dishwasher in one's home when the time-of-day pricing is the lowest. In fact, all of these applications are part of the smart grid as we at Echelon have envisioned it — a grid that is not only a highly intelligent, reliable infrastructure for an electric utility itself, but also a network of all the electrical devices we use every day, all of which intelligently cooperate together to lower costs and control energy. And there are thousands more applications yet to be developed.

The natural starting point of the smart grid is our NES System, which we believe is the most advanced, reliable, open, and economic smart metering infrastructure for electric utilities. We have now shipped over 1.6 million smart NES meters and believe this is an enormous market opportunity for us going forward. The combination of our NES System and our LWI products gives us a wonderful leadership position in smart grid developments all over the world. So, while 2009 looks uncertain, we see current events as potential catalysts for both product lines of Echelon's business, and we are quite positive about the fundamental drivers of our business and our opportunities going forward. As a result, while remaining cautious about maintaining a strong cash position as a company, we are investing in key product and application areas where we see the greatest opportunity. While continuing to develop and expand our product lines, we will work to expand our market presence around the world by adding new partners and expanding existing relationships in order to grow Echelon's market share in both NES and LWI.

I would like to thank you, our shareholders, for your continued support, and to thank our employees around the world for their creative and diligent efforts and hard work.

Sincerely,

A handwritten signature in black ink, appearing to read "Ken Oshman". The signature is fluid and cursive, written in a professional style.

Ken Oshman  
Chairman and CEO  
March 28, 2009

The foregoing may contain statements relating to future plans, events or performance. These forward-looking statements may involve risks and uncertainties, including risks associated with uncertainties pertaining to anticipated growth in the control networks market and in Echelon's business, in general, and the LONWORKS infrastructure business and NES business, in particular; the ability of Echelon's products to perform as designed; and other risks identified in our SEC filings. Actual results, events and performance may differ materially. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of this date. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

# **ECHELON CORPORATION**

## **NOTICE OF ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON MAY 14, 2009 10:00 A.M. PACIFIC TIME**

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We cordially invite you to attend the 2009 Annual Meeting of Stockholders of Echelon Corporation. The meeting will be held on Thursday, May 14, 2009 at 10:00 a.m., Pacific Time, at 570 Meridian Avenue, San Jose, California 95126. At the meeting we will:

1. Elect three Class B directors for a term of three years and until their successors are duly elected and qualified;
2. Reapprove our Management Bonus Plan;
3. Ratify the appointment of KPMG LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2009; and
4. Transact any other business as may properly come before the meeting or any postponement or adjournment thereof.

These items are fully discussed in the following pages, which are made part of this Notice. Stockholders who owned our common stock at the close of business on Monday, March 23, 2009 are entitled to notice of and to vote at the annual meeting.

Your vote is important. Whether or not you plan to attend the annual meeting, please cast your vote, as instructed in the Notice of Internet Availability of Proxy Materials, over the Internet or by telephone, as promptly as possible. You may also request a paper proxy card to submit your vote by mail, if you prefer. We encourage you to vote via the Internet. It is convenient, is more environmentally friendly, and saves us significant postage and processing costs.

Sincerely,



M. Kenneth Oshman  
Chairman of the Board and Chief Executive Officer

San Jose, California  
April 3, 2009

## 2009 ANNUAL MEETING OF STOCKHOLDERS

### NOTICE OF ANNUAL MEETING AND PROXY STATEMENT

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## **ECHELON CORPORATION**

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### **PROXY STATEMENT FOR 2009 ANNUAL MEETING OF STOCKHOLDERS**

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#### **INFORMATION CONCERNING SOLICITATION AND VOTING**

##### **General**

Our Board of Directors is soliciting Proxies for the 2009 Annual Meeting of Stockholders to be held at 570 Meridian Avenue, San Jose, California 95126 on Thursday, May 14, 2009, at 10:00 a.m., Pacific Time. The address of our principal executive office is 550 Meridian Avenue, San Jose, California 95126 and our telephone number at this address is 408-938-5200. This Proxy Statement contains important information for you to consider when deciding how to vote on the matters set forth in the attached Notice of Annual Meeting. Please read it carefully.

Beginning on April 3, 2009, we made copies of this Proxy Statement available to persons who were stockholders at the close of business on March 23, 2009, the record date for the annual meeting.

##### **Notice of Internet Availability of Proxy Materials**

Pursuant to rules recently adopted by the Securities and Exchange Commission, or the SEC, we have chosen to provide access to our proxy materials over the Internet. We are sending a Notice of Internet Availability of Proxy Materials (the "Notice of Internet Availability") to our stockholders of record and our beneficial owners. All stockholders will have the option to access the proxy materials on a website referred to in the Notice of Internet Availability or to request a printed set of the proxy materials. Instructions on how to access the proxy materials over the Internet or to request a printed copy of the proxy materials are included in the Notice of Internet Availability. You may also request to receive proxy materials in printed form by mail or electronically by e-mail on an ongoing basis.

##### **Electronic Access to Proxy Materials**

The Notice of Internet Availability will provide you with instructions on how to:

- View on the Internet our proxy materials for our annual meeting; and
- Instruct us to send our future proxy materials to you electronically by e-mail.

Choosing to receive future proxy materials by e-mail will save us the cost of printing and mailing the proxy materials to you and will reduce the environmental impact of our annual meeting. If you choose to receive future proxy materials by e-mail, you will receive an e-mail next year with instructions including a link to the proxy materials and a link to the proxy voting site. Your election to receive proxy materials by e-mail will remain in effect until you terminate it.

## **Costs of Solicitation**

We will pay the costs of soliciting proxies from stockholders. In addition, we may reimburse brokerage firms and other persons representing beneficial owners of shares for their expenses in forwarding solicitation material to such beneficial owners, including fees associated with:

- Forwarding the Notice of Internet Availability to beneficial owners;
- Forwarding printed proxy materials by mail to beneficial owners who specifically request them; and
- Obtaining beneficial owners' voting instructions.

Certain of our directors, officers and employees may solicit proxies on our behalf, without additional compensation, personally or by written communication, telephone, facsimile or other electronic means.

## **Record Date and Shares Outstanding**

Only stockholders of record at the close of business on March 23, 2009, are entitled to attend and vote at the annual meeting. On the record date, 40,591,600 shares of our common stock were outstanding and held of record. The closing price of our common stock on the Nasdaq Stock Market on the record date was \$7.50 per share.

## **QUESTIONS AND ANSWERS REGARDING OUR ANNUAL MEETING**

Although we encourage you to read this Proxy Statement in its entirety, we include this question and answer section to provide some background information and brief answers to several questions you may have about the annual meeting or this Proxy Statement.

***Q: Why am I receiving these proxy materials?***

**A:** Our Board of Directors is providing these proxy materials for you in connection with our annual meeting of stockholders, which will take place on May 14, 2009. Stockholders are invited to attend the annual meeting and are requested to vote on the proposals described in this Proxy Statement.

***Q: What is the Notice of Internet Availability?***

**A:** In accordance with rules and regulations recently adopted by the SEC, instead of mailing a printed copy of our proxy materials to all stockholders entitled to vote at the annual meeting, we are furnishing the proxy materials to our stockholders over the Internet. If you received a Notice of Internet Availability by mail, you will not receive a printed copy of the proxy materials. Instead, the Notice of Internet Availability will instruct you as to how you may access and review the proxy materials and submit your vote via the Internet. If you received a Notice of Internet Availability by mail and would like to receive a printed copy of the proxy materials, please follow the instructions for requesting such materials included in the Notice of Internet Availability.

We expect to mail the Notice of Internet Availability on or about April 3, 2009, to all stockholders entitled to vote at the annual meeting. On the date of mailing of the Notice of Internet Availability, all stockholders and beneficial owners will have the ability to access all of our proxy materials on a website referred to in the Notice of Internet Availability. These proxy materials will be available free of charge.

**Q: *What proposals will be voted on at the annual meeting?***

**A:** There are three proposals scheduled to be voted on at the annual meeting:

- Election of the nominees for director set forth in this Proxy Statement;
- Reapproval of our Management Bonus Plan; and
- Ratification of the appointment of KPMG LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2009.

**Q: *What is Echelon's voting recommendation?***

**A:** Our Board of Directors recommends that you vote your shares "FOR" each of the three nominees to our Board of Directors, "FOR" reapproval of our Management Bonus Plan and "FOR" ratification of the appointment of our independent registered public accounting firm.

**Q: *Who can vote at the meeting?***

**A:** Our Board of Directors has set March 23, 2009 as the record date for the annual meeting. All stockholders who owned Echelon common stock at the close of business on March 23, 2009, or the record date, may attend and vote at the annual meeting. Each stockholder is entitled to one vote for each share of common stock held as of the record date on all matters to be voted on. Stockholders do not have the right to cumulate votes. On March 23, 2009, 40,591,600 shares of our common stock were outstanding. Shares held as of the record date include shares that are held directly in your name as the stockholder of record and those shares held for you as a beneficial owner through a broker, bank or other nominee.

**Q: *What is the difference between holding shares as a stockholder of record and as a beneficial owner?***

**A:** Most stockholders of Echelon hold their shares through a broker, bank or other nominee rather than directly in their own name. As summarized below, there are some distinctions between shares held of record and those owned beneficially.

*Stockholders of Record*

If your shares are registered directly in your name with Echelon's transfer agent, BNY Mellon Shareowner Services, you are considered the stockholder of record with respect to those shares and the Notice of Internet Availability has been sent directly to you. As the stockholder of record, you have the right to grant your voting proxy directly to Echelon or to vote in person at the annual meeting.

*Beneficial Owners*

If your shares are held in a stock brokerage account or by a bank or other nominee, you are considered the beneficial owner of shares held in "street name," and the Notice of Internet Availability has been forwarded to you by your broker, bank or other nominee who is considered, with respect to those shares, the stockholder of record. As the beneficial owner, you have the right to direct your broker, bank or other nominee on how to vote and are also invited to attend the annual meeting. However, since you are not the

stockholder of record, you may not vote these shares in person at the annual meeting unless you request a “legal proxy” from the broker, bank or other nominee who holds your shares, giving you the right to vote the shares at the annual meeting.

**Q:** *How many votes does Echelon need to hold the annual meeting?*

**A:** A majority of Echelon’s outstanding shares as of the record date must be present at the annual meeting in order to hold the meeting and conduct business. This is called a quorum. Both abstentions and broker non-votes are counted as present for the purpose of determining the presence of a quorum. Broker non-votes, however, are not counted as shares present and entitled to be voted with respect to the matter on which the broker has expressly not voted. Thus, broker non-votes will not affect the outcome of any of the matters being voted on at the annual meeting. Generally, broker non-votes occur when shares held by a broker for a beneficial owner are not voted with respect to a particular proposal because (1) the broker has not received voting instructions from the beneficial owner and (2) the broker lacks discretionary voting power to vote such shares.

Shares are counted as present at the meeting if you:

- are present and vote in person at the meeting; or
- have properly submitted a proxy card or voting instruction card or voted by telephone or via the Internet.

**Q:** *How are votes counted?*

**A:** You may vote either “FOR” or “WITHHOLD” with respect to each Class B nominee for our Board of Directors. You may vote “FOR,” “AGAINST” or “ABSTAIN” on the other proposal. If you abstain from voting on the other proposal, it has the same effect as a vote against. If you just sign your proxy card with no further instructions, your shares will be counted as a vote “FOR” each Class B Director nominee, “FOR” reapproval of our Management Bonus Plan and “FOR” ratification of the appointment of our independent registered public accounting firm. If you do not vote and you hold your shares in a brokerage account or through a bank or other nominee, also known as “street name” (see description of “Beneficial Ownership” above), your shares will not be counted in the tally of the number of shares cast “FOR,” “AGAINST” or “ABSTAIN” on any proposal where your broker, bank or other nominee does not have discretionary authority to vote, and therefore will have the effect of reducing the number of shares needed to approve any of those items. However, shares held in street name and that are not voted, known as “broker non-votes,” may be counted for the purpose of establishing a quorum for the annual meeting as described above under the caption “Beneficial Ownership.” Voting results are tabulated and certified by Broadridge Financial Solutions, Inc.

**Q:** *What is the voting requirement to approve each of the proposals?*

**A:** With respect to Proposal One (the election of our Class B directors), directors are elected by a plurality vote, and therefore the three individuals receiving the highest number of “FOR” votes will be elected. Votes of “WITHHOLD” and broker non-votes have no legal effect on the election of directors due to the fact that such elections are by a plurality. Proposal Two (reapproval of our Management Bonus Plan) and Proposal Three (ratification of the appointment of our independent registered public accounting firm) require

the affirmative “FOR” vote of a majority of the shares of our outstanding common stock represented, in person or by proxy, and entitled to vote.

***Q: How can I vote my shares in person at the annual meeting?***

**A:** Shares held directly in your name as the stockholder of record may be voted in person at the annual meeting. If you choose to do so, please bring your proxy card or proof of identification to the annual meeting. Even if you plan to attend the annual meeting, Echelon recommends that you vote your shares in advance as described below so that your vote will be counted if you later decide not to attend the annual meeting. If you hold your shares in street name, you must request a legal proxy from your broker or other holder of record in order to vote at the annual meeting.

***Q: How can I vote my shares without attending the annual meeting?***

**A:** Whether you hold shares directly as the stockholder of record or beneficially in street name, you may direct how your shares are voted without attending the annual meeting. If you are a stockholder of record, you may vote by submitting a proxy; please refer to the voting instructions in the Notice of Internet Availability or below. If you hold shares beneficially in street name, you may vote by submitting voting instructions to your broker, bank or other nominee; please refer to the voting instructions provided to you by your broker, bank or other nominee.

*Internet* — Stockholders of record with Internet access may submit proxies by following the “Vote by Internet” instructions on the Notice of Internet Availability until 11:59 p.m., Eastern Time, on May 13, 2009 or by following the instructions at [www.proxyvote.com](http://www.proxyvote.com). Most of our stockholders who hold shares beneficially in street name may vote by accessing the website specified in the voting instructions provided by their brokers, banks or other nominees. A large number of banks and brokerage firms are participating in Broadridge Financial Solutions, Inc.’s (formerly ADP Investor Communication Services) online program. This program provides eligible stockholders the opportunity to vote over the Internet or by telephone. Voting forms will provide instructions for stockholders whose bank or brokerage firm is participating in Broadridge’s program.

*Telephone* — Depending on how your shares are held, you may be able to vote by telephone. If this option is available to you, you will have received information with the Notice of Internet Availability explaining this procedure.

*Mail* — If you are a stockholder of record, you may request a proxy card from our company, and indicate your vote by completing, signing and dating the card where indicated and by returning it in the prepaid envelope that will be provided. Stockholders who hold shares beneficially in street name may request a voting instruction form from their broker, bank or other nominee.

***Q: How can I change or revoke my vote?***

**A:** Subject to any rules your broker, bank or other nominee may have, you may change your proxy instructions at any time before your proxy is voted at the annual meeting.

*Stockholders of record* — If you are a stockholder of record, you may change your vote by (1) filing with our General Counsel, prior to your shares being voted at the annual meeting, a written notice of revocation or a duly executed proxy card, in either case dated later than the prior proxy relating to the same

shares, or (2) by attending the annual meeting and voting in person (although attendance at the annual meeting will not, by itself, revoke a proxy). Any written notice of revocation or subsequent proxy card must be received by our General Counsel prior to the taking of the vote at the annual meeting. Such written notice of revocation or subsequent proxy card should be hand delivered to our General Counsel or should be sent so as to be delivered to our principal executive offices, Attention: General Counsel.

A stockholder of record who has voted via the Internet or by telephone may also change his, her or its vote by making a timely and valid later Internet or telephone vote no later than 11:59 p.m., Eastern Time, on May 13, 2009.

*Beneficial owners* — If you are a beneficial owner of shares held in street name, you may change your vote (1) by submitting new voting instructions to your broker, bank or other nominee, or (2) if you have obtained, from the broker, bank or other nominee who holds your shares, a legal proxy giving you the right to vote the shares by attending the annual meeting and voting in person.

***Q: Where can I find the voting results of the annual meeting?***

**A:** The preliminary voting results will be announced at the annual meeting. The final results will be published in our first quarterly report on Form 10-Q filed after the date of the annual meeting.

***Q: Who are the proxies and what do they do?***

**A:** The two persons named as proxies on the proxy card, Kathleen B. Bloch, our Senior Vice President and General Counsel, and Oliver R. Stanfield, our Executive Vice president and Chief Financial Officer, were designated by our Board of Directors. All properly executed proxies will be voted (except to the extent that authority to vote has been withheld) and where a choice has been specified by the stockholder as provided in the proxy card, it will be voted in accordance with the instructions indicated on the proxy card. If you submit the proxy card, but do not indicate your voting instructions, your shares will be voted “FOR” Proposals One, Two and Three.

***Q: What should I do if I receive more than one Notice of Internet Availability or set of proxy materials?***

**A:** If you received more than one Notice of Internet Availability or set of proxy materials, your shares are registered in more than one name or brokerage account. Please follow the voting instructions on each Notice of Internet Availability or voting instruction card that you receive to ensure that all of your shares are voted.

***Q: What happens if additional proposals are presented at the annual meeting?***

**A:** Other than the three proposals described in this Proxy Statement, Echelon does not expect any additional matters to be presented for a vote at the annual meeting. If you grant a proxy, the persons named as proxy holders, Kathleen B. Bloch, our Senior Vice President and General Counsel, and Oliver R. Stanfield, our Executive Vice President and Chief Financial Officer, will have the discretion to vote your shares on any additional matters properly presented for a vote at the annual meeting. If for any unforeseen reason any of Echelon’s Class B nominees is not available as a candidate for director, the persons named as proxy holders will vote your proxy for such other candidate or candidates as may be nominated by our Board of Directors.

**Q: *Is my vote confidential?***

**A:** Proxy instructions, ballots and voting tabulations that identify individual stockholders are handled in a manner that protects your voting privacy. Your vote will not be disclosed either within Echelon or to third parties except (1) as necessary to meet applicable legal requirements, (2) to allow for the tabulation of votes and certification of the vote or (3) to facilitate a successful proxy solicitation by our Board of Directors. Occasionally, stockholders provide written comments on their proxy cards, which are then forwarded to Echelon's management.

**Q: *Who will bear the cost of soliciting votes for the annual meeting?***

**A:** Echelon will bear all expenses of soliciting proxies. Echelon may reimburse brokerage firms, custodians, nominees, fiduciaries and other persons representing beneficial owners of common stock for their reasonable expenses in forwarding solicitation material to such beneficial owners. Directors, officers and employees of Echelon may also solicit proxies in person or by other means of communication. Such directors, officers and employees will not be additionally compensated but may be reimbursed for reasonable out-of-pocket expenses in connection with such solicitation. Echelon may engage the services of a professional proxy solicitation firm to aid in the solicitation of proxies from certain brokers, bank nominees and other institutional owners. Echelon's costs for such services, if retained, will not be significant.

#### **DEADLINE FOR RECEIPT OF STOCKHOLDER PROPOSALS**

Our stockholders may submit proposals that they believe should be voted upon at our next year's annual meeting or nominate persons for election to our Board of Directors. Stockholders may also recommend candidates for election to our Board of Directors (See "*Corporate Governance and Other Matters—Consideration of Stockholder Recommendations and Nominations of Board Members*"). Pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended, some stockholder proposals may be eligible for inclusion in our 2010 proxy statement and proxy. Any such stockholder proposals must be submitted in writing to the attention of Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, no later than December 4, 2009, which is the date 120 calendar days prior to the one-year anniversary of the mailing date of this Proxy Statement. Stockholders interested in submitting such a proposal are advised to contact knowledgeable legal counsel with regard to the detailed requirements of applicable securities laws. The submission of a stockholder proposal does not guarantee that it will be included in our 2010 proxy statement.

Alternatively, under our Bylaws, a proposal or a nomination that the stockholder does not seek to include in our 2010 proxy statement pursuant to Rule 14a-8 may be submitted in writing to Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, for the 2010 annual meeting of stockholders not less than 20 days nor more than 60 days prior to the date of such meeting. Note, however, that in the event we provide less than 30 days notice or prior public disclosure to stockholders of the date of the 2010 annual meeting, any stockholder proposal or nomination not submitted pursuant to Rule 14a-8 must be submitted to us not later than the close of business on the tenth day following the day on which notice of the date of the 2010 annual meeting was mailed or public disclosure was made. For example, if we provide notice of our 2010 annual meeting on April 4, 2010 for a 2010 annual meeting on May 18, 2010, any such proposal or nomination will be considered untimely if submitted to us after April 14, 2010. For purposes of the above, "public disclosure" means disclosure in a press release reported by the Dow Jones News Service, Associated Press or a

comparable national news service, or in a document publicly filed by us with the SEC. As described in our Bylaws, the stockholder submission must include certain specified information concerning the proposal or nominee, as the case may be, and information as to the stockholder's ownership of our common stock. If a stockholder gives notice of such a proposal after the deadline computed in accordance with our Bylaws, or the Bylaw Deadline, the stockholder will not be permitted to present the proposal to our stockholders for a vote at the 2010 annual meeting.

The rules of the SEC also establish a different deadline for submission of stockholder proposals that are not intended to be included in our 2010 proxy statement with respect to discretionary voting, or the Discretionary Vote Deadline. The Discretionary Vote Deadline for the 2010 annual meeting is February 17, 2010, the date which is 45 calendar days prior to the one-year anniversary of the mailing date of this Proxy Statement. If a stockholder gives notice of such a proposal after the Discretionary Vote Deadline, our proxy holders will be allowed to use their discretionary voting authority to vote against the stockholder proposal when and if the proposal is raised at the 2010 annual meeting.

Because the Bylaw Deadline is not capable of being determined until we publicly announce the date of our 2010 annual meeting, it is possible that the Bylaw Deadline may occur after the Discretionary Vote Deadline. In such a case, a proposal received after the Discretionary Vote Deadline but before the Bylaw Deadline would be eligible to be presented at the 2010 annual meeting and we believe that our proxy holders at such meeting would be allowed to use the discretionary authority granted by the proxy to vote against the proposal at such meeting without including any disclosure of the proposal in the proxy statement relating to such meeting.

## **CORPORATE GOVERNANCE AND OTHER MATTERS**

### **Corporate Governance**

#### *Corporate Governance Guidelines*

Our Board of Directors adopted Corporate Governance Guidelines in November 2002 that outline, among other matters, the role and functions of the Board of Directors and the composition and responsibilities of various committees of the Board of Directors. The Corporate Governance Guidelines are available, along with other important corporate governance materials, at the investor relations section of our website at [www.echelon.com](http://www.echelon.com).

The Corporate Governance Guidelines provide, among other things, that:

- A majority of the directors must meet the independence criteria established by Nasdaq.
- If the Chairman of the Board is not an independent director, then a Presiding Director must be appointed by the outside directors to assume the responsibility of chairing the regularly scheduled meetings of outside directors.
- Our Board of Directors shall have a policy of holding separate meeting times for outside directors.

- All of the members of the Nominating and Governance Committee, Audit Committee and Compensation Committee must meet the criteria for independence established by Nasdaq, except that the Board may make exceptions to this policy with respect to the Nominating and Governance Committee that are consistent with regulatory requirements.
- Our Board of Directors shall have responsibility over such matters as overseeing our Chief Executive Officer and other senior management in the competent and ethical operation of our company, gathering and analyzing information obtained from management, retaining counsel and expert advisors, and overseeing and monitoring the effectiveness of governance practices.

In April, 2008, our Board of Directors appointed Robert J. Finocchio, Jr. as Presiding Director. Pursuant to the Corporate Governance Guidelines, the Presiding Director was selected by our non-employee directors and assumed the responsibilities of chairing meetings of non-employee directors, serving as the liaison between our Chief Executive Officer and our independent directors, approving Board of Directors meeting agendas and schedules and information flow to our Board of Directors and such further responsibilities that the non-employee directors as a whole designate from time to time.

As the operation of the Board of Directors is a dynamic process, the Board of Directors regularly reviews changing legal and regulatory requirements, evolving best practices and other developments. Accordingly, the Board of Directors may modify the Corporate Governance Guidelines from time to time, as it deems appropriate.

#### ***Consideration of Stockholder Recommendations and Nominations of Board Members***

The Nominating and Corporate Governance Committee of our Board of Directors will consider both recommendations and nominations from stockholders for candidates to our Board of Directors. A stockholder who desires to recommend a candidate for election to our Board of Directors shall direct the recommendation in writing to the Company Corporate Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, and must include the candidate's name, home and business contact information, detailed biographical data and qualifications, information regarding any relationships between the candidate and our company within the last three years and evidence of the nominating person's ownership of our stock and amount of stock holdings. For a stockholder recommendation to be considered by the Nominating and Corporate Governance Committee as a potential candidate at an annual meeting, nominations must be received on or before the deadline for receipt of stockholder proposals.

If, instead, a stockholder desires to nominate a person directly for election to our Board of Directors, the stockholder must follow the rules set forth by the SEC (see "*Deadline for Receipt of Stockholder Proposals*" above) and meet the deadlines and other requirements set forth in our Bylaws, including, (1) as to each person, if any, whom the stockholder proposes to nominate for election or re-election as a director: (a) the name, age, business address and residence address of such person, (b) the principal occupation or employment of such person, (c) the class and number of shares of our company which are beneficially owned by such person, (d) any other information relating to such person that is required by law to be disclosed in solicitations of proxies for election of directors and (e) such person's written consent to being named as a nominee and to serving as a director if elected; and (2) as to the stockholder giving the notice: (a) the name and address, as they appear on our company's books, of such stockholder, (b) the class and number of shares of our company which are beneficially owned by such stockholder and (c) a description of all arrangements

or understandings between such stockholder and each nominee and any other person or persons (naming such person or persons) relating to the nomination.

### ***Identifying and Evaluating Nominees for our Board of Directors***

The Nominating and Corporate Governance Committee shall use the following procedures to identify and evaluate the individuals that it selects, or recommends that our Board of Directors select, as director nominees:

- The Committee shall review the qualifications of any candidates who have been properly recommended or nominated by stockholders, as well as those candidates who have been identified by management, individual members of our Board of Directors or, if the Committee determines, a search firm. Such review may, in the Committee's discretion, include a review solely of information provided to the Committee or may also include discussions with persons familiar with the candidate, an interview with the candidate or other actions that the Committee deems proper.
- The Committee shall evaluate the performance and qualifications of individual members of our Board of Directors eligible for re-election at the annual meeting of stockholders.
- The Committee shall consider the suitability of each candidate, including the current members of our Board of Directors, in light of the current size and composition of our Board of Directors. In evaluating the suitability of the candidates, the Committee considers many factors, including, among other things, issues of character, judgment, independence, diversity, age, expertise, diversity of experience, length of service, other commitments and the like. The Committee evaluates such factors, among others, and considers each individual candidate in the context of the current perceived needs of our Board of Directors as a whole. Except as may be required by rules promulgated by Nasdaq or the SEC, it is the current sense of the Committee that there are no specific minimum qualifications that must be met by each candidate for our Board of Directors, nor are there specific qualities or skills that are necessary for one or more of the members of our Board of Directors to possess.
- After such review and consideration, the Committee selects, or recommends that our Board of Directors select, the slate of director nominees, either at a meeting of the Committee at which a quorum is present or by unanimous written consent of the Committee.
- The Committee will endeavor to notify, or cause to be notified, all director candidates of its decision as to whether to nominate such individual for election to our Board of Directors.

### ***Standards of Business Conduct***

We have adopted a Code of Business Conduct and Ethics that applies to all directors, officers and employees of Echelon. The Code of Business Conduct and Ethics can be viewed at the investor relations section of our website at [www.echelon.com](http://www.echelon.com). We will post any amendments to, or waivers from, our Code of Business Conduct and Ethics at that location on our website.

### ***Stockholder Communications***

Any stockholder may contact any of our directors by writing to them by mail or express mail c/o Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126.

Any stockholder communications directed to our Board of Directors (other than concerns regarding questionable accounting or auditing matters directed to the Audit Committee or otherwise in accordance with our Financial Information Integrity Policy, which Financial Information Integrity Policy can be viewed at the investor relations section of our website at [www.echelon.com](http://www.echelon.com)) will first go to our General Counsel, who will log the date of receipt of the communication as well as (for non-confidential communications) the identity of the correspondent in our stockholder communications log.

Unless the communication is marked “confidential,” our General Counsel will review, summarize and, if appropriate, draft a response to the communication in a timely manner. The summary and response will be in the form of a memo, which will become part of our stockholder communications log that our General Counsel maintains with respect to all stockholder communications.

At least quarterly, or more frequently as our General Counsel deems appropriate, our General Counsel will forward all such original stockholder communications along with the related memos to our Board of Directors for review.

Any stockholder communication marked “confidential” will be logged by our General Counsel as “received” but will not be reviewed, opened or otherwise held by our General Counsel. Such confidential correspondence will be immediately forwarded to the addressee(s) without a memo or any other comment by our General Counsel.

### **Meetings and Attendance of the Board of Directors and Committees of the Board of Directors**

#### ***Attendance of Directors at 2008 Annual Meeting of Stockholders***

It is the policy of our Board of Directors to strongly encourage board members to attend the annual meeting of stockholders. All but two member of our Board of Directors attended in person our annual meeting of stockholders on May 27, 2008.

#### ***Attendance at Board and Committee Meetings***

Our Board of Directors held seven meetings in 2008. Each director is expected to attend each meeting of our Board of Directors and those Committees on which he or she serves. During 2008, no director attended fewer than 75% of the aggregate of (i) the total number of meetings of our Board of Directors and (ii) the total number of meetings held by all committees of our Board of Directors on which such director served. During 2008, certain matters were approved by our Board of Directors or a committee of our Board of Directors by unanimous written consent.

### **Committees of the Board of Directors**

Our Board of Directors currently has a standing Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee. Each of the Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee has a written charter that has been approved by our

Board of Directors, copies of which can be viewed at the investor relations section of our website at [www.echelon.com](http://www.echelon.com). Pursuant to our 1997 Stock Option Plan, our Board delegated authority to our Chief Executive Officer, Mr. Oshman, to grant stock options and performance shares to employees who are not executive officers of up to a maximum of 25,000 shares per person per year and, generally, up to an aggregate of 250,000 shares per year. The Compensation Committee, Audit Committee, and Nominating and Corporate Governance Committee are described as follows:

### ***Compensation Committee***

In 2008, the Compensation Committee consisted of directors Armas Clifford Markkula, Jr., Robert R. Maxfield and Richard M. Moley until April 28, 2008, when Betsy Rafael was appointed to the Compensation Committee following the resignation on the same date of Robert R. Maxfield from the Compensation Committee. The current members of the Compensation Committee are Armas Clifford Markkula, Jr., Richard M. Moley (Chair) and Betsy Rafael. The Compensation Committee held five meetings in 2008. The purposes of the Compensation Committee are to:

- discharge the responsibilities of our Board of Directors relating to compensation of our executive officers;
- approve and evaluate executive officer compensation plans, policies and programs; and
- produce an annual report on executive compensation for inclusion in our proxy statement.

The responsibilities of the Compensation Committee include annually reviewing and approving, for our Chief Executive Officer and our other executive officers, (1) annual base salary, (2) annual incentive bonus, including the specific goals and amount, (3) equity compensation, (4) employment agreements, severance arrangements and change in control agreements and provisions and (5) any other benefits, compensation or arrangements; and conducting an annual review of the performance of our Chief Executive Officer.

### ***Audit Committee***

In 2008, the Audit Committee consisted of directors, Robert J. Finocchio, Jr., Robert R. Maxfield and Betsy Rafael, until February 14, 2008. On February 15, 2008, Robyn M. Denholm was appointed to the Audit Committee following the resignation of Robert R. Maxfield from the Audit Committee. The current members of the Audit Committee are Robyn M. Denholm, Robert J. Finocchio, Jr. (Chair) and Betsy Rafael. Our Board of Directors has determined that directors Denholm, Finocchio and Rafael are “audit committee financial experts,” as that term is defined in Item 401(h) of Regulation S-K of the Securities Act of 1933, as amended, and that all members of our Audit Committee are independent within the meaning of Rule 4200(a)(15) of the listing standards of the Marketplace Rules of the Nasdaq Stock Market. The Audit Committee held five meetings in 2008. The purposes of the Audit Committee are to:

- oversee our accounting and financial reporting processes and the internal and external audits of our financial statements;
- assist our Board of Directors in the oversight and monitoring of (1) the integrity of our financial statements, (2) our compliance with legal and regulatory requirements, (3) the independent

auditor's qualifications, independence and performance and (4) our internal accounting and financial controls;

- outline to our Board of Directors the results of its monitoring and recommendations derived therefrom and improvements made, or to be made, in internal accounting controls;
- prepare the report that the rules of the SEC require to be included in our annual proxy statement;
- appoint our independent registered public accounting firm; and
- provide to our Board of Directors such additional information and materials as it may deem necessary to make our Board of Directors aware of significant financial matters that require the attention of our Board of Directors.

The responsibilities of the Audit Committee include the continuous review of the adequacy of our system of internal controls; oversight of the work of our independent registered public accounting firm, including a post-audit review of the financial statements and audit findings; oversight of compliance with SEC requirements regarding audit related matters; review, in conjunction with counsel, any legal matters that could significantly impact our financial statements; and oversight and review of our information technology and management information systems policies and risk management policies, including our investment policies.

#### *Nominating and Corporate Governance Committee*

In 2008, the Nominating and Corporate Governance Committee consisted of directors Armas Clifford Markkula, Jr., Richard M. Moley and Larry Sonsini. The current members of the Nominating and Corporate Governance Committee are Armas Clifford Markkula, Jr., Richard M. Moley and Larry Sonsini (Chair). The Nominating and Corporate Governance Committee held one meeting in 2008. The purposes of the Nominating and Corporate Governance Committee are to:

- assist our Board of Directors by identifying prospective director nominees and to recommend to our Board of Directors the director nominees for the next annual meeting of stockholders;
- develop and recommend to our Board of Directors the governance principles applicable to our company;
- oversee the evaluation of our Board of Directors and management; and
- recommend to our Board of Directors director nominees for each committee.

The responsibilities of the Nominating and Corporate Governance Committee include evaluating the composition, organization and governance of our Board of Directors and its committees, including determining future requirements; overseeing the performance evaluation process of our Board of Directors; making recommendations to our Board of Directors concerning the appointment of directors to committees, selecting Board committee chairs and proposing the slate of directors for election; and making recommendations to our Board of Directors regarding compensation for non-employee directors and Board committee members.

## **Director Independence**

Our Board of Directors has affirmatively determined that each of its members, other than Robert R. Maxfield and M. Kenneth Oshman, are independent directors under the listing standards of the Marketplace Rules of the Nasdaq Stock Market and applicable SEC rules, and that all of its members, other than Dr. Maxfield, Mr. Oshman, and Ms. Denholm, who joined our Board of Directors in February 2008, were independent directors under the listing standards of the Marketplace Rules of the Nasdaq Stock Market in the three prior years.

Our Board of Directors has also determined that all directors serving as members of our Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee are independent under the Nasdaq listing standards and the rules of the SEC. Additionally, our Board of Directors has determined that all members of the Compensation Committee meet the non-employee definition of Rule 16b-3 promulgated under Section 16 of the Securities Exchange Act of 1934, as amended, and the outside director definition of Section 162(m) of the Internal Revenue Code of 1986, as amended.

## **Director Compensation**

In November 2002, our Board of Directors determined that in consideration for service on our Board of Directors, each non-employee director shall receive a cash payment of \$20,000 per fiscal year, to be payable on or before the day of the first meeting of our Board of Directors in each fiscal year. On February 8, 2007, our Board of Directors approved changes to the cash compensation payable to the non-employee directors. Accordingly, beginning in 2007 the cash compensation payable to each non-employee director was increased to \$40,000 per fiscal year, to be paid quarterly.

In addition, in consideration for service on our Board of Directors or on one or more of our Compensation and/or Nominating and Corporate Governance Committees of our Board of Directors, each non-employee director shall receive a cash payment of \$1,000 per Board of Directors meeting or Committee meeting attended, to be payable on the date of each such meeting so attended. We also determined that in consideration of the significantly greater time commitment and potential risk exposure for serving as a member of our Audit Committee, each director shall receive a cash payment of \$2,000 per Audit Committee meeting attended, to be payable on the date of each such meeting so attended.

Furthermore, non-employee directors are eligible to participate in our 1997 Stock Plan. The Board has adopted a program, effective as of the July 27, 2008 expiration date of the 1998 Director Option Plan, for automatically granting awards of nonqualified stock options to non-employee directors under the 1997 Plan on the same terms as grants previously made under the 1998 Director Option Plan. Such program provides for the automatic grant of an option to purchase 25,000 shares of common stock on the date on which such person first becomes a non-employee director. Additionally, each non-employee director shall automatically be granted a 10,000 share option on the date of each annual meeting of stockholders, provided he or she is re-elected to our Board of Directors or otherwise remains on our Board of Directors on such date and provided that on such date he or she shall have served on our Board of Directors for at least the preceding six months. All options granted under this program are fully vested at grant. On February 15, 2008, Ms. Denholm was granted a 25,000 share option under the 1998 Director Option Plan at a per share exercise price of \$12.73. On May 27, 2008, the date of our 2008 annual meeting of stockholders, directors Finocchio, Markkula, Moley, Rafael and Sonsini were each granted a 10,000 share option under the 1998 Director Option Plan at a per share exercise price of \$13.32.

