

DISTRIBUTED ENERGY SYSTEMS CORP

Form 10-Q

May 10, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from                      to

Commission File Number: 000-50453

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**DISTRIBUTED ENERGY SYSTEMS CORP.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of

incorporation or organization)

10 Technology Drive, Wallingford, CT 06492

(Address of registrant's principal executive office)

(203) 678-2000

(Registrant's telephone number, including area code)

20-0177690  
(I.R.S. Employer

Identification Number)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registration is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). ☐ YES ☒ NO

The number of shares outstanding of the registrant's common stock, par value \$.01 per share, as of May 4, 2007 was 39,772,882.

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**DISTRIBUTED ENERGY SYSTEMS CORP.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

|   | March 31,     | December 31,  |
|---|---------------|---------------|
|   | 2007          | 2006          |
| <b>ASSETS</b>   |               |               |
| Current assets:   |               |               |
| Cash and cash equivalents   | \$ 1,957,538  | \$ 4,911,704  |
| Marketable securities (Note 4)  | 7,367,938     | 13,256,116    |
| Current portion of restricted cash  | 971,333       | 794,705       |
| Accounts receivable, less allowances of \$701,695 and \$688,778, respectively | 7,693,257     | 7,857,484     |
| Costs in excess of billings on contracts in progress (Note 5)                 | 4,656,497     | 4,102,573     |
| Inventories, net (Note 5)   | 5,884,216     | 4,784,439     |
| Deferred costs  | 199,046       | 810,508       |
| Interest receivable   | 122,875       | 100,798       |
| Other current assets  | 806,727       | 1,060,931     |
| Total current assets  | 29,659,427    | 37,679,258    |
| Fixed assets, net   | 21,123,014    | 22,740,210    |
| Long-term portion of restricted cash  | 6,133,474     | 6,229,176     |
| Intangible assets, net  | 2,844,127     | 3,012,321     |
| Other assets, net   | 186,344       | 228,657       |
| Total assets  | \$ 59,946,386 | \$ 69,889,622 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                   |               |               |
| Current liabilities:  |               |               |
| Current portion of long-term debt   | \$ 1,319,575  | \$ 1,379,460  |
| Current portion of capital lease  | 211,436       | 208,556       |
| Accounts payable  | 5,911,583     | 6,099,536     |
| Accrued expenses (Notes 6 and 12)   | 2,285,927     | 2,035,599     |
| Accrued compensation  | 1,707,008     | 2,122,068     |
| Accrued taxes (Note 12)   | 263,979       | 348,050       |
| Billings in excess of costs on contracts in progress (Note 5)                 | 991,247       | 1,723,988     |
| Deferred revenue  | 335,154       | 836,607       |
| Customer advances   | 165,396       | 60,344        |
| Total current liabilities   | 13,191,305    | 14,814,208    |
| Long term liabilities:  |               |               |
| Deferred revenue  | 168,076       | 168,076       |
| Long-term debt  | 5,425,484     | 5,540,411     |
| Long-term portion of capital lease  | 2,575,389     | 2,626,461     |
| Total liabilities   | 21,360,254    | 23,149,156    |
| Commitments and contingencies (Note 12)                                       |               |               |
| Stockholders' equity (Note 10):   |               |               |

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|  |                   |                   |
|--|-------------------|-------------------|
| Preferred stock, undesignated, \$.01 par value per share; 5,000,000 shares authorized; no shares issued or outstanding             |                   |                   |
| Common stock, \$.01 par value; 65,000,000 shares authorized; 39,756,952 and 39,442,180 shares issued and outstanding, respectively | 397,569           | 394,421           |
| Additional paid-in capital   | 242,092,855       | 235,624,657       |
| Accumulated other comprehensive loss (Note 2)  | (5,355)           | (9,115)           |
| Accumulated deficit  | (203,898,937)     | (189,269,497)     |
| <br>Total stockholders' equity   | <br>38,586,132    | <br>46,740,466    |
| <br>Total liabilities and stockholders' equity   | <br>\$ 59,946,386 | <br>\$ 69,889,622 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DISTRIBUTED ENERGY SYSTEMS CORP.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

|   | <b>Three Months Ended March 31,</b> |                |
|---|-------------------------------------|----------------|
|   | <b>2007</b>                         | <b>2006</b>    |
| Revenue   |                                     |                |
| Contract  | \$ 6,252,537                        | \$ 5,226,288   |
| Product   | 646,825                             | 1,115,307      |
| Service   | 1,524,272                           | 1,295,476      |
| Total revenue   | 8,423,634                           | 7,637,071      |
| Cost of revenue   |                                     |                |
| Contract  | 6,476,474                           | 4,856,685      |
| Product   | 520,604                             | 1,162,884      |
| Service   | 1,793,210                           | 1,173,788      |
| Total cost of revenue   | 8,790,288                           | 7,193,357      |
| Gross margin  | (366,654)                           | 443,714        |
| Operating expenses:   |                                     |                |
| Research and development:   |                                     |                |
| Depreciation and amortization   | 102,489                             | 130,471        |
| Other research and development (includes stock based compensation in the amount of \$24,081 and \$57,340 respectively)                  | 662,846                             | 552,189        |
| Restructuring costs   | 562,375                             |                |
| Selling, general and administrative:  |                                     |                |
| Depreciation and amortization   | 1,576,765                           | 361,119        |
| Other selling, general and administrative (includes stock based compensation in the amounts of \$388,868 and \$2,256,370, respectively) | 11,497,980                          | 7,014,128      |
| Total operating expenses  | 14,402,455                          | 8,057,907      |
| Loss from operations  | (14,769,109)                        | (7,614,193)    |
| Interest income   | 250,442                             | 348,930        |
| Interest expense  | (175,288)                           | (152,313)      |
| Other income  | 64,515                              | 71,952         |
| Net loss  | \$ (14,629,440)                     | \$ (7,345,624) |
| Basic and diluted net loss per share  | \$ (0.37)                           | \$ (0.20)      |
| Shares used in computing basic and diluted net loss per share   | 39,611,254                          | 37,509,080     |

The accompanying notes are an integral part of the condensed consolidated financial statements.

**Table of Contents****DISTRIBUTED ENERGY SYSTEMS CORP.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>Three Months Ended March 31,</b> |                |
|---|-------------------------------------|----------------|
|   | <b>2007</b>                         | <b>2006</b>    |
| Cash flows from operating activities:                                       |                                     |                |
| Net loss  | \$ (14,629,440)                     | \$ (7,345,624) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                     |                |
| Depreciation and amortization   | 1,873,070                           | 595,957        |
| Provision for bad debts   | 61,049                              | 50,265         |
| Amortization (accretion) of premiums/discounts on marketable securities     | (45,314)                            | (103,723)      |
| Non-cash stock-based expense  | 418,054                             | 2,373,892      |
| Expense for warrants issued   | 5,841,471                           |                |
| Loss from sale of marketable securities                                     | 2,175                               | 13,688         |
| (Gain)/loss on disposal of assets   | 21,294                              | (37,063)       |
| Changes in operating assets and liabilities:                                |                                     |                |
| Accounts receivable   | 103,178                             | 751,672        |
| Inventories and deferred costs  | (488,315)                           | (1,654,068)    |
| Costs in excess of billings   | (553,924)                           | (716,527)      |
| Other current and non-current assets  | 267,684                             | (268,107)      |
| Accounts payable and accrued expenses                                       | (352,685)                           | (1,460,500)    |
| Accrued taxes payable   | (84,071)                            | (130,188)      |
| Billings in excess of costs   | (732,741)                           | (305,288)      |
| Deferred revenue and contract advances                                      | (396,401)                           | 650,733        |
| Net cash used in operating activities                                       | (8,694,916)                         | (7,584,881)    |
| Cash flows from investing activities:                                       |                                     |                |
| Purchases of fixed assets   | (102,218)                           | (354,966)      |
| Proceeds from the sale of fixed assets                                      |                                     | 115,000        |
| Purchases of marketable securities  |                                     | (21,880,768)   |
| Proceeds from maturities and sales of marketable securities                 | 5,935,077                           | 16,187,944     |
| Restricted cash   | (80,926)                            |                |
| Net cash provided by (used in) investing activities                         | 5,751,933                           | (5,932,790)    |
| Cash flows from financing activities:                                       |                                     |                |
| Borrowings from long-term debt  |                                     | 40,453         |
| Debt principal payments   | (223,004)                           | (175,943)      |
| Proceeds from sale of common stock, net                                     | 44,657                              | 566,753        |
| Proceeds from exercise of stock options                                     | 167,164                             | 165,265        |
| Proceeds from exercise of warrants  |                                     | 201,484        |
| Net cash (used in) provided by financing activities                         | (11,183)                            | 798,012        |
| Net decrease in cash  | (2,954,166)                         | (12,719,659)   |
| Cash and cash equivalents at beginning of year                              | 4,911,704                           | 20,600,791     |
| Cash and cash equivalents at end of period                                  | \$ 1,957,538                        | \$ 7,881,132   |

The accompanying notes are an integral part of the condensed consolidated financial statements.





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**DISTRIBUTED ENERGY SYSTEMS CORP.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. FORMATION AND OPERATIONS OF THE COMPANY**

Distributed Energy Systems Corp. (the "Company", "we" or "Distributed Energy") was incorporated in Delaware on May 19, 2003 to create and deliver products and solutions to the new energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy System brings together two established businesses: Proton Energy Systems, Inc. ("Proton") and Northern Power Systems, Inc. ("Northern"). Together, as subsidiaries of Distributed Energy System, Proton and Northern offer an array of practical energy technologies, including Proton's advanced hydrogen generation products and Northern's renewable and fossil-fuel power systems.

On January 31, 2007, we announced that we are combining our Northern Power and Proton Energy Systems businesses under Distributed Energy Systems. This change is aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. The former separate businesses of Proton and Northern will be combined in the areas of Power Generation, Hydrogen Generation, and Technology Generation.

The Company incurred significant operating losses and negative cash flow from operating activities in each of the last three years and during the quarter ended March 31, 2007. Such circumstances raise substantial doubt about our ability to continue as going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, to reduce our operating losses and operate profitably, to generate cash flow from operations, as well as our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the value at which they are carried on our consolidated financial statements.

We do not believe that our cash, cash equivalents and marketable securities on hand as of March 31, 2007, together with our currently forecasted revenues and existing backlog, will be sufficient to fund operations beyond the second quarter of 2007. Please see the discussion in footnote 14 under the caption "Subsequent Events" for more information.

Even if additional funding is obtained, our ability to continue our operations in the longer term will be subject to a number of factors that pose additional risk and uncertainty, including:

Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues.

Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow.

Our ability to control operating expenses

**2. BASIS OF PRESENTATION**

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries after elimination of significant intercompany transactions.

The condensed consolidated financial statements as of March 31, 2007 and for the three-months ended March 31, 2007 and 2006 are unaudited. In the opinion of management, all adjustments, which consist solely of

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normal recurring adjustments, necessary to present fairly in accordance with accounting principles generally accepted in the United States of America, the financial position, results of operations and cash flows for all periods presented, have been made. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for the full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the Company's audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K filed with the SEC on March 13, 2007.

### Comprehensive Loss

Comprehensive loss consists of net loss and other gains and losses affecting stockholders' equity that are not the result of transactions with owners. The following tables set forth the components of comprehensive loss resulting from our investment activities:

|   | Three Months Ended March 31 |                |
|---|-----------------------------|----------------|
|   | 2007                        | 2006           |
| Net loss  | \$ (14,629,440)             | \$ (7,345,624) |
| Reclassification adjustments for loss from the sale of marketable securities included in net loss | 2,175                       | 13,688         |
| Unrealized gain on marketable securities arising in the period                                    | 1,585                       | 8,925          |
| Total comprehensive loss  | \$ (14,625,680)             | \$ (7,323,011) |

### Concentration of Risks

Concentration of credit risk exists with respect to cash and cash equivalents, restricted cash, accounts receivable, investments, revenue and vendors. The Company maintains its cash and cash equivalents and investments with high quality financial institutions. At times, amounts may exceed federally insured deposit limits. In addition, certain critical product components are only available from one source and are subject to the source's proprietary rights.

For the quarter ended March 31, 2007, sales to five customers accounted for approximately 53% of total revenues. For the quarter ended March 31, 2006, sales to five customers accounted for approximately 35% of total revenues.

At March 31, 2007 and December 31, 2006, accounts receivable from government-sponsored agencies accounted for approximately 9% and 8% of total Company accounts receivable, respectively. At March 31, 2007 and December 31, 2006, accounts receivable from international customers accounted for approximately 34% and 35% of total Company accounts receivable, respectively. At March 31, 2007 and December 31, 2006 accounts receivable from our five largest customers, accounted for approximately 49% and 39% of total accounts receivables, respectively.

### 3. RECENT ACCOUNTING GUIDANCE

The Company adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) on January 1, 2007. As a result of the implementation of FIN 48, the Company performed a comprehensive review of any uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company's

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expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company believes it has no uncertain tax positions and accordingly, did not record any charges.

The Company will recognize accrued interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, the Company did not have any tax-related interest or penalties. The Company files income tax returns in the U.S. federal and various state jurisdictions. The Company is not currently under examination by The Internal Revenue Service (IRS) or any other state jurisdictions. The tax years 2003-2005 remain subject to examination.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. The company does not expect that the adoption of FAS 157 will have a material impact on the financial statements.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets and liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the potential impact of this statement.

**4. MARKETABLE SECURITIES**

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. As of March 31, 2007 and December 31, 2006, the Company's investment portfolio consisted of U.S. government and agency securities held by a major banking institution. The maturities of marketable securities of \$7,367,938 and \$13,256,116 at March 31, 2007 and December 31, 2006, respectively, are less than one year.

Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders' equity. The unrealized loss from marketable securities was \$5,355 and \$9,115 at March 31, 2007 and December 31, 2006, respectively. Proceeds from the sale of one security for the quarter ended March 31, 2007 totaled \$2,639,742. The cost was determined using the specific identification method and the resulting realized loss was \$2,175.

As of March 31, 2007, none of the Company's investments were determined to be other than temporarily impaired.

