POWER EFFICIENCY CORP
Form SB-2
April 25, 2007

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As filed with the Securities and Exchange Commission on April 25, 2007

Registration No. 333-[ ]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM SB-2
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

POWER EFFICIENCY CORPORATION
(Exact name of Company as specified in its charter)

DELAWARE	22-3337365
(State or other jurisdiction of incorporation of organization)	(I.R.S. Employer Identification Number)

POWER EFFICIENCY CORPORATION
3960 HOWARD HUGHES PARKWAY
SUITE 460
LAS VEGAS, NV 89169
(702) 697-0377
(Address, including zip code, and telephone number,
including area code, of Company s principal executive offices)

STEVEN Z. STRASSER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
POWER EFFICIENCY CORPORATION
3960 HOWARD HUGHES PARKWAY
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Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this Registration Statement.
If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, as amended (the Securities Act), other than securities offered only in

connection with dividend or interest reinvestment plans, check the following box. þ
If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o
If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o
If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o
If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered(1)	Proposed Maximum Offering Price Per Share	Proposed Maximum Aggregate Offering Price(2)	Amount of Registration Fee
Common Stock, par value $.001 per share	12,950,016	$0.23	$2,978,503.68	$91.44
Common Stock, par value $.001 per share (3)	6,475,008	$0.40 (4)	$2,590,003.20	$79.51
Common Stock, par value $.001 per share (3)	1,812,500	$0.40 (4)	$725,000.00	$22.26
Common Stock, par value $.001 per share (3)	972,223	$0.24 (4)	$233,333.52	$7.16
Common Stock, par value $.001 per share (3)	351,563	$0.32 (4)	$112,500.16	$3.45
Common Stock, par value $.001 per share (3)	24,000	$0.26 (4)	$5,760.00	$0.18
Common Stock, par value $.001 per share (3)	100,000	$0.30 (4)	$30,000.00	$0.92
Total	22,685,310		$6,675,100.56	$204.93

(1) Pursuant to Rule 416, there are also being registered such indeterminable additional securities as may be issued to prevent dilution as a result of stock splits, stock dividends or similar transactions.

(2) Estimated solely for the purpose

of computing the registration fee pursuant to Rule 457(c) under the Securities Act.

(3) Represents shares issuable upon conversion of obligations underlying a common stock purchase warrant issued to the selling stockholders.

(4) Represents the higher of: (i) the exercise or conversion price of the convertible security and (ii) the offering price of securities of the same class as the common stock underlying the convertible security calculated in accordance with Rule 457(c) under the Securities Act, for the purpose of calculating the registration fee pursuant to 457(g) under the Securities Act.

THE COMPANY HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE COMPANY SHALL FILE AN AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE SECURITIES AND EXCHANGE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

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The information in this prospectus is not complete and may be changed. Neither we nor the selling stockholders may sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and neither we nor the selling stockholders are soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS **SUBJECT TO COMPLETION, DATED APRIL 25, 2007**

POWER EFFICIENCY CORPORATION

22,685,310 SHARES OF COMMON STOCK

This prospectus relates to the public offering of up to 22,685,310 shares of our common stock, par value $0.001 per share, for sale by the selling stockholders, for their own account. These shares include up to 9,735,284 shares of common stock issuable upon the exercise of common stock purchase warrants issued to the selling stockholders. We will pay the expenses of registering these shares.

Our Common Stock is traded on the National Association of Securities Dealers Over The Counter Bulletin Board (the OTC Bulletin Board) under the symbol PEFF. On April 23, 2007, the closing bid price of our Common Stock as reported on the OTC Bulletin Board was $0.23.

To the extent they wish to sell shares of our common stock as provided for herein, the selling stockholders may offer and sell such shares on a continuous or delayed basis in the future. These sales may be conducted in the open market or in privately negotiated transactions and at market prices, fixed prices or negotiated prices. We will not receive any of the proceeds from the sale of the shares of common stock owned by the selling stockholders, but we will receive funds from the exercise of their warrants upon exercise. Any such proceeds will be used by us for working capital and general corporate purposes.

Our principal offices are located at 3960 Howard Hughes Parkway, Suite 460, Las Vegas, NV 89169 and our telephone number is (702) 697-0377.

This prospectus contains important information that you should know before investing. Please read it before you invest and keep it for future reference.

An investment in our securities involves a high degree of risk. You should read the Risk Factors section beginning on page 4 of this prospectus before you decide to purchase any securities.

THE SHARES OF COMMON STOCK OFFERED HEREBY INVOLVE A HIGH DEGREE OF RISK. IT IS LIKELY THAT THE COMMON STOCK WILL BE SUBJECT TO PENNY STOCK RULES, WHICH GENERALLY REQUIRE THAT A BROKER OR DEALER APPROVE A PERSON S ACCOUNT FOR TRANSACTIONS IN PENNY STOCK AND THE BROKER OR DEALER RECEIVE FROM THE INVESTOR A WRITTEN AGREEMENT TO THE TRANSACTIONS SETTING FORTH THE IDENTITY AND QUANTITY OF THE PENNY STOCKS TO BE PURCHASED BEFORE A TRADE INVOLVING A PENNY STOCK IS EXECUTED. SEE RISK FACTORS BEGINNING ON PAGE 4.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this Prospectus is April [ ], 2007

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You should rely only upon the information contained in this prospectus and the registration statement of which this prospectus is a part. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted.

You should assume the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date. This prospectus is based on information provided by us and other sources that we believe are reliable. We have summarized certain documents and other information in a manner we believe to be accurate, but we refer you to the actual documents for a more complete understanding of what we discuss in this prospectus. In making an investment decision, you must rely on your own examination of our business and the terms of the offering, including the merits and risks involved.

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PROSPECTUS SUMMARY

This section highlights selected information only and may not contain all of the information that may be important to you. Please read this entire prospectus before making your investment decision. This summary, including the summary financial information, is qualified in its entirety by the more detailed information appearing elsewhere in this prospectus. Throughout this prospectus, when we refer to Power Efficiency or when we speak of ourselves generally, we are referring to Power Efficiency Corporation unless the context indicates otherwise or as otherwise noted.

THE COMPANY

Our Business

Power Efficiency produces products that reduce energy costs in specific commercial applications, utilizing patented improvements upon motor controller technologies developed by National Aeronautics Space Administration (NASA) as well as technologies based solely on the Company s inventions. Our products are solid-state AC motor controllers that reduce the amount of power consumed by alternating current induction motors operating at constant speeds and under variable loads. Our products were previously marketed as the Performance Controller and the Power Genius, but have recently been re-branded as the EcoPro . The EcoPro reduces energy consumption on electrical equipment by electronically sensing and controlling the amount of energy the motor consumes on certain applications. The energy savings can range up to 35%, while the life of the motor is extended because of both the reduced motor operating temperatures and the reduced mechanical stress provided by its soft start technology. The efficiency of the EcoPro has been tested by Nevada Power Company, the Los Angeles Department of Water and Power and Medsker Electric, Inc., independent third parties, with positive results.

There are over one billion AC motors in operation in the U.S. alone. Customers for the EcoPro will typically be in a high electricity cost environment, may have local utility or governmental incentives to save energy, has energy usage as a significant operating cost, uses constant speed induction motors that are lightly or cyclically loaded, and has motors that run continuously or have frequent on/off cycles. This customer base represents a market which includes target sectors such as elevators, escalators, granulators, oil pump jacks, conveyors and other industrial applications.

We market our products directly under the brand name EcoPro , and through other companies under names such as Power Commander® and EcoStart . Customers include large elevator and escalator manufacturers, such as Otis Elevator Co. (a subsidiary of United Technologies, Inc.) and KONE Inc.

We are now focused on creating distribution channels to take advantage of opportunities given the current conditions in the energy market and how our product meets these needs. Management believes this multi-channel distribution strategy, if successful, will allow Power Efficiency to achieve sustainable revenue growth.

Highlights

Demonstrated Energy Savings Over 1,000 units have been installed at facilities throughout the U.S. The products have demonstrated the ability to reduce the energy consumption of AC induction motors, by up to 35% in appropriate applications.

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Patented Technology - Our products incorporate technology developed and patented by NASA. Our own patent encompasses a number of improvements on the NASA technology made by our engineers. We recently filed three provisional patents on additional technological advancements.

Extensive Engineering - Our products incorporate trade secret and engineering know-how, which we believe enables them to operate effectively over a broad range of conditions.

Large Potential Market - The United States consumes over $200 billion of electricity annually. A study for the United States Department of Energy estimates that motor driven systems consume 23% of all electricity in the U.S. and 64% of all the electricity used in the manufacturing sector. Based on our own in-house testing, our product can save up to 35% of the energy consumed by electric AC induction motors in appropriate applications. These applications include most motors that work at constant speed but are variably loaded, such as the AC motors found on many elevators, escalators, granulators, saw mills, stamping presses, and other manufacturing equipment.

New Products - We have developed and are in the process of certifying digital versions of our 30 and 80 amp products. We have also developed a prototype unit for small motors such as those found in residential and light commercial equipment and appliances.

Limited Competition - We are not aware of any products on the market today that have been certified by CE and CSA, are UL compliant, and offer the same energy-saving and soft start characteristics as our products.

International Distribution - International markets, such as those in Europe and Asia, often have higher prices for electricity than in the U.S. Therefore, we believe international markets provide a significant opportunity in the future.

A detailed description of our business strategy is provided under the heading Business below.

Selling Stockholders

The shares of Common Stock covered by this prospectus that are being offered by the selling stockholders consist of up to 21,930,620 shares issued or to be issued to the selling stockholders within 60 days of the date hereof. The full name, address and control persons of the selling stockholders are set forth beginning on page 32 of this prospectus.

Corporate Information

Our principal address is 3960 Howard Hughes Parkway, Suite 460, Las Vegas, NV 89169, and our telephone number is 702-697-0377. Our corporate website is www.powerefficiencycorp.com. The information on our website is not incorporated by reference in this prospectus.