## Director Summary Compensation Table for Fiscal 2008

The table below summarizes the compensation paid by our company to non-employee directors for the fiscal year ended December 31, 2008.

Name	Fees Earned or Paid in Cash (\$)	Option Awards	Total (\$)
		(\$)(1)(2)(3)	
Robyn M. Denholm	57,000	142,993	199,993
Robert J. Finocchio, Jr.....	56,000	51,285	107,285
Armas Clifford Markkula, Jr.....	52,000	51,285	103,285
Robert R. Maxfield (4) .....	36,000	—	36,000
Richard M. Moley .....	53,000	51,285	104,285
Betsy Rafael.....	59,000	51,285	110,285
Larry W. Sonsini.....	48,000	51,285	99,285

- (1) Reflects the dollar amount recognized for financial statement reporting purposes (disregarding an estimate of forfeitures) for fiscal 2008, in accordance with SFAS 123R, and thus may include amounts from awards granted in and prior to 2008. The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 16, 2009. These amounts do not correspond to the actual value that will be recognized by the directors upon exercise or sale of such awards.
- (2) In connection with her appointment to our Board of Directors, on February 15, 2008, Ms. Denholm was granted a fully vested option to purchase 25,000 shares at a per share exercise price of \$12.73, the closing price of our common stock on that date. On May 27, 2008, the date of our annual meeting of stockholders, each non-employee director serving in such capacity for at least the prior six months was granted a fully vested option to purchase 10,000 shares at a per share exercise price of \$13.32, the closing price of our common stock on that date.
- (3) As of December 31, 2008, the aggregate number of shares underlying options outstanding for each of our non-employee directors was:

Name	Aggregate Number of Shares
Robyn M. Denholm	25,000
Robert J. Finocchio, Jr. ....	50,000
Armas Clifford Markkula, Jr. ....	50,000
Robert R. Maxfield .....	30,000
Richard M. Moley.....	50,000
Betsy Rafael .....	20,000
Larry W. Sonsini.....	50,000

- (4) Robert R. Maxfield was classified as a non-employee director until April 28, 2008, when he was appointed Senior Vice President of Products of our company, a position he held until October 3, 2008. In addition to serving on our Board, Dr. Maxfield serves as a consultant to our company.

## PROPOSAL ONE

### ELECTION OF DIRECTORS

#### General

We currently have eight members on our Board of Directors. Our Board of Directors is divided into three classes, with each director serving a three-year term and one class being elected at each year's annual meeting of stockholders. Directors Robert J. Finocchio, Jr., Armas Clifford Markkula, Jr. and Robert R. Maxfield are the Class B directors whose terms will expire at the 2009 Annual Meeting of Stockholders and

they have been nominated by our Board of Directors for reelection at the Annual Meeting of Stockholders to be held May 14, 2009. Directors Robyn M. Denholm, Richard M. Moley and Betsy Rafael are the Class C directors whose terms will expire at the 2010 Annual Meeting of Stockholders and M. Kenneth Oshman and Larry W. Sonsini are the Class A directors whose terms will expire at the 2011 Annual Meeting of Stockholders. All of the directors, including the Class B nominees, are incumbent directors. There are no family relationships among any of our directors or executive officers, including any of the nominees mentioned above. Unless otherwise instructed, the holders of proxies solicited by this Proxy Statement will vote the proxies received by them for the three Class B nominees. In the event that any nominee is unable or declines to serve as a director at the time of the annual meeting, the proxy holders will vote for a nominee designated by the present Board of Directors to fill the vacancy. We are not aware of any reason that any nominee will be unable or will decline to serve as a director. Our Board of Directors recommends a vote "FOR" the election of each of the Class B nominees listed above.

## Director Information

### *Current Directors*

The names of the members of our Board of Directors, including the Class B nominees, their ages as of March 23, 2009 and certain information about them, are set forth below.

<u>Name</u>	<u>Age</u>	<u>Principal Occupation</u>
M. Kenneth Oshman (1).....	68	Chairman of the Board and Chief Executive Officer of Echelon
Robyn M. Denholm (3) .....	45	Chief Financial Officer of Juniper Networks, Inc.
Robert J. Finocchio, Jr. (2) (3).....	57	Corporate director, private investor and part time professor
Armas Clifford Markkula, Jr. (2) (4) (5) .....	67	Vice Chairman of the Board of Directors of Echelon
Robert R. Maxfield (2).....	67	Private investor
Richard M. Moley (4) (5).....	70	Private investor
Betsy Rafael (3) (4).....	47	Vice President, Corporate Controller and Principal Accounting Executive of Apple, Inc.
Larry W. Sonsini (2) (5).....	68	Chairman of Wilson Sonsini Goodrich & Rosati, P.C.

- (1) Sole member of the stock option committee.
- (2) Denotes nominee for election at the 2009 Annual Meeting of Stockholders.
- (3) Member of the Audit Committee.
- (4) Member of the Compensation Committee.
- (5) Member of the Nominating and Corporate Governance Committee.

### *Director Biographies*

*M. Kenneth Oshman* has been Chief Executive Officer of our company since December 1988 and Chairman of our Board of Directors since September 1989. He also served as our President from 1988 to 2001. Mr. Oshman, with three associates, founded ROLM Corporation, a telecommunications equipment company, in 1969. He was Chief Executive Officer, President and a director at ROLM from its founding until its merger with IBM in 1984. Following the merger, he became a Vice President of IBM and a member of its Corporate Management Board. He remained in that position until 1986. Prior to founding ROLM, Mr. Oshman was a member of the technical staff at Sylvania Electric Products from 1963 to 1969. Mr. Oshman also serves as a director of Sun Microsystems. Mr. Oshman earned B.A. and B.S.E.E. degrees from Rice University and M.S. and Ph.D. degrees in Electrical Engineering from Stanford University.

*Robyn M. Denholm* has been a director of our company since February 2008. Ms. Denholm is currently Chief Financial Officer of Juniper Networks. Prior to joining Juniper Networks in August 2007, Ms. Denholm was employed at Sun Microsystems where she served as Senior Vice President, Corporate Strategic Planning. In that role, she was responsible for Sun's corporate operating system, and the global sales and service administration function and she served as the leader of Sun's business transformation initiative. Ms. Denholm joined Sun in 1996 and served in executive assignments that included Senior Vice President, Finance; Vice President and Corporate Controller (Chief Accounting Officer); Vice President, Finance; Service Division, Director, Shared Financial Services APAC and Controller, Australia/New Zealand. Prior to joining Sun, Ms. Denholm served at Toyota Motor Corporation Australia for seven years and at Arthur Andersen and Company for five years, in various finance assignments. Ms. Denholm is a Fellow of the Institute of Chartered Accountants of Australia and holds a Bachelors degree in Economics from the University of Sydney and a Masters of Commerce degree from the University of New South Wales.

*Robert J. Finocchio, Jr.* has been a director of our company since 1999. Mr. Finocchio served as Chairman of the Board of Informix Corporation, an information management software company, from August 1997 to September 2000. Since September 2000, Mr. Finocchio has been a dean's executive professor at Santa Clara University's Leavey School of Business. From July 1997 until July 1999, Mr. Finocchio served as President and Chief Executive Officer of Informix. From December 1988 until May 1997, Mr. Finocchio was employed with 3Com Corporation, a global data networking company, where he held various positions, most recently serving as President, 3Com Systems. Mr. Finocchio also serves as a director of Altera Corp. and Sun Microsystems. Mr. Finocchio is a Trustee of Santa Clara University. Mr. Finocchio holds a B.S. degree in Economics from Santa Clara University and an M.B.A. degree from the Harvard Business School.

*Armas Clifford Markkula, Jr.* is the founder of our company and has served as a director since 1988. He has been Vice Chairman of our Board of Directors since 1989. Mr. Markkula was Chairman of the Board of Apple Computer from January 1977 to May 1983 and from October 1993 to February 1996 and was a director from 1977 to 1997. A founder of Apple, he held a variety of positions there, including President/Chief Executive Officer and Vice President of Marketing. Prior to founding Apple, Mr. Markkula was with Intel Corporation as Marketing Manager, Fairchild Camera and Instrument Corporation as Marketing Manager in the Semiconductor Division, and Hughes Aircraft as a member of the technical staff in the company's research and development laboratory. Mr. Markkula is a trustee of Santa Clara University. Mr. Markkula received B.S. and M.S. degrees in Electrical Engineering from the University of Southern California.

*Robert R. Maxfield* has been a director of our company since 1989. He was a co-founder of ROLM in 1969, and served as Executive Vice President and a director until ROLM's merger with IBM in 1984. Following the merger, he continued to serve as Vice President of ROLM until 1988. Since 1988, he has been a private investor. Dr. Maxfield was a venture partner with Kleiner, Perkins, Caufield & Byers, a venture capital firm, from 1989 to 1992. Dr. Maxfield received B.A. and B.S.E.E. degrees from Rice University, and M.S. and Ph.D. degrees in Electrical Engineering from Stanford University.

*Richard M. Moley* has been a director of our company since 1997. Since August 1997, Mr. Moley has been a private investor. From July 1996 to August 1997, he served as Senior Vice President, Wide Area Business Unit and as a director of Cisco Systems, following Cisco Systems' purchase of StrataCom, where he was Chairman of the Board, Chief Executive Officer and President. Mr. Moley also serves as a director of Linear Technology. Mr. Moley received a B.S. degree in Electrical Engineering from Manchester University,

an M.S. degree in Electrical Engineering from Stanford University and an M.B.A. degree from Santa Clara University.

*Betsy Rafael* has been a director of our company since November 2005. Since August 2007, Ms. Rafael has held the position of Vice President and Corporate Controller for Apple and was appointed to the additional role of Principal Accounting Executive in January 2008. From September 2006 to August 2007, Ms. Rafael held the position of Vice President, Corporate Finance for Cisco Systems. From April 2002 to September 2006, she served as Vice President, Corporate Controller and Principal Accounting Officer of Cisco Systems. From December 2000 to April 2002, Ms. Rafael was the Executive Vice President, Chief Financial Officer, and Chief Administrative Officer of Aspect Communications, Inc., a provider of customer relationship portals. From April 2000 to November 2000, Ms. Rafael was Senior Vice-President and CFO of Escalate Inc., an enterprise e-commerce application service provider. From 1994 to 2000, Ms. Rafael held a number of senior positions at Silicon Graphics, culminating her career at Silicon Graphics as Senior Vice President and Chief Financial Officer. Prior to SGI, Ms. Rafael held senior management positions in finance with Sun Microsystems and Apple Computer. Ms. Rafael began her career with Arthur Young & Company. Ms. Rafael received a B.S.C. degree in Accounting from Santa Clara University.

*Larry W. Sonsini* has been a director of our company since 1993. Mr. Sonsini serves as Chairman of the law firm of Wilson Sonsini Goodrich & Rosati, P.C., where he has practiced since 1966. Mr. Sonsini received an A.B. degree in Political Science and Economics and an L.L.B. degree from the University of California at Berkeley.

#### ***Class B Director Nominees***

Robert J. Finocchio, Jr.  
Armas Clifford Markkula, Jr.  
Robert R. Maxfield

#### ***Vote Required***

Directors shall be elected by a plurality vote. The three Class B nominees for director receiving the highest number of affirmative votes of the shares entitled to be voted for them shall be elected as directors. Votes against, abstentions and broker non-votes have no legal effect on the election of directors due to the fact that such elections are by a plurality.

#### **Board Recommendation**

**OUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE "FOR" THE PROPOSED SLATE OF CLASS B DIRECTORS.**

## **PROPOSAL TWO**

### **REAPPROVAL OF THE MANAGEMENT BONUS PLAN**

Our Board of Directors has previously adopted, and the stockholders have previously approved, the Management Bonus Plan (the “Bonus Plan”). The stockholders are being asked to approve the Bonus Plan again, so that our company may use the Bonus Plan to achieve its goals and continue to receive a tax deduction for certain compensation paid under the Bonus Plan. The Bonus Plan is subject to the reapproval of a majority of the shares of our common stock that are present in person or by proxy at the Annual Meeting. If our stockholders do not reapprove the Bonus Plan, the Bonus Plan will terminate and no bonuses will be awarded under the Bonus Plan for performance periods that begin on or after the date of the Annual Meeting. However, any awards earned under the Bonus Plan for a performance period that commenced prior to the date of the Annual Meeting will be paid pursuant to the terms of the Bonus Plan as they existed prior to the Annual Meeting.

The following paragraphs provide a summary of the principal features of the Bonus Plan and its operation. The Bonus Plan is set forth in its entirety as Appendix A to this Proxy Statement. The following summary is qualified in its entirety by reference to Appendix A.

#### **Purpose**

The purpose of the Bonus Plan is to motivate key members of management to perform to the best of their abilities and to achieve our objectives. The Bonus Plan accomplishes this by paying awards under the Bonus Plan only after the achievement of the specified goals.

The Bonus Plan also is designed to qualify as “performance-based” compensation under section 162(m) of the Internal Revenue Code. Under section 162(m), our company may not receive a federal income tax deduction for compensation paid to our Chief Executive Officer and certain other highly compensated executive officers to the extent that any of these persons receives more than \$1 million in any one year. However, if we pay compensation that is “performance-based” under section 162(m), our company still can receive a federal income deduction for the compensation even if it is more than \$1 million during a single year. The Bonus Plan allows us to pay incentive compensation that is performance-based and therefore fully tax deductible on our federal income tax return.

#### **Eligibility to Participate**

The Compensation Committee selects which of our employees (and employees of our affiliates) will be eligible to receive awards under the Bonus Plan. The actual number of employees who will be eligible to receive an award during any particular year cannot be determined in advance because the Compensation Committee has discretion to select the participants. However, it is expected that approximately 20 employees will participate in the Bonus Plan in any year.

## **Target Awards and Performance Goals**

For each performance period, the Compensation Committee may assign each participant a target award and performance goal or goals that must be achieved before an award actually will be paid to the participant. The participant's target award may be expressed as a percentage of his or her base salary at the end of the fiscal year, or may be designated as a dollar amount or some other fashion as the Compensation Committee may determine. The performance goals may require the achievement of objectives for one or more of:

- Cash Position,
- Earnings per Share,
- Individual Objectives,
- Net Income,
- Operating Cash Flow,
- Operating Income,
- Return on Assets,
- Return on Equity,
- Return on Sales,
- Revenue, or
- Total Stockholder Return.

Each of these performance measures is defined in the Bonus Plan.

## **Actual Awards**

After the performance period ends, the company may request the Compensation Committee to certify in writing whether or the extent to which the pre-established performance goals actually were achieved or exceeded. The actual award that is payable to a participant may be determined by using a formula that will increase or decrease the participant's target award based on the level of actual performance attained. However, the Bonus Plan limits actual awards to a maximum of \$5,000,000 per person in any performance period, even if the formula otherwise indicates a larger award. In addition, the Compensation Committee has discretion to reduce or eliminate the actual award payable to any participant below that which otherwise would be payable under the formula.

Actual awards generally are to be paid in cash within two and one-half months after the performance period ends. If a participant terminates employment before the end of the performance period in which the bonus is to be earned, the Compensation Committee will have discretion to pay out part or all of the award otherwise earned.

## **Administration, Amendment and Termination**

The Compensation Committee administers the Bonus Plan. Members of the Compensation Committee must qualify as outside directors under section 162(m). Subject to the terms of the plan, the Compensation Committee has sole discretion to:

- select the employees who will receive awards;

- determine the target award for each participant;
- determine the performance goals that must be achieved before any actual awards are paid;
- determine a formula to increase or decrease an award to reflect actual performance versus the predetermined performance goals; and
- interpret the provisions of the Bonus Plan.

The Board may amend or terminate the plan at any time and for any reason. An amendment also will be submitted for stockholder approval if necessary to maintain the Bonus Plan's compliance with Section 162(m).

### **Indemnification**

Our Board of Directors and Compensation Committee are generally indemnified by our company for any liability arising from claims relating to the Bonus Plan.

### **U.S. Federal Income Tax Consequences**

Under present federal income tax law, participants will recognize ordinary income equal to the amount of the award received in the year of receipt. That income will be subject to applicable income and employment tax withholding by our company. If and to the extent that the Bonus Plan payments satisfy the requirements of Section 162(m) of the Code and otherwise satisfy the requirements for deductibility under federal income tax law, we will receive a deduction for the amount constituting ordinary income to the participant.

### **Bonus Plan Benefits**

Awards that may be issued under the Bonus Plan are determined based on actual future performance, so future actual awards cannot now be determined.

### **Board Recommendation**

**OUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE "FOR" PROPOSAL TWO.**

### **PROPOSAL THREE**

### **RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

With authority granted by our Board of Directors, the Audit Committee of our Board of Directors has appointed KPMG LLP as our independent registered public accounting firm to audit our consolidated financial statements for the fiscal year ending December 31, 2009, and our Board of Directors recommends that our stockholders vote "FOR" ratification of such appointment.

KPMG LLP was originally appointed as our independent registered public accounting firm on March 21, 2002, when we retained the firm to perform the annual audit of our financial statements for the fiscal year ended December 31, 2002. A representative of KPMG LLP is expected to be present at the annual meeting, will have an opportunity to make a statement if he or she so desires and is expected to be available to respond to appropriate questions from our stockholders.

**Audit and Non-Audit Fees**

The following table sets forth fees for services KPMG LLP provided during fiscal years 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Audit fees (1) .....	\$ 1,189,000	\$ 914,000
Audit-related fees .....	\$ —	\$ —
Tax fees .....	\$ —	\$ —
All other fees (2) .....	<u>\$ —</u>	<u>\$ 45,814</u>
Total .....	<u>\$ 1,189,000</u>	<u>\$ 959,814</u>

(1) Represents fees for professional services provided in connection with the audit of our annual financial statements and review of our quarterly financial statements, advice on accounting matters that arose during the audit and audit services provided in connection with other statutory or regulatory filings. The audit fees for 2008 represent the amount billed to our company as of the date of this Proxy Statement.

(2) Represents fees for consultation and due diligence assistance regarding acquisitions that we did not pursue.

Our Audit Committee has considered whether the non-audit services provided by KPMG LLP are compatible with maintaining the independence of KPMG LLP and has concluded that the independence of KPMG LLP is maintained and is not compromised by the services provided. In accordance with its charter, the Audit Committee approves in advance all audit and non-audit services to be provided by KPMG LLP. During fiscal year 2008, 100% of the services were pre-approved by the Audit Committee in accordance with this policy.

Stockholder ratification of the selection of KPMG LLP as our independent registered public accounting firm is not required by our Bylaws or other applicable legal requirement. However, our Board of Directors is submitting the selection of KPMG LLP to our stockholders for ratification as a matter of good corporate practice. If our stockholders fail to ratify the selection, the Audit Committee will reconsider whether or not to retain that firm. Even if the selection is ratified, the Audit Committee at its discretion may direct the appointment of a different independent accounting firm at any time during the year if it determines that such a change would be in our best interests and the best interests of our stockholders.

**Board Recommendation**

**OUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE “FOR” PROPOSAL THREE.**

## SHARE OWNERSHIP BY PRINCIPAL STOCKHOLDERS AND MANAGEMENT

To our knowledge, the following table sets forth certain information with respect to beneficial ownership of our common stock, as of March 23, 2009, for:

- each person who we know beneficially owns more than 5% of our common stock;
- each of our directors;
- each of our executive officers set forth in the Summary Compensation Table; and
- all of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power with respect to the securities. Except as indicated by footnote, and subject to applicable community property laws, each person identified in the table possesses sole voting and investment power with respect to all shares of common stock shown held by them. The number of shares of common stock outstanding used in calculating the percentage for each listed person includes shares of common stock underlying options held by such person that are exercisable within 60 calendar days of March 23, 2009, but excludes shares of common stock underlying options held by any other person. Percentage of beneficial ownership is based on 40,591,600 shares of common stock outstanding as of March 23, 2009.

Name	Shares Beneficially Owned	Percentage Beneficially Owned
<b>5% Stockholders:</b>		
ENEL Investment Holding BV (1) .....	3,000,000	7.4%
Invesco Ltd. (2) .....	2,106,246	5.2%
<b>Directors and Executive Officers:</b>		
M. Kenneth Oshman (3) (4) .....	4,943,031	12.2%
Armas Clifford Markkula, Jr. (4) (5) .....	1,822,038	4.5%
Oliver R. Stanfield (4) (6) .....	655,982	1.6%
Robert R. Maxfield (4) (7) .....	380,854	*
Frederik H. Bruggink (4) (8) .....	293,598	*
Richard M. Moley (4) .....	205,589	*
Kathleen B. Bloch (4) .....	177,788	*
Robert J. Finocchio, Jr. (4) .....	95,000	*
Larry W. Sonsini (4) .....	64,261	*
Robyn M. Denholm (4) .....	25,000	*
Betsy Rafael (4) .....	20,000	*
Russell Harris (4) .....	9,460	*
All directors and executive officers as a group (14 persons) (4) .....	8,712,326	21.2%

\* Less than 1%.

- (1) Affiliate of Enel S.p.A. Principal address is Viale Regina Margherita 137, Rome, Italy 00198.
- (2) The shares are held by Invesco PowerShares Capital Management LLC and Invesco PowerShares Capital Management Ireland LTD, subsidiaries of Invesco Ltd. ("Invesco"), as disclosed in a Schedule 13G/A filed by Invesco with the SEC on February 17, 2009. The address of Invesco is 1555 Peachtree Street NE, Atlanta, GA 30309.
- (3) Mr. Oshman's principal address is c/o Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126. Includes (i) 2,905,047 shares held by M. Kenneth Oshman and Barbara S. Oshman, Trustees of the Oshman Trust dated July 10, 1979, (ii) 16,452 shares held by M. Kenneth Oshman, Trustee of the M. Kenneth Oshman 2008

Annuity Trust dated February 19, 2008, (iii) 16,452 shares held by M. Kenneth Oshman, Trustee of the Barbara S. Oshman 2008 Annuity Trust dated February 19, 2008, (iv) 300,000 shares held by M. Kenneth Oshman, Trustee of the M. Kenneth Oshman 2008A Annuity Trust dated August 1, 2008, (v) 300,000 shares held by M. Kenneth Oshman, Trustee of the Barbara S. Oshman 2008A Annuity Trust dated August 1, 2008, (vi) 458,326 shares held by M. Kenneth Oshman, Trustee of M. Kenneth Oshman 2009 Annuity Trust dated 2/20/09, (vii) 458,326 shares held by M. Kenneth Oshman, Trustee of Barbara S. Oshman 2009 Annuity Trust dated 2/20/09, (viii) 488,428 shares held by O-S Ventures, of which Mr. Oshman is general partner.

- (4) Includes, for the applicable director or executive officer, the following shares exercisable within 60 days of March 23, 2009 upon the exercise of options, performance shares and/or stock settled stock appreciation rights, or SARs. The number of shares issued upon the exercise of SARs will be reduced at the time of exercise by (i) a number of shares sufficient to cover the grant price times the number of shares with respect to which the SAR is being exercised plus (ii) a number of shares sufficient to cover the amount of certain minimum withholding taxes due at the time of exercise. The number of shares withheld to cover the grant price and withholding taxes will be calculated based on the fair market value of our common stock on the date of exercise.

	<u>Options</u>	<u>Performance Shares</u>	<u>SARs</u>
• M. Kenneth Oshman	0	0	0
• Armas Clifford Markkula, Jr.	50,000	0	0
• Oliver R. Stanfield	37,500	0	18,750
• Robert R. Maxfield	30,000	2,500	0
• Frederik H. Bruggink	35,000	0	21,564
• Richard M. Moley	50,000	0	0
• Kathleen B. Bloch	150,000	0	0
• Robert J. Finocchio, Jr.	50,000	0	0
• Larry W. Sonsini	50,000	0	0
• Robyn M. Denholm	25,000	0	0
• Betsy Rafael	20,000	0	0
• Russell Harris	0	0	0
• All directors and executive officers as a group	497,500	2,500	40,314

- (5) Includes 1,635,110 shares held by Armas Clifford Markkula, Jr. and Linda Kathryn Markkula, Trustees of the Restated Arlin Trust Dated December 12, 1990, and 136,928 shares held by the Markkula Family Limited Partnership. Mr. Markkula and his spouse disclaim beneficial ownership of all but 27,500 of the shares held by the Markkula Family Limited Partnership.
- (6) Includes 528,882 shares by held by Oliver Rueben Stanfield and Janet Helen Stanfield, Trustees of the Stanfield Family Trust UDT dated February 2, 2001, and 250 shares held by Mr. Stanfield's spouse.
- (7) Includes 348,354 shares held by Robert R. Maxfield, Trustee UA DTD 12/14/87.
- (8) Of the 35,000 shares exercisable within 60 days of March 23, 2009, 26,250 shares are vested at March 23, 2009.

## EXECUTIVE COMPENSATION AND RELATED MATTERS

### Compensation Discussion and Analysis

#### *Overview of Compensation Program and Philosophy*

Our executive compensation programs are designed to meet the following objectives:

- Attract and retain motivated and talented executives with a view to the competitive nature of the marketplace in the Silicon Valley and other areas in which we may seek executive talent;
- Provide an executive compensation structure that is not only competitive in our geographic and industry areas, but is internally equitable and consistent based on the level of responsibilities for each executive position;
- Motivate our executives to perform to the best of their abilities through a compensation strategy that includes “pay for performance”; and
- Align the interests of our executives with those of our stockholders by linking our financial and operating results to compensation paid to executive officers.

These objectives fit within our overall compensation philosophy by endeavoring to continuously improve our company’s performance, while recognizing the need to secure the future potential of our business. Our compensation philosophy is also intended to enhance stockholder value, provide proper compliance with regulatory and related requirements, and create a cohesive executive team.

To meet these objectives, we have implemented an executive compensation program based on the following policies:

- Pay cash compensation in the form of executive base pay that is competitive with the practices of other leading high technology companies in our area; and
- Pay for performance:
  - by providing long-term, significant incentives in the form of equity compensation awards, which include stock options, performance shares (also referred to as “restricted stock units”), and/or stock appreciation rights (also referred to as “SARs”), in order to retain those individuals with the leadership abilities necessary to increase long-term stockholder value; and
  - through an annual management bonus plan that is based upon our company’s strategic business or operating objectives, as well as the need to motivate executives to realize the full potential of our business.

The Compensation Committee is responsible for ensuring compliance with these objectives and policies. Accordingly, the Compensation Committee reviews and approves our company’s annual compensation arrangements with our executive officers, including annual base salary, annual incentive bonus, equity compensation, and other benefits or compensation. In performing these duties, the

Compensation Committee obtains the assistance of compensation consultants from time to time, is supported by our Human Resources Department, and receives input from our executive management.

Our executive team is currently comprised of the following individuals:

<u>Title</u>	<u>Name</u>
Chief Executive Officer	M. Kenneth Oshman
Executive Vice President and Chief Financial Officer	Oliver R. Stanfield
Senior Vice President and General Counsel	Kathleen B. Bloch
Senior Vice President – General Manager/Service Provider Group	Frederik H. Bruggink
Senior Vice President of Operations	Russell Harris
Senior Vice President of Sales and Marketing	Anders Axelsson
Senior Vice President – Products	Robert Machlin

Until May 2008, our executive team also included Beatrice Yormark, who served as our President and Chief Operating Officer until her sudden passing due to a cerebral hemorrhage.

Throughout this proxy statement, our executive team is referred to as the “executive officers” and includes our “Named Executive Officers.”

#### ***Role of our Compensation Committee***

Our Compensation Committee approves, administers and interprets our executive compensation and benefits plans and policies, including our stockholder-approved Amended and Restated 1997 Stock Plan. Our Compensation Committee is appointed by our Board of Directors, and consists entirely of directors who are independent for purposes of the listing standards of the Nasdaq Stock Market, “outside directors” for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended, and “non-employee directors” for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended. The members of our Compensation Committee currently are Armas Clifford Markkula, Jr., Richard M. Moley and Betsy Rafael, and the Committee is chaired by Mr. Moley. Robert R. Maxfield was a member of the Compensation Committee and served as its chair until May 2008, when he accepted a temporary position with our company. To preserve the independence of the Compensation Committee, Mr. Maxfield was replaced by Ms. Rafael and Mr. Moley was made Committee Chairman. Our Compensation Committee operates under a written charter adopted by our Board of Directors which is available at the Investor Relations section of our website at [www.echelon.com](http://www.echelon.com). The Compensation Committee held five meetings during 2008.

#### **Role of Executive Officers in Compensation Decisions**

Our Chief Executive Officer, with input from our Vice President of Human Resources, reviews the performance of our Named Executive Officers and presents his findings to our Compensation Committee, together with recommendations for compensation structures to be applied to the subject year. In

setting the 2008 compensation for our Named Executive Officers, our company's former President and Chief Operating Officer, Ms. Yormark, also participated with our Chief Executive Officer in reviewing the officers' performance. The Compensation Committee alone or in consultation with the full Board of Directors reviews our Chief Executive Officer's performance. The Compensation Committee considers these findings and recommendations, but makes its own final determinations. This review process is generally conducted twice each year: first, in advance of annual salary adjustments and the adoption of the annual management bonus program described below, and second, in connection with the annual equity compensation award.

#### Role of Compensation Consultants and Benchmarking

The Compensation Committee has the authority to engage its own independent advisors to assist in carrying out its responsibilities. For example, in 2006, the Compensation Committee engaged Compensia, a management compensation consulting firm, regarding key trends and observations for executive equity compensation practices by peer companies. This independent compensation consultant did not provide any other services to our company and received compensation only with respect to the services provided to the Compensation Committee. The Compensation Committee did not engage an independent consultant in 2008.

Each year, our company and the Compensation Committee use benchmarking to assess the competitiveness of the compensation of our officers in light of the compensation offered to executives at other companies. These peer companies are not limited to competitors, given the complex nature of our company's business and the various geographic locations in which we compete for talent. For 2008, the Compensation Committee relied on data from AON Radford Surveys + Consulting and salary.com. Generally, this data considered companies in Northern California, generally, and the San Jose geographic area, specifically; in peer groups defined as the "software and networking industry" and the "electronics, electronic equipment and semiconductor industry"; with revenue of between \$200 million and \$500 million and between \$500 million and \$1.0 billion. While these revenue ranges are greater than our company's revenue historically, the Compensation Committee considered that we compete for talent with larger companies such as these. The Compensation Committee also reviewed international data provided by the Radford survey, where appropriate.

The following companies were included in the relevant peer groups:

Ariba	Extreme Networks	Synopsys
BEA Systems	Foundry Networks	Tivo
Business Objects	Informatica	Ubisoft
Cadence Design Systems	Interwoven	Wind River Systems
Dolby Laboratories	Openwave	
Eclipsys	Salesforce.com	

The overall competitive data presented included base salary and formal incentive compensation in the 25<sup>th</sup>, 50<sup>th</sup> and 75<sup>th</sup> percentile and average compensation information. We generally target

salaries to be in approximately the 75th percentile of peer group companies, although other important factors are considered, including individual performance, experience and responsibilities; maintaining internal consistency of compensation for similarly situated officers; and company performance.

### *Elements of Compensation*

Our executive officers' compensation, as is the case with all of our officers, has three primary components:

- Base salary;
- Participation in the management bonus plan; and
- Participation in the annual equity compensation award.

In addition, we provide our executive officers with employee benefits that are generally available to all salaried employees in the geographical location in which they are based. We do not provide pension arrangements, post-termination payments, deferred compensation or other similar benefits to our executive officers, except that in the case of our Senior Vice President–General Manager/Service Provider Group, who is employed by our Netherlands subsidiary, we provide termination and pension payments as mandated by Dutch law.

We believe that this combination of elements provides an appropriate mix of fixed and variable pay, balances short-term operational performance with long-term stockholder value, and is conducive to executive recruitment and retention.

### Base Salaries

Base salaries are designed to compensate our Named Executive Officers for services rendered during the year, and to meet competitive norms and reward performance on an annual basis. As outlined above under “Role of Compensation Consultants and Benchmarking,” we rely on data from the Radford survey and salary.com, as well as general market sources, to keep our base salaries competitive when compared to the noted peer companies.

Salaries are reviewed each year in light of individual performance. The Compensation Committee and management also give significant weight to each officer's salary as it compares to that of other officers on our executive team, as well as to our company's overall financial and operating results. For 2008, after considering the projected financial performance of our company at the time, and taking into account the recommendations of our Chief Executive Officer and Chief Operating Officer, the Compensation Committee determined generally to limit salary increases for our officers, including our executive officers, to base salary increases of between 2.98% and 6.00%, with most increases in the 3.0% range. For 2009, given the uncertain economic environment, as well as projected compensation trends in the relevant peer groups, the Compensation Committee, upon the recommendation of management, elected to give no increases and, instead, to hold salaries unchanged.

### Management Bonus Plan

Each year we adopt a management bonus plan that is intended to motivate key members of management, including our executive officers, to perform well and achieve important company objectives. The amount of the management bonus is determined based on each manager's expected contribution to the overall outcome of our company's performance objectives, and also reflects market conditions. The management bonus may be paid in cash or other forms of compensation, including performance shares, and specific performance vesting requirements may be imposed, as determined by our Compensation Committee in its discretion.

In May 2004, our stockholders approved a Management Bonus Plan, and we are requesting that our stockholders re-approve the Management Bonus Plan at our 2009 Annual Meeting of Stockholders. The Management Bonus Plan was implemented, and stockholder approval was originally obtained and will be re-solicited at our 2009 Annual Meeting of Stockholders, to comply with Section 162(m) of the Internal Revenue Code. Section 162(m) limits the tax deductibility by a corporation of compensation paid in cash in excess of \$1.0 million paid to its chief executive officer and its four other most highly compensated executive officers. However, such compensation that qualifies as "performance based" is excluded from the \$1.0 million limit if, among other requirements, such compensation is payable only upon attainment of pre-established, objective performance goals under a plan approved by the corporation's stockholders. To the extent the management bonus in any year is payable in cash, we intend to maintain the eligibility of our Management Bonus Plan as providing "performance based" compensation under Section 162(m). Our Board of Directors may amend or terminate the Management Bonus Plan at any time and for any reason. Any such amendment will be submitted for stockholder approval to maintain the bonus plan's compliance with Section 162(m).

After reviewing the recommendations of our Chief Executive Officer and Chief Operating Officer, the Compensation Committee selects which of our employees (and employees of our subsidiaries) will be eligible to receive awards under the management bonus plan. The actual number of employees who will be eligible to receive an award under the bonus plan in any year cannot be determined in advance because the Compensation Committee has the discretion to select the participants. However, it is expected that approximately 20 employees would participate in the bonus plan in any year, for each performance period. For 2008, 18 employees were eligible to participate in the management bonus plan. For 2009, 19 employees will be eligible to participate in the management bonus plan. The Compensation Committee generally will assign a target award and one or more goals that must be achieved before an award will actually be paid to a participant. The award may be expressed as a percentage of the participant's salary, or may be designated as a dollar amount or based on some other metric as determined by the Compensation Committee. Performance metrics might include cash position, earnings per share, individual objectives, net income, operating cash flow, operating income, return on assets, return on equity, revenue, total stockholder return, or other metrics. Service-based vesting may also be required before the award vests.

For the 2008 and 2009 management bonus plans, as in past years, management recommended and the Compensation Committee determined that it would be in the best interests of our company and our stockholders to continue to conserve our cash by providing for the management bonus to be allocated in performance shares rather than paid in cash. For the 2008 management bonus plan, the Compensation Committee established individual management bonus amounts for each officer, including each executive officer. Each officer was contingently granted a right to receive performance shares in an amount equal to 75% of his or her individual bonus amount, divided by the \$13.32 per share closing price of Echelon's

common stock on February 11, 2008. For 2008, a return of our company's financial performance to long-term profitability was the key performance criteria on which the Compensation Committee focused. Thus, the issuance of the shares of our common stock underlying the performance shares was subject to the requirement that our company achieve a set level of operating income for the fiscal year ended December 31, 2008. In the case of our Senior Vice President of Sales and Marketing and Senior Vice President – General Manager/Service Provider Group, 50% of the potential bonus was tied to achieving a set level of reported revenue for our LonWorks Infrastructure or Networked Energy Services product lines for the fiscal year ended December 31, 2008. However, the operating income and revenue performance criteria were not met for the fiscal year ended December 31, 2008, so the performance shares under the 2008 management bonus plan did not vest and were automatically returned to our 1997 Stock Plan.

For 2009, the Compensation Committee implemented a management bonus plan under which each manager may receive performance shares under our 1997 Stock Plan, calculated as a dollar amount approved by the Compensation Committee, divided by the \$5.99 per share closing price of Echelon's common stock on March 10, 2009. No cash bonus will be given under this management bonus plan. The Compensation Committee felt this would both conserve cash and tie the compensation of the management to the performance of the stock of the Company over the next 12 months. The company believes that the amount of each bonus generally was set at 75% or less of comparable market levels. The Compensation Committee considered that given the current uncertain economic environment, a service vesting requirement should be implemented for the 2009 management bonus plan. Thus, the issuance to each manager of the shares of Echelon common stock underlying the performance shares is subject to the requirement that the manager continue to be employed by Echelon as of March 1, 2010. If the manager is not so employed as of that date, then the performance shares will not vest and will automatically be returned to our 1997 Stock Plan.

We expect that in future years, the Compensation Committee will continue to consider imposing specific financial performance metrics under the management bonus plan.

