DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
May 06, 2004
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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, 2004

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

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**20-0177690**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(203) 678-2000

(Registrant s telephone number, including area code)

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 x No ¨

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of May 4, 2004 was 35,409,316.

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PART I. FINANCIAL INFORMATION

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,325,719	$ 4,275,468
Marketable securities (Note 4)	52,740,173	69,572,423
Current portion of restricted cash	150,366	5,387,457
Accounts receivable, less allowances of $179,834 and $163,973, respectively	3,074,674	3,352,183
Costs in excess of billings on contracts in progress	263,811	421,355
Inventories (Note 5)	3,066,058	2,519,720
Deferred costs	4,385,774	3,321,550
Interest receivable	514,237	754,643
Other current assets	847,638	834,775
Total current assets	82,368,450	90,439,574
Fixed assets, net	21,346,581	21,726,948
Long-term portion of restricted cash	419,250	1,370,777
Intangible assets, net	5,053,984	5,515,996
Goodwill	24,191,187	24,191,187
Other assets, net	252,325	222,227
Total assets	$ 133,631,777	$ 143,466,709
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 354,450	$ 350,400
Current portion of capital lease	98,622	89,794
Accounts payable	908,143	2,901,720
Accrued expenses (Note 6 and 9)	1,241,141	4,130,447
Accrued compensation	1,640,255	1,130,009
Accrued taxes (Note 9)	1,018,890	1,043,619
Accrued service costs (Note 9)	21,887	23,300
Billings in excess of costs on contacts in progress	39,910	158,606
Deferred revenue	4,783,075	3,557,124
Customer advances	222,676	251,031
Total current liabilities	10,329,049	13,636,050
Long term liabilities:		
Long-term debt	5,998,582	6,090,232
Long-term portion of capital lease	2,602,117	2,627,525

Total liabilities	18,929,748	22,353,807
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, undesignated, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 65,000,000 shares authorized; 35,406,316 and 35,356,848 shares issued and outstanding, respectively	354,063	353,568
Additional paid-in capital	220,047,637	220,207,640
Unearned compensation	(1,744,742)	(2,277,860)
Accumulated other comprehensive income (Note 4)	30,636	62,408
Accumulated deficit	(103,985,565)	(97,232,854)
Total stockholders equity	114,702,029	121,112,902
Total liabilities and stockholders equity	$ 133,631,777	$ 143,466,709

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)

	Three Months Ended March 31,	
	2004	2003
Contract revenue	$ 1,778,480	$ 43,403
Product revenue	175,816	129,333
Total revenues	1,954,296	172,736
Costs and expenses:		
Costs of contract revenue	1,603,239	162,680
Costs of production	572,622	798,740
Research and development	1,925,657	1,968,883
General and administrative	4,809,252	2,701,810
Total costs and expenses	8,910,770	5,632,113
Loss from operations	(6,956,474)	(5,459,377)
Interest income	289,952	896,469
Interest expense	(83,154)	(61,987)
Loss on disposal of fixed assets		(24,863)
Loss on foreign exchange	(3,035)	
Net loss	$ (6,752,711)	$ (4,649,758)
Basic and diluted net loss per share	$ (0.19)	$ (0.14)
Shares used in computing basic and diluted net loss per share	35,373,541	33,457,139

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 CASH FLOWS

(Unaudited)

	Three Months Ended March 31,	
	2004	2003
Cash flows from operating activities:		
Net loss	$ (6,752,711)	$ (4,649,758)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	962,702	350,489
Amortization of premiums on securities	266,772	198,360
Non-cash stock-based expense	343,158	131,012
Loss on disposal of assets		24,863
Changes in operating assets and liabilities, excluding effect of acquisition:		
Accounts receivable	277,509	274,258
Inventories and deferred costs	(1,610,562)	(282,871)
Costs in excess of billings on contracts in progress	157,544	
Other current assets and interest receivable	227,543	953,635
Other assets	(36,854)	11,577
Accounts payable and accrued expenses	(4,374,050)	(371,982)
Accrued taxes	(24,729)	(39,378)
Billings in excess of costs on contracts in progress	(118,696)	
Deferred revenue and customer advances	1,197,596	307,141
Net cash used in operating activities	(9,484,778)	(3,092,654)
Cash flows from investing activities:		
Purchases of fixed assets	(113,567)	(491,060)
Proceeds from the sale of fixed assets		1,975
Purchases of marketable securities	(21,997,294)	(105,493,250)
Proceeds from maturities and sales of marketable securities	38,531,000	116,376,000
Restricted cash	6,188,618	
Net cash provided by investing activities	22,608,757	10,393,665
Cash flows from financing activities:		
Debt principal payments	(104,180)	(83,850)
Proceeds from sale of common stock, net	14,656	17,278
Proceeds from exercise of stock options	15,796	4,609
Net cash used in financing activities	(73,728)	(61,963)
Net increase in cash and cash equivalents	13,050,251	7,239,048
Cash and cash equivalents at beginning of period	4,275,468	16,415,337
Cash and cash equivalents at end of period	$ 17,325,719	$ 23,654,385

Cash paid during the period for interest	$ 81,519	$ 64,098

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 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 brings together two established businesses: Proton Energy Systems, Inc. (Proton) and Northern Power Systems, Inc. (Northern).

On December 10, 2003, Distributed Energy announced the completion of its acquisition of Northern (the Acquisition). The merger was accounted for as a purchase of Northern by Distributed Energy, Proton was merged into Distributed Energy as a subsidiary. As part of the acquisition, each outstanding share of Proton, a public company traded on the NASDAQ and a manufacturer of hydrogen generators and regenerative fuel cell systems, was exchanged for a share of Distributed Energy common stock. Together, as subsidiaries of Distributed Energy, Proton and Northern plan to offer an array of practical energy technologies, including Proton s advanced hydrogen generation products and Northern s renewable and fossil-fuel power systems. At the close of market on December 10, 2003, the NASDAQ National Market ceased trading of Proton shares. Effective December 11, 2003, NASDAQ began trading shares of Distributed Energy on the National Market under the ticker symbol DESC. The results of operations of Northern have been included in the financial statements of the Company as of December 11, 2003.

2. BASIS OF PRESENTATION

The condensed consolidated financial statements include the accounts of Distributed Energy and its wholly owned subsidiaries, Proton and Northern, after elimination of significant intercompany transactions. The financial statements of Proton include the accounts of its wholly owned limited liability company, Technology Drive LLC, after elimination of significant intercompany transactions. The financial statements of Northern include the accounts of its wholly owned limited liability company, NPS Condo Association, after elimination of significant intercompany transactions. The operating results of Northern are included beginning December 11, 2003.

The condensed consolidated financial statements as of March 31, 2004 and for the three-month periods ended March 31, 2004 and 2003 are unaudited. In the opinion of management, all adjustments, which consist solely of 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 on March 15, 2004.

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Comprehensive Income (Loss)

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

	Three Months Ended March 31,	
	2004	2003
Net loss	(6,752,711)	(4,649,758)
Unrealized losses on marketable securities arising during the period	(31,772)	(386,015)
Total comprehensive loss	(6,784,483)	(5,035,773)

Revenue Recognition Rental Revenue

The Company earns revenue from the rental of its HOGEN products. The Company accounts for the agreements as operating leases under the provisions of Statement of Financial Accounting Standards (SFAS) No. 13, Accounting for Leases. The agreements are cancelable at any time by either party without penalty. Rental revenue is recognized month-to-month as services are performed over the term of the rental agreement. Rental revenue is included in product revenues on our statement of operations and totaled $35,000 and $0 for the three month periods ended March 31, 2004 and 2003, respectively.

Concentration of Risks

Concentration of credit risk exists with respect to cash and cash equivalents, accounts receivable, investments 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 for which the source maintains proprietary rights.

For the quarter ended March 31, 2004, sales to one international customer and one domestic customer accounted for approximately 19% and 11% of total revenue, respectively. At March 31, 2004, accounts receivable from two customers accounted for approximately 43% of total accounts receivable.

Stock-Based Compensation

SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, prescribes accounting and reporting standards for all stock-based compensation plans, including employee stock option plans. As permitted by SFAS No. 123, the Company has elected to continue to account for stock-based compensation issued to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Under APB 25, compensation expense is computed to the extent that the fair market value of the underlying stock on the date of grant exceeds the exercise price of the employee stock option or stock award. Compensation so computed is then recognized over the vesting period.

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The following table illustrates the effect on net loss and loss per share had compensation costs for the stock-based compensation plan been determined based on grant date fair values of awards under the provisions of SFAS No. 123, for the three months ended March 31:

	2004	2003
Net loss attributable to common stockholders:		
As reported	$ (6,752,711)	$ (4,649,758)
Add: Stock-based employee compensation included in net loss	339,599	107,829
Less: Total stock-based employee compensation expense determined under fair value-based-method for all awards	(1,713,508)	(1,401,705)
Pro forma	$ (8,126,620)	$ (5,943,634)
Net loss per share applicable to common stockholders, basic and diluted		
As reported	$ (0.19)	$ (0.14)
Pro forma	$ (0.23)	$ (0.18)

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform to the 2004 presentation.