The Offering

On November 30, 2006, January 19, 2007, March 2, 2007, March 7, 2007, March 30, 2007 and March 31, 2007 the Company issued and sold an aggregate of 12,950,016 shares of its common stock and 8,287,508 common stock purchase warrants to purchase its common stock, in a private offering (the Offering) for an aggregate of $4,235,000 in cash, cancellation of indebtedness and in lieu of compensation owed to certain employees, officers and directors of the Company. The per share purchase price of the Common Stock was $0.30. The warrants have a per share exercise price of $0.40, are exercisable immediately and

expire five years from the date of issuance. The $4,235,000 investment consisted of $400,000 from the cancellation of indebtedness, approximately $50,000 in lieu of compensation owed to certain employees, officers and directors of the Company, and approximately $3,785,000 in new cash.

On November 30, 2006, the Company entered into a financing transaction in which the Company issued $2,000,000 of its two year, senior, secured promissory notes (collectively the Notes , individually a Note). The Notes bear interest of 15% per annum. Interest due under the Notes is payable quarterly, with the principal and final quarterly interest payment becoming due November 30, 2008. The Notes have a first priority security interest in all of the assets of the Company. The Company also issued common stock purchase warrants to purchasers of the Notes as part of such transaction totaling 2,500,000. The $2,000,000 loan consisted of $550,000 from Steven Strasser, the Company s Chairman, Chief Executive Officer and the Company s largest beneficial shareholder, $200,000 from Commerce Energy Group, Inc, the Company s second largest shareholder prior to the Offering, and $1,250,000 from individual investors. $1,450,000 of these Notes came from the exchange of existing notes.

We have agreed, pursuant to a registration rights agreement, to register the shares of common stock sold in the Offering, as well as shares of Common Stock underlying all of the warrants, and are fulfilling our agreement by filing the registration statement of which this prospectus is a part with the Securities and Exchange Commission.

There was no placement agent for the Offering and no cash, shares of Common Stock or other securities of the Company were issued as compensation to any third party in connection with the Offering.

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RISK FACTORS

An investment in the Company s common stock involves a high degree of risk. You should carefully consider the risks below, together with the other information contained in this prospectus, before you decide to purchase the shares offered hereby. If any of the following risks occur, our business, results of operations and financial condition could be harmed, the trading price of our common stock could decline, and you could lose all or part of your investment. The risks and uncertainties described below are intended to be the material risks that are specific to us and to our industry. New risk factors emerge from time to time and it is not possible for us to predict all such risk factors, nor can we assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause future actual results to differ materially from those contained in any historical or forward-looking statements.

RISKS RELATED TO OUR BUSINESS

Unless We Achieve Profitability and Related Positive Cash Flow, We May Not Be Able To Continue Operations, And Our Auditors Have Questioned Our Ability To Continue As A Going Concern .

We have suffered recurring losses from operations, experienced approximately a $2,760,000 deficiency of cash from operations for the year ended December 31, 2006 and lack sufficient liquidity to continue our operations without external financing. For the years ended December 31, 2006 and December 31, 2005, we had net losses of $5,020,775 and $2,570,563, respectively. In our Auditor s Report dated March 31, 2007 on our December 31, 2006 financial statements included in this report, our auditors have stated that these factors raise substantial doubt about our ability to continue as a going concern . Our financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount of liabilities that might be necessary should we be unable to continue in existence.

Our continuation as a going concern is dependent upon achieving profitable operations and related positive cash flow and satisfying our immediate cash needs by external financing until we are profitable. Our plans to achieve profitability include developing new products, obtaining new customers and increasing sales to existing customers. We are seeking to raise additional capital through equity issuance, debt financing and other types of financing, but we cannot guarantee that sufficient capital will be raised. In that regard, we have granted the holders of our senior secured notes in the aggregate principal amount of $2,000,000 a first priority security interest in substantially all our assets, which may hinder our ability to raise additional funds.

We Have A Limited Operating History, Have Experienced Recurring Losses And Have Limited Revenue.

To date, and due principally to a lack of working capital, our operations have been limited in scale. Although we have an arrangement with an outsourced production facility to manufacture our products, have established relationships with suppliers, and have received contracts for our products, we may experience difficulties in production scale-up, product distribution, and obtaining and maintaining working capital until such time as our operations have been scaled-up to normal commercial levels. We have not had a profitable quarter in the past three years and we cannot guarantee we will ever operate profitably. In addition, we have limited revenue. For the year ended December 31, 2006, our total revenues were $188,811, and for the year ended December 31, 2005, our total revenues were $276,405.

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Our Present Cash Flow Is Not Adequate To Pay Accrued Liabilities.

We had accrued payables, salaries and expenses totaling approximately $585,000 as of December 31, 2006. Approximately $210,000 of these accrued liabilities represents disputed claims, which we expect to partially pay, settle for equity, or dispute entirely. The remainder of the accrued payables, salaries and expenses are primarily current trade payables and accruals. However, these figures are only estimates and because we may not be able to negotiate successfully with creditors, creditor claims may cause a restriction in the amount of funds available for our operations.

Our Principal Obligations On Notes Payable Total $2,011,111 and This Indebtedness Is Subject To Acceleration.

In addition to the accrued payables, salaries and expenses described immediately above, as of December 31, 2006, we had $2,011,111 in aggregate principal amount of notes payable outstanding. The specific components of this indebtedness are as follows:

We owe $2,000,000 in senior secured notes, before discount. They mature in November 2008, bear interest at 15%, and are secured by a first lien on substantially all our assets. Interest payments are due and payable quarterly. The entire balance of these notes will become due and payable if we cannot pay any past due amount within 7 days of a written notice that payment is in default. As of the date of this report, we do not have any past due payments on these senior secured notes.

As of December 31, 2006, we owe our former landlord in Livonia, Michigan $11,111, before discount, in settlement of our lease dispute litigation. As of the date of this report, we do not have any past due payments on this settlement.

We Do Not Have A Bank Line Of Credit And Substantially All Our Assets Are Pledged.

At the present time, we do not have a bank line of credit, which further restricts our financial flexibility and it is unlikely we will be able to obtain a line of credit in the foreseeable future. As noted above, substantially all our assets are subject to existing liens.

We Will Require Additional Funds To Meet Our Cash Operating Expenses And Achieve Our Current Business Strategy.

We continue to have limited working capital and will be dependent upon additional financing to meet capital needs and repay outstanding debt. We cannot guarantee additional financing will be available on acceptable terms, if at all. We also need additional financing to raise the capital required to fully implement our business plan. Our current fixed operating expense level is approximately $250,000 to $300,000 per month, not considering non-cash expenses and payments to certain creditors, including accrued salaries and expenses, and may increase in the near future. We will need to issue additional debt or equity to raise required funds, and as a result existing equity owners would be diluted. When our operations require additional financing, if we are unable to obtain it on reasonable terms, we would be forced to restructure, file for bankruptcy or cease operations, any of which could cause you to lose all or part of your investment in us.

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Our Management Group Owns Or Controls A Significant Number Of The Outstanding Shares Of Our Common Stock And Will Continue To Have Significant Ownership Of Our Voting Securities For The Foreseeable Future.

Prior to the issuance of shares pursuant to the Placement, our management owned 29% of our issued and outstanding shares of Common Stock and voting equivalents. After further investment by management in this offering, management owns approximately 21% of our issued and outstanding Common Stock and voting equivalents; and approximately 19% of our issued and outstanding Common Stock and voting equivalents, if all warrants issued in the offering were exercised. As a result, these persons will have the ability, acting as a group, to effectively control our affairs and business, including the election of directors and subject to certain limitations, approval or preclusion of fundamental corporate transactions. This concentration of ownership of our Common Stock may:

- delay or prevent a change in the control;
- impede a merger, consolidation, takeover, or other transaction involving the Company; or
- discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Company.

Certain Of Our Management Team Have Relationships Which May Potentially Result In Conflicts Of Interests.

Summit Energy Ventures, LLC (Summit) owns nineteen percent (19%) of our common stock and voting equivalents, which is included in the above number. Summit is controlled by Steven Strasser, our Chairman and CEO, and he has the right to vote all shares owned by Summit. The remaining equity in Summit is owned by BJ Lackland, our CFO. Accordingly, our executive officers may have a conflict of interest in determining whether to pursue a particular course of action that would be in the best interests of the shareholders or the Company, but may not be in the best interests of the other. These relationships are discussed in more detail under Certain Relationships And Related Party Transactions herein.

Our License From NASA Has Expired.

The basic technology upon which our products are based is derived from a patent license agreement by and between us and NASA, which expired on December 16, 2002. The license expired upon expiration of NASA s underlying patents, at which time anyone, including us, became free to use the underlying NASA technology. However, we have also made certain improvements to the basic technology covered by the NASA license and we have obtained a patent on this improved technology that runs through 2017. However, we cannot guarantee that others will not seek to improve the basic technology in a similar manner.

Our Business Depends Upon The Maintenance Of Our Proprietary Technology, And We Rely, In Part, On Contractual Provisions To Protect Our Trade Secrets And Proprietary Knowledge.

We depend upon our proprietary technology, relying principally upon trade secret and patent law to protect this technology. We also regularly enter into confidentiality agreements with key employees, customers, potential customers, and vendors and limits access to and distribution of trade secrets and other proprietary information. However, these measures may not be adequate to prevent misappropriation of our technology. Additionally, our competitors may independently develop technologies substantially equivalent or superior to our technology. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. We also are subject to the risk of adverse claims and litigation alleging infringement of intellectual property rights of others.

Confidentiality agreements to which we are party may be breached, and we may not have adequate remedies for any breach. Our trade secrets may also be known without breach of such agreements or may be independently developed by competitors. Our inability to maintain the proprietary nature of our technology and processes could allow our competitors to limit or eliminate any competitive advantages we may have.