#### ***Amended and Restated 1997 Stock Plan***

Our 1997 Stock Plan was approved by our stockholders at our 2004 annual meeting. Our 1997 Stock Plan provides for the grant of the following types of incentive awards:

- Stock options,
- Stock purchase rights,
- Stock appreciation rights, and
- Performance units and performance shares.

Our 1997 Stock Plan allows for awards to be made to employees, directors and consultants who provide services to Echelon and its subsidiaries. Options may be granted as either nonqualified stock options or incentive stock options under our 1997 Stock Plan and generally must be exercised within one month following a service provider's termination other than for death or disability. Stock appreciation rights may be granted alone or in tandem with stock options. A stock appreciation right is the right to receive the appreciation in fair market value of our common stock between the exercise date and the date of grant, and the appreciation may be paid by our company in the form of either cash or shares of our common stock. Following a participant's termination from our company, he or she will only be able to exercise the vested

portion of the stock appreciation right for the period of time stated in the award agreement, which is generally one month following termination other than for death or disability. Stock purchase rights are awarded pursuant to agreements that grant our company the right to repurchase shares granted to a participant that remain subject to a restriction upon termination of the participant's service with our company for any reason. The restrictions on vesting may be whatever our company determines to be appropriate, including specific performance goals. Performance units and performance shares are awards that will result in payment to a participant only if specified performance goals or other vesting criteria are met or the awards otherwise vest. Performance units have a dollar value established by our company on the date of grant and performance shares have an initial value equal to the fair market value of a share of our common stock on the date of grant.

As of March 23, 2009, a total of 17,681,264 shares of our common stock were reserved for issuance under our 1997 Stock Plan, with 6,353,026 of such shares subject to outstanding awards granted under our 1997 Stock Plan and 11,328,238 of such shares remaining available for new awards to be granted in the future.

#### Equity Compensation Exchange Programs

In December 2008, our company completed an equity compensation "Exchange Program" under which eligible employees were given an opportunity to exchange some or all of their outstanding stock options and SARs for a predetermined number of new SARs, if the existing awards were "underwater" on the December 17, 2008 exchange grant date for the Exchange Program. An option or SAR was "underwater" if its exercise price is more than the market value of our common stock on the exchange grant date. Our Board of Directors and Compensation Committee approved the Exchange Program to restore the retention and incentive benefits of our company's equity awards. Non-employee members of our Board of Directors were not eligible to participate in the Exchange Program.

Under the Exchange Program, participating eligible employees received one new SAR for each exchanged option with an exercise price less than \$12.00 per share. For exchanged options with an exercise price equal to or greater than \$12.00 per share, participants received between 0.33 and 0.67 new SAR for each option exchanged, depending on the exercise price of the exchanged option. The exercise price of each new SAR is \$7.69, which was the fair market value of our common stock on the December 17, 2008 grant date. The fair market value was determined as the closing price of our common stock reported by the Nasdaq Global Market on that date. As a result of the Exchange Program, our company accepted for cancellation options and SARs for 4,659,926 shares of our common stock. In exchange for these cancelled awards, we granted new SARs to purchase an aggregate of 3,240,890 shares of our common stock (2,017,495 shares in respect of former options and 1,223,395 shares in respect of former SARs), resulting in a net decrease of 1,419,036 shares of common stock issuable upon exercise.

#### Long-Term Equity Incentive Compensation, including Grant Guidelines

Our Compensation Committee regularly monitors the environment in which we operate and makes changes to our equity compensation program to help us meet our goals, including achieving long-term stockholder value. We use various forms of equity compensation to motivate and reward long-term performance and encourage our employees to participate in the ownership of our company. We have granted awards based on options, SARs and performance shares, each of which carries a vesting requirement.

Our Compensation Committee is empowered by our Board of Directors and the provisions of our 1997 Stock Plan to grant awards under the Plan. In addition, our Board of Directors has delegated to a “stock option committee,” comprised solely of our Chief Executive Officer, a limited power to make equity compensation awards. In his “stock option committee” capacity, our Chief Executive Officer is empowered to grant stock options, performance shares and/or SARs under our 1997 Stock Plan, only to non-executive officer employees of our company, up to a maximum of 25,000 shares per employee per year and an aggregate limit of 250,000 shares per year. Any equity compensation awards to any executive officer or to any employee in excess of 25,000 shares in any year or in excess of the 250,000 share aggregate limit must be approved by the Compensation Committee or the Board of Directors.

In August 2007, our Board of Directors and Compensation Committee adopted general equity compensation grant guidelines regarding the timing of granting equity compensation awards to company employees, including executive officers. The guidelines provide that while we intend to follow the timing guidelines to the extent possible, our Board of Directors, the Compensation Committee or the stock option committee may issue equity compensation grants at a different time if doing so would be in the best interests of our company, our stockholders and our employees.

The equity compensation grant guidelines provide that awards will generally be granted on the 10<sup>th</sup> day of the calendar month (or the next business day, if the 10<sup>th</sup> day is not a business day). The grant date of the award will be the date that the exercise price (determined as the closing price for our company’s common stock on the Nasdaq Stock Market) and vesting date are set. Awards may be approved in advance of the grant date for that month. Award approvals by the Compensation Committee generally will be made at an in-person or telephonic committee meeting. If an award is approved by unanimous written consent, the effective date of such written consent will be the date the last signature is obtained.

The guidelines apply to awards for both new and existing employees, including executive officers. The grant date for new employees will generally be the 10<sup>th</sup> day of the month following the date the award is approved, provided that the grant date cannot be prior to the employee’s first day of employment. The guidelines provide that, in the case of the annual equity compensation award to all or any subset of existing employees, the grant date will be the date of our company’s annual meeting of stockholders for such year. In the case of awards to executive officers (including the annual award), if our company’s “insider trading window” is not then open, then the grant date shall be the day the insider trading window next opens. In 2008, the annual equity compensation grant was made on our company’s annual meeting date, which was May 27, 2008. Our company’s “insider trading window” was open on that date.

The Compensation Committee has not granted, nor does it intend to grant in the future, equity compensation awards in anticipation of the release of material nonpublic information that is likely to result in changes to the price of our common stock, such as a significant positive or negative earnings announcement. Similarly, our Compensation Committee has not timed, nor does it intend to time in the future, the release of material nonpublic information based on equity award grant dates.

#### Form of Equity Compensation Awards

On an annual basis, our Compensation Committee approves an annual equity compensation award to our employees, including our executive officers, under our 1997 Stock Plan. We intend that equity awards granted under our 1997 Stock Plan will offer long-term incentives to our employees to remain with our company and continue to perform well, and will reward each of our employees, including our executive

officers, by participating in our company's success. We regard our equity award program as an important tool for retaining and motivating our employees.

Historically, we granted equity awards to our employees in the form of stock options. However, because of the evolution of the accounting treatment of certain types of awards, particularly as a result of SFAS 123R, *Share Based Payment*, which requires a company to recognize as an expense the fair value of stock options and other stock-based compensation granted to employees, the Compensation Committee has determined that it is in the best interests of our stockholders to consider issuing forms of equity compensation other than stock options in order to limit to the extent possible the amount of compensation expense our company must record and the resulting negative impact on our earnings and earnings per share.

From time to time, the Compensation Committee has reviewed recommendations presented by management, and also consulted with Compensia, the independent management compensation consulting firm that it had retained, regarding key trends and observations for equity compensation practices by peer companies. For example, after reviewing these recommendations and trends in 2006, the Compensation Committee elected to grant equity compensation awards in an overall amount that was reduced from the prior year's stock option grant. In addition, the 2006 award did not consist of stock options, but rather consisted of two components: (i) stock appreciation rights, or SARs, and (ii) performance shares. Since that time, the Compensation Committee continued this practice and has granted SARs and performance shares in lieu of stock options as part of the annual equity compensation award to our employees.

Each SAR entitles the employee to exercise the SAR in exchange for shares of our common stock, less applicable withholding tax obligations, determined by (1) multiplying (A) the difference between the fair market value of a share of our common stock on the date of exercise over the stated exercise price of the SAR, times (B) the number of shares with respect to which the SAR is exercised; and (2) dividing the product of (A) and (B) by the fair market value of a share of our common stock on the date of exercise. Thus, as with stock options, employees are able to profit from SARs only if our stock price increases in value over the SAR's stated exercise price. We believe that the use of these stock-settled SARs will provide our company with an appropriate employee retention and motivation tool, but will result in considerably less dilution to our stockholders than if we issued stock options or did not mandate a "net exercise."

We also believe that the use of performance shares provides a more predictable value to employees than stock options, and therefore they are an efficient tool to retain and motivate employees, while also serving as an incentive to increase the value of our common stock. Performance shares also may be efficient with respect to the use of our 1997 Stock Plan share reserves because, as explained below, we believe that fewer performance shares are needed to provide a retention and incentive value similar to stock options.

In 2008, the amount of the equity compensation award to each employee, including each executive officer, was determined based on information obtained from management (and in the case of our Chief Executive Officer, the Compensation Committee and our Board of Directors), with a view to motivating the employee to perform well, while meeting internal and external competitive norms. In 2008, the Compensation Committee allocated to each executive officer a total number of shares, of which two thirds were allocated to SARs and one third was allocated to performance shares. This results in the employee being eligible to receive only one third of the number of performance shares when compared to SARs. While both SARs and performance shares are subject to vesting over a four-year period, the

Compensation Committee realized that performance shares retain value even if the market price of our common stock at the time the shares are issued is less than the market price at the time of grant. Thus, as with grants made in the prior two years, the Compensation Committee determined that, for 2008, it would be appropriate to grant performance shares on a pro rated basis when compared with SARs.

### ***Stock Ownership Guidelines***

In 2007, our Board of Directors determined that our directors and executive officers should own and hold common stock of our company to further align their interests and actions with the interests of our stockholders. Accordingly, our Board of Directors has adopted stock ownership guidelines applicable to our directors and executive officers. The guidelines provide that directors who are not also officers of our company are expected to own and hold common stock of our company with a minimum of value of \$100,000. In addition, the following guidelines apply to our executive officers:

<b><u>Position</u></b>	<b><u>Minimum Ownership Guideline</u></b>
CEO:	Shares with a value equal to 5 times base salary
President, COO, CFO:	Shares with a value equal to 3 times base salary
Senior Vice President:	Lesser of 20,000 shares or shares with a value equal to one times base salary

Company common stock that will count towards satisfying the guidelines includes:

- Shares owned outright by the director or executive officer and his or her immediate family members who share the same household, whether held individually or jointly, and shares held in trust where the director or executive officer is the beneficial owner;
- Shares owned outright and resulting from the exercise of stock options or SARs; and
- Shares purchased in the open market.

Directors and executive officers are expected to achieve the specified stock ownership level within five years after the August 2007 adoption date of the guidelines, in the case of persons who were directors or officers as of that date, or five years after the date of their appointment as a director or executive officer, in the case of new appointments. Currently, four of seven non-employee directors, four of seven executive officers and four of five Named Executive Officers exceed these ownership guidelines.

### ***Generally Available Benefits and Other Programs***

We also offer a number of other benefits to our employees, including our executive officers, including medical, dental and vision insurance, long-term and short-term disability insurance, life and accidental death and dismemberment insurance, health and dependent care flexible spending accounts, wellness programs, educational assistance, and employee assistance programs. We also maintain a tax-qualified 401(k) Plan, which provides for broad-based employee participation. Our company does not offer matching for 401(k) Plan contributions, nor does our company offer a pension program, except as mandated by local laws.

We believe that the availability of these benefits programs generally enhances employee productivity and loyalty to our company. The main objectives of our benefits programs are to give our employees access to quality healthcare, financial protection from unforeseen events, assistance in achieving retirement financial goals, and enhanced health and productivity. These generally available benefits typically do not specifically factor into decisions regarding an individual executive's total compensation or equity award package.

### ***Chief Executive Officer Compensation for 2008***

The Compensation Committee, in consultation with our Board of Directors, sets our Chief Executive Officer's compensation in accordance with the foregoing principles. As in past years, for 2008 and continuing in 2009, our Chief Executive Officer received a low salary when compared to other officers of our company and chief executive officers of our peer companies. However, the Compensation Committee has determined that in the case of Mr. Oshman, weighing our Chief Executive Officer's compensation very heavily towards equity compensation is an appropriate method to continue to align his interests with our company's long-term goals and the interests of our stockholders.

### ***Employment Arrangements***

Generally, none of our executive officers is subject to an employment or comparable agreement. However, our Senior Vice President–General Manager/Service Provider Group, Fredrick H. Bruggink, is the subject of an employment agreement in accordance with Dutch law with our Netherlands subsidiary, Echelon BV. Under Dutch law, if Mr. Bruggink's employment is terminated unilaterally by our company prior to the Dutch statutory retirement age, a severance payment, which is typically paid in a lump sum, will be calculated as the product of (A) the number of the employee's years of employment (provided that when the employee is between 40 and 50 years of age, each year is considered as 1.5 employment years, and when the employee is above 50 years of age, each year is considered as two employment years,) multiplied by (B) the employee's average gross monthly earnings (fixed salary including holiday allowance) over a certain immediately preceding period (typically one year), and multiplied by (C) a factor between 0 and 2 (which is normally 1) based on the employee's perceived "culpability" for the termination. Under Dutch law, the period in clause (B) and the factor in clause (C) are to be mutually agreed by the employer and the employee, provided that if agreement is not reached, then the issues will be submitted to the Director of the Centre of Labor & Income or the Cantonal Court (Kantongerecht) in the Netherlands.

In June 2008, our Board of Directors approved modifications to the forms of equity award agreements under our 1997 Stock Plan. Under these modifications, if within twelve months following a change in control of our company, an employee of our Company or our subsidiaries at the level of Vice President and above is subject to an involuntary (not for cause) termination within the meaning of our 1997 Stock Plan, then certain equity compensation awards of that employee would become fully vested. We believe this feature is consistent with the practice at peer companies.

### **Compensation Committee Report**

*The information contained in this report shall not be deemed to be "soliciting material" or "filed" with the SEC or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended, except to the extent that Echelon specifically incorporates it by reference into a document filed under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.*

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis for fiscal 2008. Based on the review and discussions, the Compensation Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in Echelon's Proxy Statement for its 2009 Annual Meeting of Stockholders.

This report is submitted by the Compensation Committee of the Board of Directors of Echelon.

Armas Clifford Markkula, Jr.  
Richard M. Moley, Chairman  
Betsy Rafael

### Summary Compensation Table

The following table shows compensation information for the fiscal years ended December 31, 2008, December 31, 2007 and December 31, 2006 for the named executive officers (the "Named Executive Officers"):

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$ (1))	Option Grants (\$ (1))	Non-Equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
M. Kenneth Oshman ..... <i>Chairman of the Board and Chief Executive Officer</i>	2008	109,583	—	828,906	590,229	—	—	1,528,718
	2007	105,000	—	323,847	332,927	—	—	761,774
	2006	100,000	—	272,515	235,978	—	—	608,493
Oliver R. Stanfield ..... <i>Executive Vice President &amp; Chief Financial Officer</i>	2008	358,750	—	382,477	342,479	—	—	1,083,706
	2007	345,000	—	156,815	175,865	—	—	677,680
	2006	329,583	—	118,276	84,003	—	—	531,862
Frederik H. Bruggink (2)..... <i>Senior Vice President and General Manager - Service Provider Group</i>	2008	477,999	—	340,034	296,901	—	48,994 (3)	1,163,928
	2007	417,809	—	125,917	137,153	—	45,511 (4)	726,390
	2006	363,374	24,028 (5)	71,374	58,802	—	41,429 (6)	559,007
Russell Harris..... <i>Senior Vice President of Operations</i>	2008	343,750	—	305,326	287,646	—	—	936,722
	2007	330,000	—	107,031	137,153	—	—	574,184
	2006	313,750	—	75,574	58,802	—	—	448,126
Kathleen B. Bloch..... <i>Senior Vice President and General Counsel</i>	2008	356,000	—	264,056	233,655	—	—	853,711
	2007	343,693	—	101,661	123,108	—	—	568,462
	2006	326,000	—	67,829	58,802	—	—	452,631

- (1) Reflects the dollar amount recognized for financial statement reporting purposes (disregarding an estimate of forfeitures) for the applicable fiscal year, in accordance with SFAS 123R, and thus may include amounts for awards granted in and prior to the applicable fiscal year. The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 16, 2009. These amounts do not correspond to the actual value that will be recognized by the Named Executive Officers.
- (2) Mr. Bruggink's compensation, consisting of salary, bonus, and amounts included in "All Other Compensation," was paid in euros. Translation of compensation into U.S. dollars is made using the exchange rate in effect on the date of payment.
- (3) Includes €9,650 (approximately \$13,933) contribution to private pension plan and car allowance of €23,700 (approximately \$35,061).
- (4) Includes contribution to €9,650 (approximately \$13,893) private pension plan and car allowance of €23,040 (approximately \$31,618).
- (5) This bonus payment was granted by our Board of Directors to Mr. Bruggink in recognition of his contributions to our NES business in fiscal 2005.
- (6) Includes €9,650 (approximately \$12,508) contribution to private pension plan and car allowance of €23,040 (approximately \$28,921). Does not include €863 (approximately \$1,060) paid in the fiscal year ended December 31, 2006 and earned in the fiscal year ended December 31, 2005.

## Grants of Plan-Based Awards in 2008

The following table presents information concerning each grant of an award made to a Named Executive Officer in fiscal 2008 under any plan. All awards were granted under our 1997 Stock Plan. Except as set forth in the footnotes to the below table, see “Outstanding Equity Awards at 2008 Fiscal Year-End” regarding the vesting of each award grant.

Name	Grant Date	Approval Date	Estimated Future Payouts Under Equity Incentive Plan Awards(1)			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Shares of Stock or Units (#)	Exercise or Base Price of Option Awards (\$/Sh)	Closing Price on Grant Date (\$/Sh)	Grant Date Fair Value of Stock and Option Awards (\$)(32)
			Threshold (#)	Target (#)	Maximum (#)					
M. Kenneth Oshman.....	02/11/2008	02/07/2008	—	28,153	—	—	—	13.32	374,998	
	05/27/2008	05/20/2008	—	—	—	25,000 (2)	—	13.32	333,000	
	05/27/2008	05/20/2008	—	—	—	—	75,000 (3)	13.32	492,939	
	10/23/2008	—	—	—	—	25,000 (4)	—	7.78	194,500	
	12/17/2008	—	—	—	—	—	50,000 (5)	7.69	5 (33)	
	12/17/2008	—	—	—	—	—	18,750 (6)	7.69	2 (33)	
	12/17/2008	—	—	—	—	—	56,250 (7)	7.69	32,396 (33)	
	12/17/2008	—	—	—	—	—	150,000 (8)	7.69	97,665 (33)	
	12/17/2008	—	—	—	—	—	120,000 (9)	7.69	313,716 (33)	
	12/17/2008	—	—	—	—	—	100,000 (10)	7.69	10 (33)	
12/17/2008	—	—	—	—	—	125,000 (11)	7.69	13 (33)		
Oliver R. Stanfield.....	02/11/2008	02/07/2008	—	6,456	—	—	—	13.32	85,994	
	05/27/2008	05/20/2008	—	—	—	12,500 (2)	—	13.32	166,500	
	05/27/2008	05/20/2008	—	—	—	—	37,500 (3)	13.32	246,470	
	10/23/2008	—	—	—	—	15,000 (4)	—	7.78	116,700	
	12/17/2008	—	—	—	—	—	25,000 (12)	7.69	3 (33)	
	12/17/2008	—	—	—	—	—	12,500 (13)	7.69	1 (33)	
	12/17/2008	—	—	—	—	—	80,000 (14)	7.69	209,144 (33)	
	12/17/2008	—	—	—	—	—	50,000 (15)	7.69	42,540 (33)	
12/17/2008	—	—	—	—	—	50,000 (16)	7.69	5 (33)		
Frederik H. Bruggink.	02/11/2008	02/07/2008	—	6,461	—	—	—	13.32	86,061	
	05/27/2008	05/20/2008	—	—	—	11,250 (2)	—	13.32	149,850	
	05/27/2008	05/20/2008	—	—	—	—	33,750 (3)	13.32	221,822	
	10/23/2008	—	—	—	—	15,000 (4)	—	7.78	116,700	
	12/17/2008	—	—	—	—	—	20,000 (17)	7.69	5,652 (33)	
	12/17/2008	—	—	—	—	—	60,000 (18)	7.69	156,858 (33)	
	12/17/2008	—	—	—	—	—	50,000 (19)	7.69	42,540 (33)	
	12/17/2008	—	—	—	—	—	30,001 (20)	7.69	3 (33)	

Name	Grant Date	Approval Date	Estimated Future Payouts Under Equity Incentive Plan Awards(1)			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Shares of Stock or Units (#)	Exercise or Base Price of Option Awards (\$/Sh)	Closing Price on Grant Date (\$/Sh)	Grant Date Fair Value of Stock and Option Awards (\$)(32)
			Threshold (#)	Target (#)	Maximum (#)					
Russell Harris .....	02/11/2008	02/07/2008	—	4,091	—	—	—	13.32	54,492	
	05/27/2008	05/20/2008	—	—	—	11,250 (2)	—	13.32	149,850	
	05/27/2008	05/20/2008	—	—	—	—	33,750 (3)	13.32	221,822	
	10/23/2008	—	—	—	—	15,000 (4)	—	7.78	116,700	
	12/17/2008	—	—	—	—	—	22,500 (21)	7.69	2 (33)	
	12/17/2008	—	—	—	—	—	11,250 (22)	7.69	1 (33)	
	12/17/2008	—	—	—	—	—	26,250 (23)	7.69	15,116 (33)	
	12/17/2008	—	—	—	—	—	17,500 (24)	7.69	10,931 (33)	
	12/17/2008	—	—	—	—	—	5,577 (25)	7.69	187 (33)	
	12/17/2008	—	—	—	—	—	2,354 (26)	7.69	4,825 (33)	
12/17/2008	—	—	—	—	—	62,836 (27)	7.69	6 (33)		
Kathleen B. Bloch .....	02/11/2008	02/07/2008	—	4,091	—	—	—	13.32	54,492	
	05/27/2008	05/20/2008	—	—	—	8,750 (2)	—	13.32	116,650	
	05/27/2008	05/20/2008	—	—	—	—	26,250 (3)	13.32	172,528	
	10/23/2008	—	—	—	—	15,000 (4)	—	7.78	116,700	
	12/17/2008	—	—	—	—	—	17,500 (28)	7.69	2 (33)	
	12/17/2008	—	—	—	—	—	8,750 (29)	7.69	1 (33)	
	12/17/2008	—	—	—	—	—	26,250 (30)	7.69	15,117 (33)	
12/17/2008	—	—	—	—	—	35,000 (31)	7.69	22,789 (33)		

- (1) The target amounts shown reflect estimated payouts pursuant to performance share grants, the vesting of which is subject to specific performance requirements of our company. See “Outstanding Equity Awards at 2008 Fiscal Year-End,” footnotes (14) and (34).
- (2) The amount shown reflects a performance share grant under our 1997 Stock Plan, which vests as to one-fourth of the shares on May 27, 2009 and each one-year anniversary thereafter, subject to the employee’s continued employment with our company.
- (3) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan, which vests as to one-fourth of the shares on May 27, 2009 and each one-year anniversary thereafter, subject to the employee’s continued employment with our company.
- (4) The amount shown reflects a performance share grant under our 1997 Stock Plan, which vests as to one-fourth of the shares on October 23, 2009 and each one-year anniversary thereafter, subject to the employee’s continued employment with our company.
- (5) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to our option exchange program in 2008 (the “Exchange Program”), such grant was issued in exchange for a 75,000 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share. See “Executive Compensation and Related Matters—Compensation Discussion and Analysis—Amended and Restated 1997 Stock Plan” for a description of the Exchange Program.
- (6) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 56,250 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share.
- (7) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 56,250 share stock appreciation right granted on October 31, 2006, and re-priced from \$8.43 per share to \$7.69 per share.
- (8) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 150,000 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share.
- (9) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 120,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share.
- (10) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 200,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share.

- (11) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 250,000 share stock option granted on February 23, 2001, and re-priced from \$16.688 per share to \$7.69 per share.
- (12) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 37,500 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share.
- (13) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 37,500 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share.
- (14) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 80,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share.
- (15) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 50,000 share stock option granted on April 10, 2001, and re-priced from \$11.61 per share to \$7.69 per share.
- (16) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 100,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share.
- (17) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 20,000 share stock option granted on September 20, 2002, and re-priced from \$10.52 per share to \$7.69 per share.
- (18) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 60,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share.
- (19) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 50,000 share stock option granted on April 10, 2001, and re-priced from \$11.61 per share to \$7.69 per share.
- (20) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 60,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share.
- (21) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 33,750 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share.
- (22) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 33,750 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share.
- (23) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 26,250 share stock appreciation right granted on October 31, 2006, and re-priced from \$8.43 per share to \$7.69 per share.
- (24) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 17,500 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share.
- (25) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 5,577 share stock appreciation right granted on April 22, 2005, and re-priced from \$8.52 per share to \$7.69 per share.
- (26) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 2,354 share stock option granted on April 22, 2005, and re-priced from \$8.52 per share to \$7.69 per share.
- (27) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 125,672 share stock option granted on September 4, 2001, and re-priced from \$16.44 per share to \$7.69 per share.
- (28) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 26,250 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share.
- (29) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 26,250 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share.
- (30) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 26,250 share stock appreciation right granted on October 31, 2006, and re-priced from \$8.43 per share to \$7.69 per share.
- (31) The amount shown reflects a grant of a stock appreciation right under our 1997 Stock Plan. Pursuant to the Exchange Program, such grant was issued in exchange for a 35,000 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share.
- (32) Reflects the grant date fair value of each equity award computed in accordance with SFAS 123R (disregarding an estimate of forfeitures). The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2008, filed with the SEC on March 16, 2009. These amounts do not correspond to the actual value that will be recognized by the Named Executive Officers upon exercise or sale of such award.
- (33) This amount represents the difference between the original grant date fair value and the grant date fair value of the amended and re-priced award under the Exchange Program.

## Outstanding Equity Awards at 2008 Fiscal Year-End

The table below shows all outstanding equity awards held by the Named Executive Officers at the end of our fiscal year ended December 31, 2008. All awards were granted under our 1997 Stock Plan.

Name	Grant Date	Option Awards				Stock Awards					
		Number of Securities Underlying Unexercised Options (#)		Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$ (11))	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$ (5))	
M. Kenneth Oshman .....	12/17/2008	—	50,000 (1)	—	7.69	12/17/2013	—	—	—	—	
	12/17/2008	—	18,750 (2)	—	7.69	12/17/2013	—	—	—	—	
	12/17/2008	—	56,250 (3)	—	7.69	12/17/2012	—	—	—	—	
	12/17/2008	—	150,000 (4)	—	7.69	12/17/2011	—	—	—	—	
	12/17/2008	—	120,000 (5)	—	7.69	12/17/2010	—	—	—	—	
	12/17/2008	—	100,000 (6)	—	7.69	12/17/2010	—	—	—	—	
	12/17/2008	—	125,000 (7)	—	7.69	12/17/2010	—	—	—	—	
	09/10/2007	—	—	—	—	—	14,062 (8)	114,605	—	—	
	05/27/2008	—	—	—	—	—	25,000 (9)	203,750	—	—	
	10/23/2008	—	—	—	—	—	25,000 (10)	203,750	—	—	
	10/31/2006	—	—	—	—	—	—	—	18,750 (12)	152,813	
	02/08/2007	—	—	—	—	—	—	—	35,593 (13)	290,083	
	02/11/2008	—	—	—	—	—	—	—	28,153 (14)	229,447	
	Oliver R. Stanfield .....	08/15/2005	37,500 (15)	12,500 (15)	—	8.19	08/15/2010	—	—	—	—
10/31/2006		18,750 (16)	18,750 (16)	—	8.43	10/31/2011	—	—	—	—	
12/17/2008		—	25,000 (17)	—	7.69	12/17/2013	—	—	—	—	
12/17/2008		—	12,500 (18)	—	7.69	12/17/2013	—	—	—	—	
12/17/2008		—	80,000 (19)	—	7.69	12/17/2010	—	—	—	—	
12/17/2008		—	50,000 (20)	—	7.69	12/17/2010	—	—	—	—	
12/17/2008		—	50,000 (21)	—	7.69	12/17/2010	—	—	—	—	
08/15/2005		—	—	—	—	—	4,166 (22)	33,953	—	—	
09/10/2007		—	—	—	—	—	9,375 (23)	76,406	—	—	
05/27/2008		—	—	—	—	—	12,500 (9)	101,875	—	—	
10/23/2008		—	—	—	—	—	15,000 (10)	122,250	—	—	
10/31/2006		—	—	—	—	—	—	—	12,500 (12)	101,875	
02/08/2007		—	—	—	—	—	—	—	9,322 (13)	75,974	
02/11/2008		—	—	—	—	—	—	—	6,456 (14)	52,616	

Option Awards							Stock Awards				
Name	Grant Date	Number of Securities Underlying Unexercised Options (#)		Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$ (11))	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$ (5))	
		Exercisable	Unexercisable								
Frederik H. Bruggink.....	08/15/2005	35,000 (24)	—	—	8.19	08/15/2010	—	—	—	—	
	10/31/2006	13,126 (16)	13,124 (15)	—	8.43	10/31/2011	—	—	—	—	
	09/10/2007	8,438 (25)	25,312 (25)	—	27.80	09/10/2012	—	—	—	—	
	05/27/2008	—	33,750 (26)	—	13.32	05/27/2013	—	—	—	—	
	12/17/2008	—	20,000 (27)	—	7.69	12/17/2010	—	—	—	—	
	12/17/2008	—	60,000 (28)	—	7.69	12/17/2010	—	—	—	—	
	12/17/2008	—	50,000 (29)	—	7.69	12/17/2010	—	—	—	—	
	12/17/2008	—	30,001 (30)	—	7.69	12/17/2010	—	—	—	—	
	08/15/2005	—	—	—	—	—	2,916 (31)	23,765	—	—	
	10/31/2006	—	—	—	—	—	4,374 (32)	35,648	—	—	
	09/10/2007	—	—	—	—	—	8,437 (33)	68,762	—	—	
	05/27/2008	—	—	—	—	—	11,250 (9)	91,688	—	—	
	10/23/2008	—	—	—	—	—	15,000 (10)	122,250	—	—	
	02/08/2007	—	—	—	—	—	—	—	8,284 (13)	67,515	
	02/11/2008	—	—	—	—	—	—	—	6,461 (34)	52,657	
	Russell Harris .....	12/17/2008	—	22,500 (35)	—	7.69	12/17/2013	—	—	—	—
		12/17/2008	—	11,250 (36)	—	7.69	12/17/2013	—	—	—	—
12/17/2008		—	26,250 (37)	—	7.69	12/17/2012	—	—	—	—	
12/17/2008		—	17,500 (38)	—	7.69	12/17/2011	—	—	—	—	
12/17/2008		—	5,577 (39)	—	7.69	12/17/2010	—	—	—	—	
12/17/2008		—	2,354 (40)	—	7.69	12/17/2010	—	—	—	—	
12/17/2008		—	62,836 (41)	—	7.69	12/17/2010	—	—	—	—	
08/15/2005		—	—	—	—	—	2,916 (31)	23,765	—	—	
10/31/2006		—	—	—	—	—	4,374 (32)	35,648	—	—	
09/10/2007		—	—	—	—	—	8,437 (33)	68,762	—	—	
05/27/2008		—	—	—	—	—	11,250 (9)	91,688	—	—	
10/23/2008		—	—	—	—	—	15,000 (10)	122,250	—	—	
02/08/2007		—	—	—	—	—	—	—	5,932 (13)	48,346	
02/11/2008		—	—	—	—	—	—	—	4,091 (14)	33,342	
Kathleen B. Bloch.....		02/03/2003	150,000 (42)	—	—	10.00	02/01/2013	—	—	—	—
		12/17/2008	—	17,500 (43)	—	7.69	12/17/2013	—	—	—	—
		12/17/2008	—	8,750 (44)	—	7.69	12/17/2013	—	—	—	—
	12/17/2008	—	26,250 (37)	—	7.69	12/17/2012	—	—	—	—	
	12/17/2008	—	35,000 (45)	—	7.69	12/17/2011	—	—	—	—	
	08/15/2005	—	—	—	—	—	2,916 (31)	23,765	—	—	
	10/31/2006	—	—	—	—	—	4,374 (32)	35,648	—	—	
	09/10/2007	—	—	—	—	—	6,562 (46)	53,480	—	—	
	05/27/2008	—	—	—	—	—	8,750 (9)	71,313	—	—	
	10/23/2008	—	—	—	—	—	15,000 (10)	122,250	—	—	
	02/08/2007	—	—	—	—	—	—	—	5,932 (13)	48,346	
	02/11/2008	—	—	—	—	—	—	—	4,091 (14)	33,342	

- (1) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 75,000 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (2) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 56,250 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (3) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 56,250 share stock appreciation right granted on October 31, 2006, and re-priced from \$8.43 per share to \$7.69 per share. The shares vest at the rate of one-third of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (4) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 150,000 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share. The shares vest at the rate of one-half of the shares on each of December 17, 2009 and December 17, 2010, subject to the employee's continued employment with our company.
- (5) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 120,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (6) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 200,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (7) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 250,000 share stock option granted on February 23, 2001, and re-priced from \$16.688 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (8) This performance share grant was originally for 18,750 shares and subject to vesting at the rate of one-fourth of the shares on September 10, 2008 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 4,688 of such performance shares were issued and released on September 10, 2008.
- (9) This performance share grant is subject to vesting at the rate of one-fourth of the shares on May 27, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (10) This performance share grant is subject to vesting at the rate of one-fourth of the shares on October 23, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (11) The market value is based on the \$8.15 per share closing price of our common stock on December 31, 2008.
- (12) Vesting of this performance share grant is subject to specific performance requirements of our company. The performance requirement is such that we must have achieved (calculated as of the date of announcement of our quarterly earnings) cumulative profitability over four consecutive quarters, calculated on a non-GAAP basis excluding equity compensation or any other extraordinary expense, as reasonably determined by the Compensation Committee of our Board of Directors, at some point during the four year time-based vesting period. If the performance requirement is met, then the time-based vesting will be credited as of such date and will continue on the original schedule. The original vesting schedule is that one-fourth of the shares will vest on October 31, 2007 and each one-year anniversary thereafter. If the performance requirement is never achieved during the four year time-based vesting period, then the performance shares granted will not vest and will be returned to our 1997 Stock Plan. If all or substantially all of our stock or assets are acquired, then the performance requirement will automatically be eliminated, but the time-based vesting will continue. Vesting is also subject to the employee's continued employment with our company through the applicable vesting date.
- (13) Vesting of this performance share grant is subject to specific performance requirements of our company. The performance requirement is such that within three years from the February 8, 2007 date of grant, we must have achieved (calculated as of the date of announcement of our quarterly earnings) at least two consecutive quarters of profitability, calculated on a non-GAAP basis excluding equity compensation or any other extraordinary expense, as reasonable determined by the Compensation Committee of our Board of Directors. If the performance requirement is met, then all of the shares will be issued, subject to such executive officer continuing to be employed by our company as of the end of the second consecutive quarter of profitability. If the performance requirement is not met during the three-year period, then the performance shares granted will not vest and will be returned to our 1997 Stock Plan. If all or substantially all of our stock or assets are acquired, then the performance requirement will automatically be eliminated and the performance shares shall vest.
- (14) Vesting of this performance share grant is subject to specific performance requirements of our company, in each case subject to such adjustments as the Compensation Committee of our Board of Directors may reasonable determine to reflect the effect of acquisitions, other extraordinary transactions and the like, and in each case determined as of the March 16, 2009 filing date of our Annual Report on Form 10-K for the year ended December 31, 2008: (i) one-half of the allocated performance shares will vest if reported operating profit for our company is at least \$3.0 million for the fiscal year ended December 31, 2008, and (ii) one-half of the allocated performance shares will vest if reported operating profit for our company is at least \$6.0 million for the fiscal year ended December 31, 2008.