3. RECENT ACCOUNTING GUIDANCE

On December 17, 2003, the SEC s Office of the Chief Accountant and Division of Corporation Finance issued Staff Accounting Bulletin (SAB) 104, Revenue Recognition. The SAB updates portions of the interpretive guidance included in Topic 13 of the codification of Staff Accounting Bulletins (SAB 103 codification) in order to make the guidance consistent with current authoritative accounting literature. The principal revisions relate to the incorporation of certain sections of the staff s FAQ document on revenue recognition into Topic 13. The adoption of SAB 104 has not had a material effect on the Company s financial statements.

In December 2003, FASB Interpretation No. 46R (FIN 46R), *Consolidation of Variable Interest Entities an interpretation of ARB 51* was issued. This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* which replaces FIN 46, *Consolidation of Variable Interest Entities ,* addresses consolidation by business enterprises of variable interest entities. Application of this Interpretation is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. The Company does not expect the adoption of FIN 46R to have a material effect on the Company s financial statements.

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, 2004, the Company s investment portfolio consisted of U.S. government and agency securities held

by two major banking institutions. The maturities of marketable securities are as follows:

	March 31, 2004	December 31, 2003
Less than one year	$ 34,581,492	$ 46,174,423
One to five years	18,158,681	23,398,000
	$ 52,740,173	$ 69,572,423

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Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders equity. The unrealized gain from marketable securities was $30,636 and $62,408 at March 31, 2004 and December 31, 2003, respectively. At March 31, 2004, the Company had five callable agency securities with a fair market value totaling approximately $21.2 million. Additionally, three investments approximating $11.8 million were called at par in 2004. These securities generate a higher relative rate of interest for the Company, in return for the issuer s right to call, at par value, the security before its maturity date.

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 first-in, first-out method.

	March 31, 2004	December 31, 2003
Raw materials	$ 1,318,307	$ 1,556,435
Work in process	1,530,168	722,607
Finished goods	217,583	240,678
	$ 3,066,058	$ 2,519,720

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $402,598 and $333,748 at March 31, 2004 and December 31, 2003, respectively.

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

	March 31, 2004	December 31, 2003
Costs incurred and estimated earnings on contracts in progress	$ 11,036,167	$ 13,340,014
Less: billings to date	10,812,266	13,077,265
Costs and earnings in excess of billings, net	$ 223,901	$ 262,749

	March 31, 2004	December 31, 2003
Costs in excess of billings on contracts in progress	$ 263,811	$ 421,355
Billings in excess of costs on contracts in progress	(39,910)	(158,606)
Costs and earnings in excess of billings, net	$ 223,901	$ 262,749

6. ACCRUED EXPENSES

Accrued expenses consist of the following:

	March 31, 2004	December 31, 2003
Accrued merger consideration	$	$ 2,854,582
Accrued warranty	475,460	326,290
Accrued purchases	510,406	473,755
Other accruals	255,275	475,820
	$ 1,241,141	$ 4,130,447

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7. LOSS PER SHARE

Net loss per share has been computed by dividing the net loss attributable to common stockholders by the weighted average common shares outstanding. No effect has been given to the exercise of 2,712,112 and 731,703 common stock options outstanding for the three month periods ending March 31, 2004 and 2003, respectively and 2,155,394 and 50,000 common stock warrants outstanding for the three month periods ending March 31, 2004 and 2003, respectively, since the effect would be antidilutive for all reporting periods.

8. STOCK OPTION GRANTS

During 1999, 2000, and 2003, the Company issued common stock options to employees at less than the fair value of its common stock. The compensation expense for such options is amortized over the vesting periods of the related options. Accordingly, the Company recorded stock-based compensation expense of $339,599 and $107,829 for the three-month periods ended March 31, 2004 and 2003, respectively.

9. COMMITMENTS AND CONTINGENCIES

Contracts

In November 1999, Proton entered into an agreement with Matheson Tri-Gas, Inc. (Matheson) to develop, market and distribute hydrogen generators to be used solely in laboratory applications. This agreement granted the distributor worldwide exclusivity to the commercial sale of this product during the fifteen-year term of the contract as long as the distributor met minimum purchases, as defined in the agreement. In January 2003, the exclusive distribution agreement with Matheson Inc., was jointly terminated. Under the terms of the settlement agreement Proton agreed to continue to support units under warranty, provide spare parts for five years, sell an additional 55 laboratory hydrogen generators, and agreed not to sell or market its own laboratory hydrogen generators under Proton s or any other brand name before June 30, 2003. The commitment to sell an additional 55 units to Matheson was achieved in June 2003.

In 2001, Proton entered into a 10-year agreement with STM Power, Inc. (STM) for the exclusive supply of high-pressure hydrogen replenishment systems for Stirling Cycle Engines. Under an initial purchase order relating to this agreement, STM has agreed to provide $395,000 for the product development and delivery of prototype hydrogen replenishment systems. In 2002, Proton received purchase orders totaling approximately $550,000 for additional product development and delivery of 57 high-pressure hydrogen generators. The Company accounts for the STM contract in accordance with SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts . In the fourth quarter of 2003, the Company recognized previously deferred revenue of $958,000 relating to this arrangement.

Also 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 under Phase II of the agreement, to accelerate commercial deployment of the UNIGEN product. 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. However, 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

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expenses. In December 2002, Proton was approved for Phase II funding under the agreement. The following table sets forth the cash advances and milestone achievements utilized to offset certain costs and expenses incurred related to the UNIGEN product.

	CCEF Advance Balance
December 31, 2001	$ 200,000
Advances	400,000
Milestone achieved	(600,000)
December 31, 2002	$
Advances	900,000
Milestone achieved	(675,000)
December 31, 2003	$ 225,000
Advances	
Milestone achieved	(150,000)
March 31, 2004	$ 75,000

Warranty

In October 2002, Proton learned of problems with sensor modules in its HOGEN 40 series units at customer locations that might have been affected by moisture blockage, thereby impairing the sensor s ability to detect the presence of hydrogen in the oxygen gas stream. Further investigation of these units revealed the presence of pinholes in the cell membranes, resulting in hydrogen leakage and cell failure. To address these problems, the Company contacted all of its HOGEN 40 series customers and arranged appropriate sensor testing and modifications. Since the initial recognition of this issue, the Company has replaced all but one HOGEN 40 series sensor and cell stack component in the field, and has completed the development and implementation of design changes to prevent the recurrence of these and similar problems in the future. For the year ended December 31, 2002 the Company recorded $2,462,000 for these service costs. Total expenditures related to this program amounted to $1,878,000 and $369,000 for the year ended December 31, 2003 and 2002, respectively. Additionally, in 2003 adjustments to the provision amounted to a decrease of approximately $197,000. As of March 31, 2004 $22,000 remains accrued for these costs. The liability for such service costs reflects management s estimate, as of the date of this report, of the remaining cost of the program.

In the first quarter of 2004, the Company recorded a warranty contingency of $200,000 related to two of its HOGEN 380 units located outside of the United States. This contingency is the Company s best estimate of anticipated costs associated with the units performance. The units are covered under our standard warranty, and as such the Company is liable up to the sales value of the units, approximately $245,000. In addition, as of March 31, 2004 the Company has fully reserved for the unpaid receivable balance of $35,000 related to these units. The Company does not currently anticipate incurring any costs outside of our contractual agreement.

The changes in the carrying amount of warranties for the three months ended March 31, 2003 and 2004 are as follows:

Balance as of December 31, 2002	$ 85,935
Warranties issued in 2003	
Adjustments to provision	20,419
Warranty claims	(14,354)
Balance as of March 31, 2003	$ 92,000
Balance as of December 31, 2003	$ 326,290
Warranties issued in 2004	17,079
Adjustments to provision	195,685
Warranty claims	(63,594)
Balance as of March 31, 2004	$ 475,460

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Retainage Provisions

Balances billed but not paid by the customer pursuant to retainage provisions in customer contracts are due either upon completion of the contracts and acceptance by the customer or expiration of the warranty period. At March 31, 2004 and December 31, 2003, the accounts receivable balance includes approximately $37,000 and $58,000, respectively, of retainage balances.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, a tax accrual of approximately $901,000 and $890,000 for certain state income and sales tax contingencies for which there may be exposure at March 31, 2004 and December 31, 2003, respectively. In addition, property and franchise tax accruals of approximately $118,000 and $154,000 are recorded within current liabilities at March 31, 2004 and December 31, 2003, 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 September 6, 2001, five purported class action lawsuits were filed in the United States District Court for the Southern District of New York against the Company and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering (IPO) of common stock. All of the complaints were filed allegedly on behalf of persons who purchased the Company s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that the Company 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 Class Action Complaint (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 the Company 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 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 the Company. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the Amended 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 the Company 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. Any such settlement would be subject to approval by the Court. The Company believes it has meritorious defenses to the claims made in the Amended Complaint and, if the settlement is not finalized and approved, the Company 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. The Company is not

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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.