**5. INVENTORIES AND COSTS AND BILLINGS ON CONTRACTS IN PROGRESS**

Inventories are stated at the lower of cost or market value. Cost is determined by the average cost method.

|                 | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-----------------|---------------------------|------------------------------|
| Raw materials   | \$ 3,381,540              | \$ 3,732,561                 |
| Work in process | 2,133,667                 | 923,435                      |
| Finished goods  | 369,009                   | 128,443                      |
|                 | <b>\$ 5,884,216</b>       | <b>\$ 4,784,439</b>          |

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The above inventory amounts are shown net of reserves for obsolescence and shrinkage of \$512,428 and \$493,951 at March 31, 2007 and December 31, 2006, respectively.

The information on costs and billings on contracts in progress accounted for under the percentage-of-completion method is as follows:

|  | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|--|---------------------------|------------------------------|
| Costs incurred and estimated earnings on contracts in progress   | \$ 29,187,325             | \$ 20,969,341                |
| Less: billings to date   | 25,522,075                | 18,590,756                   |
| <b>Costs and earnings in excess of (less than) billings, net</b> | <b>\$ 3,665,250</b>       | <b>\$ 2,378,585</b>          |
|  |                           |                              |
|  | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
| Costs in excess of billings on contracts in progress             | \$ 4,656,497              | \$ 4,102,573                 |
| Billings in excess of costs on contracts in progress             | (991,247)                 | (1,723,988)                  |
| <b>Costs and earnings in excess of (less than) billings, net</b> | <b>\$ 3,665,250</b>       | <b>\$ 2,378,585</b>          |

**6. ACCRUED EXPENSES**

Accrued expenses consist of the following:

|                   | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------|---------------------------|------------------------------|
| Accrued warranty  | \$ 824,365                | \$ 813,445                   |
| Accrued purchases | 576,593                   | 455,099                      |
| Other accruals    | 884,969                   | 767,055                      |
|                   | <b>\$ 2,285,927</b>       | <b>\$ 2,035,599</b>          |

**7. LOSS PER SHARE**

Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average common shares outstanding. Diluted EPS is calculated by adjusting weighted average common shares outstanding by assuming conversion of all potentially dilutive shares. In periods where a net loss is recorded, no effect is given to potentially dilutive securities since the effect would be antidilutive. Accordingly, no effect has been given to the assumed exercise of 944,871 and 3,361,414 common stock options outstanding for the three months ended March 31, 2007 and 2006, respectively, nor the assumed exercise of 3,868,524 and 673,297 common stock warrants outstanding for the three months ended March 31, 2007 and 2006, respectively, since the effect would be antidilutive for the reporting periods.

**Table of Contents****8. STOCK-BASED COMPENSATION**

On January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective transition method. SFAS 123(R) requires the measurement and recognition of compensation expense for all stock-based awards made to the Company's employees and directors including employee stock options, employee stock purchase plans, and other stock-based awards based on estimated fair values. As a result, for the three months ended March 31, 2007 and 2006, our results of operations reflect compensation expense for new stock options and awards granted and vested under our stock incentive plans, and the unvested portion of previous stock option and award grants which vested during the three months ended March 31, 2007 and 2006. Amounts recognized in the financial statements related to stock-based compensation were as follows:

|                                       | <b>Three Months Ended<br/>March 31,</b> |                  |
|---------------------------------------|---|------------------|
|                                       | <b>2007</b>                             | <b>2006</b>      |
| Selling, General and Administrative   | \$ 388,868                              | \$ 2,256,370     |
| Research and Development              | 24,081                                  | 57,340           |
| Cost of revenue                       | 5,105                                   | 60,182           |
| <br>Total non-cash stock compensation | <br>\$ 418,054                          | <br>\$ 2,373,892 |

*CEO Awards*

In the first quarter of 2006 the Company granted its CEO, Mr. Schwallie 100,000 shares of restricted common stock at a price of \$0.01 per share. The fair market value of these shares at the time of grant was \$8.84 and vested one year from the date of grant. In addition, the Company granted Mr. Schwallie 28,280 shares of restricted common stock at a price of \$0.01 per share. The fair market value of these shares at the date of grant was \$8.84 and vested immediately. Additionally, in connection with the commencement of Mr. Schwallie's employment, the Company granted Mr. Schwallie an option to purchase 500,000 shares of common stock at an exercise price of \$8.84 per share. The option vests as to 25% of the original number of shares on the first anniversary of the grant date and 25% of the original number of shares at the end of each successive year following the first anniversary of the grant date until the fourth anniversary of the grant date. The option agreement also contained a termination of relationship clause resulting in accelerated vesting during the first year of employment. As a result of these restricted stock and stock option awards the Company recorded non-cash stock based compensation charges of approximately \$147,000 and \$1,370,000 for the three months ended March 31, 2007 and 2006, respectively.

Mr. Schwallie also has the ability to earn up to 300,000 shares of restricted stock, contingent upon achievement of various company wide performance goals, including certain revenue, cash flow and gross margin targets at various intervals through June 30, 2008. The shares subject to this agreement vest immediately upon the achievement of these performance goals. The Company determined that as of March 31, 2007 it was not probable that these restricted shares would be issued and therefore no compensation cost has yet been recognized. If a change in control event, as described in our 2003 Stock Incentive Plan and meeting parameters to be determined by our board of directors, occurs, and Mr. Schwallie is still employed by the Company, these restricted shares would be granted to Mr. Schwallie unless it is no longer possible for the respective targets to be met.

*Director Compensation*

In January 2007, the Company granted a total of 75,040 shares of restricted common stock to its non-employee directors at a price of \$3.63 per share, all shares vesting monthly over a one-year period. The non-cash stock compensation cost of approximately \$66,000 associated with this restricted common stock for the three months ended March 31, 2007 is reflected in selling, general and administrative expenses.

**Table of Contents****9. RESTRUCTURING AND RELATED COSTS**

In January 2007, the Company announced that it was combining the Northern and Proton Systems businesses under Distributed Energy Systems. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. The Company also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility resulting in the elimination of about 60 jobs, or 20% of the workforce.

As a result, during the three months ended March 31, 2007, the Company recorded severance charges of approximately \$562,000. These costs are accounted for under FAS 146, Accounting for Costs Associated with Exit or Disposal Activities, and were included as a charge to the results of operations for the three months ended March 31, 2007. Any subsequent changes to the estimates of executing the currently approved plans of restructuring will be reflected in current results of operations. Severance payments will continue to be made through the second quarter of 2007.

The following table summarizes the severance provision, the severance amount paid and remaining severance costs for the 2007 restructuring costs by segment:

|                           | Northern   | Proton    | Other     | Total      |
|---------------------------|------------|-----------|-----------|------------|
| Provision                 | \$ 448,662 | \$ 50,061 | \$ 63,652 | \$ 562,375 |
| Amounts paid              | (311,935)  | (18,153)  | (4,896)   | (334,984)  |
| Balance at March 31, 2007 | \$ 136,727 | \$ 31,908 | \$ 58,756 | \$ 227,391 |

As a result of its decision to exit the Waitsfield facility and consolidate its Northern operations in Barre Vermont by June 30, 2007, the Company revised the estimated useful life and estimated residual value of the Waitsfield facility which will accelerate depreciation charges. Therefore, the Company recorded additional depreciation expense of approximately \$1.2 million during the quarter ended March 31, 2007, included in selling, general and administrative expenses, and expects to record additional depreciation expense of approximately \$1.2 million during the quarter ended June 30, 2007 related to this facility such that the facility will be reduced to its estimated net realizable value at June 30, 2007.

**10. STOCKHOLDER S EQUITY**

Changes in stockholder s equity for the three months ended March 31, 2007 were as follows (in thousands):

|  |           |
|--|-----------|
| Balance at December 31, 2006   | \$ 46,740 |
| Net loss   | (14,629)  |
| Issuance of common stock from exercise of stock options and warrants | 167       |
| Issuance of common stock from ESPP program exercises                 | 45        |
| Issuance of warrants   | 5,841     |
| Stock based compensation   | 418       |
| Change in unrealized loss on marketable securities                   | 4         |
| Balance at March 31, 2007  | \$ 38,586 |

**11. JOINT VENTURE**

On March 7, 2007, the Company entered into a Joint Venture Agreement with Morgan Stanley Wind LLC ( MSW ), a subsidiary of Morgan Stanley. This agreement establishes a framework for the Company and Morgan Stanley to work together to develop, finance, own and operate projects utilizing waste-to-energy technology, combined-heat-and-power technology and other advanced energy technologies. The agreement provides MSW the exclusive right, but not the obligation to provide financing for projects. No projects subject to

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the terms of the joint venture agreement have been entered into. In connection with the execution of the Joint Venture Agreement and as an inducement for Morgan Stanley to enter into the agreement, the Company issued to Morgan Stanley on March 7, 2007 a Common Stock Purchase Warrant entitling Morgan Stanley to purchase up to 10% of the Company's common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. The warrant may only be exercised in cash.

The warrant is immediately vested as to 8% of the Company's common stock outstanding from time to time, at a purchase price equal to the lower of \$2.25 per share or 80% of the fair market value of the common stock on the date of exercise, but in no event less than \$2.10 per share. This 8% tranche of the warrant is exercisable until the second anniversary of the grant date, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least \$2.25.

The warrant will vest in four subsequent tranches, each as to 0.5% of our common stock outstanding from time to time, at such time as MSW has funded (1) \$21.25 million, (2) \$42.5 million, (3) \$63.75 million and (4) \$85 million in the aggregate to projects developed under the Joint Venture Agreement or we have entered into engineering, procurement and construction ( EPC ) or operation and maintenance ( O&M ) contracts with projects sourced by MSW with aggregate values equal to those thresholds. Each of these subsequent tranches will have a purchase price equal to the lower of 80% of the fair market value of our common stock on the vesting date or 80% of the fair market value of the common stock on the date of exercise, but in no event less than \$2.10 per share. Each subsequent tranche will be exercisable until the second anniversary of the vesting date of that tranche, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least equal to the fair market value on the vesting date.

The Company estimated the fair value of the warrants issued under this arrangement using a binomial lattice model. The fair value of the first tranche warrants at March 7, 2007 was determined to be \$1.51 per share. As a result the company recorded a non-cash charge of \$5,841,471 associated with 3,868,524 warrants issued under this first tranche. The fair value of warrants that become available in the four subsequent tranches will be recorded when each respective funding level is achieved.

## **12. COMMITMENTS AND CONTINGENCIES**

### *Contracts*

The Company has agreements with two customers providing for construction of power systems that utilize Stirling engine technology. On February 16, 2007, the Company was notified that the manufacturer of these engines, STM Power, Inc., ( STM ) had ceased operations.

The Company has informed the two customers that, due to STM's cessation of operations, it is likely that it would be unable to complete and maintain these power systems as planned. The Company has reviewed the situation with one of these customers and believes that it can provide an alternative solution. The cost of this solution has been recorded as additional cost of contract revenues for the three months ended March 31, 2007. The Company is also reviewing alternative solutions for the second customer that was to utilize the Stirling engine technology. Due to the unique and complex requirements of this customer the Company is not presently able to reasonably estimate the potential loss it may incur, if any, on this contract, and accordingly no related costs have been accrued for in the accompanying condensed consolidated financial statements. Should an adverse resolution related to this contract occur, the Company could incur a loss of up to \$1.7 million, the full value of the contract. In addition, the costs to the Company of defending any potential litigation or other proceedings, even if resolved in its favor, could be substantial.

In 2001, Proton entered into an agreement with the Connecticut Clean Energy Fund ( CCEF ). The agreement provides Proton with financial assistance for up to \$1.5 million, \$600,000 under Phase I and \$900,000

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under Phase II of the agreement, to accelerate commercial deployment of the UNIGEN backup power unit. Proton is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach \$25 million annually. Prior to the achievement of milestones described in this agreement, these funds were subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling interest in Proton by a third party, the sale of substantially all of Proton's assets, the consolidation or merger of Proton with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, Proton records funds received as liabilities until it achieves the contract milestones, at which time such amounts are recognized as reductions in related costs and expenses.

In addition to Phase I and Phase II, CCEF agreed in September 2004 to provide \$890,000 of funding to Proton to design, build and conduct a 24-month demonstration of a 5 kilowatt Regenerative Fuel Cell (RFC) for a telecommunications site in southwestern Connecticut. In October 2004, CCEF agreed to provide \$485,000 of funding for a 15 kilowatt RFC Backup Power unit for Wallingford Electric, and \$418,000 of funding for an upgrade to an existing RFC system at Mohegan Sun Casino's Energy, Environment, Economics, and Education Center. The following table sets forth for the last three fiscal years, the customer advances and milestone achievements, utilized to offset certain costs and expenses incurred related to the UNIGEN product:

|                    | CCEF               |
|--------------------|--------------------|
|                    | Advance<br>Balance |
| December 31, 2004  | \$ 283,012         |
| Advances           | 917,167            |
| Milestone achieved | (933,300)          |
| December 31, 2005  | \$ 266,879         |
| Advances           | 276,370            |
| Milestone achieved | (543,249)          |
| December 31, 2006  | \$                 |
| Advances           | 162,140            |
| Milestone achieved | (162,140)          |
| March 31, 2007     | \$                 |

### Warranty

The changes in the carrying amount of warranties for the three months ended March 31, 2007 and 2006 are as follows:

|                             | 2007       | 2006       |
|-----------------------------|------------|------------|
| Balance as of December 31:  | \$ 813,445 | \$ 417,694 |
| Warranties issued in period | 175,281    | 107,190    |
| Adjustments to provision    | (36,590)   | 79,058     |
| Warranty claims             | (127,771)  | (181,504)  |
| Balance as of March 31:     | \$ 824,365 | \$ 422,438 |



*Sales and Use Tax Relief Program Recapture*

In connection with the construction of its Wallingford facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement (the Agreement ) with the Connecticut Development Authority (the

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Authority ). The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. The recapture clauses for relocation and early disposition/abandonment expire October 15, 2010; whereby the Company could be required to pay back a portion of the sales tax relief received. The employment threshold clause was subject to review by the Authority in the quarter ended December 31, 2006. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under the Agreement shall not exceed \$419,250 (the maximum sales and use tax benefit possible under the terms of the Agreement, plus a 7.5% penalty). Proton was required under the Agreement to place \$419,250 in escrow related to these recapture clauses. This \$419,250 is included within restricted cash as part of long-term assets. The Company did not meet the employment threshold recapture clause by the compliance date of December 31, 2006 and as such accrued \$152,000 for possible tax repayments and penalties. At this time all the other conditions that would require payment are remote and the Company has not accrued any additional liability.