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We Are Potentially Dependent On Third-Party Suppliers.

Although we believe most of the key components required for the production of our products are currently available in sufficient production quantities from multiple sources, they may not remain so readily available. It is possible that other components required in the future may necessitate custom fabrication in accordance with specifications developed or to be developed by us. Also, in the event that we, or our contract manufacturer, as applicable, are unable to develop or acquire components in a timely fashion, our ability to achieve production yields, revenues and net income can be expected to be adversely affected. Additionally, we are solely dependent on Cole Industries, Inc. (Cole) as our exclusive manufacturer. While we believe we would be successful in finding alternative manufacturers should this manufacturer not be available to manufacture our product, it could take substantial time and effort to locate such alternatives and, depending on the timing of the loss of Cole, could result in disruption in delivery schedules and harm to our clients and our reputation and future prospects.

We Are Developing And Commercializing New Energy Saving Technologies And Products Which Will Involve Uncertainty And Risks Related To Product Development And Market Acceptance.

Our success is dependent, to a large degree, upon our ability to fully develop and commercialize our technology and gain industry acceptance of our products based upon our technology and its perceived competitive advantages. Accordingly, our prospects must be considered in light of the risks, expenses and difficulties frequently encountered in connection with the establishment of a new business in a highly competitive industry, characterized by frequent new product introductions. We anticipate that we will incur substantial expense in connection with the development and testing of our proposed products and expect these expenses to result in continuing and significant losses until such time, if ever, that we are able to achieve adequate levels of sales or license revenues.

We Have Expanded Our Marketing Strategy.

Our products have been distributed primarily through Original Equipment Manufactures (OEMs). We have recently begun pursuing an expanded distribution strategy designed to reduce our reliance on OEMs. Pursuant to this strategy, we are increasing our direct sales and sales through independent representatives into new markets. Our future growth and profitability will depend upon the successful development of business relationships with additional OEMs, manufacturing representatives and distributors and their ability to penetrate the market with our products.

We Currently Depend On A Small Number Of Customers And Expect To Continue To Do So.

We currently do business with approximately 20 customers. Of this number, four customers accounted for approximately 75% of our gross revenues in 2006. We are, and may continue to be, dependent upon a small number of customers. Accordingly, the loss of one or more of these customers is likely to have a material adverse effect on our business.

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Most Of Our Current And Potential Competitors Have Greater Name Recognition, Financial, Technical And Marketing Resources, And More Extensive Customer Bases And Industry Relationships Than We Do, All Of Which Could Be Leveraged To Gain Market Share To Our Detriment, Particularly In An Environment Of Rapid Technological Change.

Although we believe we have limited competition for our specific technology, we compete against a number of companies for dollars in the electric motor energy savings market, many of which have longer operating histories, established markets and far greater financial, advertising, research and development, manufacturing, marketing, personnel and other resources than we currently have or may reasonably expect to have in the foreseeable future. This competition may have an adverse effect on our ability to expand our operations or operate profitably. The motor control industry is also highly competitive and characterized by rapid technological change. Our future performance will depend in large part upon our ability to become and remain competitive and to develop, manufacture and market acceptable products in these markets. Competitive pressures may necessitate price reductions, which can adversely affect revenues and profits. If we are not competitive in our ongoing research and development efforts, our products may become obsolete, or be priced above competitive levels. We cannot guarantee that competitors will not introduce comparable or technologically superior products, which are priced more favorably than our products.

Changes In Retail Energy Prices Could Affect Our Business.

We have found that a customer s decision to purchase the EcoPro (or similar product) is primarily driven by the payback on the investment resulting from the increased energy savings. Although management believes that current retail energy prices support an attractive return on investment for our products, the future retail price of electrical energy may not remain at such levels, and price fluctuations reducing energy expense could adversely affect product demand.

Loss Of Key Personnel Could Have Significant Adverse Consequences.

We currently depend on the services of Steve Strasser, and BJ Lackland, Chief Executive Officer, and Chief Financial Officer, respectively. The loss of the services of either of these persons could have an adverse effect on our business. As discussed under Management , we have entered into long-term employment contracts with Messrs. Strasser and Lackland, but such contracts do not guarantee they will remain with us.

We Do Not Have Key Man Life Insurance.

We presently do not have any key man life insurance policies. As soon as practicable following the commencement of profitable operations (which may never occur), we intend to purchase key man life insurance on the life of our principal executive officer, Steven Strasser. Upon purchase of such insurance, we intend to pay the premiums and be the sole beneficiary. The lack of such insurance may have a material adverse effect upon our business.

Delaware Law Limits The Liability Of Our Directors.

Pursuant to our Certificate of Incorporation, the Company s directors are not liable to us or our stockholders for monetary damages for breach of fiduciary duty, except for liability in connection with a breach of the duty of loyalty, for acts or omissions not in good faith or which involved intentional misconduct or a knowing violation of law for dividend payments or stock repurchases illegal under Delaware law or any transaction in which a director has derived an improper personal benefit.

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We Have Elected Not To Adopt Various Voluntary Corporate Governance Measures, And As A Result Stockholders May Have Limited Protections Against Interested Director Transactions, Conflicts Of Interest And Similar Matters.

Recent Federal legislation, including the Sarbanes-Oxley Act of 2002, has resulted in the adoption of various corporate governance measures designed to promote the integrity of corporate management and the securities markets. Because our securities are not yet listed on a national securities exchange or NASDAQ, we are not required to adopt these corporate governance measures and have not done so voluntarily in order to avoid incurring the additional costs associated with such measures. However, to the extent we seek to have our common stock listed on a national securities exchange or NASDAQ, such legislation will require us to make changes to our current corporate governance practices. Those changes may be costly and time-consuming. Furthermore, the absence of the governance measures referred to above with respect to our Company may leave our stockholders with more limited protection in connection with interested director transactions, conflicts of interest and similar matters.

Potential Product Liability Claims May Not Be Fully Covered By Insurance.

We may be subject to potential product liability claims that could, in the absence of sufficient insurance coverage, have a material adverse impact on us. Presently, we have general liability coverage that includes product liability up to $2,000,000. Any large product liability suits occurring early in our growth may significantly and adversely affect our ability to expand the market for our products.

RISKS RELATED TO OUR COMMON STOCK AND CAPITAL STRUCTURE

Trading In Our Common Stock Over The Last 12 Months Has Been Limited, So Investors May Not Be Able To Sell As Many Of Their Shares As They Want At Prevailing Prices.

Shares of our common stock are traded on the OTC Bulletin Board. Approximately 58,000 shares were traded on an average daily trading basis for the 12 months ended December 31, 2006. If limited trading in our common stock continues, it may be difficult for shareholders, to sell their shares. Also, the sale of a large block of our common stock could depress the market price to a greater degree than a company that typically has a higher volume of trading of its securities.

The Limited Public Trading Market May Cause Volatility In The Company s Stock Price.

Our common stock is currently traded on a limited basis on the OTC Bulletin Board under the symbol PEFF . The quotation of our common stock on the OTC Bulletin Board does not assure that a meaningful, consistent and liquid trading market currently exists, and in recent years such market has experienced extreme price and volume fluctuations that have particularly affected the market prices of many smaller companies like us. Our common stock is thus subject to this volatility. Sales of substantial amounts of our common stock, or the perception that such sales might occur, could adversely affect prevailing market prices of our common stock.

An Active And Visible Trading Market For Our Common Stock May Not Develop.

We cannot predict whether an active market for our common stock will develop in the future. In the absence of an active trading market:

Investors may have difficulty buying and selling or obtaining market quotations;

Market visibility for our common stock may be limited; and

A lack of visibility for our common stock may have a depressive effect on the market price for our common stock.

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The OTC Bulletin Board is an inter-dealer, over-the-counter market that provides significantly less liquidity than NASDAQ, and quotes for stocks included on the OTC Bulletin Board are not listed in the financial sections of newspapers, as are those for the NASDAQ Stock Market. The trading price of the common stock is expected to be subject to significant fluctuations in response to variations in quarterly operating results, changes in analysts earnings estimates, announcements of innovations by the Company or its competitors, general conditions in the industry in which we operate and other factors. These fluctuations, as well as general economic and market conditions, may have a material or adverse effect on the market price of our common stock.

Penny Stock Regulations May Impose Certain Restrictions On Marketability On The Company s Securities.

The SEC has adopted regulations which generally define a penny stock to be any equity security that has a market price of less than $5.00 per share or an exercise price of less than $5.00 per share, subject to certain exceptions. As a result, our common stock is subject to rules that impose additional requirements on broker-dealers who sell such securities to persons other than established customers and accredited investors (generally those with net worth in excess of $1,000,000 or annual income exceeding $200,000, or $300,000 together with their spouse). For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of such securities and have received the purchaser s written consent to the transaction prior to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to the transaction, of a risk disclosure document relating to the penny stock market. The broker-dealer must also disclose the commission payable to both the broker-dealer and the registered representative, current quotations for the securities and, if the broker-dealer is the sole market maker, the broker-dealer must disclose this fact and the broker-dealer s presumed control over the market. Finally, monthly statements must be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks. Consequently, the penny stock rules may restrict the ability of broker-dealers to sell the Company s securities and may affect the ability of investors to sell the Company s securities in the secondary market and the price at which such purchasers can sell any such securities.
Stockholders should be aware that, according to the Commission, the market for penny stocks has suffered in recent years from patterns of fraud and abuse. Such patterns include:

Control of the market for the security by one or a few broker-dealers that are often related to the promoter or issuer;

Manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases;

Boiler room practices involving high pressure sales tactics and unrealistic price projections by inexperienced sales persons;

Excessive and undisclosed bid-ask differentials and markups by selling broker-dealers; and

The wholesale dumping of the same securities by promoters and broker-dealers after prices have been manipulated to a desired level, along with the inevitable collapse of those prices with consequent investor losses.