10. SEGMENT FINANCIAL DATA

Management views the enterprise as two distinct operating segments, Proton and Northern, and makes decisions to allocate resources based upon those operating segments. Proton develops and manufactures proton exchange membrane, or PEM, electrochemical products. Northern 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.

Financial information as of and for the quarter ended March 31, 2004 (all amounts in $000s) is summarized below. For the quarter ended March 31, 2003, Proton was the only segment and comparative information is not relevant.

	2004
Revenues:	
Proton	$ 406
Northern	1,548
Eliminations and other	
Consolidated	$ 1,954

Included within Northern s revenues are sales to one international (United Kingdom) customer totaling approximately 19% of consolidated revenues. The Company believes it has no risk of foreign dependence.

	2004
Loss from operations:	
Proton	$ (3,223)
Northern	(2,304)
Eliminations and other	(1,429)
Consolidated	$ (6,956)

	2004
Net loss:	
Proton	$ (3,278)
Northern	(2,333)
Eliminations and other	(1,142)

Consolidated	$ (6,753)

	2004
Total assets:	
Proton	$ 99,800
Northern	39,033
Eliminations and other	(5,201)
Consolidated	$ 133,632

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

11. PRO FORMA INFORMATION (UNAUDITED)

The results of operations of the acquired business have been included in the financial statements of the Company since the date of acquisition. The following unaudited pro forma information presents a

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summary of the results of operations of the Company for the first quarter of 2003 assuming the acquisition of Northern occurred on January 1, 2003:

	Three Months Ended March 31, 2003
Revenues:	
Proton	$ 172,736
Northern	2,204,992
Other	(49,156)
Total revenues	$ 2,328,572
Net loss	$ (8,952,266)
Net loss per share basic and diluted	$ (0.26)

The unaudited pro forma results of operations are not necessarily indicative of the actual results that would have occurred had the transaction actually taken place at the beginning of the period indicated.

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, 2003. 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 word 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, 2003, and below in this Form 10-Q under the Legal Proceedings and Certain Factors That May Affect Future Results 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

Formed in May 2003, Distributed Energy Systems Corp. is creating and delivering innovative products and solutions to the energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy was formed as the parent company of two established businesses: Proton Energy Systems, Inc. (Proton) and Northern Power Systems, Inc. (Northern). Distributed Energy believes the acquisition of Northern s project integration experience will strengthen Proton s near-term capabilities, accelerate entry into early energy-related markets and contribute to advancing Proton s vision of producing hydrogen from renewable sources.

Proton was founded in 1996 to design, develop and manufacture PEM electrochemical products for commercial applications. Proton s proprietary PEM technology is incorporated in two families of products: hydrogen generators, which Proton is currently manufacturing and delivering commercial models of to customers, and regenerative fuel cell systems, which Proton is currently developing.

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Northern was incorporated in Delaware in December 1997 to design, manufacture and install reliable, cost-efficient distributed generation power systems using fossil fuel, solar energy and wind energy. Northern was originally founded in 1974 under the name of North Wind Power Company. Northern also develops, manufactures and installs utility grade wind turbines. Northern sells its products to domestic and international customers.

Distributed Energy expects to incur additional operating losses in 2004 and cannot predict when it will become profitable, if ever.

Recent Developments

The following significant events occurred in 2004:

We strengthened our intellectual property position by bringing our total U.S. and foreign patent filings to 116. We now hold 26 issued U.S. patents and three issued European patents.

We announced that Dr. Larry M. Sweet, president of the Proton subsidiary, left the company to pursue other professional interests.

We announced the successful startup of two of Proton s new HOGEN H Series onsite hydrogen generator at Mirant Corp. s Zeeland, MI power plant. Proton also received its first four commercial orders for the HOGEN H Series hydrogen generators.

We achieved several key product milestones for the Proton hydrogen generator product line; specifically, we logged more than four million cell hours on approximately 350 installed units in the field in 2003 and reduced the overall cost of our PEM electrolysis cell stacks by 20 percent over the last year.

We have been selected, through our Northern subsidiary, to negotiate for a cooperative research agreement with the U.S. Department of Energy s (DOE) National Renewable Energy Laboratory to develop a 2 Megawatt (MW) direct drive wind turbine for low wind speed sites. The wind energy project is proposed at a value of approximately $8.3 million over a four-year period.

We announced our intention to provide hydrogen generation and fueling technologies as key infrastructure components for California s new Hydrogen Highway and renewable energy economy.

We announced Proton s selection as a member of the Air Products team that will participate in DOE s hydrogen infrastructure demonstration and validation project.

We announced Proton s award of a Phase II contract to continue development on its regenerative solar/PEM fuel cell demonstration system for the Naval Air Warfare Center Weapons Division at China Lake, California.

Critical Accounting Judgments and Estimates

Distributed Energy s discussion and analysis of its financial condition and results of operations is based upon its consolidated financial statements, which have been prepared by Distributed Energy in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires Distributed Energy to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Distributed Energy s estimates include those related to revenue recognition, income taxes, depreciable lives of equipment, warranty obligations and contingency accruals. Distributed Energy bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The audit committee of Distributed Energy s board of directors has discussed Distributed Energy s critical accounting policies with management and Distributed Energy s independent accountants. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in the Company s Annual Report on Form 10-K filed on March 15, 2004.

Recent Accounting Guidance

On December 17, 2003, the SEC s Office of the Chief Accountant and Division of Corporation Finance issued Staff Accounting Bulletin (SAB) 104, Revenue Recognition. The SAB updates portions of the interpretive guidance included in Topic 13 of the codification of Staff Accounting Bulletins (SAB 103 codification) in order to make the guidance consistent with current authoritative accounting literature. The principal revisions relate to the incorporation of certain sections of the staff s FAQ document on revenue recognition into Topic 13. The adoption of SAB 104 has not had a material effect on the Company s financial statements.

In December 2003, FASB Interpretation No. 46R (FIN 46R), *Consolidation of Variable Interest Entities an interpretation of ARB 51* was issued. This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* which replaces FIN 46, *Consolidation of Variable Interest Entities ,* addresses consolidation by business enterprises of variable interest entities. Application of this Interpretation is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. The Company does not expect the adoption of FIN 46R to have a material effect on the Company s financial statements.

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Results of Operations

Comparison of the Three Months Ended March 31, 2004 and March 31, 2003

Contract revenue. Contract revenue increased from $43,000 for the three months ended March 31, 2003 to $1.8 million for the comparable period in 2004. The increase was due principally to the inclusion of $1.5 million from our Northern subsidiary, acquired in December 2003, for the three months ended March 31, 2004 and an $187,000 increase in Proton s contract revenues period to period. Proton s increased contract revenue was due to an increase to five active contracts from three for the three months ended March 31, 2004 and 2003, respectively. Of the active Proton contracts, revenue was recognized on five versus one for the three months ended March 31, 2004 and 2003, respectively. In the future, we expect to continue to generate revenue from government sponsored research and development contracts to supplement our research and development efforts.

Product revenue. Product revenue increased from $129,000 for the three months ended March 31, 2003 to $176,000 for the comparable period in 2004. The increase is attributable to an increase of $73,000 related to service, rental and other revenues, offset by decreased laboratory generator derived revenues of $26,000. Product revenue for the three months ended March 31, 2003 is predominantly comprised of laboratory generator product revenue recognized upon the expiration of the related warranty period for 24 units. Product revenue for the three months ended March 31, 2004 is comprised of laboratory generator product revenue recognized upon shipment of thirteen units. Five units were sold with a two year warranty; Proton currently lacks adequate history to recognize revenue on laboratory units shipped with a two year warranty. Approximately $28,000 of revenue has been deferred for those units sold with a two year warranty.

In the fourth quarter of 2002, we discovered performance issues relating to the operation of cell stacks and associated sensors in our HOGEN 40 series units. Our investigation revealed the presence of previously unknown pinholes in cell membranes in the field that resulted in hydrogen leakage and cell failure. As a result, we determined that recognizing revenue on shipment of our HOGEN 40 series units was no longer appropriate because of significant uncertainty surrounding the reliability of the existing design of the PEM electrolyzer (cell stack) within our HOGEN 40 series generators. We have made modifications to the existing cell stack design to improve its performance and anticipate deferring product revenue until we have compiled sufficient warranty history on units containing modified cell stacks. For this reason, product revenue from HOGEN 40 series shipments made subsequent to September 30, 2002 is deferred until the expiration of the product warranty period.

Units shipped. Total units shipped decreased from 35 for the three months ended March 31, 2003 to 30 for the comparable period in 2004. Shipments of the HOGEN 40 series units increased from three for the first quarter 2003 to 12 for the first quarter 2004. Shipments of our laboratory generator units decreased from 32 for the first quarter 2003 to 18 for the first quarter 2004. Total revenue deferred in the first quarter 2004 related to these units shipped was approximately $678,000. During 2003 the Company was in the process of replacing cell stacks in accordance with its cell stack replacement program described below and in Note 9 of the financial statements. As a result, production and selling efforts with respect to the HOGEN 40 series units were curtailed. The decrease in laboratory generator unit shipments is attributable to the Company s terminated agreement with Matheson Tri-Gas, Inc. in January 2003, under which the Company agreed not to sell or market the units before June 30, 2003 as discussed above.