- (15) This option is subject to vesting at the rate of one-fourth of the shares on August 15, 2006 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (16) This stock appreciation right is subject to vesting at the rate of one-fourth of the shares on October 31, 2007 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (17) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 37,500 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (18) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 37,500 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (19) This stock appreciation right was issued pursuant to the Exchange Program in exchange for an 80,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (20) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 100,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (21) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 50,000 share stock option granted on April 10, 2001, and re-priced from \$11.61 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (22) This performance share grant was originally for 16,667 shares and subject to vesting at the rate of one-fourth of the shares on August 15, 2006 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 4,167 of such performance shares were issued and released on each of August 15, 2006, August 15, 2007 and August 15, 2008.
- (23) This performance share grant was originally for 12,500 shares and subject to vesting at the rate of one-fourth of the shares on September 10, 2008 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 3,125 of such performance shares were issued and released on September 10, 2008.
- (24) This option is subject to vesting at the rate of one-fourth of the shares on August 15, 2006 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. The option agreement permits exercise prior to full vesting, subject to the employee entering into a restricted stock purchase agreement with respect to unvested shares.
- (25) This stock appreciation right is subject to vesting at the rate of one-fourth of the shares on September 10, 2008 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (26) This stock appreciation right is subject to vesting at the rate of one-fourth of the shares on May 27, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
- (27) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 20,000 share stock option granted on September 20, 2002, and re-priced from \$10.52 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (28) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 60,000 share stock option granted on March 17, 2004, and re-priced from \$10.89 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (29) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 50,000 share stock option granted on April 10, 2001, and re-priced from \$11.61 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (30) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 60,000 share stock option granted on February 22, 2002, and re-priced from \$16.35 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
- (31) This performance share grant was originally for 11,667 shares and subject to vesting at the rate of one-fourth of the shares on August 15, 2006 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 2,917 of such performance shares were issued and released on each of August 15, 2006, August 15, 2007 and August 15, 2008.
- (32) This performance share grant was originally for 8,750 shares and subject to vesting at the rate of one-fourth of the shares on October 31, 2007 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 2,188 of such performance shares were issued and released on each of October 31, 2007 and October 31, 2008.
- (33) This performance share grant was originally for 11,250 shares and subject to vesting at the rate of one-fourth of the shares on September 10, 2008 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 2,813 of such performance shares were issued and released on September 10, 2008.
- (34) Vesting of this performance share grant is subject to specific performance requirements of our company, in each case subject to such adjustments as the Compensation Committee of our Board of Directors may reasonable determine to reflect the effect of acquisitions, other extraordinary transactions and the like, and in each case determined as of the March 16,

- 2009 filing date of our Annual Report on Form 10-K for the year ended December 31, 2008: (i) one-fourth of the allocated performance shares will vest if reported operating profit for our company is at least \$3.0 million for the fiscal year ended December 31, 2008, (ii) one-fourth of the allocated performance shares will vest if reported operating profit for our company is at least \$6.0 million for the fiscal year ended December 31, 2008, (iii) one-fourth of the allocated performance shares will vest if reported revenue for our company's NES business is at least \$110 million for the fiscal year ended December 31, 2008, and (iv) one-fourth of the allocated performance shares will vest if reported revenue for our company's NES business is at least \$119.5 million for the fiscal year ended December 31, 2008.
- (35) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 33,750 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
  - (36) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 33,750 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
  - (37) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 26,250 share stock appreciation right granted on October 31, 2006, and re-priced from \$8.43 per share to \$7.69 per share. The shares vest at the rate of one-third of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
  - (38) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 17,500 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share. The shares vest at the rate of one-half of the shares on each of December 17, 2009 and December 17, 2010, subject to the employee's continued employment with our company.
  - (39) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 5,577 share stock appreciation right granted on April 22, 2005, and re-priced from \$8.52 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
  - (40) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 2,354 share stock option granted on April 22, 2005, and re-priced from \$8.52 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
  - (41) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 125,672 share stock option granted on September 4, 2001, and re-priced from \$16.44 per share to \$7.69 per share. The shares vest as to 100% of the shares on December 17, 2009, subject to the employee's continued employment with our company.
  - (42) This option was originally subject to vesting at the rate of one-fourth of the shares on the first anniversary of the grant date and monthly thereafter over the next 36 months. The vesting of this option was accelerated in full by our Board of Directors on November 18, 2005 to eliminate future stock compensation expense that we would otherwise have been required to recognize.
  - (43) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 26,250 share stock appreciation right granted on May 27, 2008, and re-priced from \$13.32 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
  - (44) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 26,250 share stock appreciation right granted on September 10, 2007, and re-priced from \$27.80 per share to \$7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to the employee's continued employment with our company.
  - (45) This stock appreciation right was issued pursuant to the Exchange Program in exchange for a 35,000 share stock option granted on August 15, 2005, and re-priced from \$8.19 per share to \$7.69 per share. The shares vest at the rate of one-half of the shares on each of December 17, 2009 and December 17, 2010, subject to the employee's continued employment with our company.
  - (46) This performance share grant was originally for 8,750 shares and subject to vesting at the rate of one-fourth of the shares on September 10, 2008 and each one-year anniversary thereafter, subject to the employee's continued employment with our company. 2,188 of such performance shares were issued and released on September 10, 2008.

## Option Exercises and Stock Vested for Fiscal 2008

The table below shows all stock options and SARs exercised and value realized upon exercise, and all stock awards vested and value realized upon vesting, by the Named Executive Officers during the fiscal year ended December 31, 2008.

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise	Value Realized on Exercise	Number of Shares Acquired on Vesting	Value Realized on Vesting
	(#)	(\$) (1)	(#) (1)	(\$) (2)
M. Kenneth Oshman .....	—	—	37,947	509,887
Oliver R. Stanfield .....	—	—	17,269	228,977
Frederik H. Bruggink .....	—	—	16,295	204,731
Russell Harris .....	—	—	13,461	166,217
Kathleen B. Bloch .....	—	—	12,836	158,498

- (1) The value realized equals the difference between the option exercise price and the fair market value of our common stock on the date of exercise, multiplied by the number of shares for which the option was exercised.
- (2) The value realized equals the fair market value of our common stock on the date of vesting, multiplied by the number of shares vested.

## Compensation Committee Interlocks and Insider Participation

During fiscal 2008, the following directors were members of Echelon's Compensation Committee: Armas Clifford Markkula, Jr., Robert R. Maxfield, Richard M. Moley and Betsy Rafael. Other than Robert R. Maxfield, who resigned from the Compensation Committee on April 28, 2008 and served as Senior Vice President of Products of our company from April 28, 2008 until October 3, 2008, none of these directors has at any time been an officer or employee of Echelon. None of Echelon's executive officers serves, or in the past fiscal year has served, as a member of the board of directors or compensation committee of any entity that has one or more of its executive officers serving on Echelon's Board of Directors or Compensation Committee.

## Policies and Procedures with Respect to Related Party Transactions

Our Corporate Governance Guidelines require our directors to take a proactive, focused approach to their position and to set standards that ensure that our company is committed to business success through the maintenance of the highest standards of responsibility and ethics. Thus, our Board of Directors is committed to upholding the highest legal and ethical conduct in fulfilling its responsibilities and recognizes that related party transactions can present heightened risk of potential or actual conflicts of interest. Accordingly, as a general matter, it is Echelon's preference to avoid related party transactions.

The charter of our Audit Committee requires that the members of the Audit Committee, all of whom are independent directors, review and approve in advance all related party transactions for which approval is required under applicable law. Current SEC rules define a related party transaction to include any transaction, arrangement or relationship in which our company is a participant and in which any of the following persons has or will have a direct or indirect interest:

- an executive officer, director or director nominee of Echelon;
- any person who is known to be the beneficial owners of more than 5% of our common stock;
- any person who is an immediate family member (as defined in Item 404 of Regulation S-K) of an executive officer, director or director nominee or beneficial owner of more than 5% of our common stock; and
- any firm, corporation or other entity in which any of the foregoing persons is employed or is a partner or principal or in a similar position or in which such person, together with any other of the foregoing persons, has a 5% or greater beneficial ownership interest.

## **Certain Relationships**

### ***Loans to Employees***

On October 29, 2001, we loaned Russell Harris, our Senior Vice President of Operations, \$1,000,000 in connection with his principal residence. Mr. Harris issued to us a promissory note secured by residential real estate. The note bears interest at the rate of 4.5% per annum, compounded monthly. The interest accruing under the note is due and payable in monthly installments over the nine year term of the note, and the principal is due and payable on October 29, 2010, subject to earlier repayment upon the occurrence of certain events. The terms of this loan have never been amended.

### ***Agreements with ENEL***

In June 2000, we began working with the Italian utility Enel to incorporate our technology into Enel's Contatore Elettronico project. Under this project, Enel replaced its existing stand-alone electricity meters with advanced, networked electricity meters at over 27 million of its customers' locations in Italy. We completed our scheduled deliveries under this project in 2005. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in the Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for \$130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares. The stock purchase agreement also gives Enel the right to nominate a member of our Board of Directors as long as Enel owns at least two million shares of our common stock. As a condition to the closing of the stock purchase agreement, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote the shares of our company's common stock that they beneficially own or control in favor of Enel's nominee to our Board of Directors. M. Francesco Tatò served as Enel's representative on our Board of Directors from September 2000 until June 2002. Enel has not

nominated a replacement for Mr. Tatò on our Board of Directors. In December 2005, Enel transferred to a related entity, Enel Investment Holding BV, its three million shares of our common stock. To our knowledge, Enel, through Enel Investment Holding BV, currently holds 3,000,000 shares of our common stock, representing 7.4% of our outstanding common stock as of March 23, 2009.

Pursuant to a registration rights agreement, dated September 11, 2000, between our company and Enel, Enel may, subject to certain conditions and limitations, request that we register the shares purchased under the common stock purchase agreement. In the event we elect to register any of our securities, Enel may, subject to certain limitations, include the shares purchased under the common stock purchase agreement in such registration.

### ***Reimbursement of Travel Expenses***

Mr. Oshman, our Chief Executive Officer, from time to time uses his private plane or private air travel services for company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred by Mr. Oshman for his private plane or charter aircraft travel on company business. These costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. Our Audit Committee regularly reviews these expenses. During 2008, we recognized a total of approximately \$258,000 in expenses pursuant to this reimbursement arrangement. Historically, our company had reimbursed Mr. Oshman for the cost of first class commercial air travel services for himself and company employees who accompanied him on private aircraft travel.

### ***Legal Services***

During fiscal year 2008, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C. We incur bills for legal services that vary from year to year depending upon our legal needs. In determining the independence of Mr. Sonsini, our Board of Directors reviews our relationship with Wilson Sonsini Goodrich & Rosati, P.C. in conjunction with the applicable independence guidelines under the applicable listing standards of the Nasdaq Stock Market and SEC rules.

## **OTHER INFORMATION**

### **Section 16(a) Beneficial Ownership Reporting Information**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers, directors and persons who own more than 10% of a registered class of our equity securities to file certain reports with the SEC regarding ownership of, and transactions in, our securities. Such officers, directors and 10% stockholders are also required by the SEC to furnish us with copies of all Section 16(a) forms that they file.

Based solely on our review of such forms furnished to us and written representations from certain reporting persons, we believe that all filing requirements applicable to our executive officers, directors and more than 10% stockholders were complied with during the fiscal year ended December 31, 2008, except that

a late Form 4 was filed on behalf of Robert R. Maxfield on June 2, 2008 with respect to the release of performance shares on May 28, 2008.

### **No Incorporation by Reference**

In Echelon's filings with the SEC, information is sometimes "incorporated by reference." This means that we are referring you to information that has previously been filed with the SEC and the information should be considered as part of the particular filing. As provided under SEC regulations, the "Report of the Audit Committee of our Board of Directors" and the "Compensation Committee Report" contained in this Proxy Statement specifically are not incorporated into any other filings with the SEC. In addition, this Proxy Statement includes several website addresses. These website addresses are intended to provide inactive, textual references only. The information on these websites is not part of this Proxy Statement.

### **Stockholder Proposals—2010 Annual Meeting**

Stockholders may present proposals for action at a future meeting if they comply with SEC rules and Echelon's bylaws. For additional details and deadlines for submitting proposals, see "*Deadline for Receipt of Stockholder Proposals*" in this Proxy Statement above. If you would like a copy of the requirements contained in our bylaws, please contact: Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126.

### **Available Information**

You may obtain a copy of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 without charge by sending a written request to Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, Attention: Investor Relations. The annual report is also available online at [www.echelon.com](http://www.echelon.com) or the SEC's website at [www.sec.gov](http://www.sec.gov).

## **REPORT OF THE AUDIT COMMITTEE OF OUR BOARD OF DIRECTORS**

*Notwithstanding any statement to the contrary in any of our previous or future filings with the SEC, this report of the Audit Committee of our Board of Directors shall not be deemed "filed" with the SEC or "soliciting material" under the Securities Exchange Act of 1934, as amended, and shall not be incorporated by reference into any such filings.*

The Audit Committee of our Board of Directors serves as the representative of our Board of Directors for general oversight of our financial accounting and reporting process, system of internal control, audit process, and process for monitoring compliance with laws and regulations. Our management has primary responsibility for preparing our financial statements and our financial reporting process. Our independent registered public accounting firm, KPMG LLP, is responsible for expressing an opinion on the conformity of our fiscal year 2008 audited financial statements to generally accepted accounting principles. In this context, the Audit Committee hereby reports as follows:

1. The Audit Committee has reviewed and discussed the audited financial statements with our management, including a discussion of the quality and acceptability of the financial reporting, the reasonableness of significant accounting judgments and estimates and the clarity of disclosures in the financial statements. In connection with this review and discussion, the Audit Committee asked a number of

follow-up questions of management and KPMG LLP to help give the Audit Committee comfort in connection with its review.

2. The Audit Committee has discussed with KPMG LLP the matters required to be discussed by the statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T.

3. The Audit Committee has received the written disclosures and the letter from KPMG LLP required by applicable requirements of the Public Company Accounting Oversight Board regarding KPMG LLP's communications with the Audit Committee concerning independence, and has discussed with KPMG LLP the independence of KPMG LLP.

4. Based on the review and discussions referred to in paragraphs (1) through (3) above, the Audit Committee recommended to our Board of Directors that the audited financial statements be included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, for filing with the SEC.

Our Board of Directors has adopted a written charter for the Audit Committee, a copy of which can be viewed at the investor relations section of our website at [www.echelon.com](http://www.echelon.com). Each of the members of the Audit Committee is independent as defined under the listing standards of the National Association of Securities Dealers.

Audit Committee

Robert J. Finocchio, Jr., Chairman  
Robyn M. Denholm  
Betsy Rafael

#### **OTHER MATTERS**

As of the date hereof, our Board of Directors is not aware of any other matters to be submitted at the annual meeting. If any other matters properly come before the meeting, it is the intention of the persons named in the enclosed Proxy to vote the shares they represent as our Board of Directors recommends or as they otherwise deem advisable.

THE BOARD OF DIRECTORS

San Jose, California  
April 3, 2009

**APPENDIX A**

**ECHELON CORPORATION  
MANAGEMENT BONUS PLAN  
(Effective March 26, 2004)**

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**ECHELON CORPORATION**  
**MANAGEMENT BONUS PLAN**

**SECTION 1**  
**BACKGROUND, PURPOSE AND DURATION**

1.1 Effective Date. The Plan is effective as of March 26, 2004, subject to ratification by an affirmative vote of the holders of a majority of the Shares that are present in person or by proxy and entitled to vote at the 2004 Annual Meeting of Stockholders of the Company.

1.2 Purpose of the Plan. The Plan is intended to increase shareholder value and the success of the Company by motivating key members of management (1) to perform to the best of their abilities, and (2) to achieve the Company's objectives. The Plan's goals are to be achieved by providing such members of management with incentive awards based on the achievement of goals relating to the performance of the Company. The Plan is intended to permit the grant of awards that qualify as performance-based compensation under section 162(m) of the Code.

**SECTION 2**  
**DEFINITIONS**

The following words and phrases shall have the following meanings unless a different meaning is plainly required by the context:

2.1 "1934 Act" means the Securities Exchange Act of 1934, as amended. Reference to a specific section of the 1934 Act or regulation thereunder shall include such section or regulation, any valid regulation promulgated under such section, and any comparable provision of any future legislation or regulation amending, supplementing or superseding such section or regulation.

2.2 "Actual Award" means as to any Performance Period, the actual award (if any) payable to a Participant for the Performance Period. Each Actual Award is determined by the Payout Formula for the Performance Period, subject to the Committee's authority under Section 3.6 to eliminate or reduce the award otherwise determined by the Payout Formula.

2.3 "Affiliate" means any corporation or other entity (including, but not limited to, partnerships and joint ventures) controlled by the Company.

2.4 "Base Salary" means as to any Performance Period, the Participant's annualized salary rate on the last day of the Performance Period. Such Base Salary shall be before both (a) deductions for taxes or benefits, and (b) deferrals of compensation pursuant to Company-sponsored plans.

2.5 "Board" means the Board of Directors of the Company.

2.6 "Cash Position" means as to any Performance Period, the Company's level of cash and cash equivalents, including, without limitation, amounts classified for financial reporting purposes as short-term investments and restricted investments.

2.7 “Code” means the Internal Revenue Code of 1986, as amended. Reference to a specific section of the Code or regulation thereunder shall include such section or regulation, any valid regulation promulgated thereunder, and any comparable provision of any future legislation or regulation amending, supplementing or superseding such section or regulation.

2.8 “Committee” means the committee appointed by the Board (pursuant to Section 5.1) to administer the Plan.

2.9 “Company” means Echelon Corporation, a Delaware corporation, or any successor thereto.

2.10 “Determination Date” means the latest possible date that will not jeopardize a Target Award or Actual Award’s qualification as performance-based compensation under section 162(m) of the Code.

2.11 “Disability” means a permanent and total disability determined in accordance with uniform and nondiscriminatory standards adopted by the Committee from time to time.

2.12 “Earnings Per Share” means as to any Performance Period, the Company’s or a business unit’s Net Income, divided by a weighted average number of common shares outstanding and dilutive common equivalent shares deemed outstanding, determined in accordance with U.S. GAAP; provided, however, that if Net Income as to any such Performance Period is a negative amount, then Earnings Per Share means the Company’s or business unit’s Net Income, divided by a weighted average number of common shares outstanding, determined in accordance with U.S. GAAP.

2.13 “Employee” means any employee of the Company or of an Affiliate, whether such employee is so employed at the time the Plan is adopted or becomes so employed subsequent to the adoption of the Plan.

2.14 “Excluded Items” includes, without limitation, (i) incentive compensation, (ii) in-process research and development expenses, (iii) acquisition costs, (iv) compensation expense from equity compensation, (v) operating expenses from acquired businesses, (vi) amortization of acquired intangible assets, and (vii) such other unusual or one-time items as may be identified by the Committee.

2.15 “Fair Market Value” means the closing per share selling price for Shares, as quoted on the Nasdaq National Market for the date in question.

2.16 “Fiscal Year” means the fiscal year of the Company.

2.17 “Individual Objectives” means as to a Participant for any Performance Period, the objective and measurable goals set by a “management by objectives” process and approved by the Committee (in its discretion).

2.18 “Maximum Award” means as to any Participant for any Performance Period, \$5,000,000.

2.19 “Net Income” means as to any Performance Period, the Company’s or a business unit’s income after taxes determined in accordance with U.S. GAAP, adjusted for any Excluded Items approved for exclusion by the Administrator.

2.20 “Operating Cash Flow” means as to any Performance Period, the Company’s or a business unit’s cash flow generated from operating activities, as reported in the Company’s cash flow statements and

calculated in accordance with U.S. GAAP, adjusted for any Excluded Items approved for exclusion by the Administrator.

2.21 “Operating Income” means as to any Performance Period, the Company’s or a business unit’s income from operations, determined in accordance with U.S. GAAP, adjusted for any Excluded Items approved for exclusion by the Administrator.

2.22 “Participant” means as to any Performance Period, an Employee who has been selected by the Committee for participation in the Plan for that Performance Period.

2.23 “Payout Formula” means as to any Performance Period, the formula or payout matrix established by the Committee pursuant to Section 3.4 in order to determine the Actual Awards (if any) to be paid to Participants. The formula or matrix may differ from Participant to Participant.

2.24 “Performance Period” means any Fiscal Year of the Company or such other period as determined by the Committee in its sole discretion.

2.25 “Performance Goals” means the goal(s) (or combined goal(s)) determined by the Committee (in its discretion) to be applicable to a Participant for a Target Award for a Performance Period. As determined by the Committee, the Performance Goals for any Target Award applicable to a Participant may provide for a targeted level or levels of achievement using one or more of the following measures: (a) Cash Position, (b) Earnings per Share, (c) Individual Objectives, (d) Net Income, (e) Operating Cash Flow, (f) Operating Income, (g) Return on Assets, (h) Return on Equity, (i) Return on Sales, (j) Revenue, and (k) Total Shareholder Return. The Performance Goals may differ from Participant to Participant and from award to award. Prior to the Determination Date, the Committee shall determine whether any significant element(s) shall be included in or excluded from the calculation of any Performance Goal with respect to any Participants.

2.26 “Plan” means the Echelon Corporation Management Bonus Plan, as set forth in this instrument and as hereafter amended from time to time.

2.27 “Retirement” means, with respect to any Participant, a Termination of Employment after attaining at least age 65.

2.28 “Return on Assets” means as to any Performance Period, the percentage equal to the Company’s or a business unit’s Operating Income divided by average net Company or business unit, as applicable, assets, determined in accordance with U.S. GAAP.

2.29 “Return on Equity” means as to any Performance Period, the percentage equal to the Company’s Net Income divided by average stockholder’s equity, determined in accordance with U.S. GAAP.

2.30 “Return on Sales” means as to any Performance Period, the percentage equal to the Company’s or a business unit’s Operating Income divided by the Company’s or the business unit’s, as applicable, revenue, determined in accordance with U.S. GAAP.

2.31 “Revenue” means as to any Performance Period, the Company’s or business unit’s net sales, determined in accordance with U.S. GAAP.

2.32 “Shares” means shares of the Company’s common stock.

2.33 “Target Award” means the target award payable under the Plan to a Participant for the Performance Period, expressed as a percentage of his or her Base Salary, as determined by the Committee in accordance with Section 3.3.

2.34 “Termination of Employment” means a cessation of the employee-employer relationship between an Employee and the Company or an Affiliate for any reason, including, but not by way of limitation, a termination by resignation, discharge, death, Disability, Retirement, or the disaffiliation of an Affiliate, but excluding any such termination where there is a simultaneous reemployment by the Company or an Affiliate.

2.35 “Total Shareholder Return” means as to any Performance Period, the total return (change in share price plus reinvestment of any dividends) of a Share.

2.36 “U.S. GAAP” means generally accepted accounting principles in the United States.

### **SECTION 3 SELECTION OF PARTICIPANTS AND DETERMINATION OF AWARDS**

3.1 Selection of Participants. The Committee, in its sole discretion, shall select the Employees of the Company who shall be Participants for any Performance Period. Participation in the Plan is in the sole discretion of the Committee, and on a Performance Period by Performance Period basis. Accordingly, an Employee who is a Participant for a given Performance Period in no way is guaranteed or assured of being selected for participation in any subsequent Performance Period.

3.2 Determination of Performance Goals. The Committee, in its sole discretion, shall establish the Performance Goals for each Participant for the Performance Period. Such Performance Goals shall be set forth in writing.

3.3 Determination of Target Awards. The Committee, in its sole discretion, shall establish a Target Award for each Participant. Each Participant’s Target Award shall be determined by the Committee in its sole discretion, and each Target Award shall be set forth in writing.

3.4 Determination of Payout Formula or Formulae. On or prior to the Determination Date, the Committee, in its sole discretion, shall establish a Payout Formula or Formulae for purposes of determining the Actual Award (if any) payable to each Participant. Each Payout Formula shall (a) be in writing, (b) be based on a comparison of actual performance to the Performance Goals, (c) provide for the payment of a Participant’s Target Award if the Performance Goals for the Performance Period are achieved, and (d) provide for an Actual Award greater than or less than the Participant’s Target Award, depending upon the extent to which actual performance exceeds or falls below the Performance Goals. Notwithstanding the preceding, in no event shall a Participant’s Actual Award for any Performance Period exceed his or her Maximum Award.

3.5 Date for Determinations. The Committee shall make all determinations under Section 3.1 through 3.4 on or before the Determination Date.

3.6 Determination of Actual Awards. After the end of each Performance Period, the Committee shall certify in writing the extent to which the Performance Goals applicable to each Participant for the Performance Period were achieved or exceeded. The Actual Award for each Participant shall be determined

by applying the Payout Formula to the level of actual performance that has been certified by the Committee. Notwithstanding any contrary provision of the Plan, the Committee, in its sole discretion, may (a) eliminate or reduce the Actual Award payable to any Participant below that which otherwise would be payable under the Payout Formula, and (b) determine what Actual Award, if any, will be paid in the event of a Termination of Employment prior to the end of the Performance Period.

#### **SECTION 4 PAYMENT OF AWARDS**

4.1 Right to Receive Payment. Each Actual Award that may become payable under the Plan shall be paid solely from the general assets of the Company. Nothing in this Plan shall be construed to create a trust or to establish or evidence any Participant's claim of any right to payment of an Actual Award other than as an unsecured general creditor with respect to any payment to which he or she may be entitled.

4.2 Timing of Payment. Payment of each Actual Award shall be made as soon as administratively practicable, but in no event later than 90 days after the end of the Performance Period during which the Award was earned.

4.3 Form of Payment. Each Actual Award normally shall be paid in cash (or its equivalent) in a single lump sum.

4.4 Payment in the Event of Death. If a Participant dies prior to the payment of an Actual Award earned by him or her prior to death for a prior Performance Period, the Award shall be paid to his or her estate.

#### **SECTION 5 ADMINISTRATION**

5.1 Committee is the Administrator. The Plan shall be administered by the Committee. The Committee shall consist of not less than two (2) members of the Board. The members of the Committee shall be appointed from time to time by, and serve at the pleasure of, the Board. Each member of the Committee shall qualify as an "outside director" under section 162(m) of the Code. If it is later determined that one or more members of the Committee do not so qualify, actions taken by the Committee prior to such determination shall be valid despite such failure to qualify.

5.2 Committee Authority. It shall be the duty of the Committee to administer the Plan in accordance with the Plan's provisions. The Committee shall have all powers and discretion necessary or appropriate to administer the Plan and to control its operation, including, but not limited to, the power to (a) determine which Employees shall be granted awards, (b) prescribe the terms and conditions of awards, (c) interpret the Plan and the awards, (d) adopt such procedures and subplans as are necessary or appropriate to permit participation in the Plan by Employees who are foreign nationals or employed outside of the United States, (e) adopt rules for the administration, interpretation and application of the Plan as are consistent therewith, and (f) interpret, amend or revoke any such rules.

5.3 Decisions Binding. All determinations and decisions made by the Committee, the Board, and any delegate of the Committee pursuant to the provisions of the Plan shall be final, conclusive, and binding on all persons, and shall be given the maximum deference permitted by law.

5.4 Delegation by the Committee. The Committee, in its sole discretion and on such terms and conditions as it may provide, may delegate all or part of its authority and powers under the Plan to one or more directors and/or officers of the Company; provided, however, that the Committee may delegate its authority and powers only with respect to awards that are not intended to qualify as performance-based compensation under section 162(m) of the Code.

## **SECTION 6 GENERAL PROVISIONS**

6.1 Tax Withholding. The Company shall withhold all applicable taxes from any Actual Award, including any federal, state, local, foreign or other taxes (including, but not limited to, the Participant's FICA and SDI obligations).

6.2 No Effect on Employment. Nothing in the Plan shall interfere with or limit in any way the right of the Company to terminate any Participant's employment or service at any time, with or without cause. For purposes of the Plan, transfer of employment of a Participant between the Company and any one of its Affiliates (or between Affiliates) shall not be deemed a Termination of Employment. Employment with the Company and its Affiliates is on an at-will basis only. The Company expressly reserves the right, which may be exercised at any time and without regard to when during a Performance Period such exercise occurs, to terminate any individual's employment with or without cause, and to treat him or her without regard to the effect which such treatment might have upon him or her as a Participant.

6.3 Participation. No Employee shall have the right to be selected to receive an award under this Plan, or, having been so selected, to be selected to receive a future award.

6.4 Indemnification. Each person who is or shall have been a member of the Committee, or of the Board, shall be indemnified and held harmless by the Company against and from (a) any loss, cost, liability, or expense that may be imposed upon or reasonably incurred by him or her in connection with or resulting from any claim, action, suit, or proceeding to which he or she may be a party or in which he or she may be involved by reason of any action taken or failure to act under the Plan or any award, and (b) from any and all amounts paid by him or her in settlement thereof, with the Company's approval, or paid by him or her in satisfaction of any judgment in any such claim, action, suit, or proceeding against him or her, provided he or she shall give the Company an opportunity, at its own expense, to handle and defend the same before he or she undertakes to handle and defend it on his or her own behalf. The foregoing right of indemnification shall not be exclusive of any other rights of indemnification to which such persons may be entitled under the Company's Certificate of Incorporation or Bylaws, by contract, as a matter of law, or otherwise, or under any power that the Company may have to indemnify them or hold them harmless.

6.5 Successors. All obligations of the Company under the Plan, with respect to awards granted hereunder, shall be binding on any successor to the Company, whether the existence of such successor is the result of a direct or indirect purchase, merger, consolidation, or otherwise, of all or substantially all of the business or assets of the Company.

6.6 Beneficiary Designations. If permitted by the Committee, a Participant under the Plan may name a beneficiary or beneficiaries to whom any vested but unpaid award shall be paid in the event of the Participant's death. Each such designation shall revoke all prior designations by the Participant and shall be effective only if given in a form and manner acceptable to the Committee. In the absence of any such

designation, any vested benefits remaining unpaid at the Participant's death shall be paid to the Participant's estate.

6.7 Nontransferability of Awards. No award granted under the Plan may be sold, transferred, pledged, assigned, or otherwise alienated or hypothecated, other than by will, by the laws of descent and distribution, or to the limited extent provided in Section 6.6. All rights with respect to an award granted to a Participant shall be available during his or her lifetime only to the Participant.

6.8 Deferrals. The Committee, in its sole discretion, may permit a Participant to defer receipt of the payment of cash that would otherwise be delivered to a Participant under the Plan. Any such deferral elections shall be subject to such rules and procedures as shall be determined by the Committee in its sole discretion.

## **SECTION 7 AMENDMENT, TERMINATION AND DURATION**

7.1 Amendment, Suspension or Termination. The Board, in its sole discretion, may amend or terminate the Plan, or any part thereof, at any time and for any reason. The amendment, suspension or termination of the Plan shall not, without the consent of the Participant, alter or impair any rights or obligations under any Target Award theretofore granted to such Participant. No award may be granted during any period of suspension or after termination of the Plan.

7.2 Duration of the Plan. The Plan shall commence on the date specified herein, and subject to Section 7.1 (regarding the Board's right to amend or terminate the Plan), shall remain in effect thereafter.

## **SECTION 8 LEGAL CONSTRUCTION**

8.1 Gender and Number. Except where otherwise indicated by the context, any masculine term used herein also shall include the feminine; the plural shall include the singular and the singular shall include the plural.

8.2 Severability. In the event any provision of the Plan shall be held illegal or invalid for any reason, the illegality or invalidity shall not affect the remaining parts of the Plan, and the Plan shall be construed and enforced as if the illegal or invalid provision had not been included.

8.3 Requirements of Law. The granting of awards under the Plan shall be subject to all applicable laws, rules and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required.

8.4 Governing Law. The Plan and all awards shall be construed in accordance with and governed by the laws of the State of California, but without regard to its conflict of law provisions.

8.5 Captions. Captions are provided herein for convenience only, and shall not serve as a basis for interpretation or construction of the Plan.

**EXECUTION**

IN WITNESS WHEREOF, Echelon Corporation, by its duly authorized officer, has executed the Plan on the date indicated below.

ECHELON CORPORATION

Dated: March 26, 2004

By: /s/ M. Kenneth Oshman  
Name: M. Kenneth Oshman  
Title: Chairman of the Board and Chief  
Executive Officer

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

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: 000-29748

**ECHELON CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0203595**

(I.R.S. Employer  
Identification Number)

**550 Meridian Avenue**

**San Jose, California 95126**

(Address of principal executive office and zip code)

**(408) 938-5200**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$0.01	The NASDAQ Stock Market LLC (The Nasdaq Global Market)

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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  Smaller reporting company   
(do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of June 30, 2008, the last business day of the registrant's most recently completed second fiscal quarter, there were 40,749,043 shares of the registrant's common stock outstanding, and the aggregate market value of such shares held by non-affiliates of the registrant (based on the per share closing sale price of \$10.90 of such shares on the Nasdaq Global Market on June 30, 2008) was approximately \$313.5 million. Shares of the registrant's common stock held by each executive officer and director and by each entity that owns 5% or more of the registrant's outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 28, 2009, 40,505,160 shares of the registrant's common stock, \$.01 par value per share, were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

<u>Document</u>	<u>Parts Into Which Incorporated</u>
Proxy Statement for the Annual Meeting of Stockholders to be held May 14, 2009 (Proxy Statement)	Part III

**ECHELON CORPORATION  
FORM 10-K  
FOR THE YEAR ENDED DECEMBER 31, 2008**

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## FORWARD-LOOKING INFORMATION

*This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future that are forward-looking. These statements include those discussed in Item 1, Business, including “General,” “Markets,” “Products and Services,” “Product Development,” “Marketing,” “Competition,” and “Government Regulation” in Item 1A, Risk Factors, in Item 2, “Properties,” in Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, including “Critical Accounting Policies,” “Results of Operations,” “Off-Balance-Sheet Arrangements and Other Contractual Obligations,” “Liquidity and Capital Resources,” “Related Party Transactions,” “Recently Issued Accounting Standards,” and elsewhere in this report. In this report, the words “anticipate,” “believe,” “expect,” “intend,” “future,” “moving toward” and similar expressions also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of factors including, but not limited to, those set forth in the section entitled “Risk Factors” and elsewhere in this report. All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.*

## PART I

### ITEM 1. BUSINESS

#### General

Echelon was incorporated in California in 1988 and reincorporated in Delaware in 1989. We are an ISO 9001 certified company that develops, markets, and sells system and network infrastructure products that enable everyday devices — such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves — to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience.

In the building, home, industrial, transportation, and other automation markets, we sell a suite of network infrastructure products to original equipment manufacturers (OEMs). OEMs “design in,” or embed, our products into their products and systems in order to give their products local intelligence and networking capability. We call the products that we sell to OEMs our LONWORKS<sup>®</sup> Infrastructure, or “LWI”, product line. Our LWI products include transceivers, control modules, routers, network interfaces, development tools, and software tools and toolkits. In December 2008, the protocols used in our LonWorks products and signaling used by our free topology and power line transceivers were approved as a global control standard by the International Organization for Standardization (ISO) and the International Electrotechnical Commission (IEC). Representative customers include BOC Edwards, EnerNOC, Fuji Electric, Fujitsu General, Groupe Schneider, Honeywell, Johnson Controls, NTT Data, Samsung, Schindler Elevator, Siemens, and Trane. We believe that by using our LWI products, OEMs can reduce their development time and expense and bring higher quality, more functional products to market than without our LWI products or than would be possible using alternative development approaches. Most important, we believe the resulting products can also be “energy aware” and save energy, and are also lower cost for end-users to install, maintain and operate.

For the electric utility industry we have developed an advanced metering infrastructure system that we call the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which we believe enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. Our primary channel to market for the NES system is through value-added resellers (VARs). Examples of NES VARs and partners include ES Elektrosandberg AB, ES Mätteknik, EVB, Görlitz, Limited Liability Company Engineering Center ENERGOAUDITCONTROL, and Telvent. These VARs in turn add application software, project management, and other value-added services to provide utilities with complete advanced metering systems offerings. Representative end-use customers include Vattenfall and E.ON in Sweden, Nuon in the Netherlands, Limited Liability Company Engineering Center ENERGOAUDITCONTROL in Russia, and Duke Energy in the United States.

For system integrators serving the street lighting, remote facility monitoring, and energy management markets, we have developed the *i.LON*<sup>®</sup> Internet server family of products, which provides a low-cost, robust Internet interface and local control capability for remote devices and systems. We believe that the *i.LON* product family provides a compelling platform for applications that can monitor and substantially reduce energy consumption, lower maintenance costs, and enhance safety and convenience. Representative resellers of *i.LON*-based, managed street lighting solutions include EnerNOC, Streetlight Vision, Device Insight, and Intron. Representative end-use customers include the City of Oslo, Norway and the City of Bremen, Germany.

In quick-service restaurants, our LonWorks technology and i.LON Internet Server are used to monitor and control kitchen equipment and key building systems (including HVAC and lighting) through a single network, in an effort to manage energy use and improve efficiency. For example, the quick-serve giant McDonald's is encouraging its kitchen equipment manufacturers to incorporate our LonWorks technology into new equipment as a way to lower operating costs and improve operations. The potential savings for quick-service restaurants is considerable since the average restaurant, operating without an effective control system, spends thousands of dollars a year in energy costs.

We view our system infrastructure and network infrastructure product lines as complementary to each other, tied together by a common theme of energy management. We believe that, while each offering has substantial value on its own, together they bring a more comprehensive and valuable solution to the end user and that, over time, our success in system infrastructure applications helps drive success in the network infrastructure applications and vice-versa. For example, we believe that utilities that adopt our NES system become better prospects for i.LON-based street lighting systems and for in-home and in-building energy management applications based on our LWI products. We believe the same synergy is present for utilities that first adopt an i.LON-based street lighting system. Likewise we believe that because our system products are built on our LWI products, the availability of home and commercial devices based on our LWI products represents an opportunity for utilities to extend the reach of energy management into homes and buildings.

## **Markets**

We market our products and services primarily in North America, Europe, Japan, China and other selected Asia Pacific countries. Our principal target markets include the following:

### *Electric Utilities*

We believe the worldwide electric metering industry is transitioning from stand-alone meters or limited-function automatic metering reading (AMR) systems to advanced metering infrastructure (AMI) or "smart grid" systems. These advanced systems offer two-way communication and multiple services over a common infrastructure to utilities and their customers, and provide the ability to add new functionality over time to "future proof" the system. While the timing and speed of the transition varies by geography, and even within a given geography by utility, we believe that two principal factors will drive this change: opening of energy markets to retail competition, which motivates utilities to increase service quality and flexibility while lowering their cost-to-serve; and growing concerns regarding energy availability and sustainability, which drive regulators and utilities toward time-of-use pricing, demand response, load shifting, and other programs to reduce both energy consumption and peak-load demand.