### *State Income, Sales, Property and Franchise Tax Accruals*

The Company has recorded, within current liabilities, tax accruals of approximately \$264,000 and \$348,000 for certain state income and sales tax contingencies for which there may be exposure at March 31, 2007 and December 31, 2006, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual is subject to change and the actual amount could be greater or less than the accrued amount.

### *Legal Proceedings*

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton's common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton's IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs' claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court's certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit's decision and have informed the District Court that they would like to be heard as to whether the

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settlement may still be approved even if the decision of the Court of Appeals is not reversed. The District Court indicated that it would defer consideration of final approval of the settlement pending plaintiffs' request for further appellate review. On April 6, 2007, plaintiffs' Petition for Rehearing of the Second Circuit's decision was denied. Proton believes it has meritorious defenses to the claims made in the complaints and, if the settlement is not finalized and approved, Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

### 13. SEGMENT FINANCIAL DATA

Management has chosen to organize its enterprise around its two operating subsidiaries, Proton and Northern. Proton, our hydrogen generator and fuel cell business, develops and manufactures proton exchange membrane, or PEM, electrochemical products. Northern, our distributed generation business, designs, builds and installs both stand-alone and grid-connected electric power systems for industrial, commercial and government customers. For management reporting and control, the Company is divided into the operating segments as presented below. Each segment has general autonomy over its business operations.

It is possible that as a result of the changes in the Company described in Note 1, we may change our segments. Currently, our CEO still receives and uses information about the two segments below, as well as additional information.

Financial information as of and for the quarters ended March 31, 2007 and 2006, (in thousands) is summarized below.

|              | Three Months Ended<br>March 31, |          |
|--------------|---------------------------------|----------|
|              | 2007                            | 2006     |
| Revenues:    |                                 |          |
| Proton       | \$ 2,031                        | \$ 1,892 |
| Northern     | 6,393                           | 5,745    |
| Consolidated | \$ 8,424                        | \$ 7,637 |

Included within Northern's revenues for the quarters ended March 31, 2007 and 2006 are sales to one international customer totaling approximately 7% and 12% of consolidated revenues, respectively. The Company believes it has no risk of foreign dependence.

|                        | Three Months Ended<br>March 31, |            |
|------------------------|---------------------------------|------------|
|                        | 2007                            | 2006       |
| Loss from operations:  |                                 |            |
| Proton                 | \$ (1,413)                      | \$ (1,856) |
| Northern               | (5,513)                         | (2,584)    |
| Eliminations and other | (7,843)                         | (3,174)    |
| Consolidated           | \$ (14,769)                     | \$ (7,614) |

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|                        | <b>Three Months Ended<br/>March 31,</b> |                   |
|------------------------|---|-------------------|
|                        | <b>2007</b>                             | <b>2006</b>       |
| Net loss:              |   |                   |
| Proton                 | \$ (1,410)                              | \$ (1,840)        |
| Northern               | (5,576)                                 | (2,604)           |
| Eliminations and other | (7,643)                                 | (2,902)           |
| <b>Consolidated</b>    | <b>\$ (14,629)</b>                      | <b>\$ (7,346)</b> |

|                        | <b>March<br/>31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|------------------------|-------------------------------|------------------------------|
| Total assets:          |                               |                              |
| Proton                 | \$ 71,986                     | \$ 25,380                    |
| Northern               | 24,038                        | 73,488                       |
| Eliminations and other | (36,078)                      | (28,978)                     |
| <b>Consolidated</b>    | <b>\$ 59,946</b>              | <b>\$ 69,890</b>             |

All assets of the Company are located in the United States.

**14. SUBSEQUENT EVENTS**

On May 10, 2007, we entered into a securities purchase agreement with Perseus L.L.C., or Perseus. Under this agreement, Perseus has agreed to lend us \$12.5 million. This loan would bear interest at 12.5% per annum, compounded quarterly, and would be due in full nine months from the initial funding. The loan would be secured by a security interest on all of our assets and those of our subsidiaries. In consideration for the loan, we will grant to Perseus a five-year warrant to purchase up to 10 million shares of our common stock, representing 24.99% of the shares currently outstanding, with an exercise price of \$0.80 per share. If the loan is closed, Perseus will be entitled to have an observer at board meetings. Perseus will also have the right to approve specified significant actions by our company. We have undertaken in this agreement to use commercially reasonable efforts to sell our Proton subsidiary, and we expect we would engage an investment bank to assist us in that process shortly after the initial closing. We also granted to Perseus a right of first refusal to fund any future financing transactions we might pursue. In addition, we have agreed to register for resale all the shares issuable to Perseus. Closing of this loan is expected to occur as soon as practical, after the execution of the agreement but is subject to closing conditions including the condition that our business will not have experienced a material adverse change since the signing of the securities purchase agreement. We cannot assure you that the conditions will be satisfied and the closing will occur.

In addition, the securities purchase agreement provides that Perseus will subsequently make an additional loan of \$15.0 million with a term of 18 months from the funding of the initial loan, the proceeds of which would be used in part to repay the initial \$12.5 million loan. This loan would be evidenced by a senior secured note convertible at Perseus' election into shares of our common stock at a price equal to the lower of \$1.20 or 75% of the per share market price of our common stock at the time the loan is made. We would also be obligated to issue warrants to Perseus in connection with this second loan to purchase up to 33 million shares of our common stock at prices ranging from \$1.00 to \$3.00 per share. In addition, Perseus would be entitled to representation on our board of directors equal to at least their percentage ownership in our company. This second loan is subject to the condition that the stockholders of our company have approved the transaction as required by the rules of the NASDAQ Stock Market. It is also subject to closing conditions, including the condition that our business will not have experienced a material adverse change since the initial funding. If the stockholders do not approve this second loan, or if the other closing conditions are not satisfied, then we would be required to repay the initial \$12.5 million loan on the nine-month due date anniversary using other funds.

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### **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto appearing elsewhere in this Form 10-Q and with our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2006. This Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar words. Statements that contain these words carefully because they discuss our future expectations and contain projections of our future results of operation or of our financial position or state other forward-looking information. However, there may be events in the future that we are unable to predict accurately or control. The factors in the section captioned "Critical Accounting Policies" contained in our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2006, and below in this Form 10-Q under the "Risk Factors" and "Legal Proceedings" captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

### **OVERVIEW**

We provide products and services for distributed, or on-site, power generation and storage. Using our systems, which produce energy at or near the place where it is used, our customers gain greater control over power quality, costs and management of their energy needs. We design, integrate, construct and maintain power systems using a variety of technologies and energy sources both for grid-connected customers and for customers who need power solutions for remote locations or require more reliable or environmentally benign alternatives to centrally distributed electricity. We also market our hydrogen generators, which produce hydrogen from electricity and water in a clean and efficient process, to domestic and international customers for industrial, utility and research applications. We are developing additional technologies and products for the distributed energy market, including systems that provide backup power and energy storage, hydrogen generators that produce hydrogen for fuel cell vehicles, power network architectures that link diverse power generating sources and advanced wind turbine generators.

Our distributed generation systems produce electricity from conventional fuels and from cleaner, more sustainable sources such as wind, sunlight and biofuels, using reliable power generation technologies integrated with custom controls and power electronics. We have installed over 800 systems in more than 26 countries during over 30 years of operations. Our diverse customer base ranges from those who use our systems in remote applications, such as oil and gas pipelines and telecommunications facilities, to grid-connected customers who use our systems for large commercial office buildings and manufacturing facilities. Our customers include Petróleos Mexicanos (PEMEX), S. C. Johnson & Son, Inc., Equity Office Properties Trust, The Timberland Company and Honeywell International Inc.

Our hydrogen generator systems utilize proprietary proton exchange membrane, or PEM, electrochemical technology to produce hydrogen through the electrolysis of water. Our hydrogen generators have been designed to address the existing demand for industrial hydrogen in a safer and more cost-effective manner than truck-delivered hydrogen. We have installed over approximately 900 hydrogen generators in more than 40 countries over more than five years of operations. Our hydrogen generators are also being used in demonstration projects to supply fuel to fuel cell vehicles. We are developing core PEM technology to combine our hydrogen generator technology with a fuel cell power generator to create an energy device that is able to produce and store hydrogen fuel that it can later use to generate electricity, which we refer to as a regenerative fuel cell system. In the longer term, we believe our regenerative fuel cell systems will enable renewable energy solutions by facilitating the storage of energy produced by non-depleting, non-polluting energy sources, such as solar, wind and hydroelectric power.

### ***Update on our Financial Condition; Perseus Investment***

Since December 31, 2006, our financial condition has deteriorated significantly. As of March 31, 2007, we had \$9.3 million of cash, cash equivalents and marketable securities. This reflects a decrease of \$8.8 million from the balance of cash, cash equivalents and marketable securities as of December 31, 2006. Our accounts

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receivable also declined slightly from \$7.9 million at December 31, 2006 to \$7.7 million at March 31, 2007. During the quarter ended March 31, 2007, we used \$8.7 million of cash in operating activities. Our current liabilities declined slightly from \$14.8 million at December 31, 2006 to \$13.2 million at March 31, 2007, but this was more than offset by the decline in our current assets.

We do not believe that our cash, cash equivalents and marketable securities on hand as of March 31, 2007, together with our currently forecasted revenues and existing backlog, will be sufficient to fund operations beyond the second quarter of 2007. We had anticipated that our previously announced revenue initiatives would improve sales and margins, but our sales and gross margins in the quarter ended March 31, 2007 were below our expectations and we believe sales will continue to suffer unless our financial condition improves meaningfully. Our previously announced joint venture with Morgan Stanley Wind LLC has not generated significant new business to date. Accordingly, we will be required to raise additional funds and significantly cut our costs in the very near term if our business is to survive. If we are not successful in these efforts, we may be required to liquidate our company or to seek protection from creditors in a bankruptcy proceeding. It is also possible that one or more of our existing lenders might accelerate amounts we owe to them under our debt agreements, even though those debts are currently fully collateralized.

On May 10, 2007, we entered into a securities purchase agreement with an investment fund managed by Perseus L.L.C., or Perseus. Under this agreement, Perseus has agreed to lend us \$12.5 million. This loan would bear interest at 12.5% per annum, compounded quarterly, and would be due in full nine months from the initial funding. The loan would be secured by a security interest in all of our assets and those of our subsidiaries and would be guaranteed by each of our subsidiaries. In connection with this loan, we will grant to Perseus a five-year warrant to purchase up to 10 million shares of our common stock, representing 24.99% of the shares currently outstanding, at an exercise price of \$0.80 per share. If the loan is closed, Perseus will be entitled to have an observer at board meetings. Perseus will also have the right to approve specified significant actions by our company. We have undertaken in this agreement to use commercially reasonable efforts to sell our Proton subsidiary, and we expect we would engage an investment bank to assist us in that process shortly after the initial closing. We also granted to Perseus a right of first refusal to fund any future financing transactions we might pursue. In addition, we have agreed to register for resale all the shares issuable to Perseus. Closing of this loan is expected to occur as soon as practical after the execution of the agreement, but is subject to closing conditions including the condition that our business will not have experienced a material adverse change since the signing of the securities purchase agreement. We cannot assure you that the conditions will be satisfied and the closing will occur.

In addition, the securities purchase agreement provides that Perseus will subsequently make a second loan of \$15.0 million with a term of 18 months from the funding of the initial loan, the proceeds of which would be used in part to repay the initial \$12.5 million loan. This loan would be evidenced by a senior secured note convertible at Perseus' election into shares of our common stock at a price equal to the lower of \$1.20 per share or 75% of the per share market price of our common stock at the time the loan is made. We would also be obligated to issue warrants to Perseus in connection with this second loan to purchase up to 33 million shares of our common stock at prices ranging from \$1.00 to \$3.00 per share. In addition, Perseus would be entitled to representation on our board of directors equal to at least their percentage ownership in our company. This second loan is subject to the condition that the stockholders of our company have approved the transaction as required by the rules of the NASDAQ Stock Market. It is also subject to closing conditions, including the condition that our business not have experienced a material adverse change since the initial funding. If the stockholders do not approve this second loan, or if the other closing conditions are not satisfied, then we would be required to repay the initial \$12.5 million loan on the nine-month due date anniversary using other funds.

In January 2007, we announced a 60 person (approximately 20%) reduction of our workforce and we will undertake additional workforce reductions in the near future as necessary. We also announced a plan to exit our Waitsfield, Vermont facility and combine our Vermont operations into our Barre, Vermont facility.

If the initial Perseus loan is not funded, we will need to undertake additional, more significant cost-saving initiatives in the very near term, likely including a further reduction of our workforce. We have also engaged a commercial real estate broker to identify parties that would be interested in purchasing our Connecticut facility.

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and leasing it back to us. We have received multiple proposals and are evaluating the merits of each, but there can be no assurance that we will complete a sale-leaseback transaction, particularly if our financial condition does not improve and we are not perceived as a creditworthy tenant. We are also exploring sales of other significant assets of our business, potentially including all or a portion of the assets of our Northern or Proton subsidiaries.

If the initial Perseus loan is not funded we will need to raise additional financing from some other source in the very short term. We have been pursuing various sources of equity and debt funding over the last six months, but to date we have not been successful in locating a party other than Perseus willing to provide financing on acceptable terms and conditions. If the Perseus transaction is not closed, we intend to continue aggressively to seek additional financing, but we may continue to experience difficulty in locating interested parties and there can be no assurance that we will be successful in this effort. If we were successful in raising additional capital through the sale of equity or convertible debt securities, the ownership interest of our stockholders would be diluted, probably significantly, and the terms might include liquidation or other preferences that would adversely affect their rights as common stockholders. Debt financing, if available, would likely involve agreements that include covenants limiting or restricting our ability to take specific actions such as incurring additional debt or making capital expenditures, would likely be secured by all of the assets of our company and of our Northern and Proton subsidiaries and would likely include very strict default terms.

