PROSPECT ENERGY CORP
Form N-2/A
June 29, 2006
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As filed with the Securities and Exchange Commission on June 28, 2006

Registration No. 333-132575

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT UNDER
THE SECURITIES ACT OF 1933
PRE-EFFECTIVE AMENDMENT NO. 1
POST-EFFECTIVE AMENDMENT NO.

PROSPECT ENERGY CORPORATION

(Exact Name of Registrant as Specified in Charter)

10 East 40th Street, 44th Floor
New York, NY 10016

(Address of Principal Executive Offices)

Registrant's Telephone Number, including Area Code: (212) 448-0702

John F. Barry III
M. Grier Eliasek
c/o Prospect Capital Management, LLC
10 East 40th Street, 44th Floor
New York, NY 10016
(212) 448-0702

(Name and Address of Agent for Service)

Copies of information to:
Leonard B. Mackey, Jr., Esq.
Clifford Chance US LLP
31 West 52nd Street
New York, NY 10019-6131
(212) 878-8000

Approximate Date of Proposed Public Offering: As soon as practicable after the effective date of this Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a distribution reinvestment plan, check the following box.

It is proposed that this filing will become effective (check appropriate box):

when declared effective pursuant to section 8(c).

If appropriate, check the following box:

This [post-effective] amendment designates a new effective date for a previously filed [post-effective amendment] [registration statement].

This form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act and the Securities Act registration statement number of the earlier effective registration statement for the same offering is .

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered[1][2]	Proposed Maximum Offering Price Per Unit	Proposed Maximum Aggregate Offering Price	Amount o Registration
Common Stock, $.001 par value per share[2]			300,000,000	
Preferred Stock[2]				
Warrants[3]				
Debt Securities[4]				
Total			$300,000,000[5]	$32,100.0

[1]Estimated pursuant to Rule 457 solely for the purpose of determining the registration fee. $107.00 of such amount was previously paid. The proposed maximum offering price per Security will be determined, from time to time, by the Registrant in connection with the sale by the Registrant of the securities registered under this registration statement.

[2]Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of common stock or preferred stock as may be sold, from time to time.

[3]Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of warrants as may be sold, from time to time, representing rights to purchase common stock, preferred stock or debt securities.

[4]Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of debt securities as may be sold, from time to time. If any debt securities are issued at an original issue discount, then the offering price shall be in suc greater principal amount as shall result in an aggregate price to investors not to exceed $[•].

[5]In no event will the aggregate offering price of all securities issued from time to time pursuant to this registration statemen exceed $300,000,000.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER 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 THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SECTION 8(a), MAY DETERMINE.

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The information in this prospectus is not complete and may be changed. We may not 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 it is not soliciting an offer to buy these securities in any state where the offer and sale is not permitted.

Subject to Completion
Preliminary Prospectus dated June , 2006

Prospectus dated [ ], 2006

$300,000,000

Prospectus Energy Corporation

Common Stock
Preferred Stock
Warrants
Debt Securities

We may offer, from time to time, in one or more offerings or series, together or separately, up to $300,000,000 of our common stock, preferred stock, debt securities or warrants representing rights to purchase shares of our common stock, preferred stock or debt securities, (collectively, the ''Securities'') to provide us with funds to repay outstanding debt and to acquire investments that we reasonably believe are in our acquisition pipeline. Securities may be offered at prices and on terms to be disclosed in one or more supplements to this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest in our Securities.

Our Securities may be offered directly to one or more purchasers, including existing stockholders in a rights offering, or through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will disclose any applicable purchase price, fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters or the basis upon which such amount may be calculated. See ''Plan of Distribution.'' We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of such Securities. Our common stock is traded on The NASDAQ National Market under the symbol ''PSEC.'' As of June 23, 2006, the last reported sales price for our common stock was $16.42.

Prospect Energy Corporation (''Prospect Energy'' or the ''Company'') is a financial services company that lends to and invests in middle market privately held or thinly traded public companies in the energy industry.

The Company, a Maryland corporation, has been organized as a closed-end investment company since April 13, 2004 and has filed an election to be treated as a business development company under the Investment Company Act of 1940, as amended (the ''1940 Act''), and is a non-diversified investment company within the meaning of the 1940 Act.

Prospect Capital Management, LLC manages our investments and Prospect Administration, LLC provides the administrative services necessary for us to operate.

Investing in our Securities involves a heightened risk of total loss of investment and is subject to risks. Before buying any Securities, you should read the discussion of the material risks of investing in our Securities in ''Risk Factors'' on page 12 of this prospectus. Please read this prospectus before you invest and keep it for future reference. The prospectus sets forth concisely the information about Prospect Energy that a prospective investor ought to know before investing and should be retained for future reference. The registration statement contains additional information about us and the Securities being registered by this prospectus. We file with or submit to the U.S. Securities and Exchange Commission, or the ‘‘SEC,’’ annual, quarterly and current periodic reports, proxy statements and other information meeting the informational requirements of the Securities Exchange Act of 1934, or the ‘‘Exchange Act.’’ This information and the information specifically regarding how we voted proxies, if any, relating to portfolio securities for the period ended June 30, 2005, are available free of charge by contacting us at 10 East 40th Street, 44th floor, New York, NY 10016 or by telephone at toll-free (888) 748-0702. You may inspect and copy these reports, proxy statements and other information, as well as the registration statement and related exhibits and schedules, at the Public Reference Room of the SEC at 100 F Street NE, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (202) 551-8090. The SEC maintains an Internet site that contains reports, proxy and information statements and other information filed electronically by us with the SEC which are available on the SEC's Internet site at http://www.sec.gov. Copies of these reports, proxy and information statements and other information may be obtained, after paying a duplicating fee, by electronic request at the following E-mail address: publicinfo@sec.gov, or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102.

Neither the SEC nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus may not be used to consummate sales of securities unless accompanied by a prospectus supplement.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the SEC, using the ‘‘shelf’’ registration process. Under the shelf registration process, we may offer, from time to time, up to $300,000,000 of our common stock, preferred stock, debt securities or warrants representing rights to purchase shares of our common stock, preferred stock or debt securities on the terms to be determined at the time of the offering. The Securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the Securities that we may offer. Each time we use this prospectus to offer Securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with any exhibits and the additional information described under the heading ‘‘Available Information’’ and the section under the heading ‘‘Risk Factors’’ before you make an investment decision.

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PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It does not contain all the information that may be important to an investor. For a more complete understanding of this offering, we encourage you to read this entire document and the documents to which we have referred.

Information contained or incorporated by reference in this prospectus may contain ‘‘forward–looking statements’’ within the meaning of the Private Securities Litigation Reform Act of 1995, which are statements about the future that may be identified by the use of forward–looking terminology such as ‘‘may,’’ ‘‘will,’’ ‘‘expect,’’ ‘‘intend,’’ ‘‘plans,’’ ‘‘anticipate,’ or ‘‘continue’’ or the negative thereof or other variations thereon or comparable terminology. The matters described in ‘‘Risk Factors’’ and certain other factors noted throughout this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward–looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward–looking statements. The Company reminds all investors that no forward-looking statement can be relied upon as an accurate or even mostly accurate forecast because humans cannot forecast the future.

The terms ‘‘we,’’ ‘‘us,’’ ‘‘our,’’ ‘‘Company’’ and ‘‘Prospect Energy’’ refer to Prospect Energy Corporation; ‘‘Prospect Capita Management’’ or the ‘‘Investment Adviser’’ refers to Prospect Capital Management, LLC; ‘‘Prospect Administration’’ or the ‘‘Administrator’’ refers to Prospect Administration, LLC. and ‘‘Prospect’’ refers to Prospect Capital Management, LLC, its affiliates and its predecessor companies.

The Company

Prospect Energy is a financial services company that lends to and invests in middle market privately held or thinly traded public companies in the energy industry.

We have been organized as a closed-end investment company since April 13, 2004 and have filed an election to be treated as a business development company under the 1940 Act, and we are a non-diversified company within the meaning of the 1940 Act.

The Investment Adviser

Prospect Capital Management, an affiliate of Prospect Energy, manages our investment activities. Prospect Capital Management is an investment adviser that has been registered under the Investment Advisers Act of 1940, or the ‘‘Advisers Act,’’ since March 31, 2004. Under an investment advisory agreement between the Company and Prospect Capital Management (the ‘‘Investment Advisory Agreement’’), we have agreed to pay Prospect Capital Management investment advisory fees, which will consist of an annual base management fee based on our gross assets (which include any amount borrowed, i.e.. total assets without deduction for any liabilities) as well as a two-part incentive fee based on our performance. Our headquarters are located at 10 East 40th Street, 44th Floor, New York, NY 10016, and our telephone number is (212) 448-0702.

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The Offering

We may offer, from time to time, in one or more offerings or series, together or separately, up to $300,000,000 of our Securities to provide us with funds to repay outstanding debt and to acquire investments that we reasonably believe are in our acquisition pipeline.

Our Securities may be offered directly to one or more purchasers, including existing stockholders in a rights offering, to new stockholders, via an optional cash purchase or designated offeree program, or through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will disclose the terms of the offering, including the name or names of any agents or underwriters involved in the sale of our Securities by us, the purchase price, and any fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters or the basis upon which such amount may be calculated. See ''Plan of Distribution.'' We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of our Securities.