Costs of contract revenue. Costs of contract revenue increased from $163,000 for the three months ended March 31, 2003 to $1.6 million for the comparable period in 2004. The increase in 2004 was due primarily to the inclusion of our Northern subsidiary s contract costs of $1.4 million. The remaining increase was due to Proton s increased contract costs due to an increase to five active contracts from three for the three months ended March 31, 2004 and 2003, respectively. Of the active Proton contracts,

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costs were recognized on five versus one for the three months ended March 31, 2004 and 2003, respectively.

Costs of production. Costs of production decreased from $799,000 for the three months ended March 31, 2003 to $573,000 for the comparable period in 2004. The amounts in 2003 reflect an additional $510,000 lower of cost or market and obsolescence adjustments recorded associated with modifications made to our cell stack design, as previously discussed, as well as $20,000 more in recognized laboratory generator costs, and $20,000 more in costs associated with demonstration units shipped. Cost decreases in 2004 are primarily offset by increases of $200,000 directly associated with our estimated loss provision on HOGEN 380 units located outside of the United States, $50,000 on other general warranty provisions and $100,000 in increased service and rental related expenditures.

Research and development expenses. Research and development expenses decreased from $2.0 million for the three months ended March 31, 2003 to $1.9 million for the comparable period in 2004. The decrease is attributable to a $318,000 overall decrease in Proton s research and development activities, included within which was a reduction of expenses of approximately $125,000 in the period ended March 31, 2004 due to the sale of platinum scrap, offset by the inclusion of $275,000 related to Northern s research and development efforts in the three months ended March 31, 2004 versus March 31, 2003. The research and development activities are primarily related to PEM technology in our regenerative fuel cell systems and our hydrogen generators. The decrease in Proton s research and development expense is directly related to headcount reductions attributable to workforce reductions and attrition experienced in 2003. We expect our research and development expenses to remain level or decrease for the next twelve months.

General and administrative expenses. General and administrative expenses increased from $2.7 million for the three months ended March 31, 2003 to $4.8 million for the comparable period in 2004. The increase in 2004 was due primarily to the inclusion of our Northern subsidiary s general and administrative costs of $2.2 million. These increases were offset by lower professional service expenditures, which were incurred in 2003 related to our acquisition of Northern.

Interest income. Interest income decreased from $896,000 for the three months ended March 31, 2003 to $290,000 for the comparable period in 2004. The decrease resulted from decreased cash and marketable securities balances as well as lower average interest rates. The average cash and marketable securities balances for the three months ended March 31, 2004 and 2003 were approximately $71.6 million and $148.2 million, respectively. The average interest rates for the three months ended March 31, 2004 and 2003 were approximately 1.6% and 2.4%, respectively.

Interest expense. Interest expense increased from $62,000 for the three months ended March 31, 2003 to $83,000 for the comparable period in 2004. The increase was the result of an increased average debt balance due primarily to the inclusion in the first quarter 2004 of Northern s capital lease obligation and payments made by Northern on this obligation beginning in February 2004.

Liquidity and Capital Resources

Since its inception in August 1996 through December 2003, Proton has financed its operations through convertible preferred stock issuances and an initial public offering that, in total, raised approximately $187.4 million. As of March 31, 2004, Distributed Energy had $70.1 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was $9.5 million for the three months ended March 31, 2004 and was primarily attributable to the Company s net loss and decreases in accounts payable and accrued expenses, increases in inventory and deferred costs, offset by increases in deferred

revenues and contract advances, as well as the add back of certain non-cash related expenditures. Cash used in operating activities was $3.1 million for the three months ended March 31, 2003 and was primarily attributable to

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the Company s net loss offset by a net increase in operating assets and liabilities and the add back of certain non-cash related expenditures and losses.

Cash provided by investing activities was $22.6 million for the three months ended March 31, 2004 and was primarily attributable to proceeds from the maturity of marketable securities offset by purchases of marketable securities, and decreases in restricted cash. Cash provided by investing activities was $10.4 million for the three months ended March 31, 2003 and was primarily attributable to proceeds from the maturity of marketable securities offset by purchases of marketable securities and fixed assets.

Cash used in financing activities was $74,000 for the three months ended March 31, 2004 and was primarily attributable to payments under Proton s and Northern s debt agreements. Cash used by financing activities was $62,000 for the three months ended March 31, 2003 and was primarily attributable to payments under Proton s debt agreement.

Distributed Energy anticipates that its cash and marketable securities on hand as of March 31, 2004 will be adequate to fund its operations, working capital and capital expenditure requirements for at least the next 12 months. Over the next 12 months, Distributed Energy expects to continue to fund the production of its hydrogen generators and fund on-going project costs as well as continuing its research and development activities. Distributed Energy cannot ensure that it will not require additional financing to fund its operations or that, if required, any further financing will be available to Distributed Energy on acceptable terms, or at all. If sufficient funds are not available, Distributed Energy may be required to delay, reduce or eliminate some of its research and development, manufacturing, or contract programs. The terms of any additional financing may require Distributed Energy to relinquish rights to its technologies or potential products or other assets.

Certain Factors That May Affect Future Results

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.

Distributed Energy s future success is uncertain because of its limited operating history and project based business.

Distributed Energy faces many risks and uncertainties. If it is unsuccessful in addressing these risks and uncertainties, it may be unable to generate revenue and grow its business. Proton was formed in 1996 to research and develop PEM electrochemical products. Proton began shipping late-stage development models of its hydrogen generators in 1999 and has not yet manufactured commercial regenerative fuel cell systems. Accordingly, there is only a limited basis upon which you can evaluate Proton s business and prospects, and Proton s 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 Proton s products, development of fully functioning manufacturing operations, refinement of processes and components for Proton s commercial products, recruitment of qualified personnel, ability to manufacture a product which meets cost, reliability and efficiency needs, and achievement of market acceptance for Proton s products.

As an engineering, procurement and construction contractor, Northern designs and builds a relatively small number of projects for a small number of customers each year. For many of these customers, Northern will deliver a single system with little or no opportunity for repeat business. A small number of very large projects often accounts for the majority of Northern s revenue in any given year. In years 2000-2002, fewer than five customers accounted for at least 75% of annual sales. Sales cycles are very long and projects can be delayed or cancelled for

reasons beyond Northern s control. Implementation of large projects can take over twelve months. During that time, numerous factors can contribute to cost overruns and schedule delays that impact profitability. Generally accepted accounting principles require

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Northern to defer revenue on a significant portion of its contracts until the project is completed. As a result of these factors and others discussed later in this section, Northern s revenue and operating results will vary significantly from year to year and from quarter to quarter within a year.

Distributed Energy has incurred, and expects to continue to incur, substantial losses, and may never become profitable.

Distributed Energy has incurred substantial losses since it was founded and anticipates it will continue to incur substantial losses in the future. As of March 31, 2004, Distributed Energy had an accumulated deficit of approximately $104 million. Distributed Energy cannot predict when it will operate profitably, if ever. Distributed Energy expects to continue to incur expenses related to research and development activities, expansion of its manufacturing facilities and general administrative functions. As a result, Distributed Energy anticipates that it will continue to incur losses until it can cost-effectively produce and sell its hydrogen generators. Even if Distributed Energy does achieve profitability, Distributed Energy may be unable to sustain or increase its profitability in the future.

Proton has experienced performance problems with its hydrogen generators.

Proton has experienced performance problems with certain components of its hydrogen generators, specifically hydrogen sensor modules and cell stacks, which have required component replacement. Further problems related to these or other components may occur and require additional corrective measures. If Proton is unable to solve these problems, potential purchasers of Proton products may decline to purchase them. In addition, if Proton s hydrogen generators fail after purchase, Proton s warranty exposure would increase, resulting in higher costs.

Proton may not be able to generate revenue in the future if it does not complete the development of its regenerative fuel cell systems.

Proton s regenerative fuel cell systems are still in the development stage. Proton does not know when or whether it will successfully complete research and development of commercial regenerative fuel cell systems. If Proton is unable to develop commercial regenerative fuel cell systems, it may not be able to generate future revenue and may not recover the losses it has incurred in attempting to develop these products. If Proton experiences delays in meeting its development milestones or if its regenerative fuel cell systems exhibit technical defects or cannot meet cost or performance goals, including output, useful life and reliability goals, potential purchasers of Proton s regenerative fuel cell systems may decline to purchase them or choose alternative technologies. Proton may be unable to make the substantial technological advances necessary to produce commercial regenerative fuel cell systems that provide the features and performance specifications required by customers at a competitive price. For example, Proton must identify improved hydrogen storage technologies and fuel cell module structures. If Proton is unable to successfully complete these development activities, Proton may be unable to commercially market its regenerative fuel cell systems. In some cases, Proton is attempting to expedite its development efforts by utilizing third parties for important engineering work. These third parties include vendors of hydrogen storage, purification systems, power supply and control components. If these third parties are unable to successfully complete their development activities on Proton s behalf, Proton may be unable to commercially market its regenerative fuel cell systems.