## **CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared by us in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, depreciable lives of equipment, warranty obligations and contingency accruals. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in our Annual report on Form 10-K for the fiscal year ended December 31, 2006. Our audit committee has discussed our critical accounting policies with management and our independent registered public accounting firm.

Our critical accounting policies include the following:

### **Revenue Recognition Product Revenue**

All of our product revenue is derived from the operations of our Proton segment. For product sales for which adequate product warranty information exists, we record revenue when a firm sales agreement is in place, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. If customer acceptance of products is not assured, revenue is recorded only upon formal customer acceptance. Customer acceptance provisions included in our product sales agreements may include written acceptance from the customer, acceptance upon servicing and installation of the equipment, and acceptance after a period of time. Revenue for product sales to distributors, for which there are no rights of return or price adjustments on unsold inventory, is recognized on a gross basis upon shipment to the distributors, as they assume title and risk of loss, subject to the deferral provisions below. For all product sales where adequate product warranty information does not yet exist to reasonably estimate warranty costs as required by accounting principles generally accepted in the United States, we defer revenue and costs until the expiration of the product warranty period.

During the third quarter of 2006, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN H-series products.

We also earn revenue from the rental of our HOGEN products. We account for the agreements as operating leases under the provisions of Statement of Financial Accounting Standards, or SFAS, No. 13, Accounting for Leases. The agreements are cancelable at any time by either party without penalty. Rental revenue is recognized monthly over the term of the rental agreement.

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### **Revenue Recognition Contract Revenue**

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines at our Northern Power segment. For projects with a duration of greater than three months where we have the ability to reasonably estimate total project costs to complete the contract, we recognize revenue utilizing the percentage-of-completion method as prescribed by SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1), based on the relationship of costs incurred to total estimated contract costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be judgmental. For the three months ended March 31, 2007 and 2006, approximately 84% and 81% of our contract revenue, respectively, was recognized under the percentage-of-completion method.

We also derive contract revenues from government-sponsored research and development contracts and from commercial customers. For government-sponsored research and development contracts that are fixed-price, we recognize revenue using the percentage-of-completion method under SOP 81-1. For fixed-price-incentive, or cost-reimbursement contracts that do not require us to meet specific obligations, we record revenue as work is performed. For those research and development contracts that require us to meet specified obligations, including delivery and acceptance obligations, we recognize amounts advanced as contract liabilities until such obligations are met. Once the obligations are met, we recognize the amounts as contract revenue. For all other commercial contracts, we recognize revenue under the completed contract method.

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our annual gross margin percentage for contract revenue may be affected by these changes in estimates and has fluctuated from (4)% to 7% for the three months ended March 31, 2007 and 2006, respectively.

### **Revenue Recognition Service Revenue**

For service and repair contracts, we recognize revenue as work is performed. For operating and maintenance contracts where we have agreed to provide routine maintenance services over a period of time for a fixed price, we recognize revenue ratably over the service period.

### **Warranty Costs**

Our warranty to customers is limited to replacement parts and services and generally expires one year from the date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. We record estimated warranty obligations in the period in which we recognize the related revenue. We quantify and record an estimate for warranty related costs; this estimate is principally based on historical experience. The accounting for warranties requires us to make assumptions and apply judgments when estimating product failure rates and expected material and labor costs. We make adjustments to accruals as



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warranty claim data and historical experience warrant. If actual results are not consistent with the assumptions and judgments used to calculate our warranty liability, because either failure rates or repair costs differ from our assumptions, we may be exposed to gains or losses that could be material. A 10% change in the warranty reserve at March 31, 2007 would have affected our pre-tax loss by approximately \$82,000 for the three months ended March 31, 2007.

### **Inventory**

We record inventory at the lower of cost or market value. We determine cost by the first-in, first-out method. This policy requires us to write down our inventory for the excess of the carrying value, which is typically the original cost, over the amount we expect to realize from the ultimate sale or other disposal of the inventory based upon our assumptions regarding forecasted consumer demand, market conditions, inventory aging and technological obsolescence. If any of our estimates are inaccurate, for example because of changes in technology that affect demand for certain products in an unforeseen manner, we may be exposed to losses or gains in excess of our established reserve, and those gains and losses could be material. A 10% change in our inventory reserve as of March 31, 2007 would have affected our pre-tax loss by approximately \$51,000 for the three months ended March 31, 2007.

### **Intangible Assets**

Intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for intangible assets subject to amortization is based on the amount the carrying value exceeds the fair value of the asset.

We have assessed the useful lives of its other existing intangible assets and believe that the estimated useful lives remain appropriate.

### **Long-Lived Assets**

We evaluate potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. We would be required to recognize an impairment loss if the carrying amount of long-lived assets is not recoverable based on their undiscounted cash flows. The measurement of impairment loss is then based on the difference between the carrying amount and the fair value of the asset. If actual results are not consistent with our assumptions and judgments used in estimating future cash flows and asset fair values, we may be exposed to additional impairment losses that could be material to our results of operations.

In January 2007, we announced that we were combining the Northern Power and Proton Energy Systems businesses under Distributed Energy Systems. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. We also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern Power operations in the Barre, Vermont facility. As a result of our decision to exit the Waitsfield facility and consolidate our Northern Power operations in Barre Vermont by June 30, 2007, we revised the estimated useful life and estimated residual value of the Waitsfield facility which will accelerate depreciation charges. Therefore, we recorded additional depreciation expense of approximately \$1.2 million during the quarter ended March 31, 2007 and expect to record additional depreciation expense of approximately \$1.2 million during the quarter ended June 30, 2007 related to this facility such that the facility will be reduced to its estimated net realizable value at June 30, 2007.

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### **Stock-Based Compensation**

#### *Stock-Based Compensation Employee Stock-Based Awards*

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the Employee Stock Purchase Program ( ESPP ) based on estimated fair values. SFAS 123(R) supersedes our previous accounting under APB 25, Accounting for Stock Issued to Employees for periods beginning in fiscal year 2006. In March 2005, the SEC issued SAB 107 providing supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. We adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from January 1, 2006. Our Condensed Consolidated Financial Statements, as of and for the three-month periods ended March 31, 2007 and 2006, reflect the impact of SFAS 123(R). Non-cash stock compensation expense for the three months ended March 31, 2007 and 2006, was \$407,775 and \$2,350,104, respectively, which consisted primarily of stock-based compensation expense related to employee stock options and restricted stock recognized under SFAS 123(R). In addition, stock-based compensation expense for the three-month period ended March 31, 2007 and 2006 of \$10,279 and \$23,788 respectively, were recognized related to our ESPP.

Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123, Accounting for Stock-Based Compensation. Under the intrinsic value method, no stock-based compensation expense for employee stock options had been recognized in our Consolidated Statements of Operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method we used in adopting SFAS 123(R), our results of operations prior to 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R).

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the three months ended March 31, 2007 and 2006, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the fair value on the grant date estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 31, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all stock-based awards granted will be recognized using the ratable single-option method. As stock-based compensation expense recognized in our results for the first quarter of 2007 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. The Company has determined that historical volatility is most reflective of the market conditions and the best indicator of expected volatility.

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If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. Therefore, we believe it is important for investors to be aware of the high degree of subjectivity involved when using option pricing models to estimate share-based compensation under SFAS 123(R). There is risk that our estimates of the fair values of our share-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those share-based payments in the future. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly in excess of the fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with SFAS 123(R) and the Securities and Exchange Commission's Staff Bulletin No. 107 (SAB 107) using an option pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Estimates of share-based compensation expenses are significant to our financial statements, but these expenses are based on the option valuation model and will never result in the payment of cash by us. For this reason, and because we do not view share-based compensation as related to our operational performance, we exclude estimated share-based compensation expense when evaluating the business performance of our operating segments.

The guidance in SFAS 123(R) and SAB 107 is relatively new, and best practices are not well established. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimate of share-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

Theoretical valuation models and market based-methods are evolving and may result in lower or higher fair value estimates for share-based compensation. The timing, readiness, adoption, general acceptance, reliability and testing of these methods is uncertain.

The following table highlights the impact that each of the various assumptions has on determining the fair value of an option or award when using an option-pricing model:

| <b>Impact of Inputs to Value of Stock Options</b> |                              |                  |
|---|------------------------------|------------------|
| Volatility of Stock                               | Higher the volatility        | Higher the value |
| Expected Term                                     | Longer the term              | Higher the value |
| Risk Free Rate                                    | Higher the rate              | Higher the value |
| Dividend Yield                                    | Lower the yield              | Higher the value |
| Exercise Price                                    | Lower the exercise price (A) | Higher the value |
| Stock Price (fair value)                          | Higher the stock price       | Higher the value |

(A) presumes exercise price is less than fair value

Also see Note 8 to the Condensed Consolidated Financial Statements on Stock-Based Compensation.

**Table of Contents***Stock-Based Compensation    Non-Employee Stock Options*

We account for stock-based compensation issued to non-employees in accordance with SFAS 123(R) and the consensus in Emerging Issues Task Force 96-18. These pronouncements require the fair value of equity instruments given as consideration for services rendered to be recognized as a non-cash charge to income over the shorter of the vesting or service period. The equity instruments must be revalued on each subsequent reporting date until performance is complete with a cumulative catch-up adjustment recognized for any changes in their fair value.

**Recent Accounting Guidance**

The Company adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) on January 1, 2007. As a result of the implementation of FIN 48, the Company performed a comprehensive review of any uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company's expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company believes it has no uncertain tax position and accordingly, did not record any charges.

The Company will recognize accrued interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, the Company did not have any tax-related interest or penalties. The Company files income tax returns in the U.S. federal and various state jurisdictions. The Company is not currently under examination by The Internal Revenue Service (IRS) or any other state jurisdictions. The tax years 2003-2005 remain subject to examination.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. The company does not expect that the adoption of FAS 157 will have a material impact on the financial statements.

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets and liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sales and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the potential impact of this statement.

**Results of Operations***Comparison of the Three Months Ended March 31, 2007 and March 31, 2006***Revenues:**

|              | Three months ended |              |                     |      |
|--------------|--------------------|--------------|---------------------|------|
|              | March 31,          | March 31,    |                     |      |
|              | 2007               | 2006         | Increase (decrease) |      |
| Net revenues |                    |              |                     |      |
| Contract     | \$ 6,252,537       | \$ 5,226,288 | \$ 1,026,249        | 20%  |
| Product      | 646,825            | 1,115,307    | (468,482)           | -42% |
| Service      | 1,524,272          | 1,295,476    | 228,796             | 18%  |
| Total        | \$ 8,423,634       | \$ 7,637,071 | \$ 786,563          | 10%  |

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Northern contract revenues increased approximately \$0.5 million in the first quarter of 2007 compared to the comparable 2006 quarter. This increase relates to Northern's on-site business where revenues increased by approximately \$2.0 million related to one large solar project and the recognition of revenue associated with one contract accounted for under the completed contract method of accounting. In addition power distributor contract revenue increased approximately \$0.6 million due to an increased number of active contracts. These increases were offset by a decreases of approximately \$1.4 million and \$0.7 million associated with Northern's industrial infrastructure and contract research and development, respectively, due to fewer contracts in progress compared to the prior years quarter. Proton's contract revenue increased approximately \$0.5 million related to an increased number and size of contracts in the first quarter of 2007 compared to the first quarter of 2006.

Product revenue decreased in the first quarter of 2007 compared to the comparable 2006 quarter related to fewer shipments of HOGEN S-series and laboratory hydrogen generators.

The increase in service revenue relates to Northern's increased operating and maintenance business of approximately \$0.6 million as well as an increase in Proton's service revenue of \$0.1 million associated with an increased number of hydrogen generators in the field. These increases were offset by a decrease of approximately \$0.5 million associated with Northern's international field service revenue due to the completion of commissioning on two pipelines in 2006.

As of March 31, 2007, our backlog was valued at approximately \$16.6 million, consisting of contract and service backlog valued at approximately \$12.4 million for Northern and \$3.4 million for Proton and product for Proton valued at approximately \$0.8 million.

**Costs of revenue:**

|                  | Three months ended |              |                     |      |
|------------------|--------------------|--------------|---------------------|------|
|                  | March 31,          | March 31,    |                     |      |
|                  | 2007               | 2006         | Increase (decrease) |      |
| Cost of revenues |                    |              |                     |      |
| Contract         | \$ 6,476,474       | \$ 4,856,685 | \$ 1,619,789        | 33%  |
| Product          | 520,604            | 1,162,884    | (642,280)           | -55% |
| Service          | 1,793,210          | 1,173,788    | 619,422             | 53%  |
| Total            | \$ 8,790,288       | \$ 7,193,357 | \$ 1,596,931        | 22%  |

Cost of contract revenues as a percentage of contract revenues increased from 93% in the first quarter of 2006 to 104% in the first quarter of 2007. Northern's costs of contract revenues as a percentage of revenues increased from 94% in the first quarter of 2006 to 111% in the first quarter of 2007. This increase is partially due to higher than anticipated contract costs related to one contract where additional costs are expected to be incurred in order to replace planned Stirling engines. On February 16, 2007, the Company was notified that the manufacturer of these engines, STM Power, Inc., had ceased operations. These additional costs are expected to be incurred to complete this contract using alternative technologies. Proton's cost of contract revenue as a percentage of contract revenue decreased from 83% for the three months ended March 31, 2006 to 70% for the comparable 2007 period. The increase in margin on Proton's contracts is due to a change in contract mix from lower margin cost share arrangements to higher margin fixed price and cost-plus-fixed-fee contracts.

Product cost of revenue as a percentage of product revenue decreased from 104% in the first quarter of 2006 to 80% in the first quarter of 2007. The decrease in cost of product revenue as a percentage of revenue was primarily attributable to a reduction in warranty costs associated with Proton's hydrogen generators in 2007 as compared to the 2006 period.