Set forth below is additional information regarding the offering of our Securities:

Use of proceeds	Unless otherwise specified in a prospectus supplement, we intend to use the net proceeds from the sale of our Securities for general corporate purposes, which may include investments in securities, repayment of indebtedness, acquisitions and other general corporate purposes. Pending these uses, we will invest the net proceeds primarily in cash, cash equivalents, U.S. government securities and other high-quality debt investments that mature in one year or less from the date of investment. See ''Use of Proceeds.''
Distributions	We have paid quarterly dividends to the holders of our common stock and generally intend to continue to do so. The amount of the quarterly dividends is determined by our Board of Directors and is based on our estimate of our investment company taxable income and net short-term capital gains. See ''Price Range of Common Stock'' and ''Distributions.'' Certain additional amounts may be deemed as distributed to stockholders for income tax purposes. Other types of Securities will likely pay distributions in accordance with their terms.
Taxation	We have qualified and elected to be treated for federal income tax purposes as a regulated investment company, or ''RIC.'' As a RIC, we generally do not have to pay corporate-level federal income taxes on any ordinary income or capital gains that we distribute to our stockholders as dividends. To maintain our qualification as a RIC and obtain RIC tax treatment, we must maintain specified source-of-income and asset diversification requirements and distribute annually at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, out of assets legally available for distribution. See ''Distributions'' and ''Material U.S. federal income tax considerations.''

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Dividend reinvestment plan	We have a dividend reinvestment plan for our stockholders. This is an ‘‘opt out’’ dividend reinvestment plan. As a result, when we declare a dividend, the dividends to stockholders are automatically reinvested in additional shares of our common stock, unless stockholders specifically ‘‘opt out’’ of the dividend reinvestment plan so as to receive cash dividends. Stockholders who receive distributions in the form of stock are subject to the same federal, state and local tax consequences as stockholders who elect to receive their distributions in cash. See ‘‘Dividend reinvestment plan.’’
The NASDAQ National Market Symbol	PSEC
Anti-takeover provisions	Our charter and bylaws, as well as certain statutory and regulatory requirements, contain provisions that may have the effect of discouraging a third party from making an acquisition proposal for us. These anti-takeover provisions may inhibit a change in control in circumstances that could give the holders of our common stock the opportunity to realize a premium over the market price of our common stock. See ‘‘Description of our capital stock.’’
Management arrangements	Prospect Capital Management serves as our investment adviser. Prospect Administration serves as our administrator and has engaged Vastardis Fund Services, LLC (formerly, EOS Fund Services LLC, ‘‘Vastardis’’), as sub-administrator. For a description of Prospect Capital Management, Prospect Administration, Vastardis and our contractual arrangements with these companies, see ‘‘Management—Investment Advisory Agreement,’’ and ‘‘—Administration Agreement.’’
Risk factors	Investment in our Securities involves certain risks relating to our structure and investment objectives that should be considered by the prospective purchasers of the Securities. In addition, investment in our Securities involves certain risks relating to investing in the energy sector, including but not limited to risks associated with commodity pricing, regulation, production, demand, depletion and expiration, weather, and valuation. We have a limited operating history upon which you can evaluate our business. In addition, as a business development company, our portfolio includes securities primarily issued by privately held companies. These investments may involve a high degree of business and financial risk, and are generally less liquid than public securities. Also, our determinations of fair value of privately-held securities may differ materially from the values that would exist if there was a ready market for these investments. A large number of entities compete for the same kind of investment opportunities as we do. Moreover, our

business requires a substantial amount of

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	cash to operate and to grow, and we are dependent on external financing. In addition, the failure to qualify as a RIC eligible for pass-through tax treatment under Subchapter M of the Internal Revenue Code of 1986, or the ''Code,'' on income distributed to stockholders could have a materially adverse effect on the total return, if any, obtainable from an investment in our Securities. See ''Risk Factors'' beginning on page 12 and the other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in our Securities.
Plan of distribution	We may offer, from time to time, up to $300,000,000 of our common stock, preferred stock, debt securities or warrants representing rights to purchase shares of our common stock, preferred stock or debt securities, on terms to be determined at the time of the offering, which may include a rights offering or via an optional cash purchase or designated offeree program. Securities may be offered at prices and on terms described in one or more supplements to this prospectus directly to one or more purchasers, or through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated. We may not sell Securities pursuant to this prospectus without delivering a prospectus supplement describing the method and terms of the offering of such Securities. For more information, see ''Plan of Distribution.''

Fees and Expenses

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. The table is based on our net assets at March 31, 2006 and assumes that we have borrowed all $30 million available under our line of credit on that date. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by ''you,'' ''us'' or ''Prospect Energy,'' or that ''we'' will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Prospect Energy.

Stockholder transaction expenses:

Sales load (as a percentage of offering price)(1)	5.50%
Offering expenses borne by us (as a percentage of offering price)(2)	1.32%
Dividend reinvestment plan expenses(3)	None
Total stockholder transaction expenses (as a percentage of offering price)(4)	6.82%
Annual expenses (as a percentage of net assets attributable to common stock)*:	
Base management fee	2.60%(5)
Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)	2.04%(6)
Interest payments on borrowed funds.	2.58%(7)
Other expenses.	1.96%(8)
Total annual expenses (estimated)	9.18%(6)(8)(9)

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*Net assets attributable to our common stock equal net assets (i.e., total assets less liabilities other than liabilities for money borrowed for investment purposes) at March 31, 2006.

(1)In the event that the Securities to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.

(2)The related prospectus supplement will disclose the estimated amount of offering expenses, the offering price and the offering expenses borne by us as a percentage of the offering price.

(3)The expenses of the dividend reinvestment plan are included in ‘‘other expenses.’’

(4)The related prospectus supplement will disclose the offering price and the total stockholder transaction expenses as a percentage of the offering price.

(5)Our base management fee is 2.00% of our gross assets (which include any amount borrowed, i.e., total assets without deduction for any liabilities). Assuming that we borrowed $30 million, the 2.00% management fee of gross assets equals 2.60% net assets. See ‘‘Management—Investment Advisory Agreement’’ and footnote 6 below.

(6)We expect to invest all of the net proceeds from securities registered under the registration statement of which this prospectus is a part within three years or less of the date of the initial registration and may have capital gains and interest income that could result in the payment of an incentive fee to our Investment Adviser in the first year after completion of this offering. However, the incentive fee payable to our investment adviser is based on our performance and will not be paid unless we achieve certain goals. In the chart above, we have assumed a pre-incentive fee net investment income of 10.20% as a percentage of net assets. The incentive fee consists of two parts. The first part, the income incentive fee, which is payable quarterly in arrears, will equal 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly (7% annualized) hurdle rate, subject to a ‘‘catch up’’ provision measured as of the end of each calendar quarter. In April 2006, we paid an incentive fee of $531,489 (see calculation below). We expect the incentive fees we pay to increase to the extent we earn greater interest and dividend income through our investments in portfolio companies and, to a lesser extent, realize capital gains upon the sale of warrants or other equity investments in our portfolio companies. Our Investment Adviser has voluntarily agreed that, for each fiscal quarter after January 1, 2005, the quarterly hurdle rate will be equal to the greater of (a) 1.75% and (b) a percentage equal to (i) the sum of the daily average of the ‘‘quoted treasury rate’’ for each month in the immediately preceding two quarters plus (ii) 0.50%. Our Investment Adviser may terminate this voluntary agreement at any time upon 90 days' prior notice. The ‘‘catch-up’’ provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming an annualized hurdle rate of 7%). The catch-up provision is meant to provide our Investment Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized assuming an annualized hurdle rate of 7%). The income incentive fee will be computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate the income incentive fee is also included in the amount of our gross assets used to calculate the 2% base management fee (see footnote 5 above). The second part of the incentive fee, the capital gains incentive fee, will equal 20% of our realized capital gains, if any, computed net of all realized capital losses and unrealized capital depreciation.

Examples of how the incentive fee is calculated are as follows:

Assuming pre-incentive fee net investment income of 0.55%, there would be no income incentive fee because such income would not exceed the hurdle rate of 1.75%.

Assuming pre-incentive fee net investment income of 2.00%, the income incentive fee would be as follows:

= 100% × (2.00% − 1.75%)
= 0.25%

Assuming pre-incentive fee net investment income of 2.30%, the income incentive fee would be as follows:

= (100% × (‘‘catch-up’’: 2.1875% − 1.75%)) + (20% × (2.30% − 2.1875%))
= (100% × 0.4375%) + (20% × 0.1125%)= 0.4375% + 0.0225% = 0.46%

Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains incentive fee would be as follows:

= 20% × (6% − 1%)
= 20% × 5% = 1%

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The following is a calculation of the most recently paid Incentive fee of $531,489 in April 2006:

Prior Quarter Net Asset Value	$105,363,891
Quarterly Hurdle Rate	1.7500%**
Current Quarter Hurdle	$ 1,843,868
125% of the Quarterly Hurdle Rate	2.1875%
125% of the Current Quarter Hurdle	$ 2,304,835
Current Quarter Pre Incentive Fee Net Investment Income	$ 2,657,446
Incentive Fee – ‘‘Catch-Up’’	$ 460,967
Incentive Fee – 20% in excess of 125% of the Current Quarter Hurdle	$ 70,522
Total Current Quarter Incentive Fee	$ 531,489

**Please note that the quoted treasury rate plus 0.50% was 1.5575%, therefore the quarterly hurdle rate of 1.75% was used.

For a more detailed discussion of the calculation of the two-part incentive fee, see ‘‘Management—Investment Advisory Agreement.’’

(7)

Although we may incur indebtedness before the proceeds of an offering are substantially invested, we have not yet decided to what extent we will finance investments using debt. We currently have $30 million available to us under a credit facility. For more information, see ‘‘Risk Factors—Changes in interest rates may affect our cost of capital and net investment income’’ and ‘‘Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources, Capital Raising Activities.’’ The table above assumes that we have borrowed all $30 million available under our line of credit. The table below shows our estimated annual expenses as a percentage of net assets attributable to common stock, assuming that we did not incur any indebtedness.