The Company s management is aware of the abuses that have occurred historically in the penny stock market.

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We May Never Pay Cash Dividends On Our Common Stock.
We have not paid or declared any dividends on our Common Stock and do not anticipate paying or declaring any cash dividends on our Common Stock in the foreseeable future.
Sales Of Common Stock Under Rule 144 May Adversely Affect The Market Price Of Our Common Stock.
Possible Resales under Rule 144. Of the 38,516,676 shares of the Company s common stock outstanding on the date of this report, 14,292,962 shares are freely trading in the market place (the Free Trading Shares). The Free Trading Shares are comprised mostly of shares (1) originally issued in private offerings of common stock from June through August 2005, that were later registered in the Company s Registration Statement (the Registration Statement) effective December 19, 2005, and (2) shares originally issued in transactions exempt from registration under the Securities Act. The remaining 24,223,714 shares of our common stock outstanding are restricted securities as defined in Rule 144 and under certain circumstances may be resold without registration pursuant to Rule 144. These shares include the 7,970,569 shares held by Summit and Steven Strasser in the aggregate, 3,333,334 shares held by a private investor, and the 3,249,049 shares of common stock held by Commerce Energy Group (Commerce).
In addition, the Company had approximately 23,996,693 common stock purchase warrants outstanding and approximately 13,284,896 common stock options outstanding as of the date of this report, including the warrants issued in connection with the recent offering and sale of the senior secured notes registered hereunder. The shares issuable on exercise of the options and warrants may, under certain circumstances, be available for public sale in the open market under the Registration Statement or pursuant to Rule 144, subject to certain limitations.
In general, under Rule 144, a person (or persons whose shares are aggregated) who has satisfied a one-year holding period may, under certain circumstances, sell within any three-month period a number of securities which does not exceed the greater of 1% of the then outstanding shares of common stock or the average weekly trading volume of the class during the four calendar weeks prior to such sale. Rule 144 also permits, under certain circumstances, the sale of securities, without any limitation, by a person who is not an Affiliate, as such term is defined in Rule 144(a)(1), of the Company and who has satisfied a two-year holding period. Any substantial sale of the common stock pursuant to Rule 144 may have an adverse effect on the market price of the Company s shares.
Exercise Of Outstanding Options And Warrants Will Dilute Ownership Of Outstanding Shares.
We have reserved 20,000,000 shares of our common stock for issuance upon exercise of stock options or similar awards which may be granted pursuant to the 2000 Plan, of which options to purchase an aggregate of 13,284,896 shares are outstanding. The outstanding options under the 2000 Plan have a weighted average exercise price of $0.35. As of the date of this report, we have issued warrants exercisable for 23,996,693 shares of common stock to financial consultants, investors, former employees and other business partners, having a weighted average exercise price of $0.41 and expiring on various

dates from June 2007 to November 2011. Exercise of these options and warrants in the future will reduce the percentage of common stock held by the public stockholders. Furthermore, the terms on which we could obtain additional capital during the life of the options and warrants may be adversely affected, and it should be expected that the holders of the options and warrants would exercise them at a time when we would be able to obtain equity capital on terms more favorable than those provided for by such options and warrants.

Our Issuance Of Blank Check Preferred Stock Could Adversely Affect Our Common Stockholders.

The Company s Certificate of Incorporation authorizes the issuance of blank check preferred stock with such designations, rights and preferences as may be determined from time to time by the board of directors. Accordingly, our Board of Directors is empowered, without stockholder approval, to issue preferred stock with dividends, liquidation, conversion, voting or other rights that could adversely affect the relative voting power or other rights of the holders of our common stock. In the event of issuance, the preferred stock could be used as a method of discouraging, delaying or preventing a change in control of the Company, which could have the effect of discouraging bids for the Company and thereby prevent stockholders from receiving the maximum value for their shares. Although we have no present intention to issue any shares of our preferred stock, there can be no assurance that we will not do so in the future.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus, including the sections entitled Prospectus Summary, Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business, contains forward-looking statements. These statements relate to future events, our industry, our future financial performance, growth of our target market and related worldwide markets, future demand for our products, retail electrical energy demand and prices and similar expectations. These forward-looking statements provide our current expectations or forecasts of future events and are based on the estimates, projections, beliefs of our management, as well as assumptions made by and information currently available to our management. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. For this purpose, any statements that are not historical facts contained in this Memorandum are forward-looking statements. You can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, believes, estimates, predicts, potential, continues or the negative other comparable terminology. These risks and other factors include those listed under Risk Factors and elsewhere in this prospectus. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on any forward-looking statements as they reflect our management s view only as of the date of this prospectus. We will not update any forward-looking statements to reflect events or circumstances that occur after the date on which such statement is made.

This prospectus contains statistical data that we obtained from industry sources. These sources generally indicate that they have obtained their information from sources believed to be reliable, but do not guarantee the accuracy or completeness of the information. Although we believe that the industry sources are reliable, we have not independently verified their data.

We caution you not to place undue reliance on these forward-looking statements. Such forward-looking statements relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statements, whether as a result of new information, future

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events or otherwise, even if experience or future changes make it clear that any projected results or events expressed or implied therein will not be realized. You are advised, however, to consult any further disclosures we make in future public statements and press releases.

USE OF PROCEEDS

We will not receive any proceeds from the sale of shares of our Common Stock by the selling stockholders. However, we have received $2,929,997 in net proceeds from the Placement, and if all outstanding options and warrants in respect of which the offer and sale of shares of underlying Common Stock are being registered hereunder were exercised, we would receive approximately $3,700,000 in gross proceeds.

We have used the net proceeds from the Placement for working capital and general corporate purposes. We currently plan to use any proceeds received from the exercise of options and warrants for the same purposes.

We anticipate we will need at least $250,000 to $300,000 per month to continue our current operations, not including non-cash expenses and payments to certain creditors, including accrued salaries and expenses. As discussed in Risk Factors above, we will need to make payments toward accrued liabilities out of our cash flow for the foreseeable future. Overall, our satisfaction of our cash requirements depends on our ability to raise money from external financing sources and to generate future sales.

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PRICE RANGE OF COMMON STOCK

As quoted on the OTC Bulletin Board from January 1, 2004 though December 31, 2006, the following table sets forth the high and low bid prices for our Common Stock for the periods indicated.

	Common Stock Price	
	High	**Low**
Year Ended December 31, 2004		
First Quarter	$5.04	$0.90
Second Quarter	$1.50	$0.61
Third Quarter	$0.67	$0.28
Fourth Quarter	$1.00	$0.21
Year Ended December 31, 2005		
First Quarter	$0.56	$0.20
Second Quarter	$0.25	$0.19
Third Quarter	$0.50	$0.22
Fourth Quarter	$1.10	$0.25
Year Ended December 31, 2006		
First Quarter	$0.40	$0.20
Second Quarter	$0.43	$0.20
Third Quarter	$0.30	$0.18
Fourth Quarter	$0.40	$0.21

On April 23, 2007, the last day prior to the date of this prospectus for which information was practicably available, the closing price for our Common Stock was $0.23 per share. The prices reported for the periods set forth above reflect inter-dealer prices without retail markup, mark down or commission, and may not represent actual prices. As of April 23, 2007, our Common Stock was held by 175 stockholders of record. Through the Offering, which closed on March 31, 2007, we added 18 new stockholders.

DIVIDEND POLICY

We have never declared or paid cash dividends on our capital stock and have no present intention of paying cash dividends in the foreseeable future. Payment of future dividends, if any, will be at the discretion of our board of directors and will depend on our financial condition, results of operations, capital requirements and such other factors as the board of directors deems relevant. It is the intention and present policy of our board to retain all earnings to provide for our future growth.

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CAPITALIZATION

The following table illustrates our capitalization as of December 31, 2006.

	December 31, 2006 (Audited) Actual
Stockholders Equity	
Common Stock, $.001 par value; 100,000,000 shares authorized; 35,042,009 shares issued and outstanding;	$ 35,042
Preferred Stock, $.001 par value; 10,000,000 shares authorized; none issued or outstanding	
Additional Paid in Capital	24,927,839
Accumulated Deficit	(22,917,968)
Total Stockholders Equity	$ 2,044,913

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SELECTED FINANCIAL INFORMATION

The selected statements of operations and balance sheet data for the years ended December 31, 2005 and 2006 are derived from our audited financial statements, which are included elsewhere herein. The financial data presented below is only a summary and should be read in conjunction with the other financial information appearing elsewhere in this prospectus.

	Years ended December 31,	
	2005	**2006**
Statements of Operations:		
Revenues	$ 276,405	$ 188,811
Cost of Sales	245,789	136,240
Gross Profit	30,616	52,571
Costs and Expenses:		
Research and development	418,016	567,591
Selling, general and administrative	1,641,307	3,118,233
Depreciation and amortization	22,470	34,028
Total Costs and Expenses	2,081,793	3,719,852
Loss from Operations	(2,051,177)	(3,667,281)
Other income(expense):		
Interest income	13,847	9,243
Interest expense	(529,387)	(1,354,195)
Total Other Expense, Net	(515,540)	(1,344,952)
Loss before provision for taxes	(2,566,717)	(5,012,233)
Provision for taxes	(3,846)	(8,542)
Net loss	$ (2,570,563)	$ (5,020,775)
Basic loss per common share	$ (0.18)	$ (0.20)
Weighted average common shares outstanding	14,254,029	25,150,386

Balance Sheet Data:		
Cash	$ 1,009,120	$ 1,693,584
Working capital (deficit)	(610,689)	1,318,694
Total assets	3,378,629	4,038,030
Long-term liabilities	116,526	1,397,927
Total stockholders equity	1,315,423	2,044,913

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MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

The following discussion should be read in conjunction with our financial statements and the related notes included elsewhere in this prospectus. In addition to historical information, this discussion includes forward-looking information that involves risks and assumptions which could cause actual results to differ materially from management s expectations. See Special Note Regarding Forward-Looking Statements on page 12 of this prospectus.