Proton may not be able to grow its business if it does not achieve widespread commercial acceptance of its hydrogen generators in the market for delivered hydrogen.

Proton intends to market its hydrogen generators to small and medium volume users of delivered hydrogen. Proton s business depends on the widespread commercial acceptance of its hydrogen generators, and Proton may be unable to grow its business if Proton s targeted customers do not purchase substantial numbers of Proton s hydrogen generators. Proton s targeted customers, or the distributors whom Proton intends to use to

market to these customers, may not purchase Proton s hydrogen

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generators at all or in sufficient quantities to support the growth of Proton s business. Proton s hydrogen generators will require its target customers to make a substantial initial investment, currently ranging from approximately $40,000 to $100,000 per unit for Proton s HOGEN 40 and H series models. Proton s 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 and unproven technology in the markets Proton is targeting, and Proton does not know if its targeted customers will accept Proton s product. Proton is also working to develop and implement design improvements to extend the life of its cell stack components. If Proton is unable to successfully complete these activities, sales of its hydrogen generators may be reduced.

The success of Proton s hydrogen generators as a fuel source for PEM fuel cells depends upon the development of a mass market for PEM fuel cells, and Proton may not be able to generate revenue in the future if this market does not develop.

Proton also intends to market its hydrogen generators for use as fuel generators for PEM fuel cells in a variety of applications, in particular fuel cell vehicles. If a mass market for PEM fuel cells fails to develop or develops more slowly than Proton anticipates, Proton may be unable to generate revenue in the future and recover the losses it will have incurred in the development of its hydrogen generators. PEM fuel cells represent an emerging commercial market, and Proton does not know whether end users will want to use them. The development of a mass market for PEM fuel cells may be affected by many factors outside of Proton s control, including:

- the emergence of newer, more competitive technologies;
- the cost competitiveness of PEM fuel cells compared to existing and new technologies;
- the future cost of hydrogen;
- regulatory requirements;
- consumer perceptions of the safety, reliability and functionality of PEM fuel cells; and
- consumer willingness to try a new product.

In addition, the sole market for vehicular PEM fuel cells is and will continue to be car, bus and other vehicle manufacturers. Automobile manufacturers interest in vehicular PEM fuel cells has been driven in large part by environmental laws and regulations concerning vehicle emission requirements that have been enacted in California and some northeastern states. If these laws and regulations are not kept in force or do not become widely adopted, the demand for vehicular PEM fuel cells may be limited. Further, automobile manufacturers may be able to use other technologies to meet their regulatory requirements, such as batteries, low emission internal combustion engines and hybrid internal combustion/battery engines. Even if automobile manufacturers decide to develop vehicles powered by PEM fuel cells, it may be many years before substantial numbers of vehicles powered by PEM fuel cell systems are manufactured. Further, there are several other technologies that may be used to generate hydrogen, such as hydrocarbon reforming, and there remains a strong possibility that Proton s means of generating hydrogen will not be used to supply fuel to fuel cells.

Proton may be unable to increase its revenue in the future if the use of renewable energy does not increase.

Proton anticipates that one of the primary uses of its regenerative fuel cell systems will be for storing energy produced by renewable power sources, such as solar, wind and hydroelectric power. If the demand for renewable energy develops more slowly than Proton anticipates, Proton s ability to sell its regenerative fuel cell systems could be impaired, and Proton may be unable to grow its business. The market for renewable energy is still in an early stage of development and the demand for renewable energy will remain limited until the cost of producing energy from renewable sources is substantially reduced. Power from renewable energy sources currently costs significantly more than power derived from nonrenewable sources, such as coal and oil. The growth of the renewable energy market will be

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dependent on many factors that are outside of Proton s control, such as the emergence of new, more cost-effective power technologies and products, and domestic and international regulatory requirements.

Proton expects to incur significant expenses in expanding its manufacturing facilities and production, and Proton may not be successful in these efforts.

Proton has expanded its manufacturing facilities in anticipation of increased demand for its products. If this demand does not materialize, Proton will not generate sufficient revenue to offset the costs of maintaining and operating these facilities, which could increase Proton s losses and prevent Proton from growing its business. Proton expects to expand production and may experience delays or problems in its expected expansion that could compromise its ability to increase its sales and grow its business. Factors that could delay or prevent Proton s expected production expansion include:

- the inability to purchase parts or components in adequate quantities or sufficient quality;
- the cost 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 manufacturing processes and equipment.

If Proton fails to successfully manufacture its products in commercial quantities, it may not be able to increase revenue.

To be financially successful, Proton will have to manufacture its products in commercial quantities at acceptable costs while also preserving the quality levels achieved in manufacturing these products in limited quantities. This presents a number of technological and engineering challenges. Proton may not be successful in developing product designs and manufacturing processes that permit manufacture of its hydrogen generators and regenerative fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, Proton sells some of its products for less than it costs to produce them. In addition, Proton will incur significant manufacturing start-up costs and may experience unforeseen delays and expenses in its product design and manufacturing efforts. If the commercialization of Proton s products is delayed, potential purchasers may also decline to purchase them or choose alternative technologies, both of which could impair Proton s ability to generate revenue in the future.

If Proton s suppliers do not supply it with a sufficient amount and quality of components at acceptable prices, Proton may not be able to manufacture its products commercially.

Although Proton generally attempts to use standard components for its products, the proton exchange membrane material and hydrogen purification system used in Proton s products are currently available only from limited sources. Also, Proton may be unable to purchase components of adequate quality or that meet its cost requirements. In addition, to the extent these components are proprietary products of

Proton s suppliers, or the processes used by Proton s suppliers to manufacture these components are proprietary, Proton may be unable to obtain comparable components from alternative suppliers. Proton may experience delays in production of its products and its business and financial results would suffer if it fails to identify alternate suppliers, or if Proton s supply is interrupted or reduced or there is a significant increase in cost.

In addition, platinum is a key component of Proton s PEM fuel cells. Platinum is a scarce natural resource and Proton is dependent upon a sufficient supply of this commodity. Proton may not be able to produce commercial products, or the cost of producing products may significantly increase, if there are any shortages in the supply of platinum.

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Proton may be unable to sell its products and generate revenue if it fails to establish distribution relationships.

Because Proton intends to sell some of its products through third-party distributors, the financial benefits to Proton of commercializing its products will be dependent on the efforts of others. Proton intends to enter into additional distribution agreements or other collaborative relationships to market and sell its products. If Proton is unable to enter into additional distribution agreements, or if its third-party distributors do not successfully market and sell its products, Proton may be unable to generate revenue and grow its business. Proton may seek to establish relationships with third-party distributors who also indirectly compete with Proton. For example, Proton has targeted industrial gas suppliers as potential distributors of its hydrogen generators. Because industrial gas suppliers currently sell hydrogen in delivered form, adoption by their customers of Proton s hydrogen generation products could cause them to experience declining demand for delivered hydrogen. For this reason, industrial gas suppliers may be reluctant to become distributors of Proton s hydrogen generators. In addition, Proton s third-party distributors may require Proton to provide volume price discounts and other allowances, or customize its products, either of which could reduce the potential profitability of these relationships.

Proton has historically focused on research and development activities and has limited experience in marketing, selling and servicing its products.

Proton has primarily focused on the research and development of its hydrogen generators and regenerative fuel cell systems. Consequently, Proton s management team has limited experience directing the commercialization efforts that are essential to Proton s future success. To date, Proton only has limited experience marketing, selling and servicing its hydrogen generators, and no experience marketing, selling or servicing its regenerative fuel cell systems. Furthermore, there are very few people anywhere who have significant experience marketing, selling or servicing PEM electrochemical products. Proton will have to expand its marketing and sales organization as well as its maintenance and support capability. Proton may not be successful in its efforts to market and service its products, which would compromise its ability to increase revenue.

Because Northern s projects have a very lengthy sales cycle and are often competitively bid, Northern may expend significant resources on potential customers and projects without achieving actual sales.

Northern depends on a small number of large projects for a majority of its revenue in any given year. Contracts for many of these large projects are awarded by competitive bid. The sales cycle from identification of a project opportunity to award of a contract often exceeds one year. With multiple other bidders on most large project opportunities, Northern often cannot accurately assess its probability of winning the contract prior to its award by the customer. Most large domestic distributed 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 Northern s control. During this lengthy sales cycle, Northern may incur significant expense and expend significant management effort. These factors make it very difficult for Northern to generate firm backlog well in advance of the actual projects and to accurately forecast future sales. If Northern s sales forecasts from a specific project or customer for a particular period are not realized in that period, it may be unable to compensate for the shortfall, which could harm its operating results.

Northern conducts 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 Northern does business. The occurrence of any such events at or near the site of Northern s projects could lead to delay, cancellation, or significant damage to Northern s projects or equipment. The occurrence of any such events could also cause harm, injury or death to Northern personnel working on such projects. Any such events could expose Northern to significant liabilities and would therefore adversely impact Northern s operating results and

growth.

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If Northern fails to develop and commercialize new products and technology, it may not be able to increase its revenues.