Base management fee	2.03%
Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)	2.04%
Interest payments on borrowed funds	None
Other expenses	1.96%
Total annual expenses (estimated)	6.03%

(8) ‘‘Other expenses’’ is based on an estimate of expenses during the current fiscal year representing all of our estimated recurring operating expenses (except fees and expenses reported in other items of this table) that are deducted from our operating income and reflected as expenses in our Statement of Operations. The estimate of our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations under the administration agreement. ‘‘Other expenses’’ does not include non-recurring expenses. See ‘‘Management—Administration Agreement.’’

(9) Total annual expenses as a percentage of net assets attributable to our common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The total annual expenses percentage is required by the SEC to be calculated as a percentage of net assets, rather than the total assets including assets that have been funded with borrowed monies. If the total annual expense percentage were calculated as a percentage of total assets, our total annual expenses would be 7.06% of total assets.

Example

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed we would have no leverage and that our annual operating expenses would remain at the levels set forth in the table above.

	1 year	3 years	5 years	10 years
You would pay the following expenses on a $1,000 investment, assuming a 5% annual return	$ 94	$ 270	$ 431	$ 775

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. The income incentive fee under the Investment Advisory Agreement would be zero at the 5% annual return assumption, as required by the SEC for this table, since no incentive fee is paid until the annual return exceeds 7%; however, the income incentive fee currently being earned is nevertheless used to aggregate total expenses in the

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example as if the annual return were at the level recently achieved, which is higher than 5%, in accordance with SEC requirements. Accordingly, the resulting calculations overstate expenses at the 5% annual return as these calculations do not reflect the provisions of the Investment Advisory Agreement as it would actually be applied in the case of a 5% annual return. This illustration assumes that we will not realize any capital gains computed net of all realized capital losses and unrealized capital depreciation in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses, and returns to our investors after such expenses, would be higher. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See ‘‘Dividend reinvestment plan’’ for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses. Actual expenses (including the cost of debt, if any, and other expenses) may be greater or less than those shown.

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SELECTED CONDENSED FINANCIAL DATA

(in thousands)

You should read the condensed financial information below with the Financial Statements and Notes thereto included in this prospectus. Financial information for the twelve months ended June 30, 2005 has been derived from the audited financial statements for that period. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) that are necessary to present fairly the results of such interim periods. Interim results for the three and nine months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending June 30, 2006. See ‘‘Management's Discussion and Analysis of Financial Condition and Results of Operations’’ on page 26 for more information.

	Three months ended March 31, 2006	Three months ended March 31, 2005	Nine months ended March 31, 2006	Nine months ended March 31, 2005	Twelve months ended June 30, 2005	For the period from April 13, 2004 (inception) through

						June 30, 2004
	(unaudited)	(unaudited)	(unaudited)	(unaudited)		
Investment income						
Interest income	$1,704	$ 437	$ 4,569	$ 887	$1,882	$ —
Interest income, controlled entities	1,309	828	3,316	1,876	2,704	—
Dividend income	90	10	450	24	284	—
Dividend income, controlled entities	850	500	2,249	2,200	3,151	—
Other income	73	13	487	13	72	—
Total investment income	4,026	1,788	11,071	5,000	8,093	
Operating expenses						
Investment advisory fees						
Base management fee	521	485	1,554	1,317	1,808	
Income incentive fee	533	—	1,041	—	—	
Total Investment advisory fees	1,054	485	2,595	1,317	1,808	—
Interest expense and credit facility costs	12	—	12	—	—	—
Administration costs	82	126	225	295	266	—
Legal fees	390	481	1,501	1,537	2,575	—
Valuation services	45	18	132	18	42	—
Other professional fees	85	75	313	163	230	—
Insurance expense	85	89	269	237	325	—
Directors' fees	55	55	165	147	220	—
Organizational costs	—	—	—	—	25	100
General and administrative expenses	92	15	277	48	191	—
Total operating expenses	1,900	1,344	5,489	3,762	5,682	100
Net investment income (loss)	2,126	444	5,582	1,238	2,411	(100)
Net realized loss	1	—	(18)	—	(2)	—
Net unrealized appreciation (depreciation)	828	414	1,392	414	6,342	—
Net increase (decrease) in stockholders' equity resulting from operations	$2,955	$ 858	$ 6,956	$1,652	$8,751	$ (100)
Basic and diluted net increase (decrease) in stockholders equity per common share resulting from operations	$ 0.42	0.12	$ 0.99	$ 0.23	$ 1.24	$ N/A

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The following is a schedule of financial highlights for the periods indicated below:

	For the three months ended	For the three months ended	For the nine months ended	For the nine months ended	For the twelve months ended

	March 31, 2006	March 31, 2005	March 31, 2006	March 31, 2005	June 30, 2005
Per share data[1]:					
Net asset value at beginning of period	$ 14.69	$ 13.74	$ 14.59	$ (0.01	$ (0.01)
Proceeds from initial public offering	—	—	—	13.95	13.95
Costs related to the initial public offering	—	—	0.01	(0.21)	(0.21)
Share issuance related to dividend reinvestment	0.02	—	0.02	—	—
Net investment income	0.30	0.06	0.79	0.17	0.34
Net unrealized appreciation	0.10	0.06	0.18	0.06	0.90
Dividends declared and paid	(0.30)	(0.12)	(0.78)	(0.22)	(0.38)
Net asset value at end of period	$ 14.81	$ 13.74	$ 14.81	$ 13.74	$ 14.59
Per share market value at end of period	$ 16.44	$ 12.90	$ 16.44	$ 12.90	$ 12.60
Total return based on market value[2]	11.08%	8.54%	37.35%	(12.46%)	(13.46%)
Total return based on net asset value[2]	3.00%	0.88%	7.13%	(6.88%)	7.40%
Shares outstanding at end of period	7,061,940	7,055,100	7,061,940	7,055,100	7,055,100
Ratio/supplemental data:					
Net assets at end of period (in thousands)	$ 104,602	$ 96.927	$ 104,602	$ 96,925	$ 102,967
Annualized ratio of operating expenses to average net assets	7.27%	5.51%	6.96%	5.11%	5.52%
Annualized ratio of operating income to average net assets	8.13%	1.82%	7.12%	1.68%	8.50%

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[1] Financial highlights as of March 31, 2006 and June 30, 2005 are based on 7,061,940 shares and 7,055,100 shares outstanding, respectively. Share issuance of 6,840 shares occurred on March 31, 2006.

[2] Total return based on market value is based on the change in market price per share between the opening and ending market prices per share in each period and assumes that dividends are reinvested in accordance with Prospect Energy's dividend reinvestment plan. Total return based on net asset value is based upon the change in net asset value per share between the opening and ending net asset values per share in each period and assumes that dividends are reinvested in accordance with Prospect Energy's dividend reinvestment plan. The total return is not annualized.

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RISK FACTORS

Investing in our Securities involves a high degree of risk. You should carefully consider the risks described below, together with all of the other information included in this prospectus, before you decide whether to make an investment in our Securities. The risks set out below are not the only risks we face. If any of the following risks occur, our business, financial condition and results of operations could be materially adversely affected. In such case, our net asset value and the trading price of our common stock could decline, or the value of our preferred stock, debt securities or warrants may decline, and you may lose all or part of your investment.

Risks Relating To Our Business And Structure

We are dependent upon Prospect Capital Management's key management personnel for our future success.

We depend on the diligence, skill and network of business contacts of the senior management of Prospect Capital Management. We also depend, to a significant extent, on our Investment Adviser's access to the investment professionals and the information and deal flow generated by these investment professionals in the course of their investment and portfolio management activities. For a description of the senior management team, see ‘‘Management.’’ The senior management team evaluates, negotiates, structures, closes, monitors and services our investments. Our success depends to a significant extent on the continued service of the senior management team, particularly John F. Barry III and M. Grier Eliasek. The departure of any of the senior managers of Prospect Capital Management could have a material adverse effect on our ability to achieve our investment objective. In addition, we can offer no assurance that Prospect Capital Management will remain our Investment Adviser or that we will continue to have access to its investment professionals or its information and deal flow.

Our Investment Adviser and its senior management have limited experience managing a business development company under the 1940 Act.

The 1940 Act imposes numerous constraints on the operations of business development companies. For example, business development companies are required to invest at least 70% of their total assets primarily in securities of privately held or thinly traded U.S. public companies, cash, cash equivalents, U.S. government securities and other high quality debt investments that mature in one year or less. Our Investment Adviser's and its senior management's limited experience in managing a portfolio of assets under such constraints may hinder their ability to take advantage of attractive investment opportunities and, as a result, achieve our investment objective. In addition, our investment strategies differ in some ways from those of other investment funds that have been managed in the past by the investment professionals.

We are a relatively new company with limited operating history.

We were incorporated in April 2004 and have conducted investment operations since July 2004. We are subject to all of the business risks and uncertainties associated with any new business enterprise, including the risk that we may not achieve our investment objective and that the value of your investment in us could decline substantially or fall to zero. We completed our initial public offering on July 27, 2004. As of March 31, 2006, we continue to pursue our investment strategy and 89.5% of our net assets are invested in energy companies, with the remainder invested in U.S. government and money market securities. Dividends that we pay prior to being fully invested may be substantially lower than the dividends that we expect to pay when our portfolio is fully invested. If we do not realize yields in excess of our expenses, we may incur operating losses and the market price of our shares may decline.

If our primary investments are deemed not to be qualifying assets, we could lose our status as a business development company or be precluded from investing according to our current business plan.