OVERVIEW

The Company generates revenues from a single business segment: the design, development, marketing and sale of proprietary solid state electrical components designed to reduce energy consumption in alternating current induction motors.

The Company began generating revenues from sales of its patented *EcoPro* line of motor controllers in late 1995. As of December 31, 2006, the Company had total stockholders equity of $2,044,913. The Company raised money through the sale of 10,700,008 shares of common stock in a private stock offering that closed on November 30, 2006, 14,500,000 shares of common stock in a private stock offering in July and August of 2005, the Company s sale of 2,346,233 shares of Series A-1 Convertible Preferred stock to Summit Energy Ventures, LLC in June of 2002 and the conversion of notes payable of approximately $1,047,000 into 982,504 shares of Series A-1 Convertible Preferred stock in October of 2003. In addition, in August 2000, the Company purchased the assets of Percon, formerly the largest distributor of the Company s products. The transaction was accounted for as a purchase and the Company s Statements of Operations includes Percon s results of operations since the date of acquisition. The consolidation of the operations of both entities allowed the Company to integrate the administrative, sales, marketing and manufacturing operations of Percon. Percon had developed sales contacts with major OEM s in the elevator/escalator industry and transferred those agreements to the Company as part of the sale.

RESULTS OF OPERATIONS: FISCAL YEAR 2006 COMPARED TO FISCAL YEAR 2005

REVENUES

Revenues for the year ended December 31, 2006 were $188,811 compared to $276,405 for the year ended December 31, 2005, a decrease of $87,594, or 32%. This decrease is mainly attributable to changes in sales personnel and the resulting disruptions to sales efforts in 2006.

COST OF REVENUES

Cost of revenues for the year ended December 31, 2006 were $136,240 compared to $245,789 for the year ended December 31, 2005, a decrease of $109,549 or 45%. As a percentage of product revenues, total costs of product revenues decreased to approximately 72% for the year ended December 31, 2006 compared to approximately 89% for the year ended December 31, 2005. The decrease in the costs as a percentage of product revenues was primarily due to raising some unit prices mid-year in 2006 and the sale of higher margin units in 2006.

GROSS MARGIN

Gross margin for the year ended December 31, 2006 was $52,571 compared to $30,616 for the year ended December 31, 2005, an increase of $21,955 or 72%. This increase was primarily due to raising some unit prices mid-year in 2006 and the sale of higher margin units in 2006, as well as the Company utilizing a new turn-key manufacturer for production that required less oversight by Company personnel in 2006.

OPERATING EXPENSES

Research and Development Expenses

Research and development expenses were $567,591 for the year ended December 31, 2006 compared to $418,016 for the year ended December 31, 2005, an increase of $149,575 or 36%. This increase is mainly attributable to the Company s research and development efforts on its digital controller for both its single-phase and three-phase products and payment of higher salaries to personnel, particularly for the first half of 2006, due to significantly reduced salaries in the first six months of 2005. Research and development salaries decreased in the second half of 2006. Additionally, the Company recognized a non-cash charge of approximately $56,000 related to the adoption of SFAS 123R (See Note 2 to the financial statements) in 2006.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $3,118,233 for the year ended December 31, 2006, compared to $1,641,307 for the year ended December 31, 2005, an increase of $1,476,926 or 90%. The increase in selling, general and administrative expenses over the prior year was due primarily to an increase in payroll and payroll related costs, comprised of: non-cash expenses associated with the Company s adoption of SFAS 123R (See Note 2 to the financial statements) which resulted in a non-cash charge of approximately $1,019,000, the increase in the Company s workforce in connection with the Company s new sales and marketing plan, and higher salaries paid to personnel due talign="left">

PENSION PLAN TABLE

YEARS OF SERVICE

Highest Five Year Average Compensation (1)	15	20	25	30	35
100,000	18,512	24,682	30,853	37,023	43,194
150,000	30,137	40,182	50,228	60,273	70,319
200,000	41,762	55,682	69,603	83,523	97,444
250,000	44,087	58,782	73,478	88,173	102,869
300,000	44,087	58,782	73,478	88,173	102,869
350,000	44,087	58,782	73,478	88,173	102,869
400,000	44,087	58,782	73,478	88,173	102,869

(1) For 2005, the Internal Revenue Code limits the total compensation that may be taken into account in calculating benefits to $210,000.

The base salary and cash award amounts in the Summary Compensation Table on page 13 reflect the covered compensation under the plan for Messrs. Wears and Patton, each of whom was credited with 34 years of service under

the plan as of his retirement effective December 31, 2005. The estimated annual benefits payable upon retirement at normal retirement age under the traditional formula (and applicable minimum and supplemental benefit provisions) for Messrs. Wears and Patton would have been $178,508 and $168,725, respectively. In connection with their retirement, Messrs. Wears and Patton received lump

sump benefit payments of $1,346,076 and $1,567,924, respectively, pursuant to the plan s lump sum distribution option.

Under the cash balance formula, benefits are expressed in the form of a hypothetical account balance. Each year a participant s cash balance account is increased by (i) service credits based on the participant s covered compensation and compensation in excess of the Social Security taxable wage base for that year, and (ii) interest credits based on the participant s account balance as of the end of the prior year. Service credits accrue at a rate between 5 percent and 6.10 percent, based on the participant s age and date of participation. Pension benefits earned under the cash balance formula may be distributed as a lump sum or as an annuity. The estimated annual benefits payable upon retirement at normal retirement age under the cash balance formula (and applicable minimum and supplemental benefit provisions) for Messrs. Tryniski and Kingsley are $80,018 and $91,959, respectively. As described below, Mr. Belden is scheduled to retire on July 31, 2006. The estimated annual benefit payable to Mr. Belden upon retirement as of that date under the cash balance formula (and applicable minimum and supplemental benefit provisions) is $175,000.

In addition to benefits under the tax-qualified defined benefit pension plan, Messrs. Belden, Wears, Patton, Tryniski and Kingsley earned supplemental retirement benefits pursuant to individual nonqualified supplemental retirement plan agreements (described on pages 19-20 below).

Employment Agreements

Sanford A. Belden. The Company has an employment agreement with Mr. Belden that (as amended effective December 1, 2005 in furtherance of the Company s succession plan) provides for his employment as the Company s President and Chief Executive Officer until July 31, 2006. The agreement provides that during the period from March 1, 2004 through December 31, 2004, the Company shall pay Mr. Belden a base salary at the annual rate in effect on February 29, 2004, which was $522,648. Mr. Belden s base salary for calendar years after 2004 shall be increased at the same rate as the rate applied by the Company in its merit pool for salary increases to be paid for the applicable calendar year. The agreement may be terminated by the Board for cause at any time, and shall terminate upon Mr. Belden s death or disability. If Mr. Belden s employment is terminated by the Company prior to July 31, 2006 for reasons other than cause, death, or disability, Mr. Belden will be entitled to severance pay equal to the greater of (i) the sum of Mr. Belden s annual base salary at the time of the termination and the most recent payment to Mr. Belden under the Company s Management Incentive Plan, or (ii) amounts of base salary and expected Management Incentive Plan payments that otherwise would have been payable to Mr. Belden through the unexpired term of his employment (provided that in the event that Mr. Belden s involuntary termination without cause occurs under circumstances entitling him to the change in control benefits described in the following paragraph, the foregoing severance pay shall be reduced by the consulting fee payments to be made to Mr. Belden as described below). In addition, Mr. Belden will be permitted to dispose of any restricted stock previously granted to him, all of his stock options will become fully exercisable, and the Company will cover Mr. Belden and his eligible dependents under all benefit plans and programs available to its retired employees. Upon Mr. Belden s retirement on July 31, 2006, the Company will enter into a separate consulting agreement with him, pursuant to which the Company will retain him as a consultant for a period of 36 months at a compensation rate of $4,000 per month.

If Mr. Belden s employment is terminated for reasons other than cause, death, or disability within two years following a change of control, or if Mr. Belden voluntarily resigns during this period based upon an involuntary and material adverse change in his title, duties, responsibilities, working conditions, total

remuneration, or the geographic location of his assignment, the Company will retain him as a consultant for three years at an annual consulting fee equal to his base salary plus the award to Mr. Belden under the Management Incentive Plan for the year immediately preceding the change in control, will reimburse him for any loss incurred on the sale of his home, will permit him to dispose of any restricted stock previously granted to him, and all of his stock options will become fully exercisable. As an alternative to retaining Mr. Belden as a consultant for a three-year period following a change of control, the Board of Directors may elect, in its sole discretion, to pay all benefits due to Mr. Belden in a single lump sum payment within 90 days following the change of control and Mr. Belden s termination of employment. The agreement provides that the amount of any lump sum change in control payment made to Mr. Belden will be grossed up to hold Mr. Belden harmless from all income and excise tax liability attributable to the payment.

James A. Wears. The Company entered into a separation agreement with Mr. Wears effective as of his retirement on December 31, 2005. Mr. Wears s prior employment agreement with the Company had provided for his employment until December 31, 2007. In consideration of his voluntary early retirement in furtherance of the Company s succession plan, the Company agreed to pay Mr. Wears $611,265 in three installments in July 2006, January 2007 and January 2008, with interest at the rate of 4% on the unpaid amount. The Company also agreed to (a) amend the basic formula for Mr. Wears s supplemental retirement benefit to provide that Mr. Wears will be deemed to have retired on December 31, 2007 for purposes of determining supplemental retirement benefits; (b) grant Mr. Wears options that would have been granted to him in 2006 under the 2004 Incentive Plan as if he had been employed through February 2006; (c) treat Mr. Wears as having retired in good standing (and, as such, to treat all of his stock options as fully vested); and (d) transfer to Mr. Wears ownership of the Company-owned vehicle used by him.