While Northern does not derive any revenue from the sale of any products today, its business plan contemplates that a portion of its future revenue will be derived from the sale and/or licensing of new wind turbine and power electronics products which are currently under development and not yet commercially available. Many of these future products and technologies are based on new and unproven designs and it is difficult to predict whether they will be commercially viable. If Northern fails to successfully develop and commercialize these products and technologies, it will be unable to recover the investments it has made in their development and will be unable to grow its revenue from their sales and/or licensing. In addition, Northern is likely to face significant competition in the market for these future products. Many of Northern s competitors in the markets for these products are larger and better capitalized than Northern, are better established with a worldwide presence, and are already selling competing products in these markets. New technology developments or cost reductions in existing technologies may delay or prevent the development and/or sale of some or all of Northern s planned products or make its planned products uncompetitive or obsolete.

Northern may not be able to grow its revenues in the future if a sustainable market for distributed generation does not develop.

Northern s future growth is based in part on increased use of distributed generation technologies. Distributed generation is an emerging market, and it is difficult to predict the rate at which it will develop. If a sustainable market for distributed generation fails to develop or develops more slowly than Northern anticipates, its ability to grow and achieve profitability will be negatively impacted. Many of the factors that influence the rate of adoption of distributed generation technologies are out of Northern s control. Some such factors that Northern 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 generating technologies that Northern uses in its onsite power systems;
- costs and availability of natural gas and other fuels used in alternative generating technologies;
- changes in commercial and industrial customers perceptions regarding distributed generation;
- availability of financing for distributed generation vendors, developers and users;
- economic downturns and related reductions in capital spending; and
- demand for and valuation of emissions trading credits generated by distributed generation systems.

Northern s future growth depends on its ability to provide distributed generation systems that deliver electricity at a price that is competitive with the utility grid; significant declines in the price of utility delivered electricity or Northern s inability to continue to reduce the cost of its distributed generation systems could reduce demand for its services and products.

Northern competes mainly on price per delivered kilowatt hour of electricity to the end user. In its domestic markets, Northern is competing 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 Northern s control. Northern cannot accurately predict what future electric rates will be and whether or not it can compete effectively against these rates.

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The cost per delivered kilowatt hour of electricity generated by Northern s onsite 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 Northern s control.

Costs of alternative generating technologies like solar panels, wind turbines, fuel cells and microturbines have generally been falling over the past several years, but there can be no assurances 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, Northern s ability to sell its systems and services based on these technologies will be diminished.

Financing costs are critical to the cost competitiveness of renewable energy systems in particular, because, since the fuel from the wind or sun is free, they represent the single largest operating cost. Financing costs are also highly variable and subject to change beyond Northern s control.

For reciprocating engine or turbines 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 years to come based on increased demand and limited domestic supply. Sustained high gas prices reduce the economic benefit of the onsite power systems Northern sells and may therefore result in reduced sales and revenue growth for Northern.

Because Northern s sales are reliant in part on federal and state subsidies and incentives, any reduction in federal and state subsidy programs could harm Northern s business.

Northern s domestic market for distributed generation systems currently benefits from many federal and state programs designed to promote increased use of renewable and alternative generating 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 these programs may have an adverse impact on Northern s future growth. Also, given the economic downturn and resulting budget deficits, funding for many of the state programs is at risk of being diverted to other needs.

Decreases in the price of oil and gas could reduce demand for Northern s systems, which would have an adverse impact on its revenues, results of operations and financial condition.

A large portion of Northern s 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 Northern s 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 Northern supplies. Conversely, lower oil and gas prices would reduce demand for Northern s systems and have a negative impact on its growth.

Northern depends on a small number of customers, and termination of a project by one or more of these customers could harm Northern s business

A high percentage of Northern s sales are concentrated in only a few contracts. Failure on the part of Northern or Northern s customers to perform or deliver on any one of these contracts could have a major impact on Northern s annual operating results. In addition, most of Northern s customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects Northern to a high degree of customer credit risk and risk of non-performance by its vendors. A single

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vendor s late delivery of a key component required for a project, for example, could significantly delay Northern s completion of the project and trigger liquidated or consequential damages or other penalties as may be stipulated in Northern s contracts with its customers.

Continued uncertainty in domestic and world economies and energy markets may limit Northern s growth.

Current uncertainty among Northern s target customers over the health of the economy and its impact on their business has restricted their capital spending and made it harder for Northern to sell its systems and services. Other market uncertainties that also impact Northern s 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 it does business, and domestic and international policy responses to the threat of global warming.

Northern relies on third party suppliers and subcontractors for certain components and services, and Northern could suffer losses if these suppliers and subcontractors fail to fulfill its needs.

While most of Northern s components are available from multiple suppliers, many new technologies that Northern uses in its systems are only available from a very limited number of suppliers and in some cases only a single supplier. Often Northern s suppliers custom build components to Northern s specifications for use in a particular project and delayed deliveries, poor quality and warranty issues can delay its projects, reduce its profits and damage its relationships with its end customers. Particularly for newer technologies, technical and financial problems of the manufacturer could also delay Northern s projects, increase its costs and even cause customers to terminate Northern s contracts if Northern s vendors are unable to deliver the key components or technology on which its projects are based.

Particularly in Northern s domestic commercial and industrial projects, Northern relies heavily on electrical, mechanical, civil and structural subcontractors to build and install its systems at its customers facilities based on detailed specifications and drawings that Northern provide. Often these subcontracted services account for a high percentage of the overall project cost. Northern s subcontractors failure to perform their services in a timely and quality manner can lead to significant schedule delays, increased costs and performance issues on Northern s projects. These issues can potentially trigger penalties in Northern s contracts, increase its warranty exposure, reduce its profits and damage its relationships with its customers if not managed appropriately.

Northern may not be able to develop and/or retain relationships with strategic partners.

Northern currently works with a number of strategic partners that facilitate and enhance many aspects of its business, including technology development, component supply, sales lead generation, engineering support, and project installation. Northern must continue to expand these relationships and develop new relationships in order to grow its current project based business and its future product based business. Failure to do so would negatively impact Northern s future sales growth and operating results.

Northern s projects are subject to varying levels of sales and other taxes and Northern therefore incurs significant potential tax liability.

Northern has sold and continues to sell its power systems in numerous local, state and foreign jurisdictions. Each jurisdiction s sales and income tax rules and regulations are different and evolving. Northern and its auditors often must make subjective judgments as to whether or not it has established tax nexus in certain jurisdictions where it sells its services and systems and as to whether and how much tax is due on these sales. Northern may be audited at any time by any jurisdiction where it has done business and may be required to pay additional taxes, penalties and interest. There can be no assurances that Northern has not or will not incur additional tax liabilities over and above what is currently recognized in its financial statements.

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Undetected and unanticipated defects in Northern s distributed generation systems could increase Northern s costs and harm its reputation.

Distributed generation systems designed and installed by Northern often use new and untested technologies. Many of these new technologies have limited operating histories 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, Northern may incur additional warranty and other costs and its relationships with its 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 would reduce Northern s growth and profitability.

Northern depends on government contracts for a portion of its revenue and profits.

Northern s 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. There can be no assurance that Northern s current contracts will be fully funded or that Northern will be able to secure additional government contracts for similar activities in the future. Northern is also subject to annual audits of its incurred costs on its government contracts by the Defense Contracting Audit Agency. If Northern s actual overhead cost included in its incurred costs are less than the allowable overhead costs billed on these contracts, Northern may be required to refund the excess overhead costs to the government upon completion of the DCAA audit. Such a refund would negatively impact Northern s financial position and its revenue and profits in the year in which such costs were incurred.

If Distributed Energy fails to retain its key personnel and attract and retain additional qualified personnel, it may be unable to develop its products and generate revenue.

Distributed Energy s success depends upon the continued service of its executive officers and other key employees such as manufacturing and research and development personnel. The loss of any of Distributed Energy s executive officers or key employees, especially Walter W. Schroeder or Clint Coleman, could impair Distributed Energy s ability to pursue its growth strategy. Distributed Energy does not have employment agreements with any of its key executives. Distributed Energy may not be able to attract, assimilate or retain additional highly qualified personnel in the future.

Distributed Energy currently faces and will continue to face significant competition, which could cause it to lose sales or render its products and services uncompetitive or obsolete.

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 resources than Proton does. Each of these companies has the potential to capture market share in the markets Proton intends to address, which could cause Proton to lose sales and prevent Proton from growing its business. New developments in technology may also delay or prevent the development or sale of some or all of Proton s products or make its products uncompetitive or obsolete. If this were to occur, Proton would not be able to generate sufficient revenue to offset the cost of developing its hydrogen generators and regenerative fuel cell systems.

Proton s 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

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made to the existing electric grid. Technological advances in power technology products and improvements in the electric grid may reduce the attractiveness of Proton s regenerative fuel cell systems.

As the markets for PEM fuel-cell related products, on-site hydrogen generation and backup power develop, other large industrial companies may enter these fields and compete with Proton. These large industrial companies may have the research and development, manufacturing, marketing and sales resources necessary to commercialize hydrogen generators and regenerative fuel cell systems more quickly and effectively than Proton does.