To capitalize on this opportunity, Echelon developed the NES system. With a strategy of selling the NES system through our VAR partners, we launched the NES VAR channel and shipped the first release of our NES system products for use in trials in December 2003. We, or more often our VARs or other partners, have installations that are underway or completed in Australia, Austria, Denmark, Germany, the Netherlands, Russia, Sweden, the United States, and other countries. To date, we have shipped over 1.6 million NES meters to customers around the world and, through our partners, have trials or deployments at nearly 100 utilities worldwide. We believe that the NES system serves a worldwide market opportunity arising from the need to save energy and reduce carbon emissions. In addition to announced installations, Echelon, and more often our VARs, are participating in many trial and pilot projects.

In June 2000, we began working with the Italian utility Enel to incorporate our technology into Enel's Contatore Elettronico project. Under this project, Enel replaced its existing stand-alone electricity meters with advanced, networked electricity meters at about 27 million of its customers' locations in Italy. We completed our scheduled deliveries under this project in 2005. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in the Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances. Sales to Enel and its meter manufacturers accounted for 9.1% of our total revenues in 2008, 10.3% in 2007, and 12.4% in 2006.

### *Building Automation*

Our LWI product line is used by companies worldwide in most areas of the building automation industry, including access control; automatic doors; elevators; energy management; fire/life/safety; heating, ventilation, and air conditioning (HVAC); lighting; metering; security; and automated window blinds. We believe that our products are widely accepted because they lower installed system cost, reduce ongoing life-cycle costs, and increase functionality. We also believe that an increased global interest in reducing energy consumption — both to reduce cost and minimize impact to the environment — has become a driving force behind the adoption of our LWI and i.LON Internet server products. For example, using a LONWORKS building management system to integrate and optimize HVAC, lighting, security, and other subsystems, the Crown Estate headquarters building in London was able to achieve

37% less carbon dioxide emissions than that of a comparable building and was awarded the highest rating possible by BREEAM, a U.K. assessment method that rates the environmental performance of new and existing buildings. Our OEM customers in the building automation market include Groupe Schneider, Honeywell, Johnson Controls, Philips Lighting, Schindler Elevator, Siemens, and Yamatake. Sales to Honeywell, both direct and through distribution, accounted for approximately 4.5% of our total revenues in 2008, 4.3% in 2007, and 11.0% in 2006.

#### *Industrial Automation*

Our LWI products are used in a wide range of industrial automation applications, including semiconductor fabrication plants, gas compressor stations, gasoline tank farms, oil pumping stations, water pumping stations, textile dyeing machinery, pulp and paper processing equipment, automated conveyor systems, and many other industrial environments. In such industrial installations, among other advantages, our control networks can replace complex wiring harnesses, reduce installation costs, eliminate expensive programmable logic controllers and distribute control among sensors, actuators and other devices, thereby reducing system costs, improving control and eliminating the problem of a single point of failure. For example, BOC Edwards, a leading supplier of vacuum pumping systems to the semiconductor industry, uses our products within certain vacuum pump products to replace complex wiring used to connect various motors, sensors, actuators, and displays. In addition to BOC Edwards, our OEM customers in the industrial automation market include Fuji Electric, Hitachi, and Yokagawa.

#### *Demand Response*

Echelon's products, including the i.LON Internet Server and i.LON SmartServer, are being used by several energy management companies, including EnerNOC, Inc., to implement automated demand response solutions that help business customers manage energy use and control energy costs during peak electricity periods.

#### *Street Lighting*

We believe that the street lighting market represents a large market opportunity for our LWI and i.LON Internet server products. Through the combination of our power line smart transceiver product built into ballasts to provide local intelligence, control, and reliable networking, and our i.LON Internet server, which provides local control and remote Internet connectivity, LONWORKS based street lighting systems can reduce energy consumption and cut maintenance costs through remote diagnostics and predictive failure reporting while enhancing safety and lighting quality. For example, the City of Oslo, Norway is in the process of replacing ballasts in 55,000 streetlights with electronic ballasts that communicate over existing power lines using Echelon's power line technology. Preliminary results have demonstrated energy reduction of over 50% and increased operating efficiencies on the order of 30%. Our OEM customers and reseller partners in the street lighting market include Device Insight, Luminext, Kongsberg Analogic, Philips Lighting Control, SELC, and Streetlight Vision.

#### *Home Control*

While the market for home automation and control is still developing, we believe that product innovations we have made to simplify the installation of such devices, coupled with a growing consumer demand for "green" products that can help devices manage and reduce and control their energy costs, has created a new opportunity in the market for networked home control products.

#### *Transportation*

Our products are used in important transportation applications, including railcars, light rail, buses, motor coaches, fire trucks, naval vessels, and aircraft. Our control networks can be used in these transportation systems to improve efficiency, reduce maintenance costs, and increase safety and comfort. LONWORKS technology is one of the standards required by the New York City Transit Authority when evaluating replacement alternatives for its subway cars. Key OEMs in the transportation market include Bombardier, Kawasaki, New York Air Brake, and Siemens.

### **Products & Services**

We offer a wide-ranging set of products and services. These products help our customers maximize development efficiency, minimize product cost, and maximize the opportunity to integrate across product lines and industry segments. Our products are built on a common technology base with sharing between products wherever possible.

Our LWI network infrastructure products include *transceivers, control modules, routers, network interfaces, development tools, and software tools and toolkits*. *Transceivers* and *control modules* are products that our OEM customers use to embed networking and intelligence into their products. Sales of transceivers and control modules generated approximately 25.4% of our revenues during both 2008 and 2007, and 53.5% of our revenues during 2006. In this product area, we offer an embedded control networking platform, called Pyxos™, which is designed to be built into the sensors and actuators embedded inside a machine. *Routers* are used to control and partition network traffic, increasing the total throughput and speed of the system or to provide transparent support for multiple

media, which makes it possible to signal between different types of media, such as twisted pair, power line, radio frequency, and optical fiber. *Network interfaces* are products that can be used to connect computers and controllers to a LONWORKS network. Our Mini EVK and NodeBuilder® *development tools* are designed to make it easy for OEMs to design our transceivers and control modules into their products and systems. Our *software tools and toolkits* include our LNS® network operating system, which provides a client-server platform for installing, maintaining, monitoring, and interfacing with LONWORKS networks, and the LNS based LonMaker® Integration Tool, which is built on the Microsoft Visio technical drawing package to give users a graphical, “drag and drop” environment for designing their network’s control system. In March 2009, we announced a new set of products that we collectively call LonWorks 2.0. These products include the Neuron® 5000 processor, the FT 5000 Smart Transceiver, LNS® FX network operating system, LonMaker® FX installation tool, the NodeBuilder® FX Development Tool and the Mini FX Evaluation Kit. The new and updated products offer a number of benefits to OEMs including increased performance, reduced cost, and simplified installation.

Our system infrastructure products include the *i.LON* family of Internet servers and the NES system. Our *i.LON* products provide cost-effective, secure LAN, WAN, and Internet connectivity to everyday devices in control networks. The *i.LON* 100 Internet server also includes a number of capabilities specifically designed to simplify the implementation and increase the functionality of LONWORKS-based street lighting and remote facility monitoring and energy management applications.

Our NES system is designed to provide the core networking infrastructure necessary to build and deploy an advanced metering system. It includes a family of digital electricity meters, a family of data concentrators, and the NES system software. NES electricity meters are designed to meet the needs of residential and light commercial users. Since electricity meters are measurement devices used to bill consumers, some countries require that meters be certified (or “homologated”) by a recognized authority to verify their accuracy. As of December 31, 2008, NES meters had been homologated in 17 countries and also had been homologated under the EU Measurement Instrumentation Directive (MID). As new versions of our meters are introduced, they generally must be re-homologated in a given country before they can be installed and used there. The mechanical form-factor and characteristics also vary by country. Our initial set of NES meters conformed to the IEC standards used throughout most of Europe and parts of Asia. In 2006, we added additional products that meet the BS standards used in the UK and many former British Colonies, the AS standards used in Australia, and meters that conform to the ANSI form-factor used throughout the United States and Canada. NES data concentrators are designed to reduce system cost by enabling all of the electricity on a given low voltage transformer to share a single wide area connection. Data concentrators are offered in different configurations based upon the number of meters that they are designed to manage. Data concentrators connect to the wide area network using an industry standard modem interface. They communicate using Internet standard TCP/IP, allowing our resellers and their utility customers to select a wide variety of available connectivity options including GPRS (general packet radio service), GSM (Global System for Mobile communications), PSTN (public switched telephone networks), BPL (broadband over power line), WiFi, WiMax, Fiber Optic, Ethernet and others. The NES system software is enterprise software designed to allow our customers to quickly integrate the NES system into a utility’s business processes and systems. Through the NES system software, the NES system, in effect, looks like a collection of web services and events, allowing a wide range of industry standard tools and operating environments to be used. The NES system software is designed to scale from low cost, single server implementations for small pilots, to large scale systems distributed physically and geographically across multiple servers to support millions of meters with high reliability, availability, and scalability requirements.

We also offer a variety of technical training courses covering our products and technology. These courses are designed to provide hands-on, in-depth and practical experience that can be used immediately by our customers to build products and systems based on our products. In some instances these classes are licensed to third-parties in foreign markets who present them in the local language. Additionally, we offer a variety of computer-based training courses that can be taken over the Internet. We also offer telephone, e-mail, and on-site technical support to our customers on a term contract or per-incident basis. The goal of these support services is to resolve customers’ technical problems on a timely basis, ensure that our products will be used properly, and shorten the time required for our customers to develop products that use our technology.

## **Product Development**

Our future success depends in large part on our ability to enhance existing products, reduce product cost, and develop new products that maintain technological competitiveness. We have made and intend to continue to make substantial investments in product development. We obtain extensive product development input from customers and by monitoring end-user needs and changes in the marketplace. We continue to make significant engineering investments in developing and enhancing our products and broadening the markets they serve.

Our total expenses for product development were \$37.8 million for 2008, \$32.6 million for 2007, and \$28.2 million for 2006. Included in these totals were stock-based compensation expenses of \$6.0 million, \$2.8 million, and \$2.1 million, for the years ended December 31, 2008, 2007, and 2006, respectively. We anticipate that we will continue to commit substantial resources to product development in the future and, as a result, product development expenses may continue to increase over historical levels. To date, we have not capitalized any software development costs from our development efforts.

## Marketing

Our marketing efforts focus on creating awareness of our brand, the products and solutions that we offer, and the capabilities and benefits that they bring. We conduct an integrated marketing program comprised of press releases, brochures, published papers, case studies, participation in industry trade shows, speaking at industry conferences, webinars, advertising, direct mail, newsletters, our global website, and the LONWORLD® industry exhibition and conference. We have also formed and actively participate in two associations directly focused on the adoption of our products, LONMARK® International and the Energy Services Network Association (ESNA), and participate in other relevant industry organizations.

## Sales and Distribution

In most regions of the world we market and sell our products and services using our direct sales organization, distributors, value-added resellers, and integration partners. We rely solely on distributors in certain markets in the Asia Pacific and Latin America regions. During the three years ended December 31, 2008, we had six customers that accounted for a majority of our revenues: EBV Elektronik GmbH (“EBV”), our primary distributor of our LONWORKS® Infrastructure products in Europe, Enel S.p.A. (“Enel”), an Italian utility company (including Enel’s third party meter manufacturers), Duke Energy Corporation (“Duke”), a U.S. utility company that purchases NES products directly from us, and Telvent Energia y Medioambiente SA (“Telvent”), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (“EAC”), and ES Elektrosandberg AB (“ES”), European based value added resellers of our NES products. For the years ended December 31, 2008, 2007, and 2006, the percentages of our revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2008	2007	2006
EBV	15.3%	12.8%	27.1%
ES	14.9%	11.4%	0.1%
Duke	10.3%	---%	---%
Enel	9.1%	10.3%	12.4%
Telvent	8.9%	28.3%	---%
EAC	8.3%	7.2%	---%
Total	<u>66.8%</u>	<u>70.0%</u>	<u>39.6%</u>

We support our worldwide sales personnel with application engineers and technical and industry experts working in our headquarters. Outside the United States, direct sales, applications engineering, and customer support are conducted through our offices in China, France, Germany, Hong Kong, Italy, Japan, the Netherlands, South Korea, and the United Kingdom. Each of these offices is staffed primarily with local employees.

Our international sales include both export sales and sales by international subsidiaries and accounted for 75.0% of our total revenues for 2008, 86.6% of our total revenues for 2007, and 65.5% of our total revenues for 2006.

## Manufacturing

Our manufacturing strategy is to outsource production to third parties where it reduces our costs and to limit our internal manufacturing to such tasks as quality inspection, system integration, custom configuration, testing, and order fulfillment. We maintain manufacturing agreements with Cypress and Toshiba related to the Neuron® Chip. Toshiba has informed Echelon that it does not intend to renew its Neuron Chip agreement with Echelon when it expires in January 2010. However, Toshiba and Echelon have agreed that Toshiba will continue to accept orders for Neuron Chips from its customers through September 2011 for deliveries through December 2012. In the meantime, Echelon is working closely with Toshiba to provide a smooth migration path for Toshiba’s customers using Echelon’s new Neuron 5000 processor, which Echelon intends to purchase from Open-Silicon. We also maintain manufacturing agreements with STMicroelectronics for production of our power line transceiver, with Cypress for production of our free topology transceiver, and with Cypress, On Semiconductor, and AMI Semiconductor for the production of certain other components we sell.

For most of our products requiring assembly, we use contract electronic manufacturers including Jabil, Flextronics, and TYCO. These contract electronic manufacturers procure material and assemble, test, and inspect the final products to our specifications.

## **Working Capital**

As of December 31, 2008, we had working capital, defined as current assets less current liabilities, of \$108.8 million, which was a decrease of approximately \$17.9 million compared to working capital of \$126.7 million as of December 31, 2007.

As of December 31, 2008, we had cash, cash equivalents, and short-term investments of \$87.3 million, which was a decrease of approximately \$19.9 million compared to a balance of \$107.2 million as of December 31, 2007. Cash used in operating activities in 2008 of \$3.5 million was primarily the result of our net loss of \$25.8 million and a net increase in our operating assets and liabilities of \$242,000, all of which was partially offset by non-cash charges for stock-based compensation expenses of \$14.5 million, depreciation and amortization expenses of \$7.4 million, and a decrease in accrued investment income of \$721,000.

## **Competition**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and changes in customer requirements. To maintain and improve our competitive position, we must keep pace with the evolving needs of our customers and continue to develop and introduce new products, features and services in a timely and efficient manner. The principal competitive factors that affect the markets for our products include:

- our ability to anticipate changes in customer requirements and to develop new or improved products that meet these requirements in a timely manner;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

In each of our markets, our competitors include both small companies as well as some of the largest companies in the electronics industry operating either alone or together with trade associations and partners. Our key competitors include companies such as Siemens in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Aclara, Elster, Enel, GE, IBM, Iskraemeco, Itron/Actaris, the Landis+Gyr group of companies, Siemens, and Silver Springs Networks in the utility industry; Siemens in the transportation industry; and Ember and Texas Instruments in the home control market. Key industry standard and trade group competitors include BACnet, Konnex, and DALI in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Zigbee and the ZWave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the Zigbee alliance includes over 300 member companies with promoter members such as Eaton, Ember, Freescale, Huawei Technologies, Itron, Landis+Gyr, Philips, Reliant Energy, Samsung, Schneider Electric, Siemens, STMicroelectronics, Tendril, and Texas Instruments.

Additionally, while our product implementations are proprietary to Echelon and are often protected by unique, patented implementations, LONWORKS technology is open, meaning that many of our basic control networking patents are broadly licensed without royalties or license fees. For instance, all of the network management commands required to develop software that competes with our LNS software are published. As a result, our customers are capable of developing hardware and software solutions that compete with many of our products.

## **Government Regulation**

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation as well as local, industry-specific codes and requirements. While we believe that changes in environmental regulations can benefit our sales due to the demonstrated ability of our products to reduce and better manage energy consumption, government regulatory action could also greatly reduce the market for our products or cause us to undertake significant development efforts to make our products compliant, as was the case with the Restriction of Hazardous Substances (RoHS) regulations that went into effect in Europe in 2006. Some of our competitors have also attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their products. We have resisted these efforts and will continue to oppose competitors' efforts to use regulation to impede competition in the markets for our products.

## Proprietary Rights

We own numerous patents, trademarks, and logos. As of February 28, 2009, we had received 100 United States patents, and had 7 patent applications pending. Some of these patents have also been granted in selected foreign countries. Many of the specific patents that are fundamental to LONWORKS technology have been licensed to our customers with no license fee or royalties. At present, the principal value of the remaining patents relates to our specific implementation of our products and designs.

We hold several trademarks in the United States, many of which are registered, including Echelon, LonBuilder<sup>®</sup>, LONMARK, LonTalk<sup>®</sup>, LONWORKS, Neuron, LON, LonPoint<sup>®</sup>, LonUsers<sup>®</sup>, LonMaker, 3120<sup>®</sup>, 3150<sup>®</sup>, LNS, LonManager<sup>®</sup>, Digital Home, and NodeBuilder. We have also registered some of our trademarks and logos in foreign countries.

## Employees

As of February 28, 2009, we had 325 employees worldwide, of which 152 were in product development, 70 were in sales and marketing, 53 were in general and administrative, 37 were in operations, and 13 were in customer support and training. About 214 employees are located at our headquarters in California and 45 employees are located in other offices throughout the United States. Our remaining employees are located in eleven countries worldwide, with the largest concentrations in Germany, Hong Kong, the Netherlands, the United Kingdom, and Japan. None of our employees is represented by a labor union. We have not experienced any work stoppages and we believe relations with our employees are good.

## Where to Find More Information

We make our public filings with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all exhibits and amendments to these reports, available free of charge at our website, [www.echelon.com](http://www.echelon.com), as soon as reasonably practicable after we file such material with the SEC. These materials are located in the "Investor Relations" portion of our Web site under the link "SEC Filings." The inclusion of our Web site address in this report does not include or incorporate by reference into this report any information on our Web site. Copies of our public filings may also be obtained from the SEC Web site at [www.sec.gov](http://www.sec.gov).

## Executive Officers of the Registrant

*M. Kenneth Oshman*, age 68, has been our Chairman and Chief Executive Officer since December 1988. He also served as our President from 1988 to 2001. Prior to joining Echelon, Mr. Oshman, with three associates, founded ROLM Corporation, a telecommunications equipment company, in 1969. He was Chief Executive Officer, President, and a director of ROLM from its founding until its merger with IBM in 1984. Following the merger, he became a Vice President of IBM and a member of the Corporate Management Board. He remained in that position until 1986. Prior to founding ROLM, Mr. Oshman was a member of the technical staff at Sylvania Electric Products from 1963 to 1969. In addition to his responsibilities at our company, Mr. Oshman serves as a director of Sun Microsystems. Mr. Oshman earned B.A. and B.S.E.E. degrees from Rice University and M.S. and Ph.D. degrees in Electrical Engineering from Stanford University.

*Oliver R. Stanfield*, age 59, has been our Executive Vice President & Chief Financial Officer since September 2001. He served as our Vice President and Chief Financial Officer from March 1989 to August 2001. Mr. Stanfield joined our company from ROLM, where he served in several positions since 1980, including: Director of Pricing; Vice President, Plans and Controls; Vice President, Business Planning; Vice President, Financial Planning and Analysis; Treasurer; and Controller, Mil Spec Division. Prior to joining ROLM, Mr. Stanfield worked for ITEL Corporation, Computer Automation and Rockwell International. Mr. Stanfield began his business career with Ford Motor Company in 1969 in various accounting positions while completing a B.S. degree in Business Administration and an M.B.A. degree from the University of Southern California.

*Anders B. Axelsson*, age 49, has been our Senior Vice President of Sales & Marketing since June 2003. Prior to joining our company, he was Chief Executive Officer of PowerFile, Inc. From 1999 to 2001, he was President/General Manager of Snap Appliances, Inc. Between 1992 and 1999, he worked for Measurex, which was later acquired by Honeywell, and served in several positions, including Vice President of Engineering and Marketing and President/Managing Director for Europe. Mr. Axelsson started his career with ABB in 1981 where he worked for 11 years in various sales, marketing, and engineering management positions. He holds a B.S. in Electrical Engineering from ED Technical Institute in Jonkpoing, Sweden and is a graduate of the Executive Program at the University of Michigan.

*Kathleen Bloch*, age 52, has been our Senior Vice President and General Counsel since February 2003. Prior to joining our company, Ms. Bloch was a partner in the law firm of Wilson Sonsini Goodrich & Rosati, P.C., where she practiced from 1996 to 2003. Prior to joining Wilson Sonsini Goodrich & Rosati, she was a partner with the San Francisco and Los Angeles offices of

Sheppard Mullin Richter & Hampton. Ms. Bloch received a B.S. degree in Business Administration from the University of Southern California and her law degree from Stanford Law School.

*Frederik Bruggink*, age 53, has been our Senior Vice President and General Manager of our Service Provider Group since July 2002. He served as our Senior Vice President of Sales and Marketing from September 2001 to June 2002, and as our Vice President, Europe, Middle East and Africa, from April 1996 to August 2001. Mr. Bruggink joined our company in 1996 from Banyan Systems, where he was Vice President, Europe. From 1985 to 1993, Mr. Bruggink held several positions at Stratus Computer, including General Manager for Holland, Benelux, and Northern Europe. His last position at Stratus was Vice President, Northern Europe. Prior to joining Stratus, he held sales positions at Burroughs Computers. Mr. Bruggink attended the University of Leiden.

*Russell Harris*, age 47, joined us in September 2001 as our Senior Vice President of Operations. Prior to joining our company, he served as the Vice President of Operations for NetDynamics from 1996 until its acquisition by Sun Microsystems in 1998. From 1998 to 1999, Mr. Harris served in a management transition role for Sun Microsystems. From 1991 to 1996, Mr. Harris was the Director of Operations at Silicon Graphics, Inc. From 1985 through 1991, he held various positions at Convergent Technologies and Unisys Corporation. His last position at Unisys was as Director of IT for Worldwide Operations. Mr. Harris earned B.S. and M.S. degrees in Industrial Engineering from Stanford University.

*Bob Machlin*, age 51, has been our Senior Vice President of Products since August 2008. Prior to joining our company, he served as President and CEO of SkyPilot Networks, AirFlow Networks and Catena Networks (now part of Ciena). He also held executive positions at Ascend Communications (now Alcatel-Lucent), Cascade Communications (now Alcatel-Lucent), Motorola, and Honeywell Information Systems. Mr. Machlin holds a B.S. degree in mechanical engineering from Tufts University and an M.B.A. from Harvard Business School.

## **ITEM 1A. RISK FACTORS**

*Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline.*

### **Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our operating results.**

Our business can be affected by a number of factors that are beyond our control, such as general geopolitical, economic, and business conditions. Recent turmoil in the worldwide financial markets, and the present economic slowdown and the uncertainty over its breadth, depth and duration will continue to put pressure on the global economy and have a negative effect on our business. Further, the recent worldwide financial and credit crisis has reduced the availability of liquidity and credit to fund the continuation and expansion of business operations worldwide. The shortage of liquidity and credit combined with recent substantial losses in worldwide equity markets may lead to an extended economic recession in the United States or worldwide.

While we currently do not depend on access to the credit markets to finance our operations, there can be no assurance that the deterioration in financial markets will not impair our ability to obtain financing in the future, including, but not limited to, our ability to draw on funds under our existing credit facilities or our ability to incur indebtedness if that became necessary. In addition, there could be a number of follow-on effects from the credit crisis on our business, including insolvency of certain of our key customers, which could impair our distribution channels, and result in the inability of our customers to obtain credit to finance purchases of our products. Also, the recently enacted U.S. economic stimulus legislation may also cause potential customers to delay their deployments until they can determine whether the economic incentives may become available to them under the legislation.

This uncertainty about future economic and political conditions makes it difficult for us to forecast operating results and to make decisions about future investments. If economic activity in the United States and other countries' economies remains weak, many customers may delay, reduce, or even eliminate their purchases of networking technology products. This could result in reductions in sales of our products, longer sales cycles, slower adoption of new technologies, increased price competition, and increased exposure to excess and obsolete inventory. For example, distributors could decide to reduce inventories of our products. Also, the inability to obtain credit could cause a utility to postpone its decision to move forward with a large scale deployment of our NES system. If conditions in the global economy, U.S. economy or other key vertical or geographic markets we serve remain uncertain or weaken further, we would experience material negative impacts on our business, financial condition, results of operations, cash flow, capital resources, and liquidity.

### **Our NES revenues may not be predictable.**

We and our partners sell our NES system to utilities. For several reasons, sales cycles with utility companies are generally extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of an automated meter infrastructure (AMI) system (such as one based on our NES system) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility's existing infrastructure. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES system, including:

- regulatory factors that may affect the requirements of the AMI system or the timing of its deployment;
- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;
- the deployment schedule for projects undertaken by our utility or systems integrator customers; and
- delays in installing, operating, and evaluating the results of an AMI field trial that is based on our NES system.

In addition, shipment of NES products to a particular jurisdiction or customer is generally dependent on either obtaining regulatory approval for the NES meter or other products from a third party for the relevant jurisdiction, or satisfying the customer's internal testing requirements, or both. This certification approval process is often referred to as homologation. Further, shipment of NES products into some jurisdictions requires our contract manufacturers to pass certain tests and meet various standards related to the production of our NES meters. Failure to receive any such approval on a timely basis or at all, or failure to maintain any such approval, would have a material adverse impact on our ability to ship our NES system products, and would therefore have an adverse affect on our results of operations and our financial condition.

Once a utility decides to move forward with a large-scale deployment of an AMI project that is based on our NES system, the timing of and our ability to recognize revenue on our NES system product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the AMI system, and our ability to manufacture and deliver quality products according to expected schedules. In addition, the complex revenue recognition rules relating to products such as our NES system may also require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as the acceptance of software deliverables, are met in a future period. As a consequence, our ability to predict the amount of NES revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As NES revenues account for an increasing percentage of our overall revenues, we and our investors may have increasing difficulty in projecting our financial results.

### **Sales of our NES system may fail to meet our financial targets.**

We have invested and intend to continue to invest significant resources in the development and sales of our NES system. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES system products have not yielded gross margins in line with our long term goals for this product line, while our NES related operating expenses have increased significantly.

In order to achieve our financial targets, we must meet the following objectives:

- Increase market acceptance of our NES system products in order to increase revenues;
- Increase gross margin from our NES revenues by continuing to reduce the cost of manufacturing our NES system products, while at the same time managing manufacturing cost pressures associated with commodity prices and foreign exchange fluctuations;
- Manage the manufacturing transition to reduced-cost NES products; and
- Manage our operating expenses to a reasonable percentage of revenues.

We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals.

**We are exposed to credit risk and payment delinquencies on our accounts receivable, and this risk has been heightened during the current decline in economic conditions.**

Almost none of our outstanding accounts receivables are covered by collateral or credit insurance. In addition, our standard terms and conditions permit payment within a specified number of days following shipment of product, or in some cases, after the customer's acceptance of our products. While we have procedures to monitor and limit exposure to credit risk on our receivables, there can be no assurance such procedures will effectively limit our credit risk and avoid losses. As economic conditions change and worsen, certain of our customers may face liquidity concerns and may be unable to timely satisfy their payment obligations to us, which could have a material adverse effect on our financial condition and results of operations.

**We depend on a limited number of key suppliers.**

Our future success will depend significantly on our ability to timely manufacture our products cost-effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Jabil and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in our NES system. The Neuron Chip, which is an important component that we and our customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Toshiba has informed Echelon that it does not intend to renew its Neuron Chip agreement with Echelon when it expires in January 2010. However, Toshiba and Echelon have agreed that Toshiba will continue to accept orders for Neuron Chips from its customers through September 2011 for deliveries through December 2012. In the meantime, Echelon is working closely with Toshiba to provide a smooth migration path for Toshiba's customers using Echelon's new Neuron 5000 processor, which Echelon intends to purchase from Open-Silicon. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms.

We are currently reviewing the impact the ongoing worldwide financial crisis is having on our suppliers. Some of these suppliers are large, well capitalized companies, while others are smaller and more highly leveraged. In order to mitigate these risks, we may take actions such as increasing our inventory levels and/or adding additional sources of supply. Such actions may increase our costs and increase the risk of excess and obsolete inventories. Even if we undertake such actions, there can be no assurance that we will be able to prevent any disruption in the supply of goods and services we receive from these suppliers.

We may also elect to change any of these key suppliers. For example, we are currently in the process of ending our relationship with a former CEM partner, Flextronics. As part of this transition, we have moved the production of products Flextronics built for us to alternative CEMs. We have also been required to purchase certain raw material and in-process inventory from Flextronics that Flextronics procured in anticipation of our production requirements. In addition, we currently have capital equipment located at Flextronics that must be relocated to another CEM in order to continue manufacturing our products there. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply, as we have recently done with Jabil. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

- moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;
- reestablishing acceptable manufacturing processes with a new work force; and
- exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

**Our products use components or materials that may be subject to price fluctuations, shortages, or interruptions of supply.**

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. In addition, in the past

we have occasionally experienced shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

**If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.**

Due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. We believe that similar new product introduction delays in the future, particularly with respect to the NES system, could also increase our costs and delay our revenues.

**We may incur penalties and/or be liable for damages with respect to sales of our NES system products.**

In the event of late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities or other compliance issues, the agreements governing the sales of the NES system may expose us to penalties, damages and other liabilities. Even in the absence of such contractual provisions, we may agree to assume certain liabilities for the benefit of our customers. Any such liabilities would have an adverse effect on our financial condition and operating results.

**The markets for our products are highly competitive.**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer or regulatory requirements, and localized market requirements. In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:

- our ability to anticipate changes in customer or regulatory requirements and to develop or improve our products to meet these requirements in a timely manner;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;
- our ability to meet a customer's required delivery schedules;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

Competitors for our NES system products include Aclara, Elster, Enel, GE, IBM, Iskraemeco, Itron/Actaris, the Landis+Gyr group of companies, Siemens, and Silver Springs Networks, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our NES system offering.

For our LWI products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Siemens in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, Zigbee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the

rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the Zigbee alliance includes over 300 member companies with promoter members such as Eaton, Ember, Freescale, Huawei Technologies, Itron, Landis+Gyr, Philips, Reliant Energy, Samsung, Schneider Electric, Siemens, STMicroelectronics, Tendril, and Texas Instruments.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

**Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.**

Our products may contain undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing or shipping process. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. In certain very limited instances, these agreements require that we be named as an additional insured on our customers' insurance policies. However, our customer contracts and additional insured coverage may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

**If we do not maintain adequate distribution channels, our revenues will be harmed.**

We market our NES system products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our NES system sales will be made through our VARs and integration partners, rather than directly by our company. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES system products with other companies in various geographic areas, revenues from sales of our NES system products may not meet our financial targets, which will harm our operating results and financial condition.

Currently, significant portions of our LWI revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total LWI revenues. Agreements with our distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and

sell our products, our revenues would suffer. Furthermore, if they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

**We face financial and operational risks associated with international operations.**

We have operations located in ten countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 75.0%, 86.6%, and 65.5% of our total net revenues for the years ended December 31, 2008, 2007, and 2006, respectively. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates could have an impact on revenues. As the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our NES system in the utility's local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these vendors have historically been denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, any future increase in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

Additional risks inherent in our international business activities include the following:

- timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- inherent challenges in managing international operations;
- the burdens of complying with a wide variety of foreign laws and unexpected changes in regulatory requirements, tariffs, and other trade barriers;
- economic and political conditions in the countries where we do business;
- differing vacation and holiday patterns in other countries, particularly in Europe;
- labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products;
- international terrorism and anti-American sentiment; and
- potentially adverse tax consequences, including restrictions on repatriation of earnings.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

**Our executive officers and technical personnel are critical to our business.**

Our company's success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and our technical personnel. In May 2008, our President and Chief Operating Officer, Beatrice Yormark, passed away unexpectedly. Her duties have been assumed by our Chief Executive Officer. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations, and managerial personnel, as well as our ability to successfully implement a plan for management succession.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain qualified executive officers and key personnel. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

**The sales cycle for our LWI products is lengthy and unpredictable.**

The sales cycle between initial LWI customer contact and execution of a contract or license agreement with a customer or purchaser of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM's product development, system integration, and product introduction periods have been completed. In addition, changes in our customer's budgets, or the priority they assign to control network development, could also affect the sales cycle.

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

**If we sell our NES system products directly to a utility, we will face additional risks.**

If we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility's territory, integrating the NES system into the utility's operating and billing system, overseeing management of the combined system, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, if we sell directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

**Fluctuations in our operating results may cause our stock price to decline.**

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts' expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- the mix of products and services that we sell may change to a less profitable mix;
- shipment, payment schedules, and product acceptance may be delayed;
- we may be required to modify or add to our NES product offerings to meet a utility's requirements, which could delay delivery and/or acceptance of our products;
- the complex revenue recognition rules relating to products such as our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria for our software and/or hardware products, are met in a future period;

- our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- our products may not be accepted by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;
- downturns in any customer's or potential customer's business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- recording of expense relating to equity compensation as required under SFAS No. 123R, *Share-Based Payment*, will decrease our earnings;
- we may incur costs associated with any future business acquisitions; and
- results of impairment tests for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

**We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.**

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; DLMS in the metering market; and Echonet, Zigbee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our competitors, which would have a material adverse affect on our revenues, results of operations, and financial condition.

**Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.**

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party's intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources, and cause us to incur significant expenses.

As the result of such a claim, we may elect or be required to redesign our products, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license to the third party's intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse affect on our revenues, results of operations, and financial condition.

**We have limited ability to protect our intellectual property rights.**

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

**The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.**

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including the following:

- significant stockholders may sell some or all of their holdings of our stock;
- investors may be concerned about our ability to develop additional customers for our products and services; and
- volatility in our stock price may be unrelated or disproportionate to our operating performance.

Any of these factors could have a negative impact on the market price of our stock.

**Voluntary standards and governmental regulatory actions in our markets could limit our ability to sell our products.**

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets.

In addition, many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

**Our existing stockholders control a significant percentage of our stock, which will limit other stockholders' ability to influence corporate matters.**

As of February 28, 2009, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 28.5% of our outstanding stock.

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel's nominee to our board of directors. In addition, Enel agreed to vote for our board's recommendations for the election of directors, approval of accountants, approval of Echelon's equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

**Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.**

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

At our corporate headquarters in San Jose, California, we lease two buildings, each of which contains approximately 75,000 square feet of useable space. We moved to this location in October 2001. The leases for the two buildings were scheduled to expire in 2011 and 2013, respectively.

In June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. For accounting purposes only, we are the "deemed owner" of these buildings; see Note 3 of Notes to Consolidated Financial Statements in Part II, Item 8 of this report for further explanation of the accounting treatment for these leases.

We also lease office space for some of our sales and marketing employees in China, France, Germany, Hong Kong, India, Italy, Japan, the Netherlands, South Korea, and the United Kingdom and for some of our research and development employees in Fargo, North Dakota, and Germany. The leases for these offices expire at various dates through 2018. As of December 31, 2008, the future minimum rental payments for all of our leased office space, including those for our corporate headquarters facilities, totaled approximately \$49.4 million. For the year ended December 31, 2008, the aggregate rental expense for all leased office space was approximately \$1.1 million.

We believe that our facilities will be adequate for at least the next 12 months. For additional information regarding our obligations under property leases, please see Note 8 of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report.

### ITEM 3. LEGAL PROCEEDINGS

None.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of our fiscal year ended December 31, 2008.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the Nasdaq Global Market under the symbol "ELON." We began trading on NASDAQ on July 28, 1998, the date of our initial public offering. The following table sets forth, for the quarter indicated, the high and low sales price per share of our common stock as reported on the Nasdaq Global Market.

<b>Year Ended December 31, 2008</b>	<b>Price Range</b>	
	<b>High</b>	<b>Low</b>
Fourth quarter	\$ 10.73	\$ 4.92
Third quarter	15.74	9.45
Second quarter	16.56	10.36
First quarter	22.49	10.84

<b>Year Ended December 31, 2007</b>	<b>High</b>	<b>Low</b>
Fourth quarter	\$ 30.66	\$ 14.70
Third quarter	32.49	14.93
Second quarter	18.75	10.50
First quarter	10.68	7.19

As of February 28, 2009, there were approximately 432 stockholders of record. Because brokers and other institutions hold many shares on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

#### Dividend Policy

We have never paid dividends on our capital stock and do not currently expect to pay any dividends in the foreseeable future. We intend to retain future earnings, if any, for use in our business.