Michael A. Patton. The Company entered into a separation agreement with Mr. Patton effective as of his retirement on December 31, 2005. Mr. Patton s prior employment agreement with the Company had provided for his employment until December 31, 2007. In consideration of his voluntary early retirement in furtherance of the Company s succession plan, the Company agreed to pay Mr. Patton a lump sum payment of $511,265. The Company also agreed to (a) amend the basic formula for Mr. Patton s supplemental retirement benefit to provide that Mr. Patton will be deemed to have retired on December 31, 2007 for purposes of determining supplemental retirement benefits; (b) grant Mr. Patton options that would have been granted to him in 2006 under the 2004 Incentive Plan as if he had been employed through February 2006; (c) treat Mr. Patton as having retired in good standing (and, as such, to treat all of his stock options as fully vested); and (d) transfer to Mr. Patton ownership of the Company-owned vehicle used by him.

Mark E. Tryniski. The Company has an employment agreement with Mr. Tryniski providing for his continued employment until December 31, 2008. The agreement provides that during the period from December 1, 2005 until the date on which he assumes the duties of President and Chief Executive Officer, the Company will pay Mr. Tryniski a base salary of $325,000. Upon Mr. Tryniski s assumption of the duties of President and Chief Executive Officer, the Company shall pay Mr. Tryniski a base salary at an annual rate of at least $400,000, with his base salary for calendar years after 2006 to be adjusted in accordance with the Company s regular payroll practices for executive employees. The agreement may be terminated by the Company for cause at any time, and shall terminate upon Mr. Tryniski s death or disability. The agreement provides for severance pay in the event of a termination for reasons other than cause, death, or disability, or if Mr. Tryniski is not appointed as President and Chief Executive Officer upon Mr. Belden s retirement, equal to the greater of (i) 200% of the sum of Mr. Tryniski s annual base salary at the time of termination and the most recent payment to him under the Company s Management Incentive Plan, or (ii) amounts of base salary and expected Management Incentive Plan payments payable to Mr. Tryniski through the unexpired term of his employment. In addition, if the agreement is not renewed at the end of its term (other than by reason of Mr. Tryniski s refusal to negotiate or rejection of a

bona fide offer from the Company), Mr. Tryniski is entitled to severance pay equal to 200% of the sum of his then current base salary plus the most recent payment to him under the Management Incentive Plan.

If Mr. Tryniski s employment is terminated for reasons other than cause, death, or disability within two years following a change of control or if Mr. Tryniski voluntarily resigns during this period based upon an involuntary and material adverse change in his title, duties, responsibilities, working conditions, total remuneration, or the geographic location of his assignment, the Company will retain him as a consultant for three years at an annual consulting fee equal to his then current base salary plus the award to Mr. Tryniski under the Management Incentive Plan for the year immediately preceding the change in control, will permit him to dispose of any restricted stock previously granted to him, and all of his stock options will become fully exercisable. As an alternative to paying change of control benefits to Mr. Tryniski over a three-year period, the Board of Directors may elect, in its sole discretion, to pay all benefits due to Mr. Tryniski in a single lump sum payment within 90 days following the change of control and Mr. Tryniski s termination of employment. In such event, the amount of the lump sum payment will be increased to hold Mr. Tryniski harmless from all income and excise tax liability attributable to the lump sum payment.

Scott A. Kingsley. The Company has an employment agreement with Mr. Kingsley providing for his continued employment until December 31, 2007. The agreement provides that during the period from December 31, 2004 to December 31, 2007, the Company shall pay Mr. Kingsley a base salary at an annual rate of at least $235,000, with his base salary for calendar years after 2004 to be adjusted in accordance with the Company s regular payroll practices for executive employees. The agreement may be terminated by the Company for cause at any time, and shall terminate upon Mr. Kingsley s death or disability. The agreement provides for severance pay, in the event of a termination for reasons other than cause, death, or disability, equal to the greater of (i) the sum of Mr. Kingsley s annual base salary at the time of termination and the most recent payment to him under the Company s Management Incentive Plan, or (ii) amounts of base salary and expected Management Incentive Plan payments payable to Mr. Kingsley through the unexpired term of his employment. In addition, if the agreement is not renewed at the end of its term (other than by reason of Mr. Kingsley s refusal to negotiate or rejection of a bona fide offer from the Company), Mr. Kingsley is entitled to severance pay equal to 175% of the sum of his then current base salary plus the most recent payment to him under the Management Incentive Plan.

If Mr. Kingsley s employment is terminated for reasons other than cause, death, or disability within two years following a change of control, or if Mr. Kingsley voluntarily resigns during this period based upon an involuntary and material adverse change in his title, duties, responsibilities, working conditions, total remuneration, or the geographic location of his assignment, the Company will retain him as a consultant for three years at an annual consulting fee equal to his then current base salary plus the award to Mr. Kingsley under the Management Incentive Plan for the year immediately preceding the change in control, will permit him to dispose of any restricted stock previously granted to him, and all of his stock options will become fully exercisable. As an alternative to paying change of control benefits to Mr. Kingsley over a three-year period, the Board of Directors may elect, in its sole discretion, to pay all benefits due to Mr. Kingsley in a single lump sum payment within 90 days following the change of control and Mr. Kingsley s termination of employment. In such event, the amount of the lump sum payment will be increased to hold Mr. Kingsley harmless from all income and excise tax liability attributable to the lump sum payment.

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Supplemental Retirement Plan Agreements

The Company has supplemental retirement plan agreements with Messrs. Belden, Wears, Patton, Tryniski, and Kingsley.

Sanford A. Belden. Under Mr. Belden s supplemental retirement plan agreement, the Company must provide Mr. Belden with an annual supplemental retirement benefit equal to the product of (i) 5% times Mr. Belden s number of years of service, considering only the first ten years of service, plus 2% times Mr. Belden s number of years of service in excess of ten years, times (ii) his final average salary and cash incentive payment. Unless Mr. Belden voluntarily terminates his employment prior to July 1, 2006, the amount of Mr. Belden s annual supplemental retirement benefits shall not be less than what would be calculated if he remained employed pursuant to his employment agreement through December 31, 2007 and received the base salary, including increases, and Management Incentive Plan payments (assuming a minimum incentive payment equal to 50% of base salary under the Company s Management Incentive Plan) contemplated by the employment agreement. The supplemental retirement benefit is reduced by the benefit payable under the Company s pension plan, 50% of Mr. Belden s Social Security benefit, and Company contributions on Mr. Belden s behalf and earnings attributable thereto under the Company s 401(k) Employee Stock Ownership Plan and Deferred Compensation Plan for Certain Executive Employees. The supplemental retirement benefit is payable upon the later of Mr. Belden s cessation of employment with the Company or his receipt of the final payment due under his employment agreement, generally in the form of an actuarially reduced joint and 100% survivor benefit. Benefits payable in another form are subject to the same actuarial adjustments as benefits under the Company s pension plan.

Notwithstanding the foregoing, if Mr. Belden s employment is terminated for reasons other than cause, death or disability within two years following a change of control, or if Mr. Belden voluntarily resigns during this period based upon an involuntary and material adverse change in his title, duties, responsibilities, working conditions, total remuneration, or the geographic location of his assignment, the Company must (for purposes of determining his supplemental retirement benefit described above) (i) credit Mr. Belden with additional years of service equal to the greater of three years of service or the years of service he is retained as a consultant under the terms of his employment agreement, (ii) credit Mr. Belden with two additional years of service, and (iii) determine Mr. Belden s final five year average compensation as described above by considering the years he is retained as a consultant under the terms of the employment agreement as service that precedes his termination and considering amounts paid to him during that period as salary and cash incentive payments. If the Board of Directors elects to pay Mr. Belden s change in control benefit under his employment agreement in a lump sum, the Company will pay his supplemental retirement benefit in an actuarial equivalent single lump sum payment within 90 days following the change of control and his termination of employment. The amount of any lump sum change in control payment made to Mr. Belden will be grossed up to hold Mr. Belden harmless from all income and excise tax liability attributable to the payment.

James A. Wears and Michael A. Patton. Under the supplemental retirement plan agreements for Messrs. Wears and Patton, the Company shall pay the employee an annual supplemental retirement benefit equal to the excess (if any) of (i) the annual benefit that the employee would have earned pursuant to the Company s pension plan if (a) 100% of the employee s annual compensation that is disregarded for pension plan purposes solely because of the limit imposed by Internal Revenue Code Section 401(a)(17) is added to the amount of the employee s annual compensation actually taken into account pursuant to the pension plan and (b) Internal Revenue Code Section 415 is disregarded, minus (ii) the annual benefit actually payable to the employee pursuant to the pension plan. The supplemental retirement benefit is payable upon the later of the employee s cessation of employment with the Company or his receipt of the final payment due under his employment agreement. The benefit is payable in the form of an actuarially

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reduced joint and 50% survivor benefit, provided that benefits payable in another form are subject to the same actuarial adjustments as benefits under the Company s pension plan. Pursuant to the separation agreements described on page 17, the supplemental retirement plan agreements for Messrs. Wears and Patton were amended to provide that the employee will be deemed to have retired on December 31, 2007 for purposes of calculating his supplemental retirement benefit.

Mark E. Tryniski and Scott A. Kingsley. Under the supplemental retirement plan agreements for Messrs. Tryniski and Kingsley, the Company shall pay the employee an annual supplemental retirement benefit equal to the excess (if any) of (i) the annual benefit that he would have earned pursuant to the Company s pension plan if (a) 100% of his annual compensation that is disregarded for pension plan purposes solely because of the limit imposed by Internal Revenue Code Section 401(a)(17) is added to the amount of his annual compensation actually taken into account pursuant to the pension plan and (b) Internal Revenue Code Section 415 is disregarded, minus (ii) the annual benefit actually payable to him pursuant to the pension plan. The supplemental retirement benefit is payable upon the later of the employee s cessation of employment with the Company, his receipt of the final payment due under his employment agreement, or his attainment of age 55. The benefit is payable in the form of an actuarially reduced joint and 50% survivor benefit, provided that benefits payable in another form are subject to the same actuarial adjustments as benefits under the Company s pension plan.