In order to maintain our status as a business development company, we must not acquire any assets other than ‘‘qualifying assets’’ unless, at the time of and after giving effect to such acquisition,

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at least 70% of our total assets are qualifying assets. If we acquire mezzanine loans or dividend-paying equity securities from an issuer that has outstanding marginable securities at the time we make an investment, these acquired assets cannot be treated as qualifying assets. See ‘‘Regulation—Qualifying Assets.’’ This results from the definition of ‘‘eligible portfolio company’’ under the 1940 Act, which in part looks to whether a company has outstanding marginable securities.

Amendments promulgated in 1998 by the Board of Governors of the Federal Reserve System to Regulation T under the Exchange Act expanded the definition of marginable security to include any non-equity security. These amendments have raised questions as to whether a private company that has outstanding debt securities would qualify as an eligible portfolio company.

We believe that the mezzanine loans and equity instruments that we have acquired and expect to continue to acquire should constitute qualifying assets because the privately held companies to which we lend do not, at the time of our investment, have outstanding marginable securities. Until the questions raised by the amendments to Regulation T have been clarified through SEC rulemaking or addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those mezzanine loans that are not investment grade, do not have a public secondary market, and are issued by a private issuer that does not have outstanding a class of margin eligible securities at the time of our investment. Likewise, we treat equity securities issued by a portfolio company as qualifying assets only if such securities are issued by a private company that has no marginable securities outstanding at the time we purchase such securities.

To date, we do not believe that either the SEC or its staff has taken any position with respect to our analysis of the issues discussed above and neither the SEC or its staff indicated that they concur with our analysis. We intend to adjust our investment focus as needed to comply with and/or take advantage of any future administrative position, judicial decision or legislative action.

If there were a court ruling or regulatory decision that conflicts with our interpretations, we could lose our status as a business development company or be precluded from investing in the manner described in this prospectus, either of which would have a material adverse effect on our business, financial condition and results of operations. See ‘‘—Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital.’’ Such a ruling or decision also may require that we dispose of investments that we made based on our interpretation of Regulation T. Such dispositions could have a material adverse effect on us and our stockholders. We may need to dispose of such investments quickly, which would make it difficult to dispose of such investments on favorable terms. In addition, because these types of investments will generally be illiquid, we may have difficulty in finding a buyer and, even if we do find a buyer, we may have to sell the investments at a substantial loss. See ‘‘—The lack of liquidity in our investments may adversely affect our business.’’

Our financial condition and results of operations will depend on our ability to manage our future growth effectively.

Prospect Capital Management has been registered as an investment adviser since March 31, 2004, and Prospect Energy has been organized as a closed-end investment company since April 13, 2004. As such, each entity is subject to the business risks and uncertainties associated with any young business enterprise, including the limited experience in managing or operating a business development company under the 1940 Act. Our ability to achieve our investment objective depends on our ability to grow, which depends, in turn, on our Investment Adviser's ability to continue to identify, analyze, invest in and monitor companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our Investment Adviser's structuring of investments, its ability to provide competent, attentive and efficient services to us and our access to financing on acceptable terms. As we grow, we and

Prospect Capital Management need to continue to hire, train, supervise and manage new employees. Failure to manage our future growth effectively could have a material adverse effect on our business, financial condition and results of operations.

We operate in a highly competitive market for investment opportunities.

A large number of entities compete with us to make the types of investments that we make in target energy companies. We compete with other business development companies, public and private

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funds, commercial and investment banks and commercial financing companies. Additionally, because competition for investment opportunities generally has increased among alternative investment vehicles, such as hedge funds, those entities have begun to invest in areas they have not traditionally invested in, including investments in middle-market companies. As a result of these new entrants, competition for investment opportunities at middle-market companies has intensified and we expect that trend to continue. Many of our existing and potential competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of existing and increasing competition, we may not be able to take advantage of attractive investment opportunities from time to time, and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective.

We do not seek to compete primarily based on the interest rates that we offer, and we believe that some of our competitors make loans with interest rates that are comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms and structure. If we match our competitors' pricing, terms and structure, we may experience decreased net interest income and increased risk of credit loss.

Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital.

We may issue debt securities or preferred stock and/or borrow money from banks or other financial institutions, which we refer to collectively as ‘‘senior securities,’’ up to the maximum amount permitted by the 1940 Act. Under the provisions of the 1940 Act, we are permitted, as a business development company, to issue senior securities only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we may be required to sell a portion of our investments or sell additional shares of common stock and, depending on the nature of our leverage, to repay a portion of our indebtedness at a time when such sales may be disadvantageous. In addition, issuance of additional securities could dilute the percentage ownership of our current stockholders in us.

As a business development company regulated under provisions of the 1940 Act, we are not generally able to issue and sell our common stock at a price below the current net asset value per share. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock in a rights offering to our stockholders or if (1) our Board of Directors determines that such sale is in the Company's best interests and our stockholders, (2) our stockholders approve the sale of our common stock at a price that is less than the current net asset value, and (3) the price at which our common stock is to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of such securities (less any sales load).

In addition, we may in the future seek to securitize our loans to generate cash for funding new investments. To securitize loans, we may create a wholly owned subsidiary and contribute a pool of loans to such subsidiary. This could include the sale of interests in the subsidiary on a non-recourse basis to purchasers who we would expect to be willing to accept a lower interest rate to invest in investment grade loan pools. We would retain a portion of the equity in the securitized pool of loans. An inability to successfully securitize our loan portfolio could limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings, if any. Moreover, the successful securitization of our loan portfolio might expose us to losses because the residual loans in which we do not sell interests may tend to be those that are riskier and more likely to generate losses.

If we fail to qualify as a RIC, we will have to pay corporate-level taxes on our income and our income available for distribution would be reduced.

To maintain our qualification as a RIC under the Code, and obtain RIC tax treatment, we must meet certain source of income, asset diversification and annual distribution requirements. The annual distribution requirement for a RIC is satisfied if we distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our stockholders on an annual basis. Because we expect to use debt financing in the future, we are subject to certain asset coverage ratio requirements under the 1940 Act and financial covenants that could, under certain circumstances, restrict us from making distributions necessary to qualify for RIC tax treatment. If we are unable to obtain cash from other sources, we may fail to qualify for RIC tax treatment and, thus, may be subject to corporate-level income tax. To maintain our qualification as a RIC, we must also meet certain asset diversification requirements at the end of each calendar quarter. Failure to meet these tests may result in our having to dispose of certain investments quickly in order to prevent the loss of RIC status. Because most of our investments are in private companies, any such dispositions could be made at disadvantageous prices and may result in substantial losses. If we fail to qualify as a RIC for any reason or become subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets, the amount of income available for distribution, and the actual amount of our distributions. Such a failure would have a material adverse effect on us and our shares. For additional information regarding asset coverage ratio and RIC requirements, see ‘‘Regulation—Senior securities’’ and ‘‘Material U.S. federal income tax considerations.’’

We may have difficulty paying our required distributions if we recognize income before or without receiving cash representing such income.

For federal income tax purposes, we include in income certain amounts that we have not yet received in cash, such as original issue discount, which may arise if we receive warrants in connection with the making of a loan or possibly in other circumstances, or payment-in-kind interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such original issue discount, which could be significant relative to our overall investment activities, or increases in loan balances as a result of payment-in-kind arrangements, are included in our income before we receive any corresponding cash payments. We also may be required to include in income certain other amounts that we do not receive in cash. While we focus primarily on investments that will generate a current cash return, our investment portfolio may also include securities that do not pay some or all of their return in periodic current cash distributions.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of the income incentive fee will become uncollectible.

Since in some cases we may recognize taxable income before or without receiving cash representing such income, we may have difficulty meeting the tax requirement to distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to maintain RIC tax treatment. Accordingly, we may have to sell some of our investments at times we would not consider advantageous, raise additional debt or equity capital or reduce new investment originations to meet these distribution requirements. If we are not able to obtain cash from other sources, we may fail to qualify for RIC treatment and thus become subject to corporate-level income tax. See ''Material U.S. federal income tax considerations—Taxation as a RIC.''

If we issue senior securities, including debt, you will be exposed to additional risks, including the typical risks associated with leverage.

- You will be exposed to increased risk of loss if we incur debt to make investments. If we do incur debt, a decrease in the value of our investments or in our revenues would have a greater negative impact on the value of our common stock than if we did not use debt.

- Our ability to pay dividends would be restricted if our asset coverage ratio were not at least 200% and any amounts that we use to service our indebtedness would not be available for dividends to our common stockholders.
- It is likely that any debt we incur will be governed by an indenture or other instrument containing covenants restricting our operating flexibility.
- We and you will bear the cost of issuing and servicing our senior securities.
- Any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock.

Changes in interest rates may affect our cost of capital and net investment income.

We expect that a significant portion of our debt investments will bear interest at fixed rates and the value of these investments could be negatively affected by increases in market interest rates. In addition, an increase in interest rates would make it more expensive to use debt to finance our investments. As a result, a significant increase in market interest rates could both reduce the value of our portfolio investments and increase our cost of capital, which would reduce our net investment income.

We need to raise additional capital to grow because we must distribute most of our income.

We need additional capital to fund growth in our investments. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our shareholders to maintain our RIC status. As a result, such earnings are not available to fund investment originations. We have sought additional capital by borrowing from financial institutions and may issue debt securities or additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which may have an adverse effect on the value of our Securities. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.