#### Equity Compensation Plan Summary Information

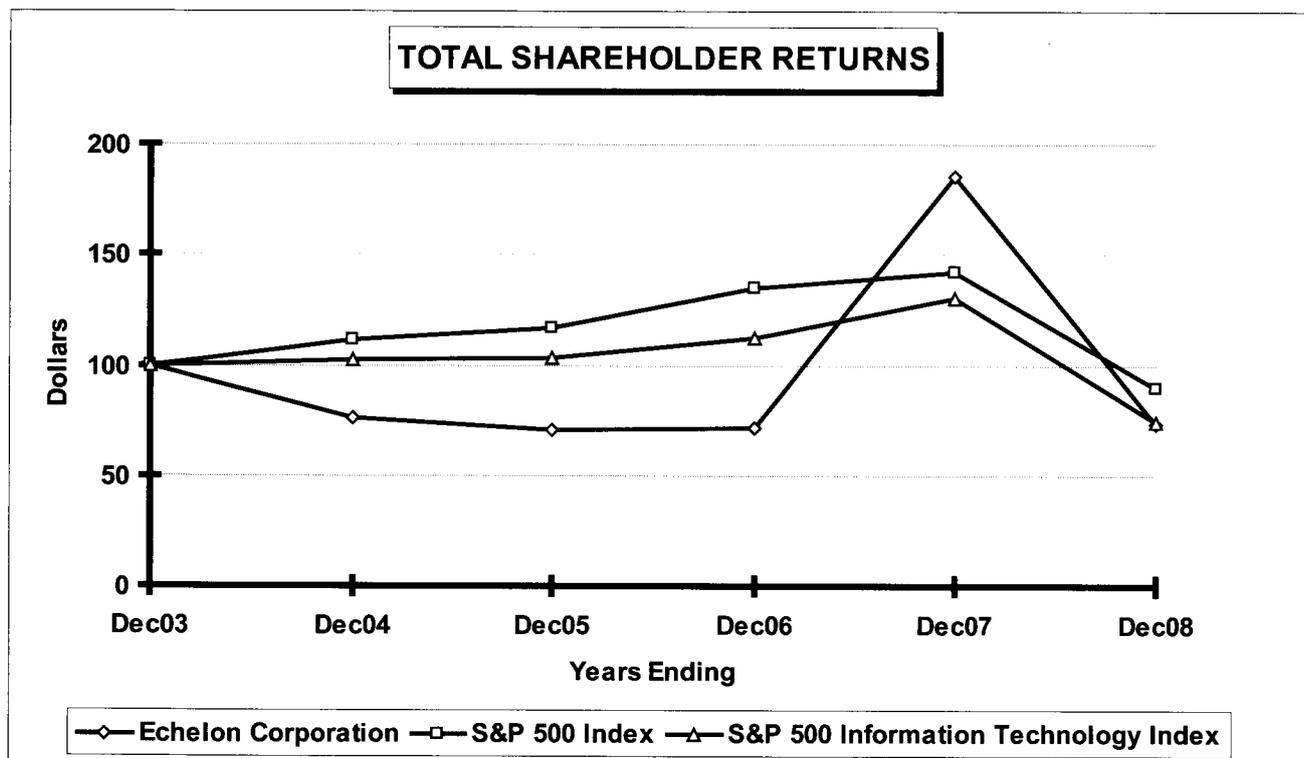
For information on our equity compensation plans, please refer to Note 4 to our accompanying consolidated financial statements.

#### Recent Sales of Unregistered Securities

There were no sales of unregistered securities during the fourth quarter of our fiscal year ended December 31, 2008.

## Stock Price Performance Graph

The graph below compares the cumulative total stockholder return on our common stock (assuming reinvestment of dividends) with the cumulative total return on the S&P 500 Index and the S&P 500 Information Technology Index (which is comprised of those companies in the information technology sector of the S&P 500 Index). The graph assumes that \$100 was invested in our common stock on December 31, 2003 and in the S&P 500 Index and the S&P 500 Information Technology Index. Historic stock price performance is not necessarily indicative of future stock performance.



## Repurchase of Equity Securities by the Company

In April 2008, the Company's board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. During the three months ended December 31, 2008, no shares were repurchased under the repurchase program. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of December 31, 2008, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011. The following table provides information about the repurchase of our common stock during the quarter ended December 31, 2008:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
October 1- October 31 .....	17,074	\$8.13	--	2,250,000
November 1- November 30 .....	437	\$6.01	--	2,250,000
December 1- December 31 .....	<u>1,596</u>	\$7.09	--	2,250,000
Total	<u>19,107</u>	\$7.99	--	2,250,000

(1) Shares purchased that were not part of our publicly announced repurchase program represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises and/or withholding tax obligations related to stock-based compensation. These purchases do not reduce the number of shares that may yet be purchased under our publicly announced repurchase program.

## ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data is derived from our consolidated financial statements. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes in Item 8 of this Form 10-K in order to fully understand factors that may affect the comparability of the information presented below.

	Year Ended December 31,				
	2008	2007	2006	2005	2004
(in thousands, except per share data)					
<b>Consolidated Statement of Operations Data:</b>					
Net revenues:					
Product	\$ 131,073	\$ 135,405	\$ 56,515	\$ 73,563	\$ 108,947
Service	2,974	2,172	761	865	974
Total revenues	<u>134,047</u>	<u>137,577</u>	<u>57,276</u>	<u>74,428</u>	<u>109,921</u>
Cost of revenues:					
Cost of product	79,984	85,035	22,039	30,928	46,059
Cost of service	2,587	2,360	1,877	2,081	1,957
Total cost of revenues	<u>82,571</u>	<u>87,395</u>	<u>23,916</u>	<u>33,009</u>	<u>48,016</u>
Gross profit	<u>51,476</u>	<u>50,182</u>	<u>33,360</u>	<u>41,419</u>	<u>61,905</u>
Operating expenses:					
Product development	37,753	32,644	28,221	24,853	24,914
Sales and marketing	23,635	21,181	20,408	20,994	19,347
General and administrative	17,143	16,083	13,949	19,401	12,702
Total operating expenses	<u>78,531</u>	<u>69,908</u>	<u>62,578</u>	<u>65,248</u>	<u>56,963</u>
Operating income (loss)	(27,055)	(19,726)	(29,218)	(23,829)	4,942
Interest and other income, net	2,925	5,717	5,817	5,225	2,140
Interest expense on lease financing obligations	(1,404)	(1,211)	(1,379)	(1,530)	(1,666)
Income (loss) before provision for income taxes	<u>(25,534)</u>	<u>(15,220)</u>	<u>(24,780)</u>	<u>(20,134)</u>	<u>5,416</u>
Provision for income taxes	297	452	350	154	586
Net income (loss)	<u>\$ (25,831)</u>	<u>\$ (15,672)</u>	<u>\$ (25,130)</u>	<u>\$ (20,288)</u>	<u>\$ 4,830</u>
Income (loss) per share <sup>1</sup> :					
Basic	\$ (0.64)	\$ (0.39)	\$ (0.64)	\$ (0.50)	\$ 0.12
Diluted	<u>\$ (0.64)</u>	<u>\$ (0.39)</u>	<u>\$ (0.64)</u>	<u>\$ (0.50)</u>	<u>\$ 0.12</u>
Shares used in per share calculation <sup>1</sup> :					
Basic	40,636	39,891	39,487	40,377	40,918
Diluted	<u>40,636</u>	<u>39,891</u>	<u>39,487</u>	<u>40,377</u>	<u>41,007</u>
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents and short-term investments	\$ 87,316	\$ 107,190	\$ 124,157	\$ 154,480	\$ 160,364
Working capital	108,811	126,711	129,521	154,869	171,032
Total assets	185,517	204,707	211,272	213,671	244,384
Total stockholders' equity	<u>132,571</u>	<u>153,211</u>	<u>153,663</u>	<u>178,551</u>	<u>208,611</u>

<sup>1</sup> See Note 1 of Notes to Consolidated Financial Statements for an explanation of shares used in computing basic net income (loss) per share, and diluted net income (loss) per share.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Annual Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as "we believe," "expect," "anticipate," "intend," "plan," "goal," "continues," "may" and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the "Business" and "Risk Factors" sections. Our actual results may differ materially.*

### Overview

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We are based in San Jose, California, and maintain offices in ten foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices — such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves — to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

We have been investing in products for use by electricity utilities for use in management of electricity distribution. We began to receive modest amounts of revenue resulting from these investments in 2004, which grew to approximately \$883,000 in 2005, decreased slightly to \$791,000 in 2006, grew substantially to \$70.6 million in 2007, and decreased slightly again to \$67.1 million in 2008. We refer to this revenue as networked energy services, or NES, revenue. We sell certain of our products to Enel and certain suppliers of Enel for use in Enel's Contatore Elettronico electricity meter management project in Italy. We refer to Echelon's revenue derived from sales to Enel and Enel's designated manufacturers as Enel Project revenue. We refer to all other revenue as LONWORKS Infrastructure, or LWI, revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LWI products. Under the revised methodology, we now defer revenue, as well as cost of goods sold, on items shipped to these distributors that remain in their inventories at quarter-end. The revision significantly reduced our first and second quarter 2006 revenues, but did not have an impact on cash flows from operations or require any changes to our historical financial statements. A more thorough explanation of this revision can be found later in this report in the "LONWORKS Infrastructure revenues" and "EBV revenues" sections of our discussion on Results of Operations.

We have a history of losses and although we achieved profitability in past fiscal periods, we incurred a loss for the years ended December 31, 2008, 2007, and 2006.

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1, "Significant Accounting Policies" of Notes to Consolidated Financial Statements in this Annual Report on Form 10-K describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective and complex judgments.

**Revenue Recognition.** Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including

software post-contract support services), training, and custom software development services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For hardware sales made to our distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user.

In most instances involving large-scale deployments, our Networked Energy Services, or NES, system products are sold as part of multiple element arrangements as that term is defined under AICPA Statement of Position 97-2 (“SOP 97-2”), *Software Revenue Recognition*, as amended. These arrangements may include electricity meters and data concentrators (collectively, the “Hardware”); NES system software, for which a royalty is charged on a per-meter basis; post-contract customer support (“PCS”) for the NES system software; and extended warranties for the Hardware. These arrangements may require us to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES system software, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize revenues for the Hardware and NES system software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. We have established vendor specific objective evidence for the PCS on the NES system software, as well as for extended warranties on our NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the latter of the delivery of all software, or the customer’s acceptance of any given Hardware shipment.

We account for the rights of return, price protection, rebates, and other sales incentives offered to distributors of our products in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 48, *Revenue Recognition When Right of Return Exists*, and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor’s Products)*.

**Stock-Based Compensation.** We account for stock-based compensation in accordance with SFAS 123R. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the estimated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton (“BSM”) option-pricing model to estimate the fair value of stock options. The estimation of fair value of share-based payment awards on the date of grant using the BSM option-pricing model is affected by the fair market value of our stock on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected term of the option, the expected volatility of our stock price over the expected term of the option, risk-free interest rates, and expected dividends.

For options and SARs granted prior to January 1, 2008, the expected term has been calculated using the simplified method as permitted under the Securities and Exchange Commission Staff Accounting Bulletin No. 107. Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. For options and SARs granted subsequent to December 31, 2007, the expected term has been calculated by applying a Monte Carlo simulation model that incorporates Echelon’s historical data on post-vest exercise activity and employee termination behavior. The expected volatility is based on both the historical volatility of the our common stock over the most recent period commensurate with the expected life of the option as well as on implied volatility calculated from the market traded options on our company’s stock. We base the risk-free interest rate that we use in the BSM option-pricing model on U.S. Treasury issues in effect at the time of option grant that have remaining terms similar to the expected term of the option. We have never paid cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Therefore, we use an expected dividend yield of zero in the BSM option-pricing model.

SFAS 123R also requires us to record compensation expense for stock-based compensation net of estimated forfeitures, and to revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share-based payment awards are amortized using the accelerated multiple option method over their requisite service period, which is generally the vesting period.

Certain of the stock-based compensation awards we issue vest upon the achievement of specific financial-based performance requirements. SFAS 123R requires us to estimate whether or not it is probable that these financial-based performance requirements will be met, and, in some cases, when they will be met. These estimates of future financial performance are based on the best information available at the time of grant, and each quarterly period thereafter until the awards are either earned or forfeited. Any

changes we make to our estimates of future financial performance could have a material impact on the amount and timing of compensation expense associated with these awards.

There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the estimated fair value of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions. The BSM option-pricing model was developed for use in estimating the fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our option grants.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different option-pricing model, stock-based compensation expense in those future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

In December 2008, the Company completed a stock option exchange program (the "Exchange Program") whereby eligible employees were given an opportunity to exchange some or all of their outstanding stock options and stock appreciation rights ("SARs"), collectively the "Surrendered Awards", for a predetermined number of new SARs. Under the Exchange Program, participating eligible employees would receive one new SAR for each exchanged option with an exercise price less than \$12.00 per share. For exchanged options with an exercise price equal to or greater than \$12.00 per share, participants would receive between 0.33 and 0.67 new SAR for each option exchanged, depending on the exercise price of the exchanged option. The Exchange Offer resulted in incremental stock-based compensation expense of approximately \$2.3 million. In determining the amount of incremental compensation expense associated with the Exchange Program, significant judgement was required to determine the fair value of the Surrendered Awards on the cancellation date, including the estimated remaining life of those awards. The Company has elected to combine both the incremental value and the unamortized original grant date fair value of the Surrendered Awards, the total of which will be recognized as compensation expense over the vesting term of the new SARs. The Company's board of directors and Compensation Committee approved the Exchange Program to restore the retention and incentive benefits of the Company's equity awards. Non-employee members of the Company's board of directors were not eligible to participate in the Exchange Program.

**Allowance for Doubtful Accounts.** We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as much as approximately net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer's payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit worthiness of our overall customer base, changes in our customers' payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions continue to worsen, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was \$323,000 as of December 31, 2008, and \$330,000 as of December 31, 2007.

**Inventory Valuation.** At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. In general, the evaluation for excess quantities includes analyses of historical sales levels by product and projections of future demand. Inventories on hand in excess of one year's forecasted demand are generally deemed to be excess.

In performing the excess inventory analysis, management considers factors that are unique to each of our NES and LWI product lines. For our NES products, the analysis requires us to consider that NES customers procure specific meter types that meet their requirements. In other words, any given customer may require a meter that is "custom" to their specifications. Accordingly, management must make significant judgments not only as to which customers will buy how many meters (and associated data concentrators), but also which meter type(s) each customer will buy. In making these judgments, management uses the best sales forecast information available at the time. However, because future sales volumes for any given customer opportunity have the potential to be significant, actual results could be materially different from original estimates. This could increase our exposure to excess inventory for which we would need to record a reserve, thereby resulting in a potentially material negative impact to our operating results.

For our LWI products, our customers generally buy from a portfolio of "off-the-shelf" or standard products. In addition, whereas for our NES customers our revenues are attributable to a relatively few customers buying substantial quantities of any given product, our LWI revenues are composed of a larger volume of smaller dollar transactions. Accordingly, while any single LWI customer's

demand for a given product may fluctuate from quarter to quarter, the fact that there are so many LWI customers buying a standard product tends to average out increases or decreases in any individual customer's demand. This has historically resulted in a relatively stable future demand forecast for our LWI products, which, absent outside forces such as worsening general economic conditions, management evaluates in determining its requirement for an excess inventory reserve.

In addition to providing a reserve for excess inventories, we also do not value inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete.

We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

**Warranty Reserves.** We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was \$849,000 as of December 31, 2008, and \$301,000 as of December 31, 2007.

## Results of Operations

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the years ended December 31, 2008, 2007, and 2006:

	<u>Year Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Revenues:			
Product	97.8%	98.4%	98.7%
Service	2.2	1.6	1.3
Total revenues	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
Cost of revenues:			
Cost of product	59.7	61.8	38.5
Cost of service	1.9	1.7	3.3
Total cost of revenues	<u>61.6</u>	<u>63.5</u>	<u>41.8</u>
Gross profit	<u>38.4</u>	<u>36.5</u>	<u>58.2</u>
Operating expenses:			
Product development	28.2	23.7	49.3
Sales and marketing	17.6	15.4	35.6
General and administrative	12.8	11.7	24.4
Total operating expenses	<u>58.6</u>	<u>50.8</u>	<u>109.3</u>
Loss from operations	(20.2)	(14.3)	(51.1)
Interest and other income, net	2.2	4.1	10.1
Interest expense on lease financing obligations	(1.1)	(0.9)	(2.3)
Loss before provision for income taxes	<u>(19.1)</u>	<u>(11.1)</u>	<u>(43.3)</u>
Provision for income taxes	0.2	0.3	0.6
Net loss	<u>(19.3)%</u>	<u>(11.4)%</u>	<u>(43.9)%</u>

## Revenues

### Total revenues

(Dollars in thousands)	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
Total revenues	\$134,047	\$137,577	\$57,276	(\$3,530)	\$80,301	(2.6%)	140.2%

The \$3.5 million decrease in total revenues in 2008 as compared to 2007 was primarily attributable to a \$3.4 million decrease in NES revenues and a \$1.3 million decrease in Enel Project revenues, partially offset by a \$1.2 million increase in LONWORKS Infrastructure revenues. The \$80.3 million increase in total revenues in 2007 as compared to 2006 was primarily attributable to a \$69.8 million increase in NES revenues, a \$7.1 million increase in Enel Project revenues, and a \$3.5 million increase in LONWORKS Infrastructure revenues.

### NES revenues

(Dollars in thousands)	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
NES Revenues	\$67,118	\$70,558	\$791	(\$3,440)	\$69,767	(4.9%)	8,820.1%

During 2008 and 2007, NES revenues were generated primarily from large scale deployments of our NES system products, whereas in 2006, NES revenues were generated primarily from the completion of system trials and, to a lesser extent, from limited shipments of NES products.

2007 NES revenues of \$70.6 million included \$14.4 million of shipments of hardware products that were accepted by our customers and in some cases paid for, in 2006. However, we could not record this revenue in 2006 since we had not yet met all of the required criteria for revenue recognition.

Our ability to recognize revenue on shipments of our NES products depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES system will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. For example, once all other revenue recognition criteria have been met, we recognize revenues for the meters (and related NES system software royalties) and data concentrators based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. In some instances, the reasons for these deferrals may not be fully under our control, which could result in the actual timing of revenue being significantly different than we currently anticipate.

We also expect that some foreign utilities will require us to price our NES system in the respective utility's local currency, which will expose us to foreign currency risk. During 2008, the portion of our NES revenue transactions conducted in currencies other than the U.S. dollar, principally the European Euro and the Australian dollar, was about \$205,000, or 0.3%. During 2007, the portion of our NES revenue transactions conducted in currencies other than the U.S. dollar, principally the European Euro and the Australian dollar, was about \$3.9 million, or 5.6%. NES revenue transactions conducted in foreign currencies during 2006 were immaterial. To date, we have not hedged any of these foreign currency risks. In most cases, in the event of a significant contract award, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project. In addition, we will face foreign currency exposures from the time we submit our foreign currency denominated bid until the award of a contract by the utility (the "bid to award" term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

### LWI revenues

(Dollars in thousands)	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
LWI Revenues	\$54,040	\$52,840	\$49,382	\$1,200	\$3,458	2.3%	7.0%

Our LWI revenues are primarily comprised of sales of our hardware products, and to a lesser extent, revenues we generate from sales of our software products and from our customer support and training offerings.

The \$1.2 million increase in LWI revenues in 2008 as compared to 2007 was primarily due to increases in revenues in the EMEA and Americas regions, partially offset by a reduction in sales in the APJ region. Within the LWI family of products, the increase was attributable to increases in our power line transceiver and i.Lon products, partially offset by a reduction in sales of our network services and development tools products.

The \$3.5 million increase in LWI revenues in 2007 as compared to 2006 was primarily attributable to the one-time effect of revisions we made in 2006 to our revenue recognition methodology for sales made to our distributor partners. During the first quarter of 2006, we modified our revenue recognition method for sales made to our European distributor, EBV (see EBV revenue discussion below). Under the revised method, revenue on sales made to EBV is deferred until EBV sells the products through to its end use customers. During the second quarter of 2006, we completed a similar revision to our revenue recognition methodology for sales made to our Asian distributor partners. This revision was necessary as, during the quarter, we modified our agreements with our Asian distributor partners. These contractual modifications, which allow the distributors to return certain of their excess inventory, were made to address changing business conditions in our Asian markets and to expand our customer base there. The revenue recognition methodology revisions for EBV and our Asian distributors resulted in one-time reductions in revenue of approximately \$2.9 million and \$1.0 million during the first and second quarters of 2006, respectively. Excluding the impact of these revenue recognition revisions, LWI revenues decreased by approximately \$442,000, or 0.9%, during 2007 as compared to 2006.

Our future LWI revenues will also be subject to further fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell our LWI products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our LWI revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 5.9% in 2008, 6.8% in 2007, and 6.3% in 2006. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, during the first quarter of 2009, the amount of our LWI revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

#### *Enel Project revenues*

	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	\$ Change	\$ Change	% Change	% Change
<i>(Dollars in thousands)</i>							
Enel Project Revenues	\$12,889	\$14,180	\$7,103	(\$1,291)	\$7,077	(9.1%)	99.6%

In October 2006, we entered into two new agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. There were no revenues from either of these new agreements during 2006. Both the \$12.9 million and the \$14.2 million of Enel project revenue recognized during 2008 and 2007, respectively, related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

The \$7.1 million in Enel Project revenues in 2006 was composed of spare parts for use in Enel's Contatore Elettronico system.

We sell our products to Enel and its designated manufacturers in United States dollars. Therefore, the associated revenues are not subject to foreign currency risks.

### EBV revenues

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
EBV Revenues	\$19,787	\$17,564	\$15,511	\$2,223	\$2,053	12.7%	13.2%

Sales to EBV, our largest distributor and the sole independent distributor of our LONWORKS Infrastructure products in Europe, accounted for 14.8% of our total revenues in 2008, 12.8% in 2007, and 27.1% in 2006. The primary factor contributing to the \$2.2 million increase during 2008 as compared to 2007 was an increase in sales of our control and connectivity transceiver products.

The primary factor contributing to the \$2.1 million increase in EBV revenues during 2007 as compared to 2006 was the fact that, during the first quarter of 2006, we revised our revenue recognition methodology for sales made to EBV. Under the revised methodology, revenues, as well as cost of goods sold, are deferred on items shipped to EBV that remain in EBV's inventories at quarter-end. Revenue is then recognized on these products, along with the corresponding gross margin, when EBV sells them to its customers in future periods. This revision resulted in a one-time revenue decrease of approximately \$2.9 million for the quarter ended March 31, 2006. The revision did not have an impact on cash flows from operations or require any changes to historical financial statements.

Excluding the impact of the accounting method revision, EBV's shipments to its customers decreased by approximately \$847,000 during 2007 as compared to 2006. We believe this decrease is the result of the Restriction of Hazardous Substances, or RoHS, regulations, which became effective in the European Union July 1, 2006. Under these new rules, manufacturers such as Echelon were required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into the region. We believe that many of EBV's customers increased their purchases of our non-RoHS compliant products during the first half of 2006, prior to effective date of the new regulations. This resulted in a high level of EBV revenue during the first half of 2006.

We currently sell our products to EBV in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2009. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our results of operations could be harmed.

### Product revenues

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
Product Revenues	\$131,073	\$135,405	\$56,515	(\$4,332)	\$78,890	(3.2%)	139.6%

The \$4.3 million decrease in product revenues between 2008 and 2007 was primarily attributable to a \$4.5 million decrease in NES product revenues and a \$1.3 million decrease in Enel Project product revenues, partially offset by a \$1.5 million increase in LonWorks Infrastructure product revenues. The \$78.9 million increase in product revenues between 2007 and 2006 was primarily attributable to a \$69.2 million increase in NES product revenues, a \$6.3 million increase in Enel Project product revenues, and a \$3.4 million increase in LonWorks Infrastructure product revenues.

### Service revenues

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
Service Revenues	\$2,974	\$2,172	\$761	\$802	\$1,411	36.9%	185.4%

The \$802,000 increase in service revenues during 2008 as compared to 2007 was primarily attributable to a \$1.1 million increase in NES support revenues, partially offset by a \$262,000 decrease in LWI training and customer support revenues. The \$1.4 million increase in service revenues during 2007 as compared to 2006 was primarily due to approximately \$732,000 of custom software development revenues generated from the Enel Project, and, to a lesser extent, an increase in NES support revenues of approximately \$623,000.

## Gross Profit and Gross Margin

(Dollars in thousands)	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
Gross Profit	\$51,476	\$50,182	\$33,360	\$1,294	\$16,822	2.6%	50.4%
Gross Margin	38.4%	36.5%	58.2%	—	—	1.9	(21.7)

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of goods sold for service revenues consists of employee-related costs such as salaries and fringe benefits as well as other direct and indirect costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

2008 gross margins of 38.4% improved slightly as compared to those generated in 2007. Favorably impacting gross margins during 2008 was the impact of improved gross margins in our NES product line. During 2007, our NES revenues were primarily generated from sales of earlier versions of our NES products. These older versions were generally more expensive to manufacture. In late 2007, we began shipping newer, cost reduced versions of our NES products that, when sold at approximately the same price as the earlier versions, yield higher gross margins. As our 2008 NES revenues were generated primarily from sales of these newer, cost reduced NES products, the gross margin attributable to our NES revenues improved.

Partially offsetting the gross margin improvements in our NES products during 2008 was the negative impact of excess and obsolete inventory reserves, warranty expenses, and purchase price variances we recorded during the year, which collectively had the effect of reducing full year gross margins by approximately 3%. The largest contributor to these additional expenses were the excess and obsolete reserves we recorded, which were primarily attributable to excess raw material inventory we purchased from our former contract electronic manufacturer (“CEM”), WKK (see further discussion below). As mentioned in our discussion of “Critical Accounting Estimates” above, reserves for excess and obsolete inventory are highly subjective and complex, and are based on management’s best estimate of future demand at each reporting date. To the extent actual demand differs from these estimates, additional reserves could be required in the future, which could have a material negative effect on our results of operations.

Lastly, during 2008, our inventory levels increased substantially as a result of our transition between CEMs. Much of this inventory remained on our balance sheet as of December 31, 2008. As a result, the amount of indirect overhead spending that was capitalized in inventory as of December 31, 2008 was higher than what was capitalized as of December 31, 2007. This had the effect of improving gross margin during 2008 by approximately 1%, as those costs would otherwise have been expensed during the respective periods. We expect that, over time, our inventory levels will decrease to more historical levels, which will result in the reduction of capitalized overhead in inventory. When this occurs, it will cause gross margin rates to decrease.

The 21.7 percentage point decrease in gross margin during 2007 as compared to 2006 was due primarily to the mix of revenues reported. During 2007, the proportion of our revenues attributable to sales of our NES system products increased significantly as compared to 2006. In general, gross margins generated from sales of our NES system products are much lower than those generated from both sales of our LONWORKS Infrastructure products and services as well as sales made under the Enel Project. As a result, when NES revenues are higher as a percentage of overall revenues, as they were during 2007, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they were during 2006, overall gross margins will be higher.

Partially offsetting the decrease in gross margins during 2007 as compared to 2006 was the impact of higher revenues. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when overall revenues increase, as they did during 2007 as compared to 2006, gross margins are favorably impacted.

## Operating Expenses

### Product development

(Dollars in thousands)	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
				\$ Change	\$ Change	% Change	% Change
Product Development	\$37,753	\$32,644	\$28,221	\$5,109	\$4,423	15.7%	15.7%

Product development expenses consist primarily of payroll and related expenses for development personnel, facility costs, equipment and supplies, fees paid to third party service providers, depreciation and amortization, and other costs associated with the development of new technologies and products.

The \$5.1 million increase in product development expenses during 2008 as compared to 2007 was primarily due to a \$6.2 million increase in compensation and other employee related expenses attributable to an increase in our product development personnel headcount, including a \$3.1 million increase in stock-based compensation expenses. Partially offsetting these increases were decreases in equipment and supply expenses and recruiting and other fees paid to third-party service providers.

The \$4.4 million increase in product development expenses during 2007 as compared to 2006 was primarily due to a \$3.1 million increase in compensation and other employee related expenses attributable to an increase in our product development personnel headcount and increased stock-based compensation expenses. To a lesser extent, increases in fees paid to third party service providers, equipment and supply expenses, and facility costs also contributed to the year-over-year increase.

### *Sales and marketing*

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	\$ Change	\$ Change	% Change	% Change
Sales and Marketing	\$23,635	\$21,181	\$20,408	\$2,454	\$773	11.6%	3.8%

Sales and marketing expenses consist primarily of payroll, commissions, and related expenses for sales and marketing personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and marketing activities.

The \$2.5 million increase in sales and marketing expenses in 2008 as compared to 2007 was primarily due to a \$2.1 million increase in compensation and other employee related expenses, including a \$1.3 million increase in stock-based compensation expenses. Also contributing to the year-over-year increase was approximately \$370,000 of unfavorable foreign currency exchange rate fluctuations between the United States dollar and the local currencies in several of the foreign countries in which we operate.

Of the \$773,000 increase in sales and marketing expenses in 2007 as compared to 2006, approximately \$460,000 was attributable to the unfavorable impact of foreign currency exchange rate fluctuations. Excluding the impact of these exchange rate fluctuations, sales and marketing expenses increased by approximately \$313,000, or 1.5%, between the two years.

### *General and administrative*

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	\$ Change	\$ Change	% Change	% Change
General and Administrative	\$17,143	\$16,083	\$13,949	\$1,060	\$2,134	6.6%	15.3%

General and administrative expenses consist primarily of payroll and related expenses for executive, accounting, and administrative personnel, professional fees for legal and accounting services rendered to our company, facility costs, insurance, and other general corporate expenses.

The \$1.1 million increase in general and administrative expenses in 2008 as compared to 2007 was primarily due to a \$1.3 million increase in stock-based compensation expenses. Excluding the impact of this increase, general and administrative expenses decreased by approximately \$238,000, or 1.5% between the two years.

Of the \$2.1 million increase in general and administrative expenses during 2007 as compared to 2006, approximately \$842,000 related to an increase in stock-based compensation expenses. The remaining \$1.3 million increase between the two periods was primarily attributable to increases in other compensation related expenses for our executive, accounting, and administrative personnel, and to a lesser extent, increases in cash compensation paid to our Board of Directors, fees paid to our independent accountants, and costs associated with other third party service providers.

### *Interest and Other Income, Net*

<i>(Dollars in thousands)</i>	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	\$ Change	\$ Change	% Change	% Change
Interest and Other Income, Net	\$2,925	\$5,717	\$5,817	(\$2,792)	(\$100)	(48.8%)	(1.7%)

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances as well as foreign exchange translation gains and losses related to short-term intercompany balances.

During 2008, interest and other income, net decreased by approximately \$2.8 million as compared to 2007. This decrease was primarily due to a \$3.9 million decrease in interest income. The reduction in interest income is primarily the result of a reduction in

our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

Partially offsetting the reduction in interest income during 2008 was a \$1.1 million increase in foreign currency translation gains. In accordance with SFAS No. 52, *Foreign Currency Translation*, we account for foreign currency translation gains and losses associated with our short-term intercompany balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar weakens in value against these foreign currencies, the associated translation losses negatively impact other income. Conversely, when the U.S. dollar strengthens, as it did during 2008, the resulting translation gains favorably impact other income.

During 2007, interest and other income, net decreased by approximately \$100,000 as compared to 2006. This decrease was primarily due to a \$331,000 decrease in interest income, partially offset by a \$214,000 reduction in foreign exchange translation and transaction losses. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods, which was primarily attributable to our operating losses. To a lesser extent, recent reductions in the weighted average yield our investment portfolio earns also contributed to the year-over-year decline in interest income.

### ***Interest Expense on Lease Financing Obligations***

	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
(Dollars in thousands)				\$ Change	\$ Change	% Change	% Change
Interest Expense on Lease Financing Obligations	\$1,404	\$1,211	\$1,379	\$193	(\$168)	15.9%	(12.2%)

In December 1999 and October 2000, we entered into two separate lease agreements with a local real estate developer for the two buildings we currently occupy at our San Jose headquarters site. As discussed in Note 3 of Notes to Consolidated Financial Statements in Item 15 of this Report, we have accounted for these leases in accordance with EITF 97-10 and SFAS 98. The application of this accounting literature causes Echelon to be considered the “deemed owner” of the two buildings for accounting purposes only.

Accordingly, we have recorded as an asset on our balance sheet the costs paid by our lessor to construct our headquarters facility, along with a corresponding financing liability for an amount equal to these lessor paid construction costs. The monthly rent payments we make to our lessor under our lease agreements are recorded in our financial statements partially as land lease expense and partially as principal and interest on the financing liability. “Interest expense on lease financing obligations” reflects the portion of our monthly lease payments that is allocated to interest expense.

In June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. As a result of the lease extension, our company increased the carrying amount of its lease financing obligations by approximately \$12.5 million to approximately \$27.6 million (an amount equal to the present value of the revised lease payments at the date of the lease extension). This had the effect of increasing the amount of our monthly attributable to interest expense. As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. Accordingly, we currently expect a higher proportion of the payments we make in 2009 will be allocated to principal repayment and less will be allocated to interest expense.

### ***Provision for Income Taxes***

	Year Ended December 31,			2008 over	2007 over	2008 over	2007 over
	2008	2007	2006	2007	2006	2007	2006
(Dollars in thousands)				\$ Change	\$ Change	% Change	% Change
Provision for Income Taxes	\$297	\$452	\$350	(\$155)	\$102	(34.3%)	29.1%

The provision for income taxes for 2008, 2007, and 2006 includes a provision for state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes and our valuation allowance on our deferred tax assets. Income taxes of \$297,000 in 2008, \$452,000 in 2007, and \$350,000 in 2006 consist primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes.

## Off-Balance-Sheet Arrangements and Other Contractual Obligations

**Off-Balance-Sheet Arrangements.** We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose our company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

**Lease Commitments.** In December 1999, we entered into a lease agreement with a real estate developer for our existing corporate headquarters in San Jose, California. In October 2000, we entered into a second lease agreement with the same real estate developer for an additional building at our headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. Both leases permit us to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated our requirement to provide the landlord with security deposits totaling \$6.2 million, which we had previously satisfied by causing to have issued standby letters of credit ("LOCs"). As of June 30, 2008, the previously issued LOCs had been returned to the bank that issued them and were cancelled. The leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98 (see Note 3 of Notes to Consolidated Financial Statements in Item 8 of this Report).

In addition, we lease facilities under operating leases for our sales, marketing, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with our corporate headquarters facilities (see Notes as referenced above). These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

**Purchase Commitments.** We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

**Indemnifications.** In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that would enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

**Royalties.** We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded as cost of products revenue in our consolidated statements of income, was approximately \$513,000 during 2008, \$573,000 during 2007, and \$493,000 during 2006.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

**Taxes.** We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting

principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of December 31, 2008, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

**Legal Actions.** From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of December 31, 2008, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

As of December 31, 2008, our contractual obligations were as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Lease financing obligations	\$ 37,998	\$ 3,097	\$ 6,309	\$ 6,468	\$ 22,124
Operating leases	11,663	1,838	2,885	1,885	5,055
Purchase commitments	17,877	17,871	6	--	--
Total	<u>\$ 67,538</u>	<u>\$ 22,806</u>	<u>\$ 9,200</u>	<u>\$ 8,353</u>	<u>\$ 27,179</u>

The amounts in the table above exclude \$1.3 million of income tax liabilities and related interest and penalties under FIN 48 as we are unable to reasonably estimate the timing of settlement. See Note 9, "Income Taxes" of Notes to Consolidated Financial Statements for further discussion.

## Liquidity and Capital Resources

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through December 31, 2008, we raised \$291.4 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. The stock repurchase program expired in March 2008.

In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of December 31, 2008, 2,250,000 shares were available for repurchase. The new stock repurchase program will expire in April 2011.

The following table presents selected financial information for each of the last three fiscal years (dollars in thousands):

	As of December 31,		
	2008	2007	2006
Cash, cash equivalents, and short-term investments	\$ 87,316	\$ 107,190	\$ 124,157
Trade accounts receivable, net	23,480	33,469	13,918
Working capital	108,811	126,711	129,521
Stockholder's equity	132,571	153,211	153,663

As of December 31, 2008, we had \$87.3 million in cash, cash equivalents, and short-term investments, a decrease of \$19.9 million as compared to December 31, 2007. Historically, our primary source of cash, other than stock sales and exercises of stock options and warrants as discussed above, has been receipts from revenue. Our primary uses of cash have been cost of revenues, compensation related payments and other operating expenses, acquisitions, capital expenditures, and purchases under our stock repurchase programs.

*Cash flows from operating activities.* Cash flows from operating activities have historically been driven by net income levels, adjustments for non-cash charges such as stock-based compensation expenses, depreciation, and amortization; changes in accrued investment income; and fluctuations in operating asset and liability balances. Net cash used in operating activities was \$3.5 million in 2008, a \$9.6 million decrease from 2007. During 2008, net cash used in operating activities was primarily the result of our net loss of \$25.8 million and a net increase in our operating assets and liabilities of \$242,000, all of which was partially offset by non-cash charges for stock-based compensation expenses of \$14.5 million, depreciation and amortization expenses of \$7.4 million, and a decrease in accrued investment income of \$721,000. During 2007, net cash used in operating activities was primarily the result of our net loss of \$15.7 million and changes in our operating assets and liabilities of \$13.2 million; partially offset by stock-based compensation charges of \$7.8 million, depreciation and amortization of \$7.4 million, and a decrease in accrued investment income of \$436,000. Cash used in operating activities in 2006 of \$18.4 million was primarily the result of our net loss of \$25.1 million; changes in our operating assets and liabilities of \$5.3 million; and an increase in accrued investment income of \$446,000; partially offset by stock-based compensation charges of \$5.5 million and depreciation and amortization of \$7.1 million.