REPORT OF THE COMPENSATION COMMITTEE ON EXECUTIVE COMPENSATION

The Company has adopted a multi-faceted approach towards compensating all of its employees, including senior management. The underlying philosophy and description of major components of the total compensation program are described below.

Philosophy

The total compensation program is intended to align compensation with business objectives and enable the Company to attract and retain individuals who are contributing to the long-term success of the Company. Towards this end:

The Company pays competitively. The Company regularly compares its cash, equity and benefits based compensation practices with those of other companies of similar size, operating in similar geographic market areas, many of which are represented in the stock performance graph included on page 23, and establishes compensation parameters based on that review.

The Company encourages teamwork. The Company recognizes that its long-term success results from the coordinated efforts of employees working towards common, well established objectives. While individual accomplishments are encouraged and rewarded, the performance of the Company is a determining factor in total compensation opportunities.

The Company strives for fairness in the administration of pay. The Company strives to ensure that compensation levels accurately reflect the level of accountability that each individual has within the Company; employees are informed of the total compensation program; decisions made regarding individual performance which affect compensation matters are based upon an objective assessment of performance; and all employees have equal access to positions within the Company which provide for increased levels of total compensation.

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The process of assessing performance involves the following:

1. Prior to the beginning of each fiscal year, the Chief Executive Officer establishes and distributes written goals, which must be approved by the full Board. Those goals include specific financial targets relative to earnings and asset quality. The Company strives to achieve financial results which are in the upper third of the results published by its peer group.
2. Individuals at each successive level of management establish written goals, which must be approved by their respective managers.
3. All goals are reviewed on an ongoing basis to ensure that the Company is responding to changes in the marketplace and economic climate, and that accomplishment of retained goals is ensured.
4. At the end of the fiscal year, performance is evaluated against goals and other key position responsibilities. Such evaluations affect decisions on salary, cash incentive, and stock option matters.

Compensation Programs

The Company defines itself as a super-community bank which provides products of a more comprehensive and advanced nature than those offered by smaller institutions, while simultaneously providing a level of service which exceeds the service quality delivered by larger regional and money center organizations. The delivery of those products and services, in ways that enhance Shareholder value, requires that the Company attract key people, promote teamwork, and reward results. In furtherance of those requirements, the Company maintains the following compensation programs.

Cash-Based Compensation

Salary. The Company sets base salaries for employees by reviewing the total cash compensation opportunities for competitive positions in the market. In order to more closely align employee compensation to the Company s performance, the Company uses a combination of competitive base salaries and performance incentive opportunities to provide for total compensation that may exceed those in comparable companies which do not generate comparable financial results.

Management Incentive Plan. The Company maintains an annual incentive plan in which 31% of its employees participate. The Company s performance to targeted asset quality, growth in earnings per share, and CAMELS rating, which targets are approved by the Board, triggers the payment of cash awards for all employees in this group. Award levels, which amount to a percentage of salary, have been established for different organizational levels within the Company. For Mr. Belden, 100% of his award is determined by the Company s performance relative to the financial targets described above. For Messrs. Wears, Patton, Tryniski, and Kingsley, 80% of their respective award opportunities reflect the Company s performance relative to the financial targets, and 20% of their respective award opportunities reflect performance to other quantitative and qualitative goals specific to their areas of responsibility.

Equity-Based Compensation

Stock Option Program. The purpose of this program is to provide additional incentives to employees to work to maximize Shareholder value. The option program serves as an effective tool in recruiting key individuals and utilizes vesting periods to encourage these individuals to continue in the employ of the Company. The Board frequently awards options in years during which the Company has

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achieved its financial targets. The number of stock options issued generally reflects a percentage of salary; and various percentages have been established for different organizational levels within the Company.

Restricted Stock. The Company has, on occasion, issued limited amounts of restricted stock to individuals to support a variety of business objectives. Examples include: performance unit shares have been issued in start-up and turnaround assignments, with vesting schedules tied to specific performance criteria; and restricted shares have been issued to employees for extraordinary service in consummating acquisitions.

The Company believes that the use of equity-based compensation such as stock options and restricted stock is important in that it aligns the interests of key personnel with those of the Shareholders. In particular, when personnel receive equity-based compensation, their overall compensation is enhanced when the market price of the Company s common stock increases and is adversely affected when the market price of the Company s common stock decreases.

CEO Compensation

In December 2005, the full Board formally reviewed Mr. Belden s performance for fiscal year 2005, his twelfth full year as the Company s President and CEO. Having determined that the Company s level of performance relative to the majority of its previously approved annual and long-term financial targets had been surpassed, the Board, operating under the terms of the Management Incentive Plan disclosed in this Report, authorized the payment of Mr. Belden s cash award for 2005, which amounted to $269,817. Mr. Belden s $539,634 base salary level for 2005 is well supported by competitive wage survey data, and the increase over his 2004 base salary level is well supported by the Company s strategic accomplishments and financial performance during the 2004 evaluation period.

The foregoing report has been provided by Lee T. Hirschey (Chair), Brian R. Ace, David C. Patterson, and Peter A. Sabia, members of the Compensation Committee. The Board has determined that each of the Compensation Committee s members is independent as defined by the NYSE Rules. The Compensation Committee has adopted a written charter setting forth its composition and responsibilities, a copy of which is available at the Company s website at www.communitybankna.com and in print to any Shareholder who requests it.

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Stock Performance Graph

The following graph compares cumulative total shareholder returns on the Company s common stock over the last five fiscal years to the S&P SmallCap Commercial Banks Index, the Nasdaq Bank Index, the S&P 600 SmallCap Index (of which the Company became a member in 2004), and the Russell 2000 Index (of which the Company became a member in 2003). Total return values were calculated as of December 31 of each indicated year assuming a $100 investment on December 31, 2000 and reinvestment of dividends.

	2000	2001	2002	2003	2004	2005
Community Bank System, Inc.	100.00	110.09	136.59	220.11	260.84	214.97
S&P SmallCap Commercial Banks Index	100.00	114.50	122.60	164.29	199.33	181.53
Nasdaq Bank Index	100.00	112.68	120.50	160.29	182.16	178.65
S&P 600 SmallCap Index	100.00	106.54	90.96	126.23	154.83	166.75
Russell 2000 Index	100.00	102.63	81.63	120.22	142.36	148.94

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AUDIT COMMITTEE REPORT

In accordance with its written charter adopted by the Board of Directors, a copy of which is available at the Company s website at www.communitybankna.com and in print to any Shareholder who requests it, the Bank s Audit/Compliance/Risk Management Committee (which also serves as the Company s Audit Committee) assists the Board in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing, and financial reporting practices of the Company and the Bank. The Committee reviews internal and external audits of the Company and the Bank and the adequacy of the Company s and the Bank s accounting, financial, and compliance controls, and investigates and makes recommendations to the Board regarding the appointment of independent auditors.

The Audit/Compliance/Risk Management Committee is comprised of four directors, each of whom the Board has determined to be independent as defined by the Sarbanes-Oxley Act and the NYSE Rules. Committee members may not serve simultaneously on the audit committees of more than two other public companies without approval of the full Board. To date, no such approval has been granted. Each of the Audit/Compliance/Risk Management Committee members are financially literate as that qualification has been interpreted by the Board and the Board has determined that Charles E. Parente, who serves on the Audit/Compliance/Risk Management Committee, qualifies as an audit committee financial expert as defined in Item 401(h) of Regulation S-K promulgated by the Securities and Exchange Commission.

In discharging its oversight responsibility as to the audit process, the Audit/Compliance/Risk Management Committee obtained from the Company s independent auditors a formal written statement describing all relationships between the auditors and the Company that might bear on the auditors independence consistent with Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees, discussed with the auditors any relationships that may impact their objectivity and independence and satisfied itself as to the auditors independence. The Committee also discussed with management and the independent auditors the quality and adequacy of the Company s internal controls. The Committee reviewed with the independent auditors their audit plans, audit scope, and identification of audit risks.

The Committee discussed and reviewed with the independent auditors all communications required by generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, as amended, Communication with Audit Committees, and, with and without management present, discussed and reviewed the results of the independent auditors examination of the financial statements. The Committee also reviewed with management and the independent auditors the audited financial statements of the Company as of and for the fiscal year ended December 31, 2005.

Based on the above-mentioned reviews and discussions with management and the independent auditors, the Committee recommended to the Board of Directors that the Company s audited financial statements be included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2005, for filing with the Securities and Exchange Commission.

The foregoing report has been provided by William M. Dempsey (Chair), John M. Burgess, Lee T. Hirschey, and Charles E. Parente, members of the Audit/Compliance/Risk Management Committee.

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AUDIT FEES

The following table sets forth the aggregate fees billed to the Company by PricewaterhouseCoopers LLP for professional services rendered for the fiscal years ended December 31, 2005 and 2004.

	2005	2004
Audit Fees	$ 343,500	$ 325,000
Audit Related Fees [(1)]	12,000	49,417
Tax Fees [(2)]	145,275	274,525
All Other Fees [(3)]	7,334	0

(1) For both 2005 and 2004, includes fees incurred in connection with the audit of Community Investment Services, Inc. For 2004, also includes fees incurred in connection with Federal Home Loan Bank collateral verification and the audit of the Company s 401(k) and Pension Plans.

(2) Includes tax preparation and compliance fees of $90,250 and $98,350 for 2005 and 2004, respectively, and fees incurred in connection with tax consultation related to acquisitions, tax planning, and other matters of $55,025 and $176,175 for 2005 and 2004, respectively.

(3) Represents subscription fees to Comperio, a PricewaterhouseCoopers LLP trademarked product.