A large percentage of our portfolio investments consist of securities of privately held or thinly traded public companies. The fair value of these securities is often not readily determinable. The determination of fair value, and thus the amount of unrealized losses we may incur in any year, is to a degree subjective, and the Investment Advisor has a conflict of interest in making the determination. We value these securities quarterly at fair value as determined in good faith by our Board of Directors based on input from our Investment Adviser, a third party independent valuation firm and our audit committee. Our Board of Directors utilizes the services of an independent valuation firm to aid it in determining the fair value of any securities. The types of factors that may be considered in fair value pricing of our investments include the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings, the markets in which the portfolio company does business, comparison to publicly traded companies, discounted cash flow and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, the valuations may fluctuate over short periods of time and may be based on estimates. The determinations of fair value by our Board of Directors may differ materially from the values that would have been used if a ready market for these securities existed. Our net asset value could be adversely affected if the determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

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The lack of liquidity in our investments may adversely affect our business.

We generally make investments in private companies. Substantially all of these securities are subject to legal and other restrictions on resale or are otherwise less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. In addition, we may face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we or our Investment Adviser has material non-public information regarding such portfolio company.

We may experience fluctuations in our quarterly results.

We could experience fluctuations in our quarterly operating results due to a number of factors, including the interest or dividend rates payable on the debt or equity securities we acquire, the default rate on debt securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, the seasonality of the energy industry, weather patterns, changes in energy prices and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

Potential conflicts of interest could impact our investment returns.

Our executive officers and directors, and the executive officers of our Investment Adviser, Prospect Capital Management, may serve as officers, directors or principals of entities that operate in the same or related lines of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of us or our stockholders. Nevertheless, it is possible that new investment opportunities that meet our investment objective may come to the attention of one these entities in connection with another investment advisory client or program, and, if so, such opportunity might not be offered, or otherwise made available, to us. However, as an investment adviser, Prospect Capital Management has a fiduciary obligation to act in the best interests of its clients, including us. To that end, if Prospect Capital Management or its affiliates manage any additional investment vehicles or client accounts in the future, Prospect Capital Management will endeavor to allocate investment opportunities in a fair and equitable manner over time so as not to discriminate unfairly against any client. If Prospect Capital Management chooses to establish another investment fund in the future, when the investment professionals of Prospect Capital Management identify an investment, they will have to choose which investment fund should make the investment.

In the course of our investing activities, under the Investment Advisory Agreement we pay base management and incentive fees to Prospect Capital Management, and reimburse Prospect Capital Management for certain expenses it incurs. As a result of the Investment Advisory Agreement, there may be times when the management team of Prospect Capital Management has interests that differ from those of our stockholders, giving rise to a conflict.

Prospect Capital Management receives a quarterly income incentive fee based, in part, on our pre-incentive fee net investment income, if any, for the immediately preceding calendar quarter. This income incentive fee is subject to a quarterly hurdle rate before providing an income incentive fee return to the Investment Adviser. To the extent we or Prospect Capital Management are able to exert influence over our portfolio companies, the income incentive fee may provide Prospect Capital Management with an incentive to induce our portfolio companies to accelerate or defer interest or other obligations owed to us from one calendar quarter to another. If our Investment Adviser terminates its voluntary agreement to have the income incentive fee be subject to a fluctuating hurdle rate, the hurdle rate would be fixed. This fixed hurdle rate has been based in relation to current interest rates, which are currently relatively low on a historical basis. Thus, if interest rates rise, it would become easier for our investment income to exceed the hurdle rate and, as a result, more likely that our Investment Adviser will receive an income incentive fee than if interest rates on our

investments remained constant or decreased. Subject to the receipt of any requisite shareholder approval under the 1940 Act, our Board of Directors may readjust the hurdle rate by amending the Investment Advisory Agreement.

The income incentive fee payable by Prospect Energy is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that has a deferred interest feature, it is possible that interest accrued under such loan that has previously been included in the calculation of the income incentive fee will become uncollectible. If this happens, our Investment Adviser is not required to reimburse us for any such income incentive fee payments. If we do not have sufficient liquid assets to pay this incentive fee or distributions to stockholders on such accrued income, we may be required to liquidate assets in order to do so. This fee structure could give rise to a conflict of interest for our Investment Adviser to the extent that it may encourage the Investment Adviser to favor debt financings that provide for deferred interest, rather than current cash payments of interest. In addition, the amount of the Investment Adviser's compensation under the incentive fee, is due, in part to the amount of unrealized depreciation accrued by the Company.

We have entered into a royalty-free license agreement with Prospect Capital Management. Under this agreement, Prospect Capital Management agrees to grant us a non-exclusive license to use the name ‘‘Prospect Energy.’’ Under the license agreement, we have the right to use the ‘‘Prospect Energy’’ name for so long as Prospect Capital Management or one of its affiliates remains our Investment Adviser. In addition, we rent office space from Prospect Administration, an affiliate of Prospect Capital Management, and pay Prospect Administration our allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations as Administrator under the administration agreement, including rent and our allocable portion of the costs of our chief financial officer and chief compliance officer and their respective staffs. This may create conflicts of interest that our Board of Directors monitors.

Changes in laws or regulations governing our operations may adversely affect our business.

We and our portfolio companies are subject to regulation by laws at the local, state and federal levels. These laws and regulations, as well as their interpretation, may be changed from time to time. Accordingly, changes in these laws or regulations could have a material adverse effect on our business. For additional information regarding the regulations we are subject to, see ‘‘Regulation.’’

Risks Related To Our Investments

We may not realize gains or income from our investments.

We seek to generate both current income and capital appreciation. However, the securities we invest in may not appreciate and, in fact, may decline in value, and the issuers of debt securities we invest in may default on interest and/or principal payments. Accordingly, we may not be able to realize gains from our investments, and any gains that we do realize may not be sufficient to offset any losses we experience.

Our portfolio is concentrated in a limited number of portfolio companies in the energy industry, which subject us to a risk of significant loss if any of these companies defaults on its obligations under any of the securities that we hold or if the energy industry experiences a downturn.

As of June 26, 2006, we had invested in fifteen companies. A consequence of this lack of diversification is that the aggregate returns we realize may be significantly adversely affected if a small number of such investments perform poorly or if we need to write down the value of any one investment. Beyond our income tax diversification requirements, we do not have fixed guidelines for diversification, and our investments are concentrated in relatively few portfolio companies. We estimate that, once we have invested substantially all of the net proceeds of this offering, we will have invested in approximately 15 to 25 portfolio companies, depending on the availability of appropriate investment opportunities consistent with our investment objective and market conditions. In addition, we concentrate on making investments in the energy industry and will invest, under normal circumstances, at least 80% of the value of our net assets (including the amount of any borrowings for

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investment purposes) in energy companies. As a result, a downturn in the energy industry could materially adversely affect us in an adverse manner.

The energy industry is subject to many risks.

We concentrate our investments in the energy industry. Our definition of energy, as used in the context of the energy industry, is broad, and different sectors in the energy industry may be subject to variable risks and economic pressures. As a result, it is difficult to anticipate the impact of changing economic and political conditions on our portfolio companies and, as a result, our financial results. The revenues, income (or losses) and valuations of energy companies can fluctuate suddenly and dramatically due to any one or more of the following factors:

- Commodity Pricing Risk. While we generally do not invest in companies that accept completely unhedged commodity risk, energy companies in general are directly affected by energy commodity prices, such as the market prices of crude oil, natural gas and wholesale electricity, especially for those who own the underlying energy commodity. In addition, the volatility of commodity prices can affect other energy companies due to the impact of prices on the volume of commodities transported, processed, stored or distributed and on the cost of fuel for power generation companies. The volatility of commodity prices can also affect energy companies' ability to access the capital markets in light of market perception that their performance may be directly tied to commodity prices. Historically, energy commodity prices have been cyclical and exhibited significant volatility. Although we require adherence to strict risk controls, including appropriate commodity and other hedges, by each of our portfolio companies, some of our portfolio companies may not engage in hedging transactions to minimize their exposure to commodity price risk. For those companies that engage in such hedging transactions, they remain subject to market risks, including market liquidity and counterparty creditworthiness.
- Regulatory Risk. The profitability of energy companies could be adversely affected by changes in the regulatory environment. The businesses of energy companies are heavily regulated by federal, state and local governments in diverse manners, such as the way in which energy assets are constructed, maintained and operated and the prices energy companies may charge for their products and services. Such regulation can change over time in scope and intensity. For example, a particular by-product of an energy process may be declared hazardous by a regulatory agency, which can unexpectedly increase production costs. Moreover, many state and federal environmental laws provide for civil penalties as well as regulatory remediation, thus adding to the potential liability an energy company may face. In addition, the deregulation of energy markets and the unresolved regulatory issues related to some power markets such as California create uncertainty in the regulatory environment as rules and regulations may be adopted on a transitional basis. We cannot assure you that the deregulation of energy markets will continue and if it continues, whether its impact on energy companies' profitability will be positive.
- Production Risk. The profitability of energy companies may be materially impacted by the volume of crude oil, natural gas or other energy commodities available for transporting, processing, storing, distributing or power generation. A significant decrease in the production of natural gas, crude oil, coal or other energy commodities, due to the decline of production from existing facilities, import supply disruption, depressed commodity prices, political events, OPEC actions or otherwise, could reduce revenue and operating income or increase operating costs of energy companies and, therefore, their ability to pay debt or dividends. In recent months, OPEC has announced changes in production quotas in response to changing market conditions, including near record high oil prices in the United States.
- Demand Risk. A sustained decline in demand for crude oil, natural gas, refined petroleum

products and electricity could materially affect revenues and cash flows of energy companies. Factors that could lead to a decrease in market demand include a recession or other adverse economic conditions, an increase in the market price of the underlying commodity, higher taxes or other regulatory actions that increase costs, or a shift in consumer demand for such products.