Service cost as a percentage of service revenue increased from 91% in the first quarter of 2006 to 118% in the first quarter of 2007. This increase in cost of service revenue as a percentage of service revenue is due to the change in Northern's mix of service contracts from higher margin international field service contracts to lower

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margin domestic operating and maintenance contracts. For the three months ended March 31, 2006 approximately 65% of service contract revenues were related to international field service compared to 16% of service contract revenues for the comparable 2007 period. Additionally, as Northern has expanded its service business, cost of service revenue for the three months ended March 31, 2007 includes infrastructure costs not incurred in the first quarter of 2006.

**Hydrogen generator units shipped:**

The following tables present hydrogen generator unit shipment details, and the revenue and costs deferred on those unit shipments:

|  | March 31,<br>2007 | March 31,<br>2006 | Increase<br>(decrease) |
|--|-------------------|-------------------|------------------------|
| <b>Hydrogen generator unit shipments</b> |                   |                   |                        |
| S series                                 | 2                 | 8                 | (6)                    |
| H series                                 | 3                 | 4                 | (1)                    |
| Laboratory generators                    | 12                | 18                | (6)                    |
| Total                                    | 17                | 30                | (13)                   |

|  | March 31,<br>2007 | March 31,<br>2006 | Increase<br>(decrease) |
|--|-------------------|-------------------|------------------------|
| <b>Revenue deferred on units shipped</b> |                   |                   |                        |
| S series                                 | \$                | \$                | \$                     |
| H series                                 |                   | 559,340           | (559,340)              |
| Laboratory generators                    |                   |                   |                        |
| Total                                    | \$                | \$ 559,340        | \$ (559,340)           |

|                                       | March 31,<br>2007 | March 31,<br>2006 | Increase<br>(decrease) |
|---------------------------------------|-------------------|-------------------|------------------------|
| <b>Cost deferred on units shipped</b> |                   |                   |                        |
| S series                              | \$                | \$                | \$                     |
| H series                              |                   | 485,705           | (485,705)              |
| Laboratory generators                 |                   |                   |                        |
| Total                                 | \$                | \$ 485,705        | \$ (485,705)           |

During the third quarter of 2006, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN H-series products. Therefore, starting in the third quarter of 2006, we began recognizing product revenue related to sales of our HOGEN H-series hydrogen generators upon shipment.

**Research and development expenses:**

The following chart reflects the amounts and percentage change of significant research and development items:

|                                 | Three months ended<br>March 31, March 31, |            |                     |
|---------------------------------|---|------------|---------------------|
|                                 | 2007                                      | 2006       | Increase (decrease) |
| <b>Research and development</b> |   |            |                     |
| Employee related                | \$ 620,032                                | \$ 710,469 | \$ (90,437) -13%    |
| Project material                | 77,868                                    | 220,759    | (142,891) -65%      |
| Depreciation and amortization   | 102,489                                   | 130,471    | (27,982) -21%       |
| Stock based compensation        | 24,081                                    | 57,340     | (33,259) -58%       |
| Other                           | (59,135)                                  | (436,379)  | 377,244 86%         |

|       |            |            |           |     |
|-------|------------|------------|-----------|-----|
| Total | \$ 765,335 | \$ 682,660 | \$ 82,675 | 12% |
|-------|------------|------------|-----------|-----|

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Employee related research and development costs and project material costs decreased related to less developmental efforts associated with Proton's hydrogen generators, and less project material costs at Northern, related to development of its power distributor products. The increase in other costs was primarily due to a decrease in CCEF program milestone-related credits earned. During the three months ended March 31, 2007, \$0.2 million of milestone related credits were earned compared to \$0.6 million for the three months ended March 31, 2006.

**Restructuring costs:**

During the three months ended March 31, 2007, the Company recorded severance charges of approximately \$562,000, resulting from the Company's strategic re-organization announced in January 2007. The re-organization effort eliminated about 60 jobs, or approximately 20% of the work force.

**Selling, general and administrative expenses:**

The following chart reflects the amounts and percentage change of significant selling, general and administrative items:

|  | Three months ended   |                     |                     |            |
|--|----------------------|---------------------|---------------------|------------|
|  | March 31,            |                     | March 31,           |            |
|  | 2007                 | 2006                | Increase (decrease) |            |
| <b>Selling, general and administrative</b> |                      |                     |                     |            |
| Employee related                           | \$ 3,020,469         | \$ 2,971,249        | \$ 49,220           | 2%         |
| Marketing and advertising                  | 225,156              | 211,118             | 14,038              | 7%         |
| Depreciation, amortization                 | 1,576,765            | 361,119             | 1,215,646           | 337%       |
| Stock based compensation                   | 388,868              | 2,256,370           | (1,867,502)         | -83%       |
| Legal, consulting and accounting           | 961,147              | 319,108             | 642,039             | 201%       |
| Other                                      | 6,902,340            | 1,256,283           | 5,646,057           | 449%       |
| <b>Total</b>                               | <b>\$ 13,074,745</b> | <b>\$ 7,375,247</b> | <b>\$ 5,699,498</b> | <b>77%</b> |

The increase in depreciation and amortization of \$1.2 million is the result of our decision to accelerate the depreciation related to our Waitsfield, VT facility based on our plan to exit that facility by June 30, 2007. The decrease in stock based compensation primarily relates to restricted stock and stock option charges of approximately \$1.2 million recorded in the first quarter of 2006 associated with the employment agreement of our CEO. The additional \$0.6 million decrease in stock based compensation relates to fewer unvested stock options outstanding as a result of employee terminations. The increase in legal, consulting and accounting expenses primarily relates to the legal fees associated with the Joint Venture Agreement with Morgan Stanley Wind, LLC and costs associated with financing efforts. The increase in other primarily relates to \$5.8 million of non-cash charges associated with warrants issued to Morgan Stanley Wind, LLC in connection with our Joint Venture Agreement.

**Interest income:** Interest income decreased from \$349,000 for the three months ended March 31, 2006 to \$250,000 for the comparable period in 2007. The decrease resulted from lower cash balances, partially offset by higher average interest rates. The average interest rates for the three months ended March 31, 2007 and 2006 were approximately 5.1% and 3.7%, respectively. The average cash and marketable securities balances for the three months ended March 31, 2007 and 2006 were approximately \$14.1 million and \$37.4 million, respectively.

**Interest expense:** Interest expense increased from \$152,000 for the three months ended March 31, 2006 to \$175,000 for the comparable period in 2007. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations.



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### **LIQUIDITY AND CAPITAL RESOURCES**

Since inception in August 1996 through March 2007, we and our predecessor, Proton, have financed our operations through convertible preferred stock issuances, an initial public offering, and an equity distribution agreement that, in total, raised approximately \$195.2 million. As of March 31, 2007, we had \$9.3 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was \$8.7 million for the three months ended March 31, 2007 and was primarily attributable to our net loss, increases in inventories as a result of less than expected demand for HOGEN hydrogen generators in the first quarter of 2007 and increases in costs in excess of billings, partially offset by non-cash depreciation, amortization, expense for warrants issued and stock compensation expense, and a decrease in billings in excess of costs. Cash used in operating activities was \$7.6 million for the three months ended March 31, 2006 and was primarily attributable to our net loss, increases in inventories and deferred costs, decreases in accounts payable as a result of timing of payments to vendors and decreases in accrued expenses.

Cash provided by investing activities was \$5.8 million for the three months ended March 31, 2007 and was primarily attributable to the proceeds from the maturity and sales of marketable securities. Cash used in investing activities was \$5.9 million for the three months ended March 31, 2006 and was primarily attributable to purchases of marketable securities, offset by proceeds from the maturity of marketable securities.

Cash used in financing activities was approximately \$11,000 for the three months ended March 31, 2007 and was primarily attributable to payments under Proton's and Northern's debt agreements partially offset by proceeds received from exercised incentive stock options. Cash provided by financing activities was \$798,000 for the three months ended March 31, 2006 and was primarily attributable to proceeds received in conjunction with the sale of stock, primarily to our new CEO, Ambrose Schwallie, our employee stock purchase plan and exercised incentive stock options, offset by payments under Proton's and Northern's debt agreements. We expect payments under our debt agreements to be approximately \$0.8 million over the next 12 months.

We incurred significant operating losses and negative cash flow from operating activities in each of the last three years and during the quarter ended March 31, 2007. Such circumstances raise substantial doubt about our ability to continue as going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, to reduce our operating losses and operate profitably, to generate cash flow from operations, as well as our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the value at which they are carried on our consolidated financial statements.

We do not believe that our cash, cash equivalents and marketable securities on hand as of March 31, 2007, together with our currently forecasted revenues and existing backlog, will be sufficient to fund operations beyond the second quarter of 2007. Please see the discussion above under the caption "Update on our Financial Condition" for more information about.

Even if the initial Perseus loan is funded, our ability to continue our operations in the longer term will be subject to a number of factors that pose additional risk and uncertainty, including:

Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues.

Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow.

Our ability to control operating expenses

**Table of Contents****ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

We invest in marketable securities consisting of U.S. government and agency securities that are held by one major banking institution. Distributed Energy's marketable securities portfolio is approximately \$7.4 million. Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

The following table provides information about Distributed Energy's financial instruments, stated at the fair value as of March 31, 2007 that are sensitive to changes in interest rates:

|                        |              |
|------------------------|--------------|
| Investments            |              |
| Fixed rate investments | \$ 7,367,938 |
| Average interest rate  | 3.47%        |

Additionally, we are exposed to market risk due to variable interest rates under our financing arrangements.

At March 31, 2007, we had \$5.2 million outstanding under our seven-year term note that is subject to a variable interest rate. The note bears interest at one month LIBOR plus 2.00%, which was 7.32% per annum at March 31, 2007. At March 31, 2007, we had \$0.6 million outstanding under our ten-year term note that is subject to a variable interest rate. The note bears interest at a variable rate equal to two percentage points less than VEDA's prevailing rate for taxable financing, which was 6.25% per annum at March 31, 2007, with a maturity date of October 6, 2015. If our variable interest rate were to increase or decrease by 10%, we do not believe such a change would have a material impact on our financial position or results of operations.

**ITEM 4. Controls and Procedures***(a) Evaluation of Disclosure Controls and Procedures*

The Company's management, with the participation of the Company's principal executive officer and principal financial and accounting officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of March 31, 2007. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial and accounting officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company's disclosure controls and procedures as of March 31, 2007, the Company's principal executive officer and principal financial and accounting officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

*(b) Changes in Internal Control over Financial Reporting*

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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### **PART II.**

#### **OTHER INFORMATION**

##### **ITEM 1. Legal Proceedings**

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton's common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton's IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs' claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court's certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit's decision and have informed the District Court that they would like to be heard as to whether the settlement may still be approved even if the decision of the Court of Appeals is not reversed. The District Court indicated that it would defer consideration of final approval of the settlement pending plaintiffs' request for further appellate review. On April 6, 2007, plaintiffs' Petition for Rehearing of the Second Circuit's decision was denied. Proton believes it has meritorious defenses to the claims made in the complaints and, if the settlement is not finalized and approved, Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

##### **ITEM 1A. Risk Factors**

The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Quarterly Report on Form 10-Q and presented elsewhere by management from time to time.

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### **RISKS RELATING TO OUR COMPANY**

**We will require additional funding and will need to significantly cut our costs in the very near term in order to continue to operate.**

We do not believe that our cash, cash equivalents and marketable securities on hand as of March 31, 2007, together with our currently forecasted revenues and existing backlog, will be sufficient to fund operations beyond the second quarter of 2007. Accordingly, we will need to raise additional funds or to significantly cut our costs in the very near term if our business is to survive. For more information about our efforts to raise additional funds and cut costs, please see the discussion under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations - Update on our Financial Condition; Perseus Investment". If we are not successful in these efforts, we might be required to liquidate our company or to seek protection from creditors in a bankruptcy proceeding, in which case the investors in our common stock could lose their entire investment.

**Our funding transaction with Perseus will result in significant new debt service, dilution to existing investors and potential control of our company by Perseus.**

On May 10, 2007, we entered into a securities purchase agreement with an investment fund managed by Perseus L.L.C., or Perseus. The most significant terms of this agreement are described under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations - Update on our Financial Condition; Perseus Investment". If our funding transaction with Perseus is closed, our company will face several new risks, including:

We will have a significant debt load which could become due in as little as nine months. The initial \$12.5 million loan from Perseus, which bears interest at a rate of 12.5% per annum, will become due in nine months. Unless our stockholders approve the terms of the second loan from Perseus, we will be obligated to fund the repayment of this loan from other sources. Even if Perseus funds the second \$15.0 million loan, that debt will be due in eighteen months unless Perseus elects to convert the loan into shares of our common stock. There can be no assurance that we will be able to fund the repayment of either Perseus loan as it becomes due. Perseus will have a security interest in all the assets of our company and our subsidiaries. If we default in the repayment of either Perseus loan, Perseus will be entitled to foreclose on all of those assets.

Current investors in our common stock will experience significant dilution. Upon the initial funding by Perseus, we will grant them a warrant to purchase up to approximately 10 million shares of our common stock at a purchase price of \$0.80 per share. If Perseus funds the second loan, we will be obligated to issue to Perseus a second warrant to purchase up to 33 million shares of our common stock at prices ranging from \$1.00 per share to \$3.00 per share. In addition, the \$15.0 million second Perseus loan will be convertible at Perseus' election into shares of our common stock at a price equal to the lower of \$1.20 per share or 75% of the per-share market price of our common stock at the time the loan is made.

Perseus will be able to block many significant actions by our company, including actions that our board of directors might deem desirable to pursue our strategic business plans and actions that might be necessary to raise funds to repay either Perseus loan.

Perseus may effectively take control of our company. If the second Perseus loan is funded, Perseus will immediately have the right to name two of our five directors. As Perseus acquires additional shares upon the exercise of its warrants or conversion of its second loan, Perseus may gain the right to name additional directors, which could constitute a majority of our directors.

**Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2006 with respect to our ability to continue as a going concern.**

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2006 with respect to our ability to continue as a going concern. This modification may negatively affect our stock price, our capital-raising efforts or our ability to enter into new contracts with customers. Our



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consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the values at which they are carried on our consolidated financial statements.