Pursuant to the Audit Committee Charter, the Company is required to obtain pre-approval by the Audit/Compliance/Risk Management Committee for all audit and permissible non-audit services obtained from its independent auditors to the extent required by applicable law. In accordance with this pre-approval policy, the Audit/Compliance/Risk Management Committee pre-approved 100% of the Audit Fees, 100% of the Audit Related Fees, 100% of the Tax Consulting Fees, and 100% of the All Other Fees for fiscal 2005 and fiscal 2004.

TRANSACTIONS WITH MANAGEMENT

Some of the directors and executive officers of the Company and the Bank (and the members of their immediate families and corporations, organizations, trusts, and estates with which these individuals are associated) are indebted to the Bank. However, all such loans were made in the ordinary course of business, do not involve more than the normal risk of collectibility or present other unfavorable features, and were made on substantially the same terms, including interest rate and collateral requirements, as those prevailing at the same time for comparable loan transactions with unaffiliated persons. No such loan is nonperforming at present. The Company expects that the Bank will continue to have banking transactions in the ordinary course of business with the Company s executive officers and directors and their associates on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with others.

Outside of these normal customer relationships, none of the directors or executive officers of the Company or the Bank and no 5% Shareholders of the Company (or members of the immediate families of any of the above or any corporations, organizations, or trusts with which such persons are associated) maintains any significant business or personal relationship with the Company or the Bank, other than as

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arises by virtue of his ownership interest in the Company or his position with the Company or the Bank. The law firm of Franklin & Gabriel, owned by Director Gabriel, provided legal services to the Bank s operations in its Finger Lakes Markets during 2005; the law firm of DiCerbo and Palumbo, of which Director DiCerbo is a partner, provided legal services to the Bank s operations in its Southern Region Markets during 2005; the law firm of Cantwell & Cantwell, owned by Director Cantwell, provided legal services to the Bank s operations in its Northern Region Markets during 2005; and Director Sally A. Steele, Esq. provided legal services to the Bank s operations in its Pennsylvania Markets during 2005. For services rendered during 2005 and for related out-of-pocket disbursements, DiCerbo and Palumbo received $259,391 from the Bank, Franklin and Gabriel received $62,133 from the Bank, and Cantwell & Cantwell received $49,832 from the Bank. The amount received by Director Steele for legal services rendered during 2005 and for related out-of-pocket disbursements did not exceed 5% of her firm s gross revenues.

Pursuant to the terms of its written charter, the Audit/Compliance/Risk Management Committee is responsible for reviewing and approving all related-party transactions involving the Company or the Bank. Consistent with this responsibility, the Committee has reviewed and approved the foregoing relationships as being consistent with the best interests of the Company and the Bank.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires the Company s directors, executive officers and holders of more than 10% of the Company s common stock (collectively, Reporting Persons) to file with the Securities and Exchange Commission initial reports of ownership and reports of changes in ownership of the common stock. Such persons are required by regulations of the Securities and Exchange Commission to furnish the Company with copies of all such filings. Based solely on its review of the copies of such filings received by it and written representations of Reporting Persons with respect to the fiscal year ended December 31, 2005, the Company believes that all Reporting Persons complied with all Section 16(a) filing requirements in the fiscal year ended December 31, 2005 except as follows: Timothy Baker, the Company s Director of Special Projects, filed one late report on Form 4 reflecting a single purchase transaction; Director DiCerbo filed three late reports on Form 4, each reflecting a single purchase transaction; and each of the following individuals filed one late report on Form 4 with respect to a single grant of stock options by the Company: Directors Ace, Cantwell, Parente and Steele, and Messrs. Belden, Patton and Wears.

SHAREHOLDER PROPOSALS

If Shareholder proposals are to be considered by the Company for inclusion in a proxy statement for a future meeting of the Company s Shareholders, such proposals must be submitted on a timely basis and must meet the requirements established by the Securities and Exchange Commission for Shareholder proposals. Shareholder proposals for the Company s 2007 Annual Meeting of Shareholders will not be deemed to be timely submitted unless they are received by the Company at its principal executive offices by December 14, 2006. Such Shareholder proposals, together with any supporting statements, should be directed to the Secretary of the Company. Shareholders submitting proposals are urged to submit their proposals by certified mail, return receipt requested.

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INDEPENDENT AUDITORS

PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm, were retained by the Company at the direction of the Board of Directors. The independent auditors have audited the financial statements of the Company for the fiscal year ended December 31, 2005 and performed such other nonaudit services as the Board requested.

A representative of PricewaterhouseCoopers LLP will be present at the Meeting. This representative will have the opportunity to make a statement, if he or she so desires, and will be available to respond to appropriate questions from Shareholders.

OTHER MATTERS

The Board of Directors of the Company is not aware of any other matters that may come before the Meeting. However, the Proxies may be voted with discretionary authority with respect to any other matters that may properly come before the Meeting.

Date: April 13, 2006

By Order of the Board of Directors

Donna J. Drengel
Secretary

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ANNUAL MEETING OF SHAREHOLDERS OF
COMMUNITY BANK SYSTEM, INC.
May 16, 2006

Please date, sign and mail
your proxy card in the
envelope provided as soon
as possible.

ê Please detach along perforated line and mail in the envelope provided. ê

THE BOARD OF DIRECTORS RECOMMEND A VOTE FOR THE ELECTION OF ALL NOMINEES.
E AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK

1. ELECTION OF DIRECTORS:

o **FOR ALL NOMINEES**

o **WITHHOLD AUTHORITY FOR ALL NOMINEES**

o **FOR ALL EXCEPT** (See instructions below)

NOMINEES:
¡ John M. Burgess
¡ David C. Patterson
¡ Sally A. Steele
¡ Mark E. Tryniski

In their discretion, such attorneys-in-fact and proxies are authorized to vote upon such other business as may properly come before the meeting.

This Proxy, when properly executed, will be voted in the manner directed herein by the undersigned.

IF NO DIRECTION IS GIVEN, THIS PROXY WILL BE VOTED FOR THE ELECTION OF ALL NOMINEES.

INSTRUCTION: To withhold authority to vote for any individual nominee(s), mark **FOR ALL EXCEPT** and fill in the circle next to each nominee you wish to withhold, as shown here: =

Please check here if you plan to attend the meeting. o

To change the address on your account, please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method. o

Signature of Shareholder Date: Signature of Shareholder Date:

Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.

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The Directors and Officers
of
COMMUNITY BANK SYSTEM, INC.
extend a cordial invitation for you to
join them for refreshments in the
Harbour Ballroom
WYNDHAM SYRACUSE HOTEL
East Syracuse, New York
at 12:00 Noon
immediately prior to the
ANNUAL MEETING OF SHAREHOLDERS
Tuesday, May 16, 2006

James A. Gabriel	Sanford A. Belden
Chairman	President & CEO

Wyndham Syracuse Hotel
6301 Route 298
East Syracuse, New York 13057
Phone 315-432-0200 Fax: 315-433-1210

0 n

PROXY

COMMUNITY BANK SYSTEM, INC.
5790 Widewaters Parkway
Dewitt, New York 13214-1883
THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS

The undersigned hereby appoints Charles M. Ertel and Donna J. Drengel, proxies, with power to act without the other and with power of substitution, and hereby authorizes them to represent and vote, as designated on the other side, all the shares of stock of Community Bank System, Inc. standing in the name of the undersigned with all powers which the undersigned would possess if present at the Annual Meeting of Shareholders of the Company to be held May 16, 2006 or any adjournment thereof.

(Continued, and to be marked, signed and dated on the reverse side)

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ANNUAL MEETING OF SHAREHOLDERS OF
COMMUNITY BANK SYSTEM, INC.
May 16, 2006

PROXY VOTING INSTRUCTIONS

MAIL Date, sign and mail your proxy card in the envelope provided as soon as possible.

- or -

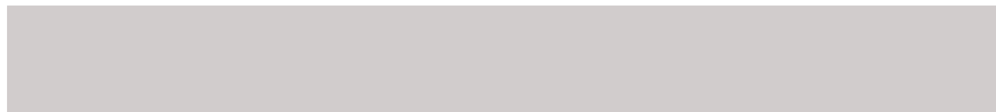
TELEPHONE Call toll-free **1-800-PROXIES** (1-800-776-9437) from any touch-tone telephone and follow the instructions. Have your proxy card available when you call.

- OR -

INTERNET Access **www.voteproxy.com** and follow the on-screen instructions. Have your proxy card available when you access the web page.

COMPANY NUMBER

ACCOUNT NUMBER



You may enter your voting instructions at 1-800-PROXIES or www.voteproxy.com up until 11:59 PM Eastern Time the day before the cut-off or meeting date.

â Please detach along perforated line and mail in the envelope provided IF you are not voting via telephone or the Internet. â

THE BOARD OF DIRECTORS RECOMMEND A VOTE FOR THE ELECTION OF ALL NOMINEES.
E AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK

1. **ELECTION OF DIRECTORS:**

o **FOR ALL NOMINEES**

NOMINEES:

¡ John M. Burgess

In their discretion, such attorneys-in-fact and proxies are authorized to vote upon such other business as may properly come before the meeting.

¡ David C. Patterson

o **WITHHOLD AUTHORITY** ¡

Sally A. Steele

FOR ALL NOMINEES ¡ Mark E. Tryniski

FOR ALL EXCEPT
o (See instructions below)

This Proxy, when properly executed, will be voted in the manner directed herein by the undersigned.

IF NO DIRECTION IS GIVEN, THIS PROXY WILL BE VOTED FOR THE ELECTION OF ALL NOMINEES.

INSTRUCTION: To withhold authority to vote for any individual nominee(s), mark **FOR ALL EXCEPT** and fill in the circle next to each nominee you wish to withhold, as shown here: =

Please check here if you plan to attend the meeting. o

To change the address on your account, please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method. o

Signature of Shareholder Date: Signature of Shareholder Date:

Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.