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- Depletion and Exploration Risk. A portion of any one energy company's assets may be dedicated to natural gas, crude oil and/or coal reserves and other commodities that naturally deplete over time. Depletion could have a material adverse impact on such company's ability to maintain its revenue. Further, estimates of energy reserves may not be accurate and, even if accurate, reserves may not be fully utilized at reasonable costs. Exploration of energy resources, especially of oil and gas, is inherently risky and requires large amounts of capital.
- Weather Risk. Unseasonable extreme weather patterns could result in significant volatility in demand for energy and power. This volatility may create fluctuations in earnings of energy companies.
- Operational Risk. Energy companies are subject to various operational risks, such as failed drilling or well development, unscheduled outages, underestimated cost projections, unanticipated operation and maintenance expenses, failure to obtain the necessary permits to operate and failure of third-party contractors (for example, energy producers and shippers) to perform their contractual obligations. In addition, energy companies employ a variety of means of increasing cash flow, including increasing utilization of existing facilities, expanding operations through new construction, expanding operations through acquisitions, or securing additional long-term contracts. Thus, some energy companies may be subject to construction risk, acquisition risk or other risk factors arising from their specific business strategies.
- Competition Risk. The progress in deregulating energy markets has created more competition in the energy industry. This competition is reflected in risks associated with marketing and selling energy in the evolving energy market and a competitor's development of a lower-cost energy or power source, or of a lower cost means of operations, and other risks arising from competition.
- Valuation Risk. Since mid-2001, excess power generation capacity in certain regions of the United States has caused substantial decreases in the market capitalization of many energy companies. While such prices have recovered to some extent, we can offer no assurance that such decreases in market capitalization will not recur, or that any future decreases in energy company valuations will be insubstantial or temporary in nature.
- Terrorism Risk. Since the September 11th attacks, the United States government has issued public warnings indicating that energy assets, specifically those related to pipeline infrastructure, production facilities and transmission and distribution facilities, might be specific targets of terrorist activity. The continued threat of terrorism and related military activity will likely increase volatility for prices of natural gas and oil and could affect the market for products and services of energy companies. In addition, any future terrorist attack or armed conflict in the United States or elsewhere may undermine economic conditions in the United States in general.
- Financing Risk. Some of our portfolio companies rely on the capital markets to raise money to pay their existing obligations. Their ability to access the capital markets on attractive terms or at all may be affected by any of the risks associated with energy companies described

above, by general economic and market conditions or by other factors. This may in turn affect their ability to satisfy their obligations with us.

Our investments in prospective portfolio companies may be risky and you could lose all or part of your investment.

We invest in companies in the energy industry, most of which have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective and the value of our investment in them may decline substantially or fall to zero.

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In addition, investment in the middle market energy companies that we are targeting involves a number of other significant risks, including:

- these companies may have limited financial resources and may be unable to meet their obligations under their securities that we hold, which may be accompanied by a deterioration in the value of their equity securities or of any collateral with respect to debt securities and a reduction in the likelihood of our realizing on any guarantees we may have obtained in connection with our investment;
- they may have shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and market conditions, as well as general economic downturns;
- because many of these companies are privately held companies, public information is generally not available about these companies. As a result, we will depend on the ability of our Investment Adviser to obtain adequate information to evaluate these companies in making investment decisions. If our Investment Adviser is unable to uncover all material information about these companies, it may not make a fully informed investment decision, and we may lose money on our investments;
- they are more likely to depend on the management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a material adverse impact on our portfolio company and, in turn, on us;
- they may have less predictable operating results, may from time to time be parties to litigation, may be engaged in changing businesses with products subject to a risk of obsolescence and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position. In addition, our executive officers, directors and our Investment Adviser could, in the ordinary course of business, be named as defendants in litigation arising from proposed investments or from our investments in the portfolio companies.

Economic recessions or downturns could impair our portfolio companies and harm our operating results.

Our portfolio companies will generally be affected by the conditions and overall strength of the national, regional and local economies, including interest rate fluctuations, changes in the capital markets and changes in the prices of their primary commodities and products. These factors also impact the amount of residential, industrial and commercial growth in the energy industry. Additionally, these factors could adversely impact the customer base and customer collections of our portfolio companies.

As a result, many of our portfolio companies may be susceptible to economic slowdowns or recessions and may be unable to repay our loans or meet other obligations during these periods. Therefore, our non-performing assets are likely to increase, and the value of our portfolio is likely to decrease, during these periods. Adverse economic conditions also may decrease the value of collateral securing some of our loans and the value of our equity investments. Economic slowdowns or recessions could lead to financial losses in our portfolio and a decrease in revenues, net income and assets. Unfavorable economic conditions also could increase our funding costs, limit our access to the capital markets or result in a decision by lenders not to extend credit to us. These events could prevent us from increasing investments and harm our operating results.

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans and foreclosure on its secured assets, which could trigger cross-defaults under other agreements and jeopardize a portfolio company's ability to meet its obligations under the debt or equity securities that we hold. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms, which may include the waiver of certain financial covenants, with a defaulting portfolio company. In addition, if one of our portfolio companies were to go bankrupt, even though we may have structured our interest as

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senior debt or preferred equity, depending on the facts and circumstances, including the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might recharacterize our debt or equity holding and subordinate all or a portion of our claim to those of other creditors.

Our portfolio companies may incur debt or issue equity securities that rank equally with, or senior to, our investments in such companies.

We invest primarily in mezzanine debt and dividend-paying equity securities issued by our portfolio companies. Our portfolio companies usually have, or may be permitted to incur, other debt, or issue other equity securities, that rank equally with, or senior to, the securities in which we invest. By their terms, such instruments may provide that the holders are entitled to receive payment of dividends, interest or principal on or before the dates on which we are entitled to receive payments in respect of the securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of securities ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying the senior security holders, the portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of securities ranking equally with securities in which we invest, we would have to share on an equal basis any distributions with other security holders in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of the relevant portfolio company. In addition, we may not be in a position to control any portfolio company in which we invest. As a result, we are subject to the risk that a portfolio company in which we invest may make business decisions with which we disagree and the management of such company, as representatives of the holders of their common equity, may take risks or otherwise act in ways that do not serve our interests as debt or preferred equity investors.

We may not be able to fully realize the value of the collateral securing our debt investments.

Although a substantial amount of our debt investments are protected by holding security interests in the assets of the portfolio companies, we may not be able to fully realize the value of the collateral securing our investments due to one or more of the following factors:

- since our debt investments are primarily made in the form of mezzanine loans, our liens on the collateral, if any, are subordinated to those of the senior secured debt of the portfolio companies, if any. As a result, we may not be able to control remedies with respect to the collateral;
- the collateral may not be valuable enough to satisfy all of the obligations under our secured loan, particularly after giving effect to the repayment of secured debt of the portfolio company that ranks senior to our loan;
- bankruptcy laws may limit our ability to realize value from the collateral and may delay the realization process;
- our rights in the collateral may be adversely affected by the failure to perfect security interests in the collateral;
- how effectively the collateral would be liquidated and the value received could be impaired or impeded by the need to obtain regulatory and contractual consents; and
- by its nature, some or all of the collateral may be illiquid and may have no readily ascertainable market value. The liquidity and value of the collateral could be impaired as a result of changing economic conditions, competition, and other factors, including the availability of suitable buyers.

Our incentive fee could induce Prospect Capital Management to make speculative investments.

The incentive fee payable by us to Prospect Capital Management may create an incentive for our Investment Adviser to make investments on our behalf that are more speculative or involve more risk than would be the case in the absence of such compensation arrangement. The way in which the

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incentive fee payable is determined (calculated as a percentage of the return on invested capital) may encourage the Investment Adviser to use leverage to increase the return on our investments. The use of leverage would increase the likelihood of default, which would disfavor holders of our common stock. Similarly, because the Investment Adviser will receive an incentive fee based, in part, upon net capital gains realized on our investments, the Investment Adviser may invest more than would otherwise be appropriate in companies whose securities are likely to yield capital gains, as compared to income producing securities. Such a practice could result in our investing in more speculative securities than would otherwise be the case, which could result in higher investment losses, particularly during economic downturns.

The incentive fee payable by us to Prospect Capital Management also could create an incentive for our Investment Adviser to invest on our behalf in instruments, such as zero coupon bonds, that have a deferred interest feature. Under these investments, we would accrue interest income over the life of the investment but would not receive payments in cash on the investment until the end of the term. Our net investment income used to calculate the income incentive fee, however, includes accrued interest. For example, accrued interest, if any, on our investments in zero coupon bonds will be included in the calculation of our incentive fee, even though we will not receive any cash interest payments in respect of payment on the bond until its maturity date. Thus, a portion of this incentive fee would be based on income that we may not have yet received in cash.

We have not yet identified all of the potential investments for our portfolio.

We have not yet identified all of the potential investments for our portfolio, and, thus, you will not be able to evaluate all of our potential investments prior to purchasing our Securities. This factor will increase the uncertainty, and thus the risk, of investing in our Securities.

Our investments in foreign securities may involve significant risks in addition to the risks inherent in U.S. investments.

Our investment strategy contemplates potential investments in securities of foreign companies. Investing in foreign companies may expose us to additional risks not typically associated with investing in U.S. companies. These risks include changes in exchange control regulations, political and social instability, expropriation, imposition of foreign taxes, less liquid markets and less available information than is generally the case in the United States, higher transaction costs, less government supervision of exchanges, brokers and issuers, less developed bankruptcy laws, difficulty in enforcing contractual obligations, lack of uniform accounting and auditing standards and greater price volatility.

Although currently all of our investments are, and we expect that most of our investments will be, U.S. dollar-denominated, our investments that are denominated in a foreign currency will be subject to the risk that the value of a particular currency will change in relation to one or more other currencies. Among the factors that may affect currency values are trade balances, the level of short-term interest rates, differences in relative values of similar assets in different currencies, long-term opportunities for investment and capital appreciation, and political developments.