### **Our joint venture relationship with Morgan Stanley Wind LLC may not produce the benefits we hope for and could result in adverse accounting consequences.**

As part of our strategy to provide project finance alternatives to our customers, we entered into a joint venture agreement with Morgan Stanley Wind LLC, or MSW, in March 2007. Although this agreement contemplates that MSW will generally contribute 85% of the capital necessary to meet project financing requirements, MSW is not obligated to finance any particular projects or any projects at all. Accordingly, we cannot assure you that this arrangement will provide the strategic benefits that we hope for. In addition, the agreement contemplates that we will generally contribute 15% of the capital necessary to meet project financing requirements for those projects that MSW funds. Although we are not technically required to provide any financing to projects that we do not approve, if we do not do so MSW might determine not to fund projects or to fund fewer projects. Finally, we are not able at this time to determine whether the joint venture company or any project companies formed and funded under this arrangement will be consolidated with us for purposes of preparing our financial statements. If these companies are required to be consolidated with us, our financial statements may include assets, liabilities, revenues and expenses that we do not fully control.

### **The warrant we issued to MSW allows them to purchase up to 10% of our common stock outstanding from time to time; accordingly, any dilution resulting from future issuances of our common stock, options, warrants or other convertible securities will be increased by the effect of this warrant.**

In connection with our execution of the joint venture agreement with MSW, we issued to MSW a warrant entitling them to purchase up to 10% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. Accordingly, if we issue any new shares of our common stock, or issue any options or warrants to purchase our common stock or other securities convertible into our common stock, this will trigger a right of MSW under its warrant to acquire additional shares equal to as much as 10% of the new issuance. This feature of the warrant has the effect of increasing the dilution to current stockholders that would result from any issuances of our common stock or securities related to our common stock, including an issuance in connection with any financing transaction we may undertake.

### **Our revenue and results of operations may fluctuate significantly as a result of factors outside of our control, which could cause the market price of our common stock to decline.**

We expect our revenue and results of operations to vary significantly from quarter to quarter. As a result, quarterly comparisons of our financial results are not necessarily meaningful and should not be relied on as an indication of our future performance. In addition, due to our stage of development, we cannot predict our future revenue or results of operations with a precise degree of accuracy. As a consequence, our results may fall below the expectations of securities analysts and investors, which could cause the price of our common stock to decline. Factors that may affect our results include:

the status of development of our technology, products and manufacturing capabilities;

the cost and availability of raw materials and key components;

warranty and service cost for products in the field;

the introduction, timing and market acceptance of new products introduced by us or our competitors;

the development of strategic relationships and distribution channels;



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general economic conditions, which can affect customers' capital investments and the length of sales cycles;

the development of vehicular PEM fuel cells and renewable energy markets; and

government regulation.

We expect to continue make investments in all areas of our business, particularly in research and product development and in expanding our manufacturing and project finance capability. Because the investments associated with these activities are relatively fixed in the short-term, we may be unable to adjust our spending quickly enough to offset any unexpected shortfall in our revenue growth. In addition, because we are in the very early stages of selling our products and have a limited number of customers, we expect our order flow to be uneven from period to period.

### **We have incurred, and expect to continue to incur, substantial losses, and we may never become profitable.**

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of March 31, 2007, we had an accumulated deficit of \$204 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing capability and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators. Even if we achieve profitability, we may be unable to sustain or increase our profitability in the future.

### **Our future success is uncertain because of our limited commercial history selling many of our products.**

We have only been shipping commercial models of our hydrogen generators during the last five years and have not yet manufactured commercial regenerative fuel cell systems. We began shipping commercial models of our 100 kilowatt wind turbine in 2004. Accordingly, there is only a limited basis upon which to evaluate our products, business and prospects, and our future success is uncertain. You should consider the challenges, expenses, delays and other difficulties typically involved in the establishment of a new business, including the continued development of products, development of fully functioning manufacturing operations, refinement of processes and components for our commercial products, recruitment of qualified personnel, ability to manufacture a product which meets cost, reliability and efficiency needs, and achievement of market acceptance for our products.

### **Our distributed generation business is characterized by a long sales cycle and a relatively small number of projects each year, which can lead to variability and unpredictability in this business from period to period and financial losses on individual projects.**

As an engineering, procurement and construction contractor, we design and build a relatively small number of projects for a small number of customers each year. For many of these customers, we will deliver a single system with little or no opportunity for repeat business. Contracts for many of these large projects are awarded by competitive bid. With multiple other bidders on most large project opportunities, we often cannot accurately assess the probability of winning the contract prior to its award by the customer. Sales cycles are very long and projects can be delayed or cancelled for reasons beyond our control. Most large domestic distributed generation and hydrogen generation project opportunities are discretionary purchases for the customer, and, as a result, at the end of the sales cycle many such projects may never materialize for reasons beyond our control. During this lengthy sales cycle, we may incur significant expense and expend significant management effort. Implementation of projects that we are awarded can sometimes take over twelve months. During that time, numerous factors can contribute to cost overruns and schedule delays that affect profitability or result in a net loss. Generally accepted accounting principles may require us to defer revenue on a significant portion of our contracts until the project is



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completed, depending on contract terms. These factors make it very difficult for us to generate firm backlog well in advance of the actual projects and to accurately forecast future sales. If our sales forecasts from a specific project or customer for a particular period are not realized in that period, we may be unable to compensate for the shortfall, which could harm our results of operations. In addition, our revenue and results of operations may vary significantly from year to year and from quarter to quarter within a year.

**Our distributed generation business is dependent on a small number of customers, and termination of a project by one or more of these customers could harm our business.**

Typically, sales of our distributed generation systems are made to customers under single contracts to provide highly specialized on-site power systems designed and built to meet customer specifications. For three months ended March 31, 2007, our largest 5 customers accounted for 53% of our revenues and our largest 10 customers accounted for 67% of our revenues. Because such a high percentage of our sales are concentrated in so few contracts, failure by us or our customers to perform or deliver on any one of these contracts could have a major impact on our annual results of operations. In addition, most of our customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects us to a high degree of customer credit risk and risk of non-performance by our vendors. A single vendor's late delivery of a key component required for a project, for example, could significantly delay our completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in our contracts with our customers.

**In the past, we have experienced performance problems with our hydrogen generators.**

In the past, we have experienced performance problems with some components of our hydrogen generators, specifically hydrogen sensor modules, power supplies and cell stacks, which have required component replacement. We cannot guarantee that further problems related to these or other components or products will not occur and require additional corrective measures. If we are unable to solve these problems, potential purchasers of our products may decline to purchase them, which could affect our ability to grow our revenues. We could also face liability to our customers and harm to our reputation as a result.

**We may not be able to grow our business if we do not achieve widespread commercial acceptance of our hydrogen generators in the market for delivered hydrogen.**

We market our hydrogen generators to small and medium volume users of delivered hydrogen. Our method of supplying hydrogen by producing it on-site using PEM electrolysis represents a significant departure from conventional means of supplying hydrogen to end users. PEM electrolysis is a new technology in the markets we are targeting, and we do not know if our targeted customers will accept our product. Our business depends on the widespread commercial acceptance of our hydrogen generators, and we may be unable to grow our business if our targeted customers do not purchase substantial numbers of our hydrogen generators. Our targeted customers, or the distributors whom we intend to use to market to these customers, may not purchase our hydrogen generators at all or in sufficient quantities to support the growth of our business. Our hydrogen generators will require our target customers to make a substantial initial investment.

**We expect to incur significant expenses as we continue to expand our manufacturing production, and we may not be successful in these efforts.**

We have expanded our hydrogen generator and distributed generation manufacturing facilities in anticipation of increased demand for our products. If this demand does not materialize, we will not generate sufficient revenue to offset the costs of maintaining, expanding and operating these facilities, which could increase our losses and prevent us from growing our business. We expect to expand production and may experience delays or problems in our expected expansion that could compromise our ability to increase our sales and grow our business. Factors that could delay or prevent our expected production expansion include:

the inability to purchase parts or components in adequate quantities or sufficient quality, including from sole source vendors;

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the cost and availability of raw materials;

the failure to increase assembly and test operations;

the failure to hire and train additional manufacturing personnel; and

the failure to develop and implement cost-efficient manufacturing processes and equipment.

In addition, we may incur significant manufacturing costs and may experience unforeseen delays and expenses in our product design and manufacturing efforts. If the commercialization of our products is delayed, potential purchasers may also decline to purchase them or choose alternative technologies, both of which could impair our ability to generate revenue in the future.

### **We may not be able to increase revenues in the future if we do not complete the development of new products and technologies.**

We anticipate that a portion of our future revenue from our distributed generation business will be derived from the sale or licensing of regenerative fuel cell, wind turbine and power electronics products and technologies which we are currently developing or have only recently made commercially available. Many of these new products and technologies are based on new and unproven designs, and it is difficult to predict whether they will be commercially viable. If we fail to successfully develop and commercialize these products and technologies on the timetable we anticipate or at all, we will be unable to recover the investments we have made in their development and will be unable to grow our revenue from their sale or licensing. In addition, we may not be successful in developing product designs and manufacturing processes that permit the manufacture of our hydrogen generators and fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, we sell some of our products for less than it costs to produce them. New technology developments or cost reductions in existing technologies may also delay or prevent the development or sale of some or all of our planned products or make our planned products uncompetitive or obsolete.

### **We rely on third party suppliers and subcontractors for certain components and services, and we could suffer losses if these suppliers and subcontractors fail to fulfill our needs.**

Many of the components in our distributed generation and hydrogen generation systems, including the proton exchange membrane material used in our PEM products, hydrogen purification system and custom-designed power supplies used in our products, are available only from a limited number of suppliers and in some cases only a single supplier. Some of our suppliers are small- and medium-size companies that may not be able to increase production in an acceptable time period or at acceptable prices or quality levels. In addition, to the extent these components are proprietary products of our suppliers, or the processes used by our suppliers to manufacture these components are proprietary, we may be unable to obtain licenses on commercially reasonable terms or at all and we may be unable to obtain comparable components from alternative suppliers. Often our supplier's custom engineer components to our specifications for use in our systems. Delayed deliveries, poor quality and warranty issues can delay production of our products or completion of our projects, reduce our profits and damage our relationships with our customers.

We have agreements with two customers providing for construction of power systems that utilize Stirling engine technology. On February 16, 2007, we were notified that the manufacturer of these engines, STM Power, Inc., had ceased operations. We have informed the customers that, due to STM's cessation of operations, we are likely unable to complete and maintain these power systems as planned. We have informed the customers that, due to STM's cessation of operations, it is likely that we will be unable to complete and maintain these power systems as planned. We have reviewed the situation with one of these customers and believe that we can provide an alternative solution. The cost of this solution has been recorded as cost of contract revenues for the three months ended March 31, 2007. We are also reviewing alternative solutions for the second customer that was to utilize the Stirling engine technology. Due to the complex requirements of this customer we are not presently

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able to reasonably estimate its potential loss on this contract. Should an adverse resolution related to this contract occur, we could incur a loss of up to \$1.7 million, the full value of the contract. In addition, the costs to us of defending any litigation or other proceedings, even if resolved in our favor, could be substantial.

We rely heavily on electrical, mechanical, civil and structural subcontractors to build and install our distributed generation systems at our customers' facilities based on detailed specifications and drawings that we provide. Often these subcontracted services account for a high percentage of the overall project cost. Our subcontractors' failure to perform their services in a timely and quality manner can lead to significant schedule delays, increased costs and performance issues on our projects. These issues can trigger penalties in our contracts, expose us to claims for liquidated and consequential damages, increase our warranty exposure, reduce our profits and damage our relationships with customers if not managed appropriately.

### **Market factors affect our costs and availability of materials.**

Our products contain a number of materials, from metals to computer components. In particular, platinum is a key component of our PEM fuel cells. Platinum is a scarce natural resource and we are dependent upon a sufficient supply of this commodity. Decreases in the availability or increases in the prices of the commodities or other components of our products could impair our ability to acquire the materials necessary to meet our manufacturing requirements and result in significantly higher prices for those materials, either of which could cause delayed or lost sales and an increase in our manufacturing costs.

### **We may be unable to sell our systems and products and generate revenue if we fail to establish development, engineering, distribution or other strategic relationships.**

We currently work with a number of other parties who facilitate and enhance many aspects of our distributed generation systems business, including technology development, component supply, sales lead generation, engineering support and project installation. We must continue to expand these relationships and develop new relationships in order to grow our current project-based business. Failure to do so would negatively affect our future sales growth and results of operations.

Because we intend to sell some of our products through third-party distributors or industrial gas companies, the financial benefits to us of commercializing our products will be dependent on the efforts of others. We intend to enter into additional distribution agreements or other collaborative relationships to market and sell our products. If we are unable to enter into additional distribution agreements, or if our third-party distributors do not successfully market and sell our products, we may be unable to generate revenue and grow our business. We may seek to establish relationships with third-party distributors who also compete with us. For example, we have signed agreements with industrial gas suppliers who act as distributors of our hydrogen generators. Because industrial gas suppliers currently sell hydrogen in delivered form, adoption by their customers of our hydrogen generation products could cause them to experience declining demand for delivered hydrogen. For this reason, industrial gas suppliers may not be motivated to promote our hydrogen generators. Also, these agreements may be terminated by either party with 90 days written notice. If these agreements are terminated, we may be unable to generate revenue and grow our business. In addition, our third-party distributors may require us to provide volume price discounts and other allowances, or customize our products, either of which could reduce the potential profitability of these relationships.

### **We cannot guarantee that we will be successful in our efforts to increase our business in the operations and maintenance of distributed generation equipment, and we may incur additional risk and liability which could harm our business.**

We intend to grow our operating and maintenance business. This may include operations in less stable countries, which could expose us to unforeseen risks, including war, terrorism, flu pandemics, kidnapping and environmental hazards. Also, maintaining distributed generation equipment may expose us to additional sources of liability, including performance of equipment, uptime availability of equipment, maintenance and warranty costs.