*Cash flows from investing activities.* Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash used in investing activities was \$23.8 million for 2008, a \$71.0 million increase over 2007. Net cash used in investing activities in 2008 was primarily the result of net purchases of available-for-sale short-term investments and by capital expenditures of \$4.6 million. Net cash provided by investing activities in 2007 was primarily the result of proceeds from maturities and sales of our available-for-sale short-term investments; partially offset by capital expenditures of \$8.1 million. During 2006, net cash provided by investing activities of \$4.8 million was primarily the result of proceeds from maturities and sales of our available-for-sale short-term investments; partially offset by capital expenditures of \$4.7 million.

*Cash flows from financing activities.* Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase program and principal payments under our lease financing obligations. Net cash used in financing activities was \$10.1 million for 2008, a \$14.2 million increase over 2007. Net cash used in financing activities in 2008 was primarily attributable to \$8.9 million of open-market repurchases of our common stock under our stock repurchase program, \$1.8 million of principal payments on our lease financing obligations, and \$1.6 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options; partially offset by proceeds of \$2.1 million from issuance of common stock upon exercise of options by our employees. Net cash provided by financing activities in 2007 was primarily attributable to proceeds of \$11.2 million from issuance of common stock upon exercise of options by our employees, partially offset by \$4.5 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options, and \$2.6 million of principal payments on our lease financing obligations. During 2006, net cash used in financing activities of \$8.6 million was primarily attributable to \$6.3 million of open-market repurchases of our common stock under our stock repurchase program, and repurchases of \$239,000 of our common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of stock options, and \$2.3 million of principal payments on our lease financing obligations; partially offset by proceeds of \$265,000 from issuance of common stock as a result of options exercised by our employees.

We use well-regarded investment managers to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated U.S. government securities, U.S. corporate obligations, and to a lesser extent, foreign corporate obligations and money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We maintain a \$15.0 million line of credit with our primary bank. As of December 31, 2008, our primary bank has issued, against the line of credit, a standby letter of credit totaling \$217,000. Other than causing to have issued standby letters of credit, we have never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

We expect that cash requirements for our payroll and other operating costs will continue at or slightly above existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. Furthermore, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business. In addition, any continued weakening of economic conditions, or changes in our planned cash outlay, could also negatively affect our existing cash, cash equivalents, and investment balances. However, based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to, the risks detailed in Part I, Item 1A - Risk Factors. In the unlikely event that we would require additional financing within this period, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

## Related Party Transactions

During the years ended December 31, 2008, 2007, and 2006, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our Chairman and Chief Executive Officer, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During 2008, we recognized a total of approximately \$258,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for \$130.7 million (see Note 11 to our accompanying consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares.

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. As of February 28, 2009, a representative of Enel has not been appointed to our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

During 2008, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$12.9 million, \$5.0 million of which was included in accounts receivable at December 31, 2008. During 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$14.2 million, \$3.0 million of which was included in accounts receivable at December 31, 2007. During 2006, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$7.1 million.

## Recently Issued Accounting Standards

See Note 1(t) "Recent Accounting Pronouncements" in Notes to the Consolidated Financial Statements in Item 15 of Part IV of this Annual Report on Form 10-K for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on financial condition and results of operations, which is incorporated herein by reference.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

*Market Risk Disclosures.* The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

*Interest Rate Sensitivity.* We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 100 basis points from levels at December 31, 2008, the fair market value of the portfolio would decline by an immaterial amount, due primarily to the fact that current interest rates remain at historically low levels. We currently intend to hold our fixed income investments until maturity or for a period of time as needed to recover any decline in value due to interest rate fluctuation, and therefore we would not expect our

operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. However, in the unlikely event it was necessary, we could decide to sell some or all of our short-term investments prior to maturity to meet the liquidity needs of the company.

*Foreign Currency Exchange Risk.* We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. Due to our modest exposure to foreign currency fluctuations, if foreign exchange rates were to fluctuate by 10% from rates at December 31, 2008, our financial position and results of operations would not be materially affected. However, it is possible that there could be a material impact in the future.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The Financial Statements and Supplementary Data required by this item are set forth in Item 6 and at the pages indicated in Item 15(a).

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### ***(a) Evaluation of Effectiveness of Disclosure Controls and Procedure***

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Annual Report on Form 10-K, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of December 31, 2008.

### ***(b) Management's Report on Internal Control Over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008. This evaluation was based on the framework in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control — Integrated Framework*, our management concluded that our internal control over financial reporting is effective at this reasonable assurance level as of December 31, 2008. The Company's independent registered public accounting firm, KPMG LLP, has issued an attestation report on the Company's internal control over financial reporting. The report on the audit of internal control over financial reporting appears on page 41 of this Form 10-K.

***(c) Changes in Internal Control Over Financial Reporting***

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Echelon is scheduled to hold its 2009 annual meeting of stockholders on May 14, 2009. The meeting will commence at 10:00 a.m., PDT, and will be held at our corporate headquarters located at 570 Meridian Avenue, San Jose, California 95126. The date of record for the annual meeting is March 23, 2009.

## PART III

### ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE MATTERS

The information regarding our executive officers required by this Item is incorporated herein by reference from the section titled "Executive Officers of Registrant" in Part I of this annual report on Form 10-K. The remaining information required by this Item is incorporated herein by reference from our Proxy Statement for the 2009 Annual Meeting of Stockholders (the "2009 Proxy Statement"), which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year ended December 31, 2008.

### ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference from our 2009 Proxy Statement.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated herein by reference from our 2009 Proxy Statement.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference from our 2009 Proxy Statement.

### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference from our 2009 Proxy Statement.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Form:

1. Financial Statements

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Report of Independent Registered Public Accounting Firm	41
Consolidated Balance Sheets	42
Consolidated Statements of Operations	43
Consolidated Statements of Stockholders' Equity	44
Consolidated Statements of Cash Flows	45
Consolidated Statements of Comprehensive Loss	46
Notes to Consolidated Financial Statements	47

2. Financial Statement Schedule

See Note 12 in Notes to Consolidated Financial Statements 68

All other schedules have been omitted because they are not applicable or the required information is included in the Consolidated Financial Statements or the Notes thereto.

3. Exhibits

Item 601 of Regulation S-K requires the following exhibits listed below. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

ExhibitNo.	Description of Document
3.2*	Amended and Restated Certificate of Incorporation of Registrant.
3.3*	Amended and Restated Bylaws of Registrant.
4.1*	Form of Registrant's Common Stock Certificate.
4.2*	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1*	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2*+	1997 Stock Plan and forms of related agreements.
10.2(a)*+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(e)*+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.3*+	1988 Stock Option Plan and forms of related agreements.
10.4*	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5*	Form of International Distributor Agreement.
10.6*	Form of OEM License Agreement.
10.7*	Form of Software License Agreement.
10.8*	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9*+	1998 Director Option Plan.
21.1*	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1*	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*	Previously filed.
+	Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders  
Echelon Corporation:

We have audited the accompanying consolidated balance sheets of Echelon Corporation and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 2008. We also have audited Echelon Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Echelon Corporation's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting appearing under Item 9A(b). Our responsibility is to express an opinion on these consolidated financial statements and the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Echelon Corporation and subsidiaries as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles. Also in our opinion, Echelon Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ KPMG LLP

Mountain View, California  
March 16, 2009

ECHELON CORPORATION  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except share and per share amounts)

	December 31,	
	2008	2007
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 37,669	\$ 76,062
Short-term investments	49,647	31,128
Accounts receivable, net of allowances of \$1,010 in 2008 and \$1,428 in 2007 <sup>1</sup>	23,480	33,469
Inventories	16,513	14,012
Deferred cost of goods sold	2,482	6,656
Other current assets	4,707	2,092
Total current assets	134,498	163,419
Property and equipment, net	40,574	30,776
Goodwill	8,417	8,548
Other long-term assets	2,028	1,964
TOTAL ASSETS	\$ 185,517	\$ 204,707
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 10,675	\$ 12,945
Accrued liabilities	5,053	4,551
Current portion lease financing obligations	1,439	2,900
Deferred revenues	8,520	16,312
Total current liabilities	25,687	36,708
Long-Term Liabilities:		
Lease financing obligations, excluding current portion	25,350	13,151
Other long-term liabilities	1,909	1,637
Total long-term liabilities	27,259	14,788
Commitments and Contingencies (Note 8)		
Stockholders' Equity:		
Preferred stock, \$0.01 par value:		
Authorized – 5,000,000 shares; none outstanding	—	—
Common stock, \$0.01 par value:		
Authorized – 100,000,000 shares		
Issued – 43,676,229 shares in 2008 and 43,205,524 shares in 2007		
Outstanding – 40,457,045 shares in 2008 and 40,736,340 shares in 2007	437	432
Additional paid-in capital	313,549	298,556
Treasury stock, at cost (3,219,184 shares in 2008 and 2,469,184 shares in 2007)	(28,130)	(19,259)
Accumulated other comprehensive income	784	1,718
Accumulated deficit	(154,069)	(128,236)
Total stockholders' equity	132,571	153,211
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 185,517	\$ 204,707

<sup>1</sup> Includes related party amounts of \$4,970 in 2008 and \$3,000 in 2007. See Note 11 for additional information on related party transactions.

See accompanying notes to the consolidated financial statements.

**ECHELON CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)

	Year Ended December 31,		
	2008	2007	2006
<b>REVENUES:</b>			
Product	\$ 131,073	\$ 135,405	\$ 56,515
Service	2,974	2,172	761
<b>Total revenues<sup>1</sup></b>	<b>134,047</b>	<b>137,577</b>	<b>57,276</b>
<b>COST OF REVENUES:</b>			
Cost of product	79,984	85,035	22,039
Cost of service	2,587	2,360	1,877
<b>Total cost of revenues</b>	<b>82,571</b>	<b>87,395</b>	<b>23,916</b>
<b>Gross profit</b>	<b>51,476</b>	<b>50,182</b>	<b>33,360</b>
<b>OPERATING EXPENSES:</b>			
Product development	37,753	32,644	28,221
Sales and marketing	23,635	21,181	20,408
General and administrative	17,143	16,083	13,949
<b>Total operating expenses</b>	<b>78,531</b>	<b>69,908</b>	<b>62,578</b>
Loss from operations	(27,055)	(19,726)	(29,218)
Interest and other income, net	2,925	5,717	5,817
Interest expense on lease financing obligations	(1,404)	(1,211)	(1,379)
Loss before provision for income taxes	(25,534)	(15,220)	(24,780)
Provision for income taxes	297	452	350
<b>NET LOSS</b>	<b>\$ (25,831)</b>	<b>\$ (15,672)</b>	<b>\$ (25,130)</b>
<b>Loss per share:</b>			
Basic	\$ (0.64)	\$ (0.39)	\$ (0.64)
Diluted	\$ (0.64)	\$ (0.39)	\$ (0.64)
<b>Shares used in per share calculation:</b>			
Basic	40,636	39,891	39,487
Diluted	40,636	39,891	39,487

<sup>1</sup> Includes related party amounts of \$12,889 in 2008, \$14,180 in 2007, and \$7,103 in 2006. See Note 11 for additional information on related party transactions

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(in thousands)

	Common Stock		Treasury Stock		Additional Paid-In Capital	Accumulated Other Comprehen- sive Income (Loss)	Accumu- lated Deficit	Total
	Shares	Amount	Shares	Amount				
BALANCE AT DECEMBER 31, 2005	41,473	\$ 415	(1,673)	\$ (12,925)	\$ 278,268	\$ (118)	\$ (87,089)	\$ 178,551
Exercise of stock options	125	1	—	—	763	—	—	764
Release of performance shares	72	1	—	—	(1)	—	—	—
Stock received for payment of option exercise price	(61)	(1)	—	—	(498)	—	—	(499)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(29)	—	—	—	(239)	—	—	(239)
Repurchase of stock	—	—	(796)	(6,334)	—	—	—	(6,334)
Repurchase of employee shares	(3)	—	—	—	(25)	—	—	(25)
Stock-based compensation	—	—	—	—	5,460	—	—	5,460
Foreign currency translation adjustment	—	—	—	—	—	751	—	751
Unrealized holding gain on available-for-sale securities	—	—	—	—	—	364	—	364
Net loss	—	—	—	—	—	—	(25,130)	(25,130)
BALANCE AT DECEMBER 31, 2006	41,577	\$ 416	(2,469)	\$ (19,259)	\$ 283,728	\$ 997	\$ (112,219)	\$ 153,663
Exercise of stock options	1,949	19	—	—	18,378	—	—	18,397
Release of performance shares	228	2	—	—	(2)	—	—	—
Stock received for payment of option exercise price	(332)	(3)	—	—	(7,166)	—	—	(7,169)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(213)	(2)	—	—	(4,127)	—	(345)	(4,474)
Repurchase of employee shares	(3)	—	—	—	(54)	—	—	(54)
Stock-based compensation	—	—	—	—	7,799	—	—	7,799
Foreign currency translation adjustment	—	—	—	—	—	651	—	651
Unrealized holding gain on available-for-sale securities	—	—	—	—	—	70	—	70
Net loss	—	—	—	—	—	—	(15,672)	(15,672)
BALANCE AT DECEMBER 31, 2007	43,206	\$ 432	(2,469)	\$ (19,259)	\$ 298,556	\$ 1,718	\$ (128,236)	\$ 153,211
Exercise of stock options	405	4	—	—	3,913	—	—	3,917
Release of performance shares	322	3	—	—	(3)	—	—	—
Stock received for payment of option exercise price	(130)	(1)	—	—	(1,799)	—	—	(1,800)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(124)	(1)	—	—	(1,540)	—	(2)	(1,543)
Repurchase of stock	—	—	(750)	(8,871)	—	—	—	(8,871)
Repurchase of employee shares	(3)	—	—	—	(36)	—	—	(36)
Stock-based compensation	—	—	—	—	14,458	—	—	14,458
Foreign currency translation adjustment	—	—	—	—	—	(967)	—	(967)
Unrealized holding gain on available-for-sale securities	—	—	—	—	—	33	—	33
Net loss	—	—	—	—	—	—	(25,831)	(25,831)
BALANCE AT DECEMBER 31, 2008	43,676	\$ 437	(3,219)	\$ (28,130)	\$ 313,549	\$ 784	\$ (154,069)	\$ 132,571

See accompanying notes to the consolidated financial statements.

**ECHELON CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Year Ended December 31,		
	2008	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (25,831)	\$ (15,672)	\$ (25,130)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	7,406	7,441	7,120
Increase in (reduction of) allowance for doubtful accounts	(29)	88	(23)
Loss (gain) on disposal of fixed assets	10	10	(2)
Reduction of (increase in) accrued investment income	721	436	(446)
Stock-based compensation	14,458	7,799	5,460
Change in operating assets and liabilities:			
Accounts receivable	10,079	(19,621)	(2,889)
Inventories	(2,428)	(2,631)	(8,119)
Other current assets	(2,647)	93	(380)
Accounts payable	(2,382)	6,262	2,921
Deferred cost of goods sold	4,177	12,404	(18,738)
Accrued liabilities	654	925	(2,776)
Deferred revenues	(7,669)	(10,518)	24,747
Deferred rent	(26)	(75)	(105)
Net cash used in operating activities	<u>(3,507)</u>	<u>(13,059)</u>	<u>(18,360)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of available-for-sale short-term investments	(91,239)	(65,545)	(85,971)
Proceeds from sales and maturities of available-for-sale short-term investments	72,033	120,796	95,436
Changes in other long-term assets	(42)	31	37
Capital expenditures	<u>(4,570)</u>	<u>(8,053)</u>	<u>(4,696)</u>
Net cash provided by (used in) investing activities	<u>(23,818)</u>	<u>47,229</u>	<u>4,806</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from exercise of stock options	2,117	11,216	265
Principal payments of lease financing obligations	(1,789)	(2,580)	(2,297)
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(1,574)	(4,520)	(239)
Repurchase of common stock under stock repurchase program	<u>(8,871)</u>	<u>—</u>	<u>(6,334)</u>
Net cash provided by (used in) financing activities	<u>(10,117)</u>	<u>4,116</u>	<u>(8,605)</u>
<b>EFFECT OF EXCHANGE RATES ON CASH</b>	<u>(951)</u>	<u>364</u>	<u>491</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<u>(38,393)</u>	<u>38,650</u>	<u>(21,668)</u>
<b>CASH AND CASH EQUIVALENTS:</b>			
Beginning of year	76,062	37,412	59,080
End of year	<u>\$ 37,669</u>	<u>\$ 76,062</u>	<u>\$ 37,412</u>
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>			
Cash paid for interest on lease financing obligations	<u>\$ 1,454</u>	<u>\$ 1,196</u>	<u>\$ 1,366</u>
Cash paid for income taxes	<u>\$ 562</u>	<u>\$ 431</u>	<u>\$ 199</u>
Noncash investing and financing information – Increase in property and equipment and related lease financing obligation due to lease extension (see Note 3)	<u>\$ 12,526</u>	<u>\$ —</u>	<u>\$ —</u>

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
(in thousands)

	Year Ended December 31,		
	2008	2007	2006
Net loss	\$ (25,831)	\$ (15,672)	\$ (25,130)
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustment	(967)	651	751
Unrealized holding gain on available-for-sale securities	33	70	364
Comprehensive loss	\$ (26,765)	\$ (14,951)	\$ (24,015)

See accompanying notes to the consolidated financial statements.

**ECHELON CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. SIGNIFICANT ACCOUNTING POLICIES:**

*(a) Operations*

Echelon Corporation (the “Company”) was incorporated in California in February 1988 and was reincorporated in Delaware in January 1989. The Company develops, markets, and supports a wide range of hardware and software products and services that enable OEMs and systems integrators to design and implement open, interoperable, distributed control networks. The Company’s products are based on its LonWorks networking technology, an open standard for interoperable networked control. In a LonWorks control network, intelligent control devices, called nodes, communicate using the Company’s LonWorks protocol. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. The Company sells its products and services around the world to the building, industrial, transportation, utility/home and other automation markets.

*(b) Basis of Presentation*

The Company’s consolidated financial statements reflect operations of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated.

*(c) Risks and Uncertainties*

The Company’s operations and performance depend significantly on worldwide economic conditions and their impact on purchases of the Company’s products as well as the ability of suppliers to provide the Company with products and services in a timely manner. The impact of any of the matters described below could have an adverse affect on the Company’s business, results of operations and financial condition.

- The Company’s sales are currently concentrated with a relatively small group of customers, as approximately 67% of net revenues for the year ended December 31, 2008 was derived from six customers. Customers in any of the Company’s target market sectors may experience unexpected reductions in demand for their products and reduce their purchase orders from us, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.
- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. As a result of current credit market conditions, if any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.
- Due to the continuing current worldwide economic crisis, coupled with the fact that the Company’s NES customers generally procure products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.

*(d) Use of Estimates*

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgements, assumptions, and estimates that affect amounts reported in the Consolidated Financial Statements and accompanying notes. Significant estimates and judgements are used for revenue recognition, stock-based compensation, allowance for doubtful accounts, inventory valuation, allowance for warranty costs, income taxes, and other loss contingencies. In order to determine the carrying values of assets and liabilities that are not readily apparent from other sources, the Company bases its estimates and assumptions on current facts, historical experience, and various other factors that it believes to be reasonable under the circumstances. Actual results experienced by the Company may differ materially from management’s estimates.

(e) *Revenue Recognition*

The Company's revenues are derived from the sale and license of its products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For hardware sales made to the Company's distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

In accordance with AICPA Statement of Position 97-2 ("SOP 97-2"), *Software Revenue Recognition*, as amended, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence ("VSOE") of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of its LONWORKS<sup>®</sup> Infrastructure products that are considered multiple element arrangements under SOP 97-2. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support ("PCS"). The VSOE for this PCS is based on prices paid by the Company's customers for stand-alone purchases of PCS. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

In most instances involving large-scale deployments, the Company's Networked Energy Services ("NES") system products are sold as part of multiple element arrangements, which may include electricity meters and data concentrators (collectively, the "Hardware"); NES system software, for which a royalty is charged on a per-meter basis; PCS for the NES system software; and extended warranties for the Hardware. These arrangements may require the Company to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES system software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and NES system software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. The Company has established VSOE for the PCS on the NES system software, as well as for extended warranties on its NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

In arrangements which include significant customization or modification of software, the Company recognizes revenue using the percentage-of-completion method, as described in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, if the Company believes it is able to make reasonably dependable estimates of the extent of progress toward completion. The Company measures progress toward completion using an input method based on the ratio of costs incurred, principally labor, to date to total estimated costs of the project. These estimates are assessed continually during the term of the contract, and revisions are reflected when the changed conditions become known. Revenues from these types of arrangements are included in service revenues in the condensed consolidated statement of operations.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, *Revenue Recognition When Right of Return Exists*, and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*. During the first and second quarters of 2006, the Company modified its revenue recognition method for sales made to its distributor partners. Under the revised method, revenue on sales made to distributors is deferred until the distributor sells the products through to its end-use customers. The impacts of this revenue recognition methodology revision were one-time reductions in revenues of approximately \$2.9 million and \$1.0 million during the first and second quarters of 2006, respectively.

(f) *Deferred Revenue and Deferred Cost of Goods Sold*

Deferred revenue and deferred cost of goods sold result from transactions where the Company has shipped product or performed

services for which all revenue recognition criteria have not yet been met. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

*(g) Stock-Based Compensation*

Effective January 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R ("SFAS 123R"), *Share-Based Payment*, and Securities and Exchange Commission Staff Accounting Bulletin No. 107 ("SAB 107"). SFAS 123R eliminated the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*, and instead generally requires that such transactions be accounted for using a fair-value-based method.

The Company uses the Black-Scholes-Merton ("BSM") option-pricing model to determine the fair value of stock-based awards. The BSM model is consistent with the option-pricing model the Company used to value stock-based awards granted prior to January 1, 2006 for pro forma disclosure purposes under SFAS No. 123 ("SFAS 123"), *Accounting for Stock-Based Compensation*. Stock-based compensation expense for awards granted prior to January 1, 2006 is based on the BSM calculated grant date fair value as determined under the pro forma provisions of SFAS 123.

Further information regarding stock-based compensation can be found in Note 5 of these Notes to Consolidated Financial Statements.

*(h) Cash and Cash Equivalents*

The Company considers bank deposits, money market investments and all debt and equity securities with an original maturity of three months or less to be cash and cash equivalents.

*(i) Short-Term Investments*

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Securities classified as available-for-sale are reported at fair value with the related unrealized holding gains and losses, net of tax, being included in accumulated other comprehensive income (loss).

*(j) Fair Value Measurements*

The Company measures at fair value its cash equivalents and available-for-sale investments in accordance with SFAS No. 157 ("SFAS 157"), *Fair Value Measurements*. SFAS 157 specifies a valuation hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's own assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets;
- Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3 – Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to minimize the use of unobservable inputs and to use observable market data, if available, when estimating fair value. Other than cash and money market funds, the Company's only financial assets or liabilities required to be measured at fair value on a recurring basis at December 31, 2008, are fixed income available-for-sale securities. See Note 2 for a summary of the input levels used in determining the fair value of the Company's cash equivalents and short-term investments as of December 31, 2008.

*(k) Inventories*

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor, and manufacturing overhead. When required, provisions are made to reduce excess and obsolete inventories to their estimated net realizable value. Inventories consist of the following (in thousands):

	December 31,	
	2008	2007
Purchased materials	\$ 6,844	\$ 4,379
Work-in-process	89	360
Finished goods	9,580	9,273
	<u>\$ 16,513</u>	<u>\$ 14,012</u>

*(l) Impairment of Long-Lived Assets Including Goodwill*

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the asset's carrying value to the future undiscounted cash flows the asset is expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair value. For the three years ended December 31, 2008, the Company recognized no material impairments.

Costs in excess of the fair value of tangible and other identifiable intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill, which is tested for impairment using a two-step approach. The Company evaluates goodwill, at a minimum, on an annual basis during the first quarter and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. For purposes of this analysis, the Company considers itself as a single reporting unit. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any. To date, the Company has recorded no impairment of goodwill.

*(m) Software Development Costs*

For software to be sold, leased, or otherwise marketed, the Company capitalizes eligible computer software development costs upon the establishment of technological feasibility, which the Company has defined as completion of a working model. For the three years ended December 31, 2008, costs that were eligible for capitalization were insignificant and, thus, the Company has charged all software development costs to product development expense in the accompanying consolidated statements of operations.

*(n) Accrued Liabilities*

Accrued liabilities consisted of the following (in thousands):

	December 31,	
	2008	2007
Accrued payroll and related costs	\$ 2,666	\$ 3,006
Accrued taxes	70	37
Customer deposits	643	932
Warranty reserve	849	301
Other accrued liabilities	825	275
	<u>\$ 5,053</u>	<u>\$ 4,551</u>

*(o) Foreign Currency Translation*

The functional currency of the Company's subsidiaries is the local currency. Accordingly, all assets and liabilities are translated into U.S. dollars at the current exchange rate as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rate prevailing during the period. Gains and losses resulting from the translation of the financial statements are included in accumulated other comprehensive income (loss).

Remeasurement adjustments for non-functional currency monetary assets and liabilities, including short-term intercompany balances, are included in other income (expense) in the accompanying consolidated statements of operations. Currently, the Company does not employ a foreign currency hedge program utilizing foreign currency exchange contracts as the foreign currency transactions and risks to date have not been significant.

*(p) Concentrations of Credit Risk and Suppliers*

The Company's financial instruments consist of cash equivalents, short-term investments, accounts receivable, accounts payable, and lease financing obligations. The carrying value of the Company's financial instruments approximates fair value. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of investments, which are classified as either cash equivalents or short-term, and trade receivables. With respect to its investments, the Company has an investment policy that limits the amount of credit exposure to any one financial institution and restricts placement of the Company's investments to financial institutions independently evaluated as highly creditworthy. With respect to its trade receivables, the Company performs ongoing credit evaluations of each of its customers' financial condition. For a customer whose credit worthiness does not meet the Company's minimum criteria, the Company may require partial or full payment prior to shipment. Alternatively, prior to shipment, customers may be required to provide the Company with an irrevocable letter of credit or arrange for some other form of coverage to mitigate the risk of uncollectibility, such as a bank guarantee. Additionally, the Company establishes an allowance for doubtful accounts and sales return allowances based upon factors surrounding the credit risk of specific customers, historical trends, and other available information.

With the exception of amounts owed the Company on sales made to certain significant customers, concentrations of credit risk with respect to trade receivables are generally limited due to the Company's large number of customers and their dispersion across many different industries and geographies. For the years ended December 31, 2008 and 2007, the percentage of the Company's total accounts receivable balance that were due from the following significant customers is as follows (refer to Note 6 "Significant Customers" for a discussion of revenues generated from the Company's significant customers):

	December 31,	
	2008	2007
Duke Energy Corporation	21.9%	---%
Enel (and its contract manufacturers)	21.2%	9.0%
Limited Liability Company Engineering Center ENERGOAUDITCONTROL	6.7%	27.7%
ES Elektrosandberg AB	4.7%	12.0%
EBV	4.2%	1.7%
Telvent Energia Y Medio Ambiente	1.9%	35.7%
Total	<u>60.6%</u>	<u>86.1%</u>

For most of the Company's products requiring assembly, it relies on a limited number of contract electronic manufacturers, principally Jabil, Flextronics, and TYCO. The Company also maintains manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in the Company's NES system. The Neuron Chip, which is an important component that the Company and its customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Toshiba has informed the Company that it does not intend to renew its Neuron Chip agreement with Echelon when it expires in January 2010. Another semiconductor supplier, STMicroelectronics, manufactures the Company's power line smart transceiver products, for which the Company has no alternative source. In addition, the Company currently purchases several key products and components from sole or limited source suppliers with which it does not maintain signed agreements that would obligate them to supply to the Company on negotiated terms.

If any of the Company's key suppliers were to stop manufacturing the Company's products or cease supplying the Company with its key components, it could be expensive and time consuming to find a replacement. Also, as the Company's NES business grows, it will be required to expand its business with its key suppliers or find additional sources of supply. There is no guarantee that the Company would be able to find acceptable alternative or additional sources.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with the Company's product, assembly and test specifications could adversely affect the Company's revenues and gross profit, and could result in claims against the Company by its customers, which could harm the Company's results of operations and financial position.

*(q) Computation of Basic and Diluted Net Loss Per Share and Pro Forma Basic Net Loss Per Share*

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is calculated by adjusting the weighted average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations for the years ended December 31, 2008, 2007, and 2006 (in thousands, except per share amounts):

	Year Ended December 31,		
	2008	2007	2006
Net loss (Numerator):			
Net loss, basic and diluted	\$ (25,831)	\$ (15,672)	\$ (25,130)
Shares (Denominator):			
Weighted average shares used in basic computation	40,636	39,891	39,487
Weighted average shares used in diluted computation	40,636	39,891	39,487
Net loss per share:			
Basic	\$ (0.64)	\$ (0.39)	\$ (0.64)
Diluted	\$ (0.64)	\$ (0.39)	\$ (0.64)

For the years ended December 31, 2008, 2007, and 2006, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there are no potentially dilutive stock options due to the Company's net loss position. The number of stock options and performance shares excluded from these calculations in 2008, 2007, and 2006 were 6,860,098, 7,907,702, and 8,985,716, respectively.

*(r) Income Taxes*

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*. FIN 48 requires the Company to take a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon effective settlement. The Company re-evaluates its income tax positions on a quarterly basis to consider factors such as changes in facts or circumstances, changes in or interpretations of tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in recognition of a tax benefit or an additional charge to the tax provision. Upon adoption of FIN 48, the Company adopted an accounting policy to classify interest and penalties on unrecognized tax benefits as income tax expense. For years prior to the adoption of FIN 48, the Company also reported interest and penalties on unrecognized tax benefits as income tax expense.

*(s) Comprehensive Loss*

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments.

*(t) Recent Accounting Pronouncements*

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP FAS 142-3"). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used in determining the useful life of a recognized intangible asset under Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008, and early adoption is prohibited. The impact of FSP FAS 142-3 will depend upon the nature, terms, and size of the acquisitions the Company consummates after the effective date.

In February 2008, the FASB issued FSP FAS 157-2, *Effective date of SFAS No. 157* ("FSP FAS 157-2"). FSP FAS 157-2 delays the effective date for SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis to the fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company does not expect its adoption of SFAS 157 for nonfinancial assets and liabilities on January 1,

2009, will impact its consolidated results of operations or financial condition. In October 2008, the FASB issued FSP 157-3, *Determining Fair Value of a Financial Asset in a Market That Is Not Active* (“FSP 157-3”). FSP 157-3 clarifies the application of SFAS No. 157, *Fair Value Measurements*, in an inactive market. It demonstrates how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not impact the Company’s consolidated results of operations or financial condition.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (“SFAS 141R”). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Earlier application of SFAS 141R is prohibited. Accordingly, any business combinations the Company may engage in will be recorded and disclosed following existing GAAP until January 1, 2009. The impact of SFAS 141R will depend upon the nature, terms, and size of the acquisitions the Company consummates after the effective date.

## 2. CASH EQUIVALENTS AND INVESTMENTS

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company’s available-for-sale short-term investments, by major security type, were as follows (in thousands):

	December 31,					
	2008			2007		
	Amortized Cost	Aggregate Fair Value	Net Unrealized Holding Gains	Amortized Cost	Aggregate Fair Value	Net Unrealized Holding Gains
U.S. corporate securities:						
Commercial paper	\$ 14,964	\$ 14,965	\$ 1	\$ ---	\$ ---	\$ ---
Corporate notes and bonds	3,172	3,191	19	22,442	22,462	20
	18,136	18,156	20	22,442	22,462	20
Foreign corporate notes and bonds	5,502	5,502	---	515	517	2
U.S. government agency securities	25,933	25,989	56	8,141	8,149	8
Total investments in debt securities	\$ 49,571	\$ 49,647	\$ 76	\$ 31,098	\$ 31,128	\$ 30

As of December 31, 2008 and 2007, the Company’s available-for-sale securities had original contractual maturities of between three to twenty-four months, and from ten to twenty-four months, respectively. As of December 31, 2008 and 2007, the average remaining term to maturity for the Company’s available-for-sale securities was three and six months, respectively.

The following tables show gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2008 and 2007, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

	December 31, 2008					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Foreign corporate notes and bonds	517	(1)	---	---	517	(1)
Total	\$ 517	\$ (1)	\$ ---	\$ ---	\$ 517	\$ (1)

	December 31, 2007					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate notes and bonds	5,946	(14)	769	(1)	6,715	(15)
Total	\$ 5,946	\$ (14)	\$ 769	\$ (1)	\$ 6,715	\$ (15)

Market values were determined for each individual security in the investment portfolio. The decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. Investments are reviewed periodically to identify possible impairment. When evaluating the investments, the Company reviews factors such as length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, and the Company's ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value. For each of the three years ended December 31, 2008, gross realized gains and losses on the Company's investment portfolio were not material.

The fair value of cash equivalents and short-term investments was determined using the following inputs at December 31, 2008 (in thousands):

	Fair Value Measurements at Reporting Date Using			
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Total	(Level 1)	(Level 2)	(Level 3)
Money market funds	\$ 2,399	\$ 2,399	\$ --	\$ --
Fixed income available-for-sale securities	82,641	--	82,641	--
Total	\$ 85,040	\$ 2,399	\$ 82,641	\$ --

Fixed income available-for-sale securities are included in cash and cash equivalents and short-term investments in the Company's condensed consolidated balance sheet. Of the \$82.6 million of fixed income available-for-sale securities, approximately \$33.0 million are classified as cash equivalents, while the remaining \$49.6 million are classified as short-term investments. As discussed in Note 1, cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

### 3. PROPERTY AND EQUIPMENT

A summary of property and equipment, net as of December 31, 2008 and December 31, 2007 is as follows (in thousands):

	December 31, 2008	December 31, 2007
Buildings and improvements	\$ 37,356	\$ 40,850
Computer and other equipment	22,869	19,403
Software	4,674	4,511
Furniture and fixtures	2,792	2,666
Leasehold improvements	3,917	3,809
	71,608	71,239
Less: Accumulated depreciation and amortization	(31,034)	(40,463)
Property and equipment, net	\$ 40,574	\$ 30,776

Property and equipment are stated at cost. The cost of buildings and improvements for our leased San Jose, California headquarters facilities, for which we are the "deemed owner" for accounting purposes only, includes both the costs paid for directly by the Company and the costs paid for by the builder (lessor) from the period commencing with the start of construction through the lease commencement date for each building. These "building assets" are reflected as "Buildings and Improvements" in the schedule above. Building improvements paid for by the Company subsequent to the lease commencement date of each building are reflected as "Leasehold Improvements" in the schedule above.

Effective June 2008, the building leases were amended, resulting in an extension of the lease term for both buildings through March 2020. As a result of the lease extensions, the lease financing obligations for each building were increased based on the present value of the revised lease payments on the date of the extension, with a corresponding increase to the net carrying amount of the cost of the building assets (see further information below).

Depreciation is provided using the straight-line method as follows:

- Building assets and leasehold improvements are depreciated over the shorter of the remaining lease term or estimated useful lives (see further information below);
- Computer equipment and related software, other equipment, and furniture and fixtures are depreciated over their estimated useful lives of two to five years; and
- Certain telecommunications equipment is depreciated over its estimated useful life of 10 years.

#### *Accounting for buildings and improvements*

In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. In October 2000, the Company entered into a second lease agreement with the same real estate developer for an additional building at its headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. Both leases permit the Company to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated the Company's requirement to provide the landlord with security deposits totaling \$6.2 million, which the Company had previously satisfied by causing to have issued standby letters of credit ("LOCs"). As of June 30, 2008, the previously issued LOCs had been returned to the bank that issued them and were cancelled.

The Company has historically accounted for the two buildings at its San Jose, California headquarters site under EITF Issue No. 97-10 ("EITF 97-10"), *The Effect of Lessee Involvement in Asset Construction*, and SFAS No. 98 ("SFAS 98"), *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases – an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11*. EITF 97-10 applies to entities involved with the construction of an asset that will be leased when the construction project is completed. During construction, the Company paid for certain tenant improvements, including structural elements of the buildings, and, in accordance with EITF 97-10, is therefore the "deemed owner" for accounting purposes of the two buildings at its San Jose, California headquarters site. Accordingly, the Company recorded assets for the total costs of the buildings and improvements, including the costs paid by the lessor (the legal owner of the buildings), with corresponding liabilities for the costs paid by the lessor. Upon completion of construction of each building, the Company did not meet the sale-leaseback criteria in SFAS 98 for de-recognition of the building assets and liabilities. Therefore the leases are accounted for as financing obligations.

For the December 1999 and October 2000 lease agreements, the Company initially recorded lease financing obligations of \$12.0 million and \$15.2 million, respectively, which corresponded to the building asset costs paid for by the lessor. As a result of the lease extension in June 2008, the Company increased the carrying amount of its lease financing obligations by approximately \$12.5 million to approximately \$27.6 million (an amount equal to the present value of the revised lease payments at the date of the lease extension), with a corresponding increase to the net carrying amount of the building assets. In addition, all of accumulated depreciation on the building assets at the date of the lease extensions (approximately \$16.0 million) was eliminated with a corresponding decrease to the gross carrying amount of the building assets. As a result of the extension in lease terms, the Company also extended the estimated useful lives of the building assets and the leasehold improvements to equal the amended lease term.