We may employ hedging techniques to minimize these risks, but we can offer no assurance that such strategies will be effective. If we engage in hedging transactions, we may expose ourselves to risks associated with such transactions. We may utilize instruments such as forward contracts, currency options and interest rate swaps, caps, collars and floors to seek to hedge against fluctuations in the relative values of our portfolio positions from changes in currency exchange rates and market interest rates. Hedging against a decline in the values of our portfolio positions does not eliminate the possibility of fluctuations in the values of such positions or prevent losses if the values of such positions decline. However, such hedging can establish other positions designed to gain from those same developments, thereby offsetting the decline in the value of such portfolio positions. Such hedging transaction may also limit the opportunity for gain if the values of the portfolio positions should increase. Moreover, it may not be possible to hedge against an exchange rate or interest rate fluctuation that is so generally anticipated that we are not able to enter into a hedging transaction at an acceptable price.

The success of our hedging transactions depends on our ability to correctly predict movements, currencies and interest rates. Therefore, while we may enter into such transactions to seek to reduce

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currency exchange rate and interest rate risks, unanticipated changes in currency exchange rates or interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. The degree of correlation between price movements of the instruments used in a hedging strategy and price movements in the portfolio positions being hedged may vary. Moreover, for a variety of reasons, we may not seek to establish a perfect correlation between such hedging instruments and the portfolio holdings being hedged. Any such imperfect correlation may prevent us from achieving the intended hedge and expose us to risk of loss. In addition, it may not be possible to hedge fully or perfectly against currency fluctuations affecting the value of securities denominated in non-U.S. currencies.

Risks Relating To Our Securities

There is a risk that you may not receive dividends or that our dividends may not grow over time.

We have made and intend to continue to make distributions on a quarterly basis to our stockholders out of assets legally available for distribution. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions or year-to-year increases in cash distributions. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. See ‘‘Distributions.’’

Provisions of the Maryland General Corporation Law and of our charter and bylaws could deter takeover attempts and have an adverse impact on the price of our common stock.

The Maryland General Corporation Law and our charter and bylaws contain provisions that may have the effect of discouraging, delaying or making more difficult a change in control and preventing the removal of incumbent directors. We are covered by the Maryland Business Combination Act (the ‘‘Business Combination Act’’) to the extent such statute is not superseded by applicable requirements of the 1940 Act. However, our Board of Directors has adopted a resolution exempting any business combination between us and any other person from the Business Combination Act, subject to prior approval of such business combination by our Board, including a majority of our directors who are not interested persons as defined in the 1940 Act. In addition, the Maryland Control Share Acquisition Act (the ‘‘Control Share Act’’) provides that control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast on the matter. Our bylaws contain a provision exempting from the Control Share Act any and all acquisitions by any person of our shares of stock. If the applicable board resolution is repealed or our Board does not otherwise approve a business combination, the Business Combination Act and the Control Share Act (if we amend our bylaws to be subject to that Act) may discourage others from trying to acquire control of us and increase the difficulty of consummating any offer.

Additionally, under our charter, our Board of Directors is divided into three classes serving staggered terms; our Board of Directors may, without stockholder action, authorize the issuance of shares of stock in one or more classes or series, including preferred stock; and our Board of Directors may, without stockholder action, amend our charter to increase the number of shares of stock of any class or series that we have authority to issue. The existence of these provisions, among others, may have a negative impact on the price of our common stock and may discourage third party bids for ownership of our Company. These provisions may prevent any premiums being offered to you for shares of our common stock.

Investing in our Securities may involve a high degree of risk.

The investments we make in accordance with our investment objective may result in a higher amount of risk than alternative investment options and volatility or loss of principal. Our investments in portfolio companies may be speculative and aggressive, and therefore, an investment in our shares may not be suitable for someone with low risk tolerance.

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The market price of our Securities may fluctuate significantly.

The market price and liquidity of the market for our Securities may be significantly affected by numerous factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include:

- significant volatility in the market price and trading volume of securities of business development companies or other companies in the energy industry, which are not necessarily related to the operating performance of these companies;
- changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;
- loss of RIC status;
- changes in earnings or variations in operating results;
- changes in the value of our portfolio of investments;
- any shortfall in revenue or net income or any increase in losses from levels expected by investors or securities analysts;
- departure of one or more of Prospect Capital Management's key personnel;
- operating performance of companies comparable to us;
- changes in prevailing interest rates;
- litigation matters;
- general economic trends and other external factors; and
- loss of a major funding source.

We may allocate the net proceeds from any offering in ways with which you may not agree.

We will have significant flexibility in investing the net proceeds of any offering of our Securities. We may use the net proceeds from the offering in ways with which you may not agree or for investments other than those contemplated at the time of the offering, unless such change in the use of proceeds is subject to stockholders' approval or prohibited by law.

Sales of substantial amounts of our Securities in the public market may have an adverse effect on the market price of our Securities.

As of May 27, 2006, we have 7,061,940 shares of common stock outstanding. Sales of substantial amounts of our Securities or the availability of such Securities for sale could adversely affect the prevailing market price for our Securities. If this occurs and continues, it could impair our ability to raise additional capital through the sale of Securities should we desire to do so.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Prospect Energy was incorporated under the Maryland General Corporation Law in April 2004. We have elected to be treated as a business development company under the 1940 Act. Accordingly, we are required to comply with certain regulatory requirements. For instance, we generally have to invest at least 70% of our total assets in ‘‘qualifying assets,’’ including securities of private or thinly traded public U.S. companies, cash, cash equivalents, U.S. government securities and high-quality debt investments that mature in one year or less. We will typically invest under normal circumstances, at least 80.0% of net assets in energy companies.

We completed our initial public offering on July 27, 2004. As of March 31, 2006, we continue to pursue our investment strategy and 89.5% of our net assets are invested in energy companies, with the remainder invested in U.S. government and money market securities.

We invest in companies in the energy industry, most of which have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective and the value of our investment in them may decline substantially or fall to zero.

Our portfolio generated an annualized current yield of 18.0 % and 21.8% as of March 31, 2006 and as of June 30, 2005, respectively, across all our long-term debt and equity investments. This yield includes interest from all of our long-term investments as well as dividends from GSHI and Unity Virginia Holdings. We expect this number to decline over time as we become fully invested. Monetization of, or dividends from, other equity positions that we hold is not included in this yield estimate.

RESULTS OF OPERATIONS

Investment Activity

As of March 31, 2006, we completed our sixth full quarter since completion of our initial public offering on July 27, 2004, with approximately 1.9% of our net assets invested in an obligation of the Federal Home Loan Bank; 89.5%, or about $93.6 million, in ten long-term portfolio investments and 8.3% in two money market funds. The remaining 0.3% represents other assets in excess of liabilities.

Long-term Portfolio Investments

On February 1, 2006, we converted the $0.5 million of redeemable preferred equity in Unity Virginia Holdings, LLC (‘‘Unity’’) to additional subordinated secured debt. On May 10, 2006, Unity sought relief from creditors under Chapter 11 of Title 11 of the United States Code.

On February 9, 2006, we provided $6.9 million of senior secured debt financing to Genesis Coal Corporation (‘‘Genesis’’), a coal production company based in Prestonsburg, Kentucky. Genesis is led by Jerry Tackett and David Stetson, who have significant experience in the Appalachian coal business. Genesis holds leases on approximately 4,700 mineral acres with approximately 10 million recoverable tons of low to medium sulfur coal reserves in Floyd County, Kentucky. The majority of this coal is located underground. Genesis has separate fixed-price multi-year contracts for a majority of its production with a major electric utility and a major coal producer and marketer. Our funding is being utilized to acquire non-management shareholder interests, to acquire additional mining equipment, and to increase production rates.

On February 15, 2006, we provided $3.0 million of senior secured debt and a $0.2 million preferred equity investment in Appalachian Energy Holdings, LLC. (‘‘AEH’’), an energy services company based in Charleston, West Virginia. AEH is led by R. William West, who has more than 30

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years of experience in natural resource related construction, equipment fleet management, and services. AEH is an energy services business focused on acquiring and expanding small and medium-sized energy services companies in the fragmented Appalachian region. AEH provides services to customers in the coal, natural gas, and oil industries. Existing lines of business include tree clearance, road construction, excavation, drill site preparation, pipeline construction, and reclamation. Prospect's capital, along with external equity, is being used by AEH to acquire East Cumberland, LLC, and C&S Oilfield and Pipeline Construction, LLC.

During the three months ended March 31, 2006, we provided an additional $2.8 million of senior secured debt to Worcester Energy Company, Inc. (‘‘WECO’’). WECO is using this as operational funding for ongoing activities. We have retained a controlling interest in WECO as part of this additional funding.

GSHI owns and operates a major gas gathering and processing system in the East Texas Field in Gregg, Upshur, Rusk and Smith counties, Texas. This system consists of two processing facilities (the Longview Plant and the Chapel Hill Plant) and approximately 1,000 miles of associated gathering and transportation pipelines. GSHI controls the only independent gathering system in the East Texas Field serving all of the approximately 4,000 currently operating wells in the region. GSHI completed construction and started operation of the 22.5 mile Exxon Hawkins NGL Pipeline connecting the Exxon Hawkins gas plant to GSHI on June 6, 2005. Deliveries for 2005 averaged 650 barrels per day and are expected to exceed 1,000 barrels per day in 2006. The Agreement with Exxon Gas & Power Marketing Company (‘‘Exxon’’) is effective as of June 30, 2004 and has a term of seven years with an annual renewal provision thereafter. Under the agreement, Exxon is to deliver a specified minimum number of barrels of natural gas liquids in the first five years and to pay a transportation, treating and fractionation fee, which includes a capital recovery component. After five years or delivery of the specified minimum number of barrels, whichever comes first, the fee decreases to a base transportation, treating and fractionation rate for the remainder of the contract term. Total capital expenditures for 2005 were approximately $3.5 million of which $3.25 million was related to the construction of the Exxon Hawkins NGL Pipeline. GSHI continued to perform according to expectation and benefited from a strong commodity price environment, generating operating earnings of approximately $13.1 million in 2005.