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### **We may not recognize revenue in the full amount of our backlog, which could harm our business.**

Our backlog was approximately \$16.6 million as of March 31, 2007. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of March 31, 2007 from which we expect to recognize revenue in fiscal 2007 is likely to be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog. The actual accrual of revenue on engagements included in backlog may never occur or may change because a contract could be reduced, modified or terminated early. If we fail to realize revenue from engagements included in our backlog as of March 31, 2007, our revenue and results of operations for fiscal 2007 as well as future reporting periods may be materially harmed.

### **We depend on government contracts for a portion of our revenue and profits and to fund a portion of our research and development relating to new products.**

Our government contracts relate to research and development on renewable energy technologies, hybrid system architectures and advanced power electronics. Changes in government policy toward distributed generation or budget restrictions may reduce or eliminate funding for these types of research and development activities. Generally, our U.S. government research and development contracts are subject to the risk of termination at the convenience of the contracting agency and require us to obtain or produce components for our systems from sources located in the United States rather than foreign countries. There can be no assurance that our current contracts will be fully funded or that we will be able to secure additional government contracts for similar activities in the future. If such funding were discontinued, we may not have sufficient internal funding to continue with these development efforts and may therefore have to reduce our development of these products, delay their development or abandon them altogether. Discontinuation or delay in our development of proprietary products and technology could limit our ability to execute our business plan and may have an adverse impact on our ability to increase revenues and generate a profit. We are also subject to annual audits of our incurred costs on government contracts by the Defense Contracting Audit Agency, or DCAA. If our actual overhead cost included in our incurred costs is less than the allowable overhead costs billed on these contracts, we may be required to refund the excess overhead costs to the government upon completion of the DCAA audit. Such a refund would negatively affect our financial position and our results of operations in the year in which such costs were incurred.

Further, no assurance can be given that the internal controls we have in place to oversee our government contracts are sufficient to prevent isolated violations of applicable laws, regulations and standards. If the agencies determine that we or one of our subcontractors engaged in improper conduct, we may be subject to civil or criminal penalties and administrative sanctions, payments, fines and suspension or prohibition from doing business with the government.

### **We currently face and will continue to face significant competition, which could cause us to lose sales or render our products and services uncompetitive or obsolete.**

The distributed generation market is highly competitive and evolving rapidly. We face a wide variety of competitors, including equipment manufacturers, distributors, packagers, system integrators, general contractors, engineering firms, project developers and energy service companies. Many of our competitors are significantly larger and better capitalized than we are and have greater access to financial and other resources, and therefore may be able to devote more resources to the following activities that may allow them to establish a competitive advantage in the marketplace:

sales and marketing of their products and services;

seller financing for the sale of their products or services;

development and commercialization of new technologies;

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partnering and other collaborative efforts with sales channel partners, vendors and technology providers;

adaptation to changes in customer requirements;

expanded design, engineering and other performance and service capabilities; and

system and other infrastructure development that reduces costs.

The markets for delivered hydrogen and reliable backup power are highly competitive. There are a number of companies located in the United States, Canada and abroad that deliver hydrogen, sell hydrogen generation equipment or are developing PEM fuel cell technology. Many of these companies have substantially greater financial and other resources than we do, including a worldwide presence, name recognition and better historical performance. Each of these companies has the potential to capture market share in the markets we intend to address, which could cause us to lose sales and prevent us from growing our business. New developments in technology may also delay or prevent the development or sale of some or all of our products or make our products uncompetitive or obsolete. If this were to occur, we would not be able to generate sufficient revenue to offset the cost of developing our hydrogen generators and regenerative fuel cell systems.

Our regenerative fuel cell systems are one of a number of power technology products being developed today to provide high quality, highly reliable backup power to the existing electric transmission system, or grid. These products include advanced batteries, ultracapacitors, microturbines, flywheels, internal combustion generator sets, superconducting magnetic energy storage devices, other fuel cell types and fuel cells using alternative hydrogen supply applications. Improvements are also being made to the existing electric grid. Technological advances in power technology products and improvements in the electric grid may reduce the attractiveness of our regenerative fuel cell systems.

**We depend on our intellectual property, and our failure to protect it could enable competitors to market products with similar features that may reduce demand for our products.**

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to ours, which could reduce demand for our products. Our success depends substantially upon the internally developed technology that is incorporated in our products. We rely on patent, trademark and copyright laws, trade secret protection and confidentiality or license agreements with our employees, customers, strategic partners and others to protect our intellectual property rights. The steps we take to protect our intellectual property rights, however, may be inadequate. We may be unable to prevent unauthorized parties from attempting to copy or otherwise obtaining and using our products or technology. Policing unauthorized use of our technology is difficult, and we may not be able to prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our intellectual property as fully as those in the United States. Others may circumvent the trade secrets, trademarks and copyrights that we own, and any of the U.S. patents or foreign patents owned by us or subsequently issued to us may be invalidated, circumvented, challenged or rendered unenforceable. In addition, we may not be issued any patents as a result of our pending and future patent applications, and even if any patents are issued, they may not protect our intellectual property rights, and third parties may challenge the validity or enforceability of issued patents. In addition, other parties may independently develop similar or competing technologies designed around any patents that may be issued to us.

Most of our intellectual property is not covered by any patent or patent application. We seek to protect this proprietary intellectual property, which includes intellectual property that may not be patented or patentable, in part by confidentiality agreements with our contactors, distributors, employees and others. These agreements afford only limited protection and may not provide us with adequate remedies for any breach or prevent other persons or institutions from asserting rights to intellectual property arising out of these relationships.

Unauthorized parties may attempt to copy aspects of our products or to obtain and use our proprietary information. Litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets

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and to determine the validity and scope of the proprietary rights of others. Any litigation could result in substantial costs, the diversion of resources and the distraction of management, with no assurance of success.

### **We could incur substantial costs defending against claims that our products infringe on the proprietary rights of others.**

The patent situation in the field of wind turbine, distributed generation and PEM fuel cell technology is complex. A large number of patents, including overlapping patents, relating to this technology have been granted worldwide. We are aware of patents in the wind turbine and distributed generation fields held by potential competitors and other third parties, including Ballard Power Systems Inc., General Electric Company, Asea Brown Boveri Ltd., Siemens AG, Gamesa Corporacion Tecnologica, S.A., ENERCON GmbH and Mitsubishi Corporation. We are also aware of patents in the fuel cell architecture field held by potential competitors and other third parties, including Ballard Power Systems Inc., General Motors Corporation, Giner, Inc., Oronzio deNora Impianti Elettrochimici S.p.A., Parker-Hannifin Corporation, Hydrogenics Corporation, Lynntech, Inc., Plug Power Inc., Shinko Pantec Co., Ltd., Siemens AG, Toyota Motor Corporation, United Technologies Corporation and Whatman Inc. Third parties could claim infringement by us with respect to these patents or other patents or proprietary rights, and we may incur significant costs defending ourselves in such proceedings and there is no assurance that we will prevail in any such proceeding.

While we have a limited license under a patent held by General Electric Company with respect to variable-speed wind turbines, if we incorporate this type of technology into future wind-related generation products and are not able to design and engineer non-infringing technology, we may be required to extend or modify our license on this technology. If we are unsuccessful in developing non-infringing technologies, we may be required to cease or redirect our development efforts or obtain licensing, royalty or other agreements. There can be no assurance that we can obtain such licensing or other agreements on favorable terms or at all, in which case our ability to execute our business plan, grow our sales and generate a profit may be adversely affected.

In addition, some of our employees are parties to assignment of invention and nondisclosure agreements with their former employers. These agreements generally grant the former employer rights to technology developed by the employee while employed by the former employer and prohibit disclosure of that technology or other employer information to third parties. We cannot assure you that such employers will not assert claims against us or our employees alleging a breach of those agreements or other violations of their proprietary rights or alleging rights to inventions by our employees, or that we would prevail in any such proceeding.

Any infringement claims against us, whether meritorious or not, could:

be time-consuming;

result in costly litigation or arbitration and diversion of technical and management personnel; or

require us to develop non-infringing technology or to enter into royalty or licensing agreements.

We might not be successful in developing non-infringing technologies. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, or at all, and could significantly harm our business and results of operations. A successful claim of infringement against us or our failure or inability to license the infringed or similar technology could require us to pay substantial damages and could harm our business because we would not be able to sell the affected product without redeveloping the product or incurring significant additional expense. In addition, to the extent we agree to indemnify customers or other third parties against infringement of the intellectual property rights of others, a claim of infringement could require us to incur substantial time, effort and expense to indemnify these customers and third parties and could disrupt or terminate their ability to use, market or sell our products.

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**International intellectual property protection is particularly uncertain and costly, and we have not obtained or sought patent or trademark protection in many foreign countries where our products and services may be developed, manufactured, marketed or sold.**

Intellectual property law outside the United States is even more uncertain and costly than in the United States and is currently undergoing review and revision in many countries. Further, the laws of some foreign countries may not protect our intellectual property rights to the same extent as U.S. laws. Moreover, we have not sought, obtained or maintained patent and trademark protection in many foreign countries in which our products and services may be developed, manufactured, marketed or sold by us or by others.

**We may be exposed to lawsuits and other claims if our products or systems malfunction or fail or we fail to deliver services, which could increase our expenses, harm our reputation and prevent us from growing our business.**

Our distributed generation systems often use new and untested technologies. Many of these new technologies have not reached a level of maturity that allows for a predictable level of reliability and may be subject to malfunction or failure when subjected to prolonged use in non-test conditions. Should these new technologies fail to perform as specified by their vendors, we may incur significant warranty and other costs and our relationships with our customers may suffer. Also, many vendors of these new technologies have limited financial resources and may not be able to adequately support their products in the field. All these issues could reduce our growth and profitability. Many of our systems are also located in very remote locations with extremely harsh climates that are difficult and expensive to access. The possibility of system failures could cause us to incur significant expense to redesign, reengineer, repair and/or replace defective systems or system components. In addition, as we expand our overhaul, operations and maintenance services business, we may be subject to additional liability for maintaining distributed generation equipment, including performance of equipment, uptime availability of equipment, maintenance and warranty cost.

Since our products are power producing devices, it is possible that consumers could be injured or killed by our products, whether by product malfunctions, defects, improper installation or other causes. In particular, hydrogen is a flammable gas and can pose safety risks if not handled properly. We have experienced instances with our products where hydrogen appears to have caused a flame that burned several components in the system. Further investigation of this unit revealed the presence of pinholes in the cell membranes, resulting in hydrogen leakage and cell failure. We cannot be certain that future similar instances will not occur. In addition, our products may require modifications to operate properly under extreme temperatures. Potential customers will also rely upon our products for critical needs, such as backup power. A malfunction of our products could result in significant tort or warranty claims. In addition, a well-publicized actual or perceived problem could adversely affect the market's perception of our products. This could result in a decline in demand for our products, which would reduce our revenue and harm our business. In addition, since sales of our existing products have been modest and the products we are developing incorporate new technologies and use new installation methods, we cannot predict whether or not product liability claims will be brought against us in the future or the effect of any resulting adverse publicity on our business. Moreover, we may not have adequate resources in the event of a successful claim against us. We have evaluated the potential risks we face and believe that we have appropriate levels of insurance for product liability claims. We rely on our general liability insurance to cover product liability claims and have not obtained separate product liability insurance. The successful assertion of product liability claims against us could result in potentially significant monetary damages, and if our insurance protection is inadequate to cover these claims, we could be required to make significant payments.

**We conduct business in many countries that are politically and economically unstable.**

The potential for political unrest, acts of terrorism and war, and economic collapse exists in many countries in which we currently, or may be in the future, do business. The occurrence of any such events at or near the site of our projects could lead to delay, cancellation or significant damage to our projects or equipment. The

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occurrence of any such events could also cause harm, injury or death to our personnel working on such projects. Any such events could expose us to significant liabilities and would therefore adversely affect our results of operations and growth.

We also subcontract work or may hire temporary and permanent employees in countries that are politically and economically unstable. It is more difficult to perform background checks on these foreign workers or to be sure that conduct and performance are in the best interests of our company and in full compliance with applicable laws.

### **Our current or planned international operations subject our business to additional risks, which could cause revenues to decline.**

A large portion of our revenue is generated from sales of remote power projects in the oil and gas and telecommunications markets. Many of these projects are sold to foreign entities and are delivered to locations outside of the United States, such as the Middle East, Eurasia, Africa and South America. In addition, we intend to market our hydrogen generators to small- and medium-volume users of delivered hydrogen worldwide. Selling our services and products internationally exposes us to many additional costs, risks and potential liabilities, which, if improperly managed, could limit our ability to grow in these markets and adversely affect our results of operations. These include:

exchange controls;

complying with U.S. legal requirements for the exporting of goods;

complying with the commercial, regulatory and legal requirements of foreign markets, particularly in developing countries;

obtaining and/or enforcing intellectual property protection;

overcoming trade barriers such as duties, tariffs and taxes;

enforcing contract terms and conditions;

collecting receivables;

managing operations and staff across disparate geographic areas; and

currency risks.

In addition, a change in the value of the U.S. dollar may make our services and products less competitive in international markets.

### **If we undertake additional acquisitions, they may be disruptive to our business and could have an adverse effect on our future operations and the market price of our common stock.**

We intend to pursue additional growth through the acquisition of companies, businesses and intellectual property.

Any future acquisitions would involve a number of risks, including the following:



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the anticipated benefits from any acquisition may not be achieved;

the integration of acquired businesses requires substantial attention from management. The diversion of management's attention and any difficulties encountered in the transition process could harm our business;

we may assume contingent or unknown liabilities of an acquired company, and any provision we make for indemnification for such liabilities may not be adequate;

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in future acquisitions, we could issue additional shares of our capital stock, incur additional indebtedness or pay consideration in excess of book value, which could have a dilutive effect on future net income, if any, per share or could increase our indebtedness and interest expense; and

new business acquisitions must be accounted for under the purchase method of accounting. These acquisitions may generate significant intangible assets and result in substantial related amortization charges to us.