The distributed generation market is also highly competitive and evolving rapidly. Northern faces a wide variety of competitors, including equipment manufacturers, distributors, packagers, system integrators, general contractors, engineering firms, project developers, and energy service companies. Many of Northern s competitors are significantly larger and better capitalized than Northern, and therefore may be able to devote more resources to the following activities that 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 product or services;
- development and commercialization of new technologies;
- partnering and other collaborative efforts with sales channel partners, vendors and technology providers;
- expanded design, engineering and other fulfillment and service capabilities; and
- systems and other infrastructure development that reduces costs.

Distributed Energy depends on its intellectual property, and Distributed Energy s failure to protect it could enable competitors to market products with similar features that may reduce demand for Distributed Energy s products.

If Distributed Energy is unable to protect its intellectual property, Distributed Energy s competitors could use its intellectual property to market products similar to its products, which could reduce demand for Distributed Energy s products. Distributed Energy s success depends substantially upon the internally developed technology that is incorporated in its products. Distributed Energy may be unable to prevent unauthorized parties from attempting to copy or otherwise obtain and use its products or technology. Policing unauthorized use of Distributed Energy s technology is difficult, and Distributed Energy may not be able to prevent misappropriation of its technology, particularly in foreign countries where the laws may not protect Distributed Energy s intellectual property as fully as those in the United States. Others may circumvent the trade secrets, trademarks and copyrights that Distributed Energy owns, and any of the U.S. patents or foreign patents owned by Distributed Energy or subsequently issued to Distributed Energy may be invalidated, circumvented, challenged or rendered unenforceable. In addition, Distributed Energy may not be issued any patents as a result of its pending and future patent applications, and any patents issued to Distributed Energy may not have the breadth of claim coverage sought by Distributed Energy.

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

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Distributed Energy could incur substantial costs defending its intellectual property from infringement by others.

Unauthorized parties may attempt to copy aspects of Distributed Energy s products or to obtain and use its proprietary information. Litigation may be necessary to enforce Distributed Energy s intellectual property rights, to protect its trade secrets and to determine the validity and scope of the proprietary rights of others. Any litigation could result in substantial costs and diversion of resources with no assurance of success.

Distributed Energy could incur substantial costs defending against claims that its products infringe on the proprietary rights of others.

The patent situation in the field of PEM fuel cell technology is complex. A large number of patents, including overlapping patents, relating to this technology have been granted worldwide. Distributed Energy is aware of patents in the fuel cell architecture field held by potential competitors and other third parties, including Ballard Power Systems, General Motors, Giner, H-Power, Oronzio deNora Impianti Electrochemical, Packard Instrument, Plug Power, Shinko Pantec, Siemens, Toyota, United Technologies and Whatman. Third parties could claim infringement by Proton with respect to these patents or other patents or proprietary rights, and Proton may not prevail in any such proceeding.

Northern is aware of a patent held by General Electric with respect to variable-speed wind turbines. If Northern incorporates variable-speed wind turbine technology into future wind-related generation products and is not able to design and engineer non-infringing technology, it may be required to license this technology from General Electric. If Northern is unsuccessful in developing non-infringing technologies, it may be required to cease or redirect its development efforts or obtain licensing, royalty or other agreements. There can be no assurance that Northern can obtain such licensing or other agreements on favorable terms or at all, in which case Northern s ability to execute its business plan, grow its sales and generate a profit may be adversely affected.

In addition, some of Distributed Energy s 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. Distributed Energy cannot assure that such employers will not assert claims against Distributed Energy or its employees alleging a breach of those agreements or other violations of their proprietary rights or alleging rights to inventions by Distributed Energy s employees, or that Distributed Energy would prevail in any such proceeding.

Any infringement claim against Distributed Energy, whether meritorious or not, could:

- be time-consuming;
- result in costly litigation or arbitration and diversion of technical and management personnel; or
- require Distributed Energy to develop non-infringing technology or to enter into royalty or licensing agreements.

Distributed Energy might not be successful in developing non-infringing technologies. Royalty or licensing agreements, if required, may not be available on terms acceptable to Distributed Energy, or at all, and could significantly harm its business and operating results. A successful claim

of infringement against Distributed Energy or its failure or inability to license the infringed or similar technology could require Distributed Energy to pay substantial damages and could harm its business because it would not be able to sell the affected product without redeveloping the product or incurring significant additional expense. In addition, to the extent Distributed Energy agrees to indemnify customers or other third parties against infringement of the intellectual property rights of others, a claim of infringement could require Distributed Energy 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 Distributed Energy s products.

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Distributed Energy may be exposed to lawsuits and other claims if its products or systems malfunction or fail, which could increase Distributed Energy s expenses, harm its reputation and prevent Distributed Energy from growing its business.

Any liability for damages resulting from malfunctions or failures of Distributed Energy s products or systems could be substantial and could increase Distributed Energy s expenses and prevent Distributed Energy from growing its business. In particular, hydrogen is a flammable gas and can pose safety risks if not handled properly. Proton has experienced an instance with one of its products where hydrogen appears to have leaked into the ambient oxygen stream resulting in 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. Although Proton has taken steps to improve safety and reliability in its products, Proton cannot be certain that future similar instances will not occur. In addition, Proton s products may require modifications to operate properly under extreme temperatures. Potential customers will also rely upon Proton s products for critical needs, such as backup power. A malfunction of Proton s 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 Proton s products. This could result in a decline in demand for Proton s products, which would reduce Proton s revenue and harm its business.

Northern s standard power system warranty includes a one-year warranty period for defects in design, materials and workmanship of its systems. Northern has not provided guarantees of the performance of its systems to date but may be required to do so in the future. Most of its systems are custom designed to individual customers specifications and may include new and unproven technologies, system architectures, and component configurations. Many of its 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 Northern to incur significant expense to redesign, reengineer, repair and/or replace defective systems or system components. Furthermore, Northern projects often have high visibility in its target markets, so that any such failures could damage its reputation and limit future sales in these markets.

Government regulations may impair Distributed Energy s ability to market and sell its products.

Proton s products are potentially subject to federal, local and foreign laws and regulations governing, among other things, emissions to air as well as laws relating to occupational health and safety. Proton may incur substantial costs or liabilities in complying with governmental regulations. Proton s potential customers must also comply with numerous laws and regulations, which could affect their interest in Proton s products. Proton 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. electric industry may ultimately expand the market for distributed generation systems of the type that Northern sells, 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 Northern s access to certain of its target markets.

Distributed Energy s failure to manage growth could harm its business.

Distributed Energy intends to introduce new products, increase its production capacity and develop additional distributor relationships. If Distributed Energy is successful, a significant strain on its senior

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management team and other resources may result. In addition, Distributed Energy may be required to hire additional senior management personnel. Distributed Energy s ability to manage growth will depend in part on its ability to continue to enhance its operating, financial and management information systems. Distributed Energy s personnel, systems and controls may be unable to support its growth.

Distributed Energy may not be able to obtain sufficient funds to grow its business.

Proton and Northern have regularly needed to raise funds to operate their businesses. Proton believes it may need to raise additional funds to achieve full commercialization of some or all of its products. Northern s project-based business requires a significant amount of capital in order to increase the number and size of projects it can undertake and therefore increase its revenues. If Distributed Energy is unable to raise additional funds when needed, the ability of Proton and Northern to operate and grow their businesses could be impaired. Distributed Energy does not know whether it will be able to secure additional funding or funding on terms acceptable to it. Distributed Energy s ability to obtain additional funding will be subject to a number of factors, including market conditions, its operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If Distributed Energy issues additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

Distributed Energy s revenue and operating results may fluctuate significantly as a result of factors outside of Distributed Energy s control, which could cause the market price of its common stock to decline.

Distributed Energy expects its revenue and operating results to vary significantly from quarter to quarter. As a result, quarterly comparisons of Distributed Energy s financial results are not necessarily meaningful and should not be relied on as an indication of Distributed Energy s future performance. In addition, due to Distributed Energy s stage of development, it cannot predict its future revenue or results of operations accurately. As a consequence, Distributed Energy s operating results may fall below the expectations of securities analysts and investors, which could cause the price of Distributed Energy s common stock to decline. Factors that may affect Distributed Energy s operating results include:

- the status of development of Distributed Energy s technology, products and manufacturing capabilities;
- the cost 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 Distributed Energy or its competitors;
- the development of strategic relationships and distribution channels;
- 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.

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

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Distributed Energy s current or planned international operations subject its business to additional risks, which could cause revenues to decline.

For the past three years, Northern has generated a majority of its revenue 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. Selling Northern s services internationally exposes it to many additional costs, risks, and potential liabilities, which, if improperly managed, could limit its ability to grow in these markets and adversely impact its operating results. In addition Proton intends to market its hydrogen generators to small and medium volume users of delivered hydrogen. Proton s business depends on the widespread commercial acceptance of its hydrogen generators, and Proton may be unable to grow its business if Proton s targeted customers do not purchase substantial numbers of Proton s hydrogen generators. Proton s targeted customers, or the distributors whom Proton intends to use to market to these customers, may not purchase Proton s hydrogen generators at all or in sufficient quantities to support the growth of Proton s business. Costs, risks and potential liabilities faced by Distributed Energy as a result of international operations include:

- complying with the commercial 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; and
- managing operations and staff across disparate geographic areas.