For the years ended December 31, 2008, 2007, and 2006, the Company has recorded depreciation expense associated with the building assets of \$2.3 million, \$2.7 million, and \$2.7 million, respectively. As of December 31, 2008 and December 31, 2007, the net book value of the building assets was \$22.7 million and \$12.5 million, respectively.

Under the lease agreements, a portion of the total lease payments is accounted for as an operating lease of land and recorded as expense on a straight-line basis over the term of the lease. The remaining portions of the monthly lease payments are considered to be payments of principal and interest on the lease financing obligations. For the years ended December 31, 2008, 2007 and 2006, land lease expense was \$604,000, \$452,000, and \$452,000, respectively; principal reductions on the lease financing obligations were \$1.8 million, \$2.6 million and \$2.3 million, respectively; and interest expense was \$1.4 million, \$1.2 million, and \$1.4 million, respectively. See Note 8 for further information on commitments for future minimum lease payments associated with the lease financing obligations.

#### 4. STOCKHOLDERS' EQUITY AND EMPLOYEE STOCK OPTION PLANS

##### *(a) Preferred Stock*

As of December 31, 2008, the Company was authorized to issue 5,000,000 shares of new \$0.01 par value preferred stock, of which none was outstanding.

##### *(b) Common Stock*

As of December 31, 2008, the Company was authorized to issue 100,000,000 shares of \$0.01 par value common stock, of which 40,457,045 were outstanding.

In March and August 2004, March 2006, and February 2007, the Company's board of directors approved a stock repurchase program, which authorized the Company to repurchase up to 3.0 million shares of the Company's common stock. Since inception, the Company repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. The stock repurchase program expired in March 2008.

In April 2008, the Company's board of directors approved a new stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. Since inception, the Company has repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of December 31, 2008, 2,250,000 shares were available for repurchase. The new stock repurchase program will expire in April 2011.

##### *(c) Stock Option Programs*

The Company grants equity compensation awards under the 1997 Stock Plan (the "1997 Plan"). Prior to July 2008, the Company also issued options to certain members of its Board of Directors under the 1998 Director Option Plan (the "Director Option Plan"). A more detailed description of each plan can be found below.

Stock option and other equity compensation grants are designed to reward employees, officers, and directors for their long-term contribution to the Company, to align their interest with those of the Company's stockholders in creating stockholder value, and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants is based on competitive practices, operating results of the Company, and accounting regulations. Since the inception of the 1997 Plan, the Company has granted options to all of its employees.

Historically, the Company has issued new shares upon the exercise of stock options. However, treasury shares are also available for issuance, although the Company does not currently intend to use treasury shares for this purpose.

##### *1997 Stock Plan*

During 1997, the Company adopted the 1997 Stock Plan (the "1997 Plan") for employees, officers and directors, which was amended and restated in May 2004. As of December 31, 2008, a total of 15,110,662 shares of Common Stock were reserved for issuance under the 1997 Plan. This plan includes annual increases on the first day of the Company's fiscal year (beginning in 2000) not to exceed the lesser of (i) 5,000,000 shares or (ii) 4% of the outstanding shares on such date. Incentive stock options to purchase shares of common stock may be granted at not less than 100% of the fair market value. Options granted prior to June 15, 2000 and after May 5, 2003, generally have a term of five years from the date of grant. Options granted June 15, 2000 through May 5, 2003, generally have a term of ten years. The exercise price of stock options granted under the 1997 Plan is determined by the Board of Directors (or a Committee of the Board of Directors), but will be at least equal to 100% of the fair market value per share of common stock on the date of grant (or at least 110% of such fair market value for an incentive stock option granted to a stockholder with greater than 10% voting power of all our stock), except that up to 10% of the aggregate number of shares reserved for issuance under the 1997 Plan (including shares that have been issued or are issuable in connection with options exercised or granted under the 1997 Plan) may have exercise prices that are from 0% to 100% of the fair market value of the common stock on the date of grant. Options generally vest ratably over four years.

The 1997 Plan also allows for the issuance of stock purchase rights and options that are immediately exercisable through execution of a restricted stock purchase agreement. Shares purchased pursuant to a stock purchase agreement generally vest ratably over four years. In the event of termination of employment, the Company, at its discretion, may repurchase unvested shares at a price equal to the original issuance price. In addition, the 1997 Plan allows for the issuance of stock appreciation rights, performance shares and performance units. Stock appreciation rights ("SARs") are rights to receive, in cash or shares of our common stock, as designated on the grant date, the appreciation in fair market value of common stock between the exercise date and the date of grant. To date, the

Company has only issues SARs that can be settled in shares of the Company's common stock. SARs may be granted alone or in tandem with options. The exercise price of a SAR will be at least equal to 100% of the fair market value per share of common stock on the date of grant. SARs issued by the Company generally vest in equal, annual installments over four years, and expire on the fifth anniversary of the grant date. Performance units and performance shares are awards that result in a payment to a participant, generally in the form of an issuance of shares of the Company's common stock, at such time as specified performance goals or other vesting criteria are achieved or the awards otherwise vest. Performance shares issued by the Company generally vest in equal, annual installments over four years, although certain of these performance shares vest 100% after two years while others have additional financial-based performance requirements that must be met before vesting can occur. Performance shares with performance-based vesting conditions expire no later than the fourth anniversary of the grant date if the performance criteria have not been met.

#### *1998 Directors Option Plan*

Non-employee directors are entitled to participate in the 1998 Director Option Plan (the "Director Plan"). The Director Plan was adopted by the Board of Directors in May 1998 and became effective upon the closing of the initial public offering of the Company's stock in July 1998. The Director Plan expired in July 2008. Future grants made to members of our Board of Directors will be made from the 1997 Plan. Prior to its expiration, options granted under the Director Plan were generally fully vested on the date of grant and had exercise prices equal to the per share fair market value of the Company's common stock on the date of grant. During 2008, 2007, and 2006, options to purchase an aggregate of 75,000, 60,000 and 50,000 shares, respectively, were granted under the Director Plan. The weighted average exercise prices for the option grants in 2008, 2007, and 2006, were \$13.12, \$13.74, and \$7.99, respectively.

In the event of a merger of the Company with or into another corporation or the sale of substantially all of the assets of the Company, each option granted under the Director Plan shall be assumed or an equivalent option may be substituted by the successor corporation. Following such assumption or substitution, if the optionee's status as a director of the successor corporation terminates other than upon a voluntary resignation by the optionee, the option shall become fully exercisable, including as to shares as to which it would not otherwise be exercisable. If the outstanding options are not assumed or substituted, the options shall become fully vested and exercisable. Options granted must be exercised within three months of the end of the optionee's tenure as a director of the Company, or within twelve months after such director's termination by death or disability, but in no event later than the expiration of the option's five year term; provided, however, that shares subject to an option granted to a director who has served as a director with the Company for at least five years shall become fully vested and exercisable for the remainder of the option's five year term upon such director's termination. No option granted under the Director Plan is transferable by the optionee other than by will or the laws of descent and distribution, and each option is exercisable, during the lifetime of the optionee, only by such optionee.

#### *(d) Employee Stock Option Exchange Program*

On November 19, 2008, the Company announced a voluntary employee stock option exchange program (the "Exchange Program") whereby eligible employees were given an opportunity to exchange some or all of their outstanding stock options and SARs, collectively the "Surrendered Awards", for a predetermined number of new SARs. Under the Exchange Program, participating eligible employees would receive one new SAR for each Surrendered Award with an exercise price less than \$12.00 per share. For exchanged options with an exercise price equal to or greater than \$12.00 per share, participants would receive between 0.33 and 0.67 new SARs for each Surrendered Award exchanged, depending on the exercise price of the Surrendered Award. The Company's board of directors and Compensation Committee approved the Exchange Program to restore the retention and incentive benefits of the Company's equity awards. Non-employee members of the Company's board of directors were not eligible to participate in the Exchange Program.

On December 17, 2008, in accordance with the Exchange Program, the Company accepted and cancelled options and SARs to purchase 4,659,926 shares of its common stock. On the same day, the Company granted new SARs totaling 3,240,890 shares. The new SARs were granted at an exercise price of \$7.69, the closing price of the Company's stock on December 17, 2008. The new SARs granted under the Exchange Program have vesting schedules and maximum terms as follows:

<b>Percentage of Surrendered Award Vested as of December 17, 2008</b>	<b>Vesting Schedule of New SARs</b>	<b>Maximum Term of New SARs</b>
Fully vested	100% of the new SARs will be scheduled to vest on the first anniversary of the new grant date	two (2) years
75% vested	50% of the new SARs will be scheduled to vest on each of the first and second anniversaries of the new grant date	three (3) years
50% vested	33.33% of the new SARs will be scheduled to vest on each of the first three (3) anniversaries of the new grant date	four (4) years
25% or less vested	25% of the new SARs will be scheduled to vest on each of the first four (4) anniversaries of the new grant date	five (5) years

See Note 5 for a discussion of the accounting for the Exchange Program.

(e) *Stock Award Activity*

The following table summarizes stock award activity under all plans for the years ended December 31, 2008, 2007, and 2006:

	Shares Available for Grant	Options Outstanding	
		Number Outstanding	Weighted- Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2005	6,949,420	8,089,473	\$ 11.24
Options and stock appreciation rights granted	(852,734)	852,734	8.40
Performance shares granted	(387,909)	---	---
Options and stock appreciation rights cancelled	534,902	(534,902)	12.94
Performance shares cancelled	25,896	---	---
Options exercised	---	(124,625)	6.13
Additional shares reserved	1,692,020	---	---
BALANCE AT DECEMBER 31, 2006	7,961,595	8,282,680	\$ 10.91
Options and stock appreciation rights granted	(1,022,219)	1,022,219	24.72
Performance shares granted	(441,871)	---	---
Options and stock appreciation rights cancelled	323,070	(323,070)	12.35
Performance shares cancelled	42,183	---	---
Options exercised	---	(1,949,006)	9.44
Additional shares reserved	1,664,301	---	---
BALANCE AT DECEMBER 31, 2007	8,527,059	7,032,823	\$ 13.26
Options and stock appreciation rights granted	(4,297,547)	4,297,547	8.98
Performance shares granted	(777,732)	---	---
Options and stock appreciation rights cancelled	5,266,484	(5,266,484)	14.96
Performance shares cancelled	128,109	---	---
Options exercised	---	(405,561)	9.66
Unissued shares returned to plan	6,510	---	---
1998 Directors Plan shares expired	(855,000)	---	---
Additional shares reserved	1,729,454	---	---
BALANCE AT DECEMBER 31, 2008	9,727,337	5,658,325	\$ 8.69

The total intrinsic value of options exercised during the years ended December 31, 2008, 2007, and 2006 was approximately \$1.6 million, \$24.8 million, and \$261,000, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

The following table provides additional information regarding performance share activity for the years ended December 31, 2008, 2007, and 2006:

	Number Nonvested and Outstanding	Weighted- Average Grant Date Fair- Value
BALANCE AT DECEMBER 31, 2005	412,968	\$ 7.82
Performance shares granted	387,909	8.59
Performance shares vested and released	(71,945)	8.19
Performance shares forfeited	(25,896)	8.05
BALANCE AT DECEMBER 31, 2006	703,036	\$ 8.20
Performance shares granted	441,871	21.61
Performance shares vested and released	(227,845)	7.60
Performance shares forfeited	(42,183)	9.84
BALANCE AT DECEMBER 31, 2007	874,879	\$ 15.05
Performance shares granted	777,732	10.88
Performance shares vested and released	(322,729)	12.93
Performance shares forfeited	(128,109)	13.22
BALANCE AT DECEMBER 31, 2008	1,201,773	\$ 13.11

The fair value of each performance share grant was estimated on the date of grant by multiplying the number of shares granted times the fair market value of the Company's stock on the grant date. The total intrinsic value of performance shares vested and released during the years ended December 31, 2008, 2007, and 2006 was approximately \$3.9 million, \$3.5 million, and \$582,000, respectively. The intrinsic value is calculated by multiplying the fair market value of the Company's stock on the vesting date by the number of shares vested.

The following table provides additional information for significant ranges of outstanding and exercisable stock options and stock appreciation rights as of December 31, 2008:

Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
\$6.11	649,463	1.70	\$ 6.11	\$ 1,324,905
6.29-7.65	185,541	1.96	6.76	258,717
7.69	3,240,890	3.13	7.69	1,490,809
7.81-9.13	565,665	3.21	8.29	9,198
9.27-13.32	653,598	3.10	11.51	---
\$13.56-\$30.76	363,168	3.23	18.71	---
Outstanding	5,658,325	2.84	\$ 8.69	\$ 3,083,629
Vested and expected to vest	5,383,689	2.83	\$ 8.71	\$ 2,964,465
Exercisable	1,973,829	2.24	\$ 9.51	\$ 1,517,598

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$8.15 as of December 31, 2008, the last market trading day of 2008, which would have been received by the option holders had all option holders exercised their options as of that date.

## 5. STOCK-BASED COMPENSATION:

### (a) Valuation of Options, SARs, and Performance Shares Granted

The Company has elected to use the BSM option-pricing model to estimate the fair value of stock options and SARs that it grants. The BSM model incorporates various assumptions including volatility, expected term of the option from the date of grant to the time of exercise, risk-free interest rates, and dividend yields. Excluding SARs granted in December 2008 as part of the Exchange Program, which is discussed further below, the weighted average fair value of options and SARs granted during the years ended December 31, 2008, 2007, and 2006, was \$6.33, \$10.86, and \$3.49, respectively, and was determined using the following weighted average assumptions:

	Year Ended December 31,		
	2008	2007	2006
Expected dividend yield.....	0.0%	0.0%	0.0%
Risk-free interest rate.....	2.7%	4.1%	4.6%
Expected volatility .....	61.1%	54.6%	50.5%
Expected term (in years).....	4.1	3.6	3.6

The expected dividend yield reflects the fact that the Company has not paid any dividends in the past and does not currently intend to pay dividends in the foreseeable future. The risk-free interest rate assumption is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option. The expected volatility is based on both the historical volatility of the Company's common stock over the most recent period commensurate with the expected life of the option as well as on implied volatility calculated from the market traded options on the Company's stock. For options and SARs granted prior to January 1, 2008, the expected term has been calculated using the simplified method as permitted under SAB 107. Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. For options and SARs granted subsequent to December 31, 2007, the expected term has been calculated by applying a Monte Carlo simulation model that incorporates the Company's historical data on post-vest exercise activity and employee termination behavior.

The grant date fair value of performance shares granted to employees is determined by multiplying the fair market value of the Company's stock on the grant date times the number of performance shares awarded. During 2008, the Company issued a limited number of performance shares to a consultant. The fair value for these awards is determined at the earlier of the date at which a commitment for performance by the consultant to earn the performance shares is reached, or the date at which the consultant's performance necessary for the performance shares to vest has been completed.

### (b) Accounting for Employee Stock Option Exchange Program

As discussed in Note 4, the Company completed a stock option exchange program for eligible employees on December 17, 2008. Under SFAS 123R, the Exchange Program is considered a modification to the Surrendered Awards, which requires the calculation of incremental compensation cost. The incremental compensation cost is calculated by comparing the fair value of each newly issued SAR to the fair value of the corresponding Surrendered Award, each of which was calculated as of December 17, 2008 using the BSM option-pricing model. To the extent the fair value of the newly issued SARs exceeds the fair value of the Surrendered Awards, there is incremental compensation cost. The total incremental compensation cost resulting from the Exchange Program was \$2.3 million, and was calculated using the following weighted average assumptions.

	Surrendered Awards	Newly Issued SARs
Expected dividend yield.....	0.0%	0.0%
Risk-free interest rate.....	0.8%	1.0%
Expected volatility .....	77.1%	73.7%
Expected term (in years).....	2.5	2.9

The Company must also continue to amortize previously unrecognized compensation expense related to the original grant date fair value of the Surrendered Awards. The Company has elected to combine both the incremental value and the unamortized original grant date fair value of the Surrendered Awards, the total of which will be recognized as compensation expense over the vesting term of the new SARs.

(c) Expense Allocation

Compensation expense for all share-based payment awards, including those granted prior to January 1, 2006, has been recognized in accordance with SFAS 123R using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the years ended December 31, 2008, 2007, and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures have been estimated based on historical experience.

As of December 31, 2008, there were 186,581 nonvested performance shares outstanding (with a grant date fair value of \$1.9 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Cumulative compensation expense of \$631,000 through December 31, 2008 associated with 119,148 of these performance shares (with a grant date fair value of approximately \$1.0 million) has been recognized assuming that those financial performance requirements will be achieved. If such requirements are not met, no compensation cost is recognized and any recognized compensation cost will be reversed. No compensation expense has been recognized associated with the remaining 67,433 performance shares (with a grant date fair value of \$898,000) as management does not currently expect the financial performance requirements for these awards will be met.

As of December 31, 2008, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was \$25.0 million, which is expected to be recognized over the next 19 months on a weighted-average basis, and of which \$410,000 relates to awards subject to certain financial based performance requirements.

The following table summarizes the stock-based compensation expense related to employee stock options and share awards under SFAS 123R for the years ended December 31, 2008, 2007, and 2006, which was allocated as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Cost of sales – product.....	\$ 1,628	\$ 901	\$ 487
Cost of sales – service.....	209	87	55
Stock-based compensation expense included in cost of sales.....	1,837	988	542
Product development .....	6,032	2,849	2,147
Sales and marketing .....	2,986	1,683	1,334
General and administrative .....	3,603	2,279	1,437
Stock-based compensation expense included in operating expenses ..	12,621	6,811	4,918
Total stock-based compensation expense related to stock options and share awards.....	14,458	7,799	5,460
Tax benefit .....	--	--	--
Stock-based compensation expense related to stock options and share awards, net of tax .....	\$ 14,458	\$ 7,799	\$ 5,460

Of the \$14.5 million of compensation expense recorded for the year ended December 31, 2008, approximately \$4.3 million related to equity compensation awards granted during 2008, while the remaining \$10.2 million related to equity compensation awards granted on or before December 31, 2007. Of the \$7.8 million of compensation expense recorded for the year ended December 31, 2007, approximately \$3.3 million related to equity compensation awards granted during 2007, while the remaining \$4.5 million related to equity compensation awards granted on or before December 31, 2006. Of the \$5.5 million of compensation expense recorded for the year ended December 31, 2006, approximately \$941,000 related to equity compensation awards granted during 2006, while the remaining \$4.5 million related to equity compensation awards granted on or before December 31, 2005.

As of December 31, 2008, approximately \$146,000 and \$24,000 of stock-based compensation expense was capitalized as part of the cost of inventory and deferred cost of goods sold, respectively. As of December 31, 2007, approximately \$74,000 and \$37,000 of stock-based compensation expense was capitalized as part of the cost of inventory and deferred cost of goods sold, respectively. As of December 31, 2006, no stock-based compensation expense was capitalized as part of the cost of an asset.

## 6. SIGNIFICANT CUSTOMERS:

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three years ended

December 31, 2008, the Company had six customers that accounted for a majority of its revenues: EBV Elektronik GmbH (“EBV”), the Company’s primary distributor of its LONWORKS® Infrastructure products in Europe, Enel S.p.A. (“Enel”), an Italian utility company (including Enel’s third party meter manufacturers), Duke Energy Corporation (“Duke”), a US utility company that purchases NES products directly from the Company, and Telvent Energia y Medioambiente SA (“Telvent”), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (“EAC”), and ES Elektrosandberg AB (“ES”), European based value added resellers of the Company’s NES products. For the years ended December 31, 2008, 2007, and 2006, the percentages of the Company’s revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2008	2007	2006
EBV	15.3%	12.8%	27.1%
ES	14.9%	11.4%	0.1%
Duke	10.3%	---	---
Enel	9.1%	10.3%	12.4%
Telvent	8.9%	28.3%	---
EAC	8.3%	7.2%	---
Total	66.8%	70.0%	39.6%

Of the percentage of sales made to EBV, approximately 0.5% for the year ended December 31, 2008, related to sales of components we sold to EBV, which EBV in turn sold to one of Enel’s third party meter manufacturers. Elsewhere in these Consolidated Financial Statements, those sales are reported as Enel Project revenues. The Company’s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2009. Please refer to Note 11, Related Parties, for additional information regarding the Company’s agreements with Enel

## 7. GOODWILL:

The carrying amount of goodwill as of December 31, 2008, 2007, and 2006 relates to three acquisitions, including ARIGO Software GmbH (“ARIGO”) in 2001, BeAtHome in 2002, and MTC in 2003. The goodwill acquired as part of the ARIGO transaction is valued in Euros, and is therefore subject to foreign currency translation gains and losses. The changes in the carrying amount of goodwill, net for the years ended December 31, 2007 and 2008 are as follows (in thousands):

	<u>Amount</u>
Balance as of December 31, 2006	\$ 8,278
Unrealized foreign currency translation gain	270
Balance as of December 31, 2007	8,548
Unrealized foreign currency translation loss	(131)
Balance as of December 31, 2008	<u>\$ 8,417</u>

## 8. COMMITMENTS AND CONTINGENCIES:

### (a) Lease Commitments

As discussed in Note 3, the leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98. As of December 31, 2008, future minimum lease payments for these lease financing obligations were as follows (in thousands):

2009	\$ 3,097
2010	3,135
2011	3,174
2012	3,214
2013	3,254
2014 and thereafter	<u>22,124</u>
Total payments	\$ 37,998
Amount representing interest	<u>(11,209)</u>
Present value of future minimum lease payments	\$ 26,789
Lease financing obligations classified as current	\$ 1,439
Lease financing obligations classified as long-term	<u>\$ 25,350</u>

The Company also leases facilities under operating leases for its sales, marketing, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia including a land lease for accounting purposes associated with the Company's corporate headquarters facilities. These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, the Company also leases certain equipment and, for some of its sales personnel, automobiles. These operating leases are generally less than five years in duration.

As of December 31, 2008, future minimum lease payments under all operating leases, including \$8.7 million related to the land lease associated with the Company's corporate headquarters facilities (see Note 3), were as follows (in thousands):

2009	\$ 1,838
2010	1,646
2011	1,239
2012	995
2013	890
2014 and thereafter	<u>5,055</u>
Total	<u>\$ 11,663</u>

Rent expense for all operating leases was approximately \$1.9 million for 2008, \$1.7 million for 2007, and \$1.6 million for 2006. Although certain of the operating lease agreements provide for escalating rent payments over the term of the lease, rent expense under these agreements is recognized on a straight-line basis. As of December 31, 2008, the Company has accrued approximately \$447,000 of deferred rent related to these agreements, of which approximately \$37,000 is reflected in current liabilities while the remainder is reflected in other long-term liabilities in the accompanying consolidated balance sheet. As of December 31, 2007, the Company had accrued approximately \$467,000 of deferred rent related to these agreements, of which approximately \$99,000 is reflected in current liabilities while the remainder is reflected in other long-term liabilities. See Note 3 for explanation of land lease expense on the Company's corporate headquarters facilities.

*(b) Royalties*

The Company has certain royalty commitments associated with the shipment and licensing of certain of its products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded as a component of cost of product revenues in the Company's consolidated statements of income, was approximately \$513,000, \$573,000, and \$493,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

The Company will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of its products. The Company is currently unable to estimate the maximum amount of these future royalties. However, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

*(c) Guarantees*

In the normal course of business, the Company provides indemnifications of varying scope to its customers against claims of intellectual property infringement made by third parties arising from the use of its products. Historically, costs related to these indemnification provisions have not been significant. However, the Company is unable to estimate the maximum potential impact of these indemnification provisions on its future results of operations.

As permitted under Delaware law, the Company has entered into agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential

amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has directors and officers insurance coverage that would enable it to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

*(d) Taxes*

The Company conducts operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on the Company's operations in that particular location. While the Company strives to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with accounting principles generally accepted in the United States of America, the Company makes a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and the Company believes that, as of December 31, 2008, it has adequately provided for such contingencies. However, it is possible that the Company's results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where the Company conducts its operations.

*(e) Legal Actions*

From time to time, in the ordinary course of business, the Company is subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of December 31, 2008, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

*(f) Line of Credit*

The Company maintains a \$15.0 million line of credit with its primary bank. As of December 31, 2008, the Company's primary bank has issued, against the line of credit, a standby letter of credit totaling \$217,000. Other than causing to have issued standby letters of credit, the Company has never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

**9. INCOME TAXES:**

The provision for income taxes attributable to continuing operations is based upon income (loss) before income taxes from continuing operations as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Domestic	\$ (25,842)	\$ (15,802)	\$ (24,612)
Foreign	308	582	(168)
	<u>\$ (25,534)</u>	<u>\$ (15,220)</u>	<u>\$ (24,780)</u>

The Company accounts for income taxes in accordance with SFAS No. 109 ("SFAS 109"), *Accounting for Income Taxes*. SFAS 109 provides for an asset and liability approach under which deferred income taxes are based upon enacted tax laws and rates applicable to the periods in which the taxes become payable.

The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Federal:			
Current	\$ (136)	\$ ---	\$ ---
Deferred	---	---	---
Total federal provision	<u>(136)</u>	<u>---</u>	<u>---</u>
State:			
Current	5	10	10
Deferred	---	---	---
Total state provision	<u>5</u>	<u>10</u>	<u>10</u>
Foreign:			
Current	428	442	340
Deferred	---	---	---
Total foreign provision	<u>428</u>	<u>442</u>	<u>340</u>
Total provision for income taxes	<u>\$ 297</u>	<u>\$ 452</u>	<u>\$ 350</u>

The provision for income taxes differs from the amount estimated by applying the statutory Federal income tax rate to income before taxes as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Federal tax at statutory rate of 35%	\$ (8,937)	\$ (5,327)	\$ (8,673)
State taxes, net of federal benefit	5	10	10
U.S.-Foreign rate differential	155	239	399
Change in Valuation Allowance	9,766	5,346	8,134
Others	(692)	184	480
Total provision for income taxes	<u>\$ 297</u>	<u>\$ 452</u>	<u>\$ 350</u>

As of December 31, 2008 and 2007, a valuation allowance has been recorded for the entire gross deferred tax asset as a result of uncertainties regarding the realization of the asset balance. As of December 31, 2008 and 2007, the Company had no significant deferred tax liabilities. The components of the net deferred income tax asset are as follows (in thousands):

	December 31,	
	2008	2007
Net operating loss carry forwards	\$ 38,876	\$ 34,898
Tax credit carry forwards	15,231	13,250
Fixed and intangible assets	8,021	7,191
Capitalized research and development costs	32	56
Reserves and other cumulative temporary differences	<u>14,168</u>	<u>10,546</u>
Gross deferred income tax assets	76,328	65,941
Valuation allowance	<u>(76,328)</u>	<u>(65,941)</u>
Net deferred income tax assets	<u>\$ --</u>	<u>\$ --</u>

As of December 31, 2008, part of our valuation allowance on deferred tax assets pertains to certain tax credits and net operating loss carry forwards. In the future, we will reduce the valuation allowance associated with these credits and losses upon the earlier of the period in which we utilize them to reduce the amount of income tax we would otherwise be required to pay on our income tax returns, or when it becomes more likely than not that the deferred tax assets are realizable. If the valuation allowance associated with these credits and losses is realized, the tax benefit of certain of these credits and losses will be accounted for as a credit to stockholders' equity rather than as a reduction of income tax expense. In addition, the Internal Revenue Code of 1986, as amended,

contains provisions that limit the net operating loss and credit carryforwards available for use in any given period upon the occurrence of certain events, including a significant change in ownership interests. The Company performed an analysis of the ownership changes in 2001. Since that time, some ownership changes may have occurred, which could cause certain of the Company's net operating loss and credit carryforwards to be limited in future periods.

As of December 31, 2008, the Company had net operating loss carryforwards of \$132.3 million for federal income tax reporting purposes and \$48.2 million for state income tax reporting purposes, which expire at various dates through 2028. In addition, as of December 31, 2008, the Company had approximately \$8.6 million and \$9.7 million of tax credit carry forwards for increased research expenditures for federal and California purposes, respectively. The federal research tax credits will expire at various dates if not utilized by 2028 and the state tax credit can be carried over indefinitely. In accordance with current Internal Revenue Code rules, federal net operating loss carryforwards must be utilized in full before federal research and development tax credits can be used to offset current tax liabilities. As a result, depending on the Company's future taxable income in any given year, some or all of the federal increased research tax credits, as well as portions of the Company's federal and state net operating loss carryforwards, may expire before being utilized.

Amounts held by foreign subsidiaries are generally subject to United States income taxation on repatriation to the United States. The Company currently intends to permanently reinvest its undistributed earnings from its foreign subsidiaries outside the United States and United States income taxes have not been provided on cumulative total earnings of \$6.6 million. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

The Company adopted FIN 48 on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. FIN 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, and disclosure and transition.

The following is a rollforward of the Company's uncertain tax benefits for the years ended December 31, 2008 and 2007 (in thousands):

	Year Ended December 31,	
	2008	2007
Balance as of the beginning of the year	\$ 5,808	\$ 4,697
Tax positions related to current year:		
Additions	549	1,136
Reductions	---	---
Tax positions related to prior years:		
Additions	707	229
Reductions	(2,278)	(187)
Settlements	---	---
Lapses in statute of limitations	(124)	(67)
Balance as of the end of the year	<u>\$ 4,662</u>	<u>\$ 5,808</u>

Included in the balance of total unrecognized tax benefits at December 31, 2008 are potential benefits of \$1.0 million, which if recognized, would affect the effective rate on income from continuing operations.

Upon adoption, the Company had accrued interest and penalties related to the uncertain tax benefits of approximately \$293,000. In 2007, the Company decreased the prior year balance by \$13,000 and accrued \$47,000 of additional penalties and interest. In 2008, the Company decreased the prior year balance by \$59,000 and accrued \$42,000 of additional penalties and interest.

The Company is subject to taxation in the United States and various state and foreign jurisdictions. In the United States, the tax years from 1992 remain open to examination by federal and most state tax authorities due to certain net operating loss and credit carryforward positions. In the foreign jurisdictions, the number of tax years open to examination by local tax authorities ranges from three to six years.

## **10. WARRANTY RESERVES:**

When evaluating the reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are generally provided for when the associated revenue is recognized. In addition, additional warranty reserves may be established when the Company becomes aware of a specific warranty related problem, such as a product recall. Such additional warranty reserves are based on the Company's current estimate of the total out-of-pocket costs expected to be incurred to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. The reserve for warranty costs was \$849,000 as of December 31, 2008 and \$301,000 as of December 31, 2007.

## **11. RELATED PARTIES:**

During the years ended December 31, 2008, 2007, and 2006, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our Chairman and Chief Executive Officer, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby Echelon will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During 2008, we recognized a total of approximately \$258,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations.

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of the Company's board of directors. A representative of Enel is not presently serving on the Company's board.

At the same time as the Company entered into the stock purchase agreement with Enel, it also entered into a Research and Development and Technological Cooperation Agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers may purchase additional electronic components and finished goods from Echelon. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the years ended December 31, 2008, 2007, and 2006, the Company recognized revenues of approximately \$12.9 million, \$14.2 million, and \$7.1 million, respectively, related to products and services sold to Enel and its contract manufacturers. As of December 31, 2008, approximately \$5.0 million of the 2008 revenues were included in accounts receivable. As of December 31, 2007, approximately \$3.0 million of the 2007 revenues were included in accounts receivable.

**12. VALUATION AND QUALIFYING ACCOUNTS (in thousands):**

	<u>Balance at Beginning of Period</u>	<u>Charged/ (Credited) to Revenues and Expenses</u>	<u>Write-Off of Previously Provided Accounts</u>	<u>Balance at End of Period</u>
Year Ended December 31, 2008:				
Allowance for Doubtful Accounts	\$ 330	\$ (5)	\$ 2	\$ 323
Allowance for Customer Returns and Sales Credits	\$ 1,098	\$ 7,058	\$ 7,469	\$ 687
Year Ended December 31, 2007:				
Allowance for Doubtful Accounts	\$ 250	\$ 88	\$ 8	\$ 330
Allowance for Customer Returns and Sales Credits	\$ 791	\$ 6,531	\$ 6,224	\$ 1,098
Year Ended December 31, 2006:				
Allowance for Doubtful Accounts	\$ 300	\$ (23)	\$ 27	\$ 250
Allowance for Customer Returns and Sales Credits	\$ 1,211	\$ 5,673	\$ 6,093	\$ 791

**13. SEGMENT:**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports. SFAS 131 also requires disclosures about products and services, geographic areas, and major customers.

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All of the Company's products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer's application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa ("EMEA"); and Asia Pacific/ Japan ("APJ"). Each geographic area provides products and services to the Company's customers located in the respective region. The Company's long-lived assets include property and equipment, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of December 31, 2008 and 2007, long-lived assets of approximately \$47.5 million and \$37.7 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

The Company has three primary product lines: NES, LonWorks Infrastructure, and products and services sold to Enel. Summary revenue information by product line for the years ended December 31, 2008, 2007, and 2006 is as follows (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
NES	\$ 67,118	\$ 70,558	\$ 791
LonWorks Infrastructure	54,040	52,840	49,382
Enel	12,889	14,179	7,103
Total	<u>\$ 134,047</u>	<u>\$ 137,577</u>	<u>\$ 57,276</u>

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the customer is domiciled. Summary revenue information by geography for the years ended December 31, 2008, 2007 and 2006 is as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Americas	\$ 33,448	\$ 18,561	\$ 19,748
EMEA	88,312	99,164	29,991
APJ	12,287	19,852	7,537
Total	<u>\$ 134,047</u>	<u>\$ 137,577</u>	<u>\$ 57,276</u>

For information regarding the Company's major customers, please refer to Note 6, Significant Customers.

#### 14. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED):

The following tables set forth certain consolidated statement of operations data for each of the quarters in 2008 and 2007. This information has been derived from our quarterly unaudited consolidated financial statements. The quarterly unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements included in this report and include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of such information when read in conjunction with our annual audited consolidated financial statements and notes appearing in this report. The operating results for any quarter do not necessarily indicate the results for any subsequent period or for the entire fiscal year.

## Selected Quarterly Financial Data

### Consolidated Statement of Operations Data:

#### Revenues:

Product

\$ 36,065 \$ 28,875 \$ 31,466 \$ 34,667 \$ 46,158 \$ 23,733 \$ 26,437 \$ 39,077

Service

730 625 691 928 741 980 259 192

Total revenues

36,795 29,500 32,157 35,595 46,899 24,713 26,696 39,269

#### Cost of revenues:

Cost of product

22,986 15,715 18,751 22,532 27,066 14,004 15,331 28,634

Cost of service

607 592 675 713 650 722 505 483

Total cost of revenues

23,593 16,307 19,426 23,245 27,716 14,726 15,836 29,117

Gross profit

13,202 13,193 12,731 12,350 19,183 9,987 10,860 10,152

#### Operating expenses:

Product development

9,602 9,713 9,402 9,036 8,928 7,820 8,118 7,778

Sales and marketing

5,815 5,653 6,162 6,005 5,902 4,884 4,968 5,427

General and administrative

4,146 3,761 4,721 4,515 4,376 3,976 4,163 3,568

Total operating expenses

19,563 19,127 20,285 19,556 19,206 16,680 17,249 16,773

Loss from operations

(6,361) (5,934) (7,554) (7,206) (23) (6,693) (6,389) (6,621)

Interest and other income, net

606 1,141 519 659 1,351 1,381 1,488 1,497

Interest expense on lease financing obligations

(430) (435) (265) (274) (287) (297) (308) (319)

Income (loss) before provision for income taxes

(6,185) (5,228) (7,300) (6,821) 1,041 (5,609) (5,209) (5,443)

Income tax expense

67 136 74 20 129 108 107 108

Net income (loss)

\$ (6,252) \$ (5,364) \$ (7,374) \$ (6,841) \$ 912 \$ (5,717) \$ (5,316) \$ (5,551)

#### Income (loss) per share:

Basic

\$ (0.15) \$ (0.13) \$ (0.18) \$ (0.17) \$ 0.02 \$ (0.14) \$ (0.13) \$ (0.14)

Diluted

\$ (0.15) \$ (0.13) \$ (0.18) \$ (0.17) \$ 0.02 \$ (0.14) \$ (0.13) \$ (0.14)

#### Shares used in net income (loss) per share calculation:

Basic

40,433 40,554 40,774 40,788 40,690 40,121 39,508 39,227

Diluted

40,433 40,554 40,774 40,788 43,721 40,121 39,508 39,227

### Three Months Ended

Dec. 2008	Sep. 2008	June 2008	March 2008	Dec. 2007	Sep. 2007	June 2007	March 2007
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(in thousands, except per share data)



## EXHIBIT INDEX

Exhibit	
No.	Description of Document
3.2*	Amended and Restated Certificate of Incorporation of Registrant.
3.3*	Amended and Restated Bylaws of Registrant.
4.1*	Form of Registrant's Common Stock Certificate.
4.2*	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1*	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2*+	1997 Stock Plan and forms of related agreements.
10.2(a)*+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(e)*+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.3*+	1988 Stock Option Plan and forms of related agreements.
10.4*	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5*	Form of International Distributor Agreement.
10.6*	Form of OEM License Agreement.
10.7*	Form of Software License Agreement.
10.8*	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9*+	1998 Director Option Plan.
21.1*	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1*	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Previously filed.

+ Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.



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