## **RISKS RELATING TO OUR INDUSTRY**

**We may not be able to grow our revenues in the future if a sustainable market for our distributed energy and hydrogen generation products and services does not develop.**

Our future growth will be based in part on increased use of distributed generation, on the development of a mass market, particularly in the automobile industry, for PEM fuel cells that utilize our hydrogen generators as a fuel source and on growth in the use of renewable energy. These are emerging markets and it is difficult to predict the rate at which they will develop. If a sustainable market for distributed energy technologies fails to develop or develops more slowly than we anticipate, our ability to grow and achieve profitability will be negatively affected. Many of the factors that influence the rate of adoption of distributed energy and hydrogen generation technologies are out of our control. Some of these factors that we cannot control are:

utility electric rates;

changes in federal, state and local regulatory requirements;

changes in federal and state incentives and subsidies;

cost, quality, performance and availability of the alternative power generation technologies used or supported by our power systems and hydrogen generators;

costs and availability of natural gas, diesel, hydrogen and other fuels used in distributed energy technologies;

changes in customers' perceptions regarding distributed generation, PEM fuel cells and alternative energy;

customer reluctance to try new products and technology;

availability of financing for distributed generation vendors, developers and users;

economic downturns and related reductions in capital spending;

demand for and valuation of emissions trading credits generated by distributed generation systems; and

the emergence of newer, more competitive technologies.

**If we fail to retain key personnel and attract and retain additional qualified personnel, we may be unable to develop our products and generate revenue.**

Our success depends upon the continued service of our executive officers and other key employees such as manufacturing and research and development personnel. The loss of any of our executive officers or key employees could impair our ability to pursue our growth strategy. We do not have employment agreements with many of our key executives. We may not be able to attract, assimilate or retain additional highly qualified personnel in the future.

**We may be affected by skilled labor shortages and labor disputes.**

We require experienced engineers, technicians and machinists to conduct our business. No assurance can be given that the supply of these skilled persons will always be adequate to meet our requirements or that we will be able to attract an adequate number of skilled persons. Labor disputes could also occur at our manufacturing

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facilities, which may affect our business. While our employees are not currently represented by labor unions or organized under collective bargaining agreements, labor disputes could occur at any of our facilities.

### **Declines in the price of utility-delivered electricity or our inability to continue to reduce the cost of our distributed generation systems could reduce demand for our services and products.**

Our distributed generation systems compete mainly on price per delivered kilowatt-hour of electricity to the end user. In the domestic market, we compete against the cost of electricity delivered by the local utilities through the electric grid. The cost of electricity varies widely from utility to utility and from state to state and is subject to change based on factors beyond our control. We cannot accurately predict what future electricity rates will be and whether or not we can compete effectively against these rates.

The cost per delivered kilowatt-hour of electricity generated by our on-site power systems is also based primarily on the following three factors: the cost of the underlying generating technologies, the cost of financing, and the cost of fuel. All these factors are outside of our control.

Costs of alternative power generation technologies like solar panels and wind turbines have generally been falling over the past several years, but there can be no assurance that they will continue to fall in the future. Without federal or state subsidies or incentives, the cost of these technologies is often not competitive with traditional generating technologies or the cost of utility power. If the costs of these alternative technologies do not continue to fall or subsidies are no longer available, our ability to sell systems and services based on these technologies will be diminished.

Financing costs are critical to the cost competitiveness of renewable energy. Since fuel from the wind or sun is free, financing costs represent the single largest operating cost. Financing costs are also highly variable and subject to change beyond our control. If financing costs increase, it could reduce demand for our products.

For reciprocating engine or turbine-based power systems, fuel is the largest operating cost. The predominant fuel for these systems is natural gas. The price of natural gas has been highly volatile and is currently projected to remain high for several years based on increased demand and limited domestic supply. Sustained high gas prices reduce the economic benefit of the on-site power systems we sell and may therefore cause us to experience reduced sales and revenue growth.

### **Utility companies could place barriers to our entry into the market, and we may not be able to effectively sell our products and systems.**

Utility companies could place barriers on the installation of our products and systems or their interconnection with the electric grid. Further, they may charge additional fees to customers who install on-site generation systems, thereby reducing the electricity they take from the utility, or who use power from the grid for backup or standby purposes. These types of restrictions, fees or charges could impair the ability of our potential customers to install or effectively use our products and systems or increase the cost to our potential customers for using our products and systems. This could make our products and systems less desirable, thereby adversely affecting our revenue and profitability potential.

### **Decreases in the price of oil and gas could reduce demand for our distributed generation systems, which would harm our ability to grow our business.**

A large portion of our current revenue is generated from the sale of remote power systems to the international oil and gas industry for use on remote pipelines and offshore platforms. Demand for our power systems from this market segment depends in part on the current and future commodity price of oil and gas. Higher oil and gas prices stimulate increased development of remote oil and gas fields and related infrastructure, which in turn stimulates increased demand for remote power systems of the type we supply. Conversely, lower oil and gas prices would reduce demand for current systems and have a negative impact on our growth.

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Most of our wind turbine products are sold for use in power systems used by remote communities to replace or augment internal combustion engines. Demand for our wind turbines from this market segment depends in part on the current and future commodity prices of oil and gas. Higher oil and gas prices provide incentives for customers to invest in technologies such as wind turbines that reduce their need for petroleum-based fuels. Conversely, lower oil and gas prices would tend to reduce the incentive for customers to invest in capital equipment to produce electrical power.

### **Continued uncertainty in domestic and world economies and energy markets may limit our growth.**

Current uncertainty among our target customers over the health of the economy and its impact on their business has restricted their capital spending and made it harder for us to sell our distributed generation systems and services. Other market uncertainties that also affect our ability to increase sales include the future of deregulation of the domestic electricity market, the future price of oil and natural gas, political instability in the Middle East and other regions where we do business, and domestic and international policy responses to environmental issues.

### **Because sales of our distributed generation systems are reliant in part on federal and state subsidies and incentives, any reduction in federal or state subsidy programs could harm our business.**

The domestic market for our distributed generation systems currently benefits from many federal and state programs designed to promote increased use of renewable and distributed generation technologies. The federal government, for example, offers tax credits for energy produced by wind and solar generators. States like California, New York, New Jersey, Connecticut and Massachusetts offer cash incentives which reduce the initial capital cost to customers who invest in renewable and distributed generation systems. All these federal and state incentive and subsidy programs have specific expiration dates and there can be no assurance that these programs will be extended. Termination of one or more of these programs may have an adverse impact on our future growth. Additionally, there can be no assurance that new programs will be created. In an economic downturn, with resulting budget deficits, funding for many of the state programs may be at risk of being diverted to other needs.

### **Government regulations may impair our ability to market and sell our products.**

Our products and projects are potentially subject to federal, state, local and foreign laws and regulations governing, among other things, waste water discharge and air emissions as well as laws relating to occupational health and safety. We may incur substantial costs or liabilities in complying with governmental regulations. Our potential customers must also comply with numerous laws and regulations, which could affect their interest in our products and projects. We could incur potentially significant expenditures in complying with environmental and health and safety laws, regulations and requirements that may be adopted or imposed in the future.

Electricity generation and delivery are both heavily regulated by federal and state governments. While deregulation and restructuring of the U.S. power industry may ultimately expand the market for distributed generation systems of the type that we sell, recent problems associated with deregulation in key domestic markets like California may impose additional barriers to distributed generation. California and other states, for example, allow utilities to impose exit fees, standby charges and other penalties on customers who install distributed generation systems. Federal and state regulations regarding air quality and interconnection to the utility grid also impose additional costs and potential liabilities on our business. Changes in these regulations could reduce or eliminate our access to certain of our target markets. Changes in regulatory standards or policies could reduce the level of investment in the research and development of alternative power sources. Any reduction or termination of such programs can increase the cost to our potential customers, making our systems less desirable, and thereby adversely affecting our revenue and results of operations.

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**Compliance with environmental regulations can be expensive, and noncompliance with these regulations may result in adverse publicity and potentially significant monetary damages and fines.**

We are required to comply with all federal, state, local and foreign regulations regarding protection of the environment. If more stringent regulations are adopted in the future, the costs of compliance with these new regulations could be substantial. If we fail to comply with present or future environmental regulations, we may be required to pay substantial fines, suspend production or cease operations. We use, generate and discharge toxic, volatile and otherwise hazardous chemicals and wastes in our research and development and manufacturing activities. Any failure by us to control the use of, or to restrict adequately the discharge of, hazardous substances could subject us to potentially significant monetary damages and fines or suspensions in our business operations. In addition, under some foreign, federal and state statutes and regulations, we may be deemed responsible for investigative and remedial costs at formerly owned or operated locations, or at third party sites at which our wastes were disposed.

## **OTHER RISKS**

**Our stock price is likely to be highly volatile and may result in substantial losses for investors purchasing shares.**

The market price of our common stock is likely to continue to be highly volatile. The stock market in general and the market for technology-related stocks in particular, has been highly volatile. As a result, investors in our common stock may experience a decrease in the value of their common stock regardless of our operating performance or prospects. Our common stock may not trade at the same levels as other technology-related stocks and technology-related stocks in general may not sustain their current market prices. In addition, an active public market for our securities may not be sustained.

The trading price of our common stock could be subject to wide fluctuations in response to:

our perceived prospects;

variations in our operating results and achievement of key business targets;

changes in securities analysts' recommendations or earnings estimates;

the inclusion of a going concern modification in our independent registered public accountant's audit report;

differences between our reported results and those expected by investors and securities analysts;

announcements of new products by us or our competitors;

market sentiment toward power technology and alternative energy stocks in general or to us in particular;

trading of options or other derivatives on our common stock;

market reaction to any acquisition, joint venture or strategic investments announced by us or our competitors; and

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general economic or stock market conditions unrelated to our operating performance.

In the past, securities class action litigation has often been instituted against companies following periods of volatility in their stock price. This type of litigation could result in substantial costs and divert management's attention and resources.

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### **Our executive officers, directors and their affiliates hold a large percentage of our stock and their interests may differ from other stockholders.**

Our directors, executive officers and individuals or entities affiliated with our directors as a group beneficially own, approximately 8.9% of our outstanding common stock at April 25, 2007. The interests of these stockholders may differ substantially from the interests of other stockholders. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of our directors, and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation and mergers or sales of substantially all of our assets. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us or our other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire us at a price per share that is above the then-current market price.

### **Provisions of our certificate of incorporation and bylaws and Delaware law could inhibit a takeover that stockholders may consider favorable and diminish the voting rights of the holders of our common stock.**

There are provisions in our certificate of incorporation and bylaws that make it more difficult for a third party to acquire, or attempt to acquire, control of us, even if a change in control may be considered favorable by our stockholders. For example, our board of directors has the authority to issue up to 5,000,000 shares of preferred stock. The board of directors can fix the price, rights, preferences, privileges and restrictions of the preferred stock without any further vote or action by our stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. As a result, the market price of our common stock and the voting and other rights of our stockholders may be adversely affected. The issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

Our certificate of incorporation and bylaws contain other provisions that could have an anti-takeover effect, including:

only one of the three classes of directors is elected each year;

stockholders have limited ability to remove directors;

stockholders cannot take actions by written consent;

stockholders cannot call a special meeting of stockholders; and

stockholders must give advance notice to nominate directors or submit proposals for consideration at stockholder meetings.

In addition, we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which regulates corporate acquisitions. These provisions could discourage potential acquisition proposals and could delay or prevent a change in control transaction. They could also have the effect of discouraging others from making tender offers for our common stock. These provisions may also prevent changes in our management.

### **Because we do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.**

We anticipate that we will retain our earnings to support operations and to finance the growth and development of our business and do not expect to pay cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.



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### **ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On March 7, 2007, we entered into a Joint Venture Agreement with Morgan Stanley Wind LLC, a subsidiary of Morgan Stanley, or the joint venture agreement. In connection with the execution of the joint venture agreement, we issued to Morgan Stanley Wind LLC on March 7, 2007 a Common Stock Purchase Warrant entitling Morgan Stanley Wind LLC to purchase up to 10% of our common stock outstanding as of the date of the final exercise of the warrant, including shares issuable upon the exercise of options, warrants and other convertible or exchangeable securities. This issuance was made in a private placement in reliance upon an exemption from registration under Section 4(2) of the Securities Act.

The warrant vests in multiple tranches as described below:

The warrant is immediately vested as to 8% of our common stock outstanding from time to time, at a purchase price equal to the lower of (i) \$2.25 per share and (ii) 80% of the fair market value of the common stock on the date of exercise, but in no event less than \$2.10 per share, and in each case subject to adjustment pursuant to the terms of the warrant. This 8% tranche of the warrant is exercisable until the second anniversary of the grant date, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least \$2.25 per share.

The warrant will vest in four subsequent tranches, each as to 0.5% of our common stock outstanding from time to time, including at such time as Morgan Stanley Wind LLC has funded (1) \$21.25 million, (2) \$42.5 million, (3) \$63.75 million and (4) \$85 million in the aggregate to projects developed under the joint venture agreement or we have entered into engineering, procurement and construction or operation and maintenance contracts with projects sourced by Morgan Stanley Wind LLC or its affiliates with aggregate values equal to those thresholds. Each of these subsequent tranches will have a purchase price equal to the lower of (i) 80% of the fair market value of our common stock on the vesting date and (ii) 80% of the fair market value of our common stock on the date of exercise, but, in the case of clause (ii), in no event less than \$2.10 per share. Each subsequent tranche will be exercisable until the second anniversary of the vesting date of that tranche, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least equal to the fair market value on the vesting date.

### **ITEM 5. Other Information**

### **ITEM 6. Exhibits**

ent dated March 7, 2007 between the registrant and Morgan Stanley Wind LLC (incorporated herein by reference to exhibit 10.1 of the company's report on Form 8-K)  
 ase Warrant issued on March 7, 2007 by the registrant to Morgan Stanley Wind LLC (incorporated herein by reference to exhibit 10.2 of the company's report on Form 8-K)  
 to Section 302 of the Sarbanes-Oxley Act of 2002  
 to Section 302 of the Sarbanes-Oxley Act of 2002  
 to Section 906 of the Sarbanes-Oxley Act of 2002  
 to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 10, 2007

DISTRIBUTED ENERGY SYSTEMS CORP.

**(Registrant)**

By: */s/ Ambrose L. Schwallie*  
Ambrose L. Schwallie

Chief Executive Officer

(Principal Executive Officer)

By: */s/ Peter J. Tallian*  
Peter J Tallian

Chief Financial Officer