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

Because Distributed Energy relies on third parties to fund a portion of its research and development relating to new products, any decrease in such third party funding could limit its ability to develop new products.

Distributed Energy receives significant external funding from the Department of Energy, the National Renewable Energy Laboratory and other public and private entities for the development of its proprietary products and technology. Changes in government policy toward distributed generation or budget restrictions may reduce or eliminate funding from these sources for these types of research and development activities. If such funding was discontinued, Distributed Energy may not have sufficient internal funding to continue with these development efforts and may therefore have to reduce its development of these products, delay their development or abandon them altogether. Discontinuation or delay in its development of proprietary products and technology could limit Distributed Energy s ability to execute its business plan and may have an adverse impact on its ability to increase revenues and generate a profit. Distributed Energy is also subject to annual audits of its incurred costs on its government contracts by the Defense Contracting Audit Agency, or DCAA, and other agencies. If Distributed Energy s actual overhead cost included in its incurred costs are less than the allowable overhead costs billed on these contracts, Distributed Energy may be required to refund the excess overhead costs to the government upon completion of the DCAA audit. Such refunds would negatively impact Distributed Energy s financial position and its revenue and profits in the year in which such costs were incurred.

The anticipated benefits of the merger may not be realized in a timely fashion, or at all, and Distributed Energy s operations may be adversely affected.

The success of the merger of Proton and Northern into Distributed Energy will depend, in part, on Distributed Energy s ability to realize the growth opportunities and synergies of combining Proton and Northern and to effectively utilize the resources of the combined companies following the merger. The

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merger involves risks related to the integration and management of acquired operations and personnel. The integration of the businesses will be a complex, time-consuming and potentially expensive process and may disrupt Distributed Energy s business if not completed in a timely and efficient manner. Some of the difficulties that may be encountered by the combined companies include:

- the diversion of management s attention from other ongoing business concerns;
- challenges in enhancing Northern s internal procedures, contracts and systems as needed for it to function as part of a public company;
- the inability to utilize the acquired resources effectively; and
- demonstrating to the combined company s customers, suppliers and partners that the mergers will not result in adverse changes in client service standards or business focus.

If Distributed Energy s management focuses too much time, money and effort to integrate Northern s operations and assets, they may not be able to execute Proton s overall business strategy. Additionally, the combined companies may not progress at the same rates as have been experienced by Proton and Northern, respectively, operating as separate companies in the past.

Distributed Energy s stock price is likely to be highly volatile and may result in substantial losses for investors purchasing shares.

The market price of Distributed Energy s common stock is likely 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 Distributed Energy s common stock may experience a decrease in the value of their common stock regardless of Distributed Energy s operating performance or prospects. Distributed Energy s 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 Distributed Energy s securities may not be sustained.

The trading price of Distributed Energy s common stock could be subject to wide fluctuations in response to:

- Distributed Energy s perceived prospects;
- variations in Distributed Energy s operating results and achievement of key business targets;
- changes in securities analysts recommendations or earnings estimates;
- differences between Distributed Energy s reported results and those expected by investors and securities analysts;
- announcements of new products by Distributed Energy or its competitors;

market reaction to any acquisition, joint venture or strategic investments announced by Distributed Energy or its competitors; and

general economic or stock market conditions unrelated to Distributed Energy s 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.

Distributed Energy s executive officers, directors and their affiliates hold a large percentage of Distributed Energy s stock and their interests may differ from other stockholders.

Distributed Energy s directors, executive officers and individuals or entities affiliated with Distributed Energy s directors as a group beneficially own, approximately 20% of Proton s outstanding common stock at March 31, 2004. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of Distributed Energy s directors, and the approval of any

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other action requiring the approval of Distributed Energy s stockholders, including any amendments to Distributed Energy s certificate of incorporation and mergers or sales of substantially all of Distributed Energy s assets. In addition, without the consent of these stockholders, Distributed Energy could be prevented from entering into transactions that could be beneficial to it or its other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire Distributed Energy at a price per share that is above the then-current market price.

The provisions of Distributed Energy s 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 Distributed Energy common stock.

There are provisions in Distributed Energy s certificate of incorporation and bylaws that make it more difficult for a third party to acquire, or attempt to acquire, control of Distributed Energy, even if a change in control may be considered favorable by Distributed Energy s stockholders. For example, Distributed Energy s 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 Distributed Energy stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. As a result, the market price of Distributed Energy s common stock and the voting and other rights of its stockholders may be adversely affected. The issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

Distributed Energy s 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, Distributed Energy is 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 Distributed Energy s common stock. These provisions may also prevent changes in Distributed Energy s management.

Distributed Energy s failure to comply with NASDAQ s listing standards could result in its delisting by NASDAQ from the NASDAQ National Market and severely limit the ability to sell Distributed Energy s common stock.

Distributed Energy s common stock is traded on the NASDAQ National Market. Under NASDAQ s listing maintenance standards, if the closing bid price of Distributed Energy common stock is under $1.00 per share for 30 consecutive trading days, NASDAQ will notify Distributed

Energy that it may be delisted from the NASDAQ National Market. If the closing bid price of Distributed Energy common stock does not thereafter regain compliance for a minimum of 10 consecutive trading days during the 90 days following notification by NASDAQ, NASDAQ may delist Distributed Energy s common stock from trading on the NASDAQ National Market. There can be no assurance that Distributed Energy s common stock will remain eligible for trading on the NASDAQ National Market. In addition, if Distributed Energy s common stock is delisted, Distributed Energy s stockholders would not be able to

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sell Distributed Energy common stock on the NASDAQ National Market, and their ability to sell any of Distributed Energy s common stock would be severely if not completely limited.

ITEM 3. ***Quantitative and Qualitative Disclosures About Market Risk***

The Company holds marketable securities consisting of U.S. government and agency securities that are held by two major banking institutions. The Company s marketable securities portfolio of approximately $52.7 million includes five callable agency securities with a fair market value totaling approximately $21.2 million. In the first quarter of 2004, three investments approximating $11.8 million were called at par. These securities generate a higher relative rate of interest for the Company; in return, the embedded call option gives the issuer the right to buy back the security. 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.

ITEM 4. ***Controls and Procedures***

The Company s management, with the participation of the Company s chief executive officer and chief financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2004. Based on this evaluation, the Company s chief executive officer and chief financial officer concluded that, as of March 31, 2004, the Company s disclosure controls and procedures were (1) designed to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the Company s chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance 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.

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, 2004 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II.

OTHER INFORMATION

ITEM 1. ***Legal Proceedings***

Between July 3, 2001 and September 6, 2001, five purported class action lawsuits were filed in the United States District Court for the Southern District of New York against the Company and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering (IPO) of common stock. All of the complaints were filed allegedly on behalf of persons who purchased the Company s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that the Company 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 Class Action Complaint (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 the Company joined in an omnibus motion to dismiss the

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lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs claims, including those in the 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 the Company. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the Amended 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 the Company 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. Any such settlement would be subject to approval by the Court. The Company believes it has meritorious defenses to the claims made in the Amended Complaint and, if the settlement is not finalized and approved, the Company 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. The Company 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 2. ***Changes in Securities and Use of Proceeds***

On October 4, 2000, Proton closed an initial public offering of its common stock. The effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed was September 28, 2000, and the Commission file number assigned to the registration statement was 333-39748.

After deducting underwriting discounts and commissions and offering expenses, our net proceeds from the offering were approximately $125.8 million. The net proceeds have been allocated for general corporate purposes and capital expenditures, including purchase of equipment for and leasehold improvements to our manufacturing facility, and the possible acquisition of businesses, products or technologies that are complementary to our business. As of March 31, 2004, approximately $57.2 million of the net proceeds of the offering had been used to fund operations and purchase fixed assets and $20.3 million has been used in the acquisition of Northern Power Systems, Inc (the Acquisition). The remaining net proceeds are invested in U.S. Government and Agency securities. In October 2001, we loaned $275,000 of the proceeds to Mr. Schroeder, who is president and a director of the Company. In July 2002, the loan was paid in full. We made a cash distribution of $1.00 per share payable on June 20, 2003 to stockholders of record as of June 6, 2003. The aggregate amount of this distribution was $33,927,297. No other portion of the proceeds of Proton s initial public offering were paid directly or indirectly to any director, officer or general partner of us or our associates, persons owning ten percent or more of any class of our equity securities, or an affiliate of us.

ITEM 3. ***Default upon Senior Securities***

Not Applicable.

ITEM 4. ***Submission of Matters to a Vote of Security Holders***

Not Applicable.

ITEM 5. ***Other Information***

Not Applicable.

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ITEM 6. ***Exhibits and Reports on Form 8-K***

(a) Exhibits

Exhibit 31 Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K

On March 11, 2004, the Registrant furnished a Current Report on Form 8-K under Item 9, containing a copy of its earnings release for the period ended December 31, 2003 (including financial statements) pursuant to Item 12 