Prospect Energy's investment in GSHI is comprised of $18.4 million in subordinated secured debt (‘‘Subordinated Debt’’) and 100% common equity shares ($12.3 million). The Subordinated Debt matures on December 22, 2011. The loan is paid in equal quarterly installments of $876,190 beginning December 31, 2006 and bears interest at 18%. Interest paid in 2005 was $3.312 million or $828,000 quarterly. Amounts outstanding on the Subordinated Debt at December 31, 2005 were $18.4 million. Additionally, on December 22, 2004, GSHI entered into a $12.5 million senior secured term loan (‘‘Senior Debt’’) with Citibank Texas, N.A. (formerly known as First American Bank, SSB). The Senior Debt matures on December 22, 2010. The loan is paid in equal quarterly installments of $543,479 beginning on June 30, 2005 and bears interest at LIBOR plus 225 basis points. Interest paid on the Senior Debt in 2005 was $682,875 and amounts outstanding at December 31, 2005 were $10.869 million.

During the nine months ended March 31, 2006, we had one repayment of debt in entirety. On December 29, 2005, Miller Petroleum, Inc. repaid $3.2 million that was originally due August 21, 2006. We have retained our equity interest in Miller Petroleum, Inc.

Investment Income

We generate revenue in the form of interest income on the debt securities that we own, dividend income on any common or preferred stock that we own, and capital gains or losses on any debt or equity securities that we acquire in portfolio companies and subsequently sell. Our investments, if in the form of debt securities, will typically have a term of one to ten years and bear interest at a fixed or floating rate. To the extent achievable, we will seek to collateralize our investments by obtaining security interests in our portfolio companies' assets. We also may acquire minority or majority equity interests in our portfolio companies, which may pay cash or in-kind dividends on a recurring or

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otherwise negotiated basis. In addition, we may generate revenue in other forms including commitment, origination, structuring or due diligence fees; fees for providing managerial assistance; and possibly consultation fees. Any such fees generated in connection with our investments are recognized as earned.

Investment income, which consists of interest income, dividend income, and origination fee accretion totaled $4.0 million for the quarter ended March 31, 2006 compared to $3.9 million for the quarter ended December 31, 2005 and $1.8 million for the quarter ended March 31, 2005. As well, investment income totaled $11.1 million for the nine months ended March 31, 2006 compared to $5.0 million for the nine months ended March 31, 2005. The remaining investment income during the three months ended March 31, 2006 was generated primarily from investments in short-term Federal Home Loan Bank Discount Notes and cash equivalents.

Operating Expenses

Our primary operating expenses consist of investment advisory fees, legal and professional fees and other operating and overhead-related expenses. These expenses include our allocable portion of overhead under the administration agreement with Prospect Administration under which Prospect Administration provides administrative services and facilities for Prospect Energy. Our investment advisory fees compensate our Investment Adviser for its work in identifying, evaluating, negotiating, closing and monitoring our investments. We bear all other costs and expenses of our operations and transactions in accordance with our administration agreement with Prospect Administration.

Operating expenses totaled $1.9 million for the quarter ended March 31, 2006 as compared to $1.9 million for the quarter ended December 31, 2005 and $1.3 million for the quarter ended March 31, 2005. Operating expenses totaled $5.5 million for the nine months ended March 31, 2006 compared to $3.8 million for the nine months ended March 31, 2005. The base management fee totaled $0.5 million for the quarter ended March 31, 2006 compared to $0.5 million for the quarter ended December 31, 2005 and $0.5 million for the quarter ended March 31, 2005. The base management fee totaled $1.6 million for the nine months ended March 31, 2006 compared to $1.3 million for the nine months ended March 31, 2005. The current quarter is the second quarter where an income incentive fee has been earned by the Investment Adviser. The fee totaled $0.5 million as compared to $0.5 million in the prior quarter. Legal and professional fees began to stabilize during the three months ended March 31, 2006, as litigation related costs began to decrease.

Net Investment Income, Net Unrealized Appreciation and Net Increase in Stockholders' Equity Resulting from Operations

Prospect Energy's net investment income totaled $2.1 million for the quarter ended March 31, 2006 compared to $2.0 million for the quarter ended December 31, 2005 and $0.4 million for the quarter ended March 31, 2005. Net investment income totaled $5.6 million for the nine months ended March 31, 2006 compared to $1.2 million for the nine months ended March 31, 2005. Net investment income represents the difference between investment income and operating expenses and is directly impacted by the items described above. Net unrealized appreciation totaled $0.8 million for the quarter ended March 31, 2006 compared to $0.5 million for the quarter ended December 31, 2005 and $0.4 million for the quarter ended March 31, 2005, primarily as a result of the increase in fair value of our investment in GSHI. Net unrealized appreciation totaled $1.4 million for the nine months ended March 31, 2006 compared to $0.4 million for the nine months ended March 31, 2005. Net increase in stockholders' equity resulting from operations represents the sum of the returns generated from net investment income, realized gains (losses) and from unrealized appreciation (depreciation).

Financial Condition, Liquidity and Capital Resources

The Company's liquidity and capital resources were generated primarily from the remaining net proceeds of its initial public offering as well as from cash flows from operations. We generated $97.0 million in cash from the net proceeds of our initial offering. We used cash flows in operating activities totaling ($3.2) million for the nine months ended March 31, 2006 compared to ($82.6) million

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for the nine months ended March 31, 2005. We declared and paid dividends totaling $5.5 million for the nine months ended March 31, 2006 compared to $1.6 million for the nine months ended March 31, 2005. In the future, we may also fund a portion of our investments through borrowings from banks, issuances of senior securities or secondary offerings. We may also securitize a portion of our investments in mezzanine or senior secured loans or other assets. Our objective is to put in place such borrowings in order to expand our portfolio. Our primary use of funds will be investments in portfolio companies and cash distributions to holders of our common stock.

At March 31, 2006, we held no cash in the segregated account maintained in conjunction with a limited indemnity issued to Citibank Texas, N.A. (formerly First American Bank, SSB). The limited indemnity with Citibank required us to indemnify Citibank for up to $12.0 million for any losses it realizes on its term loan to GSHI resulting only from potential legal claims that might or could be asserted by certain third parties. This limited indemnity was backed by the funds in the segregated account. During the quarters ended December 31, 2005 and June 30, 2005, $9.6 million and $3.3 million of previously segregated funds were released to the Company, respectively. These reductions reflected a waiver of the segregated funds requirement due to the developments related to legal claims and prior payments by GSHI to Citibank Texas, N.A., respectively.

Capital Raising Activities

On February 17, 2006, we entered into a $20,000,000 senior revolving credit facility (‘‘Facility’’) with a syndicate of lenders administered by the Bank of Montreal. Interest on borrowing under the Facility is charged at either (i) a LIBOR rate loan plus the applicable percentage at such time, generally 250 basis points, or (ii) the greater of the lender prime rate or the federal funds effective rate plus 50 basis points. Loans under the Facility are collateralized by a perfected first priority security interest in all of the assets of the Company, including all investments in its portfolio companies. The Facility will be used to supplement Prospect Energy's equity capital to make additional portfolio investments. This Facility, which, together with other borrowings (which may include reverse repos and similar transactions), may be used in the future to leverage our capital. Our objective is to put in place such borrowings in order to expand our portfolio. Our primary use of funds will be investments in portfolio companies and cash distributions to holders of our common stock. Subsequently the credit facility has been increased to $30.0 million.

Quantitative and Qualitative Disclosures about Market Risk.

We are subject to financial market risks, including changes in interest rates, equity price risk and some of the loans in our portfolio may have floating rates. To date, a significant, but declining, percentage of our assets have been and are invested in short-term U.S. treasury bills. We may hedge against interest rate fluctuations by using standard hedging instruments such as futures, options and forward contracts subject to the requirements of the 1940 Act. While hedging activities may insulate us against adverse changes in interest rates, they may also limit our ability to participate in the benefits of higher interest rates with respect to our portfolio of investments. During the three and nine months ended March 31, 2006 and the twelve months ended June 30, 2005, we did not engage directly in hedging activities.

Controls and Procedures.

As of March 31, 2006, Prospect Energy carried out an evaluation, under the supervision and with the participation of Prospect Energy's management, including Prospect Energy's chief executive officer and chief financial officer, of the effectiveness of the design and operation of Prospect Energy's disclosure controls and procedures (as defined in Rule 13a-15 of the Exchange Act). Based on that evaluation, as of April 27, 2006, the chief executive officer and the chief financial officer have concluded that Prospect Energy's current disclosure controls and procedures are effective in timely alerting them of material information relating to Prospect Energy that is required to be disclosed by Prospect Energy in the reports it files or submits under the Exchange Act.

Internal Control Over Financial Reporting. Our management, under the supervision and with the participation of our chief executive officer and chief financial officer, is responsible for establishing and

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maintaining adequate internal control over financial reporting, as such responsibility is defined in Rule 13a-15(f) of the Exchange Act, and for performing an assessment of the effectiveness of internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Prospect Energy's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, thought not eliminate, this risk.

There have been no changes in Prospect Energy's internal control over financial reporting that occurred during the three months ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

RIC Status

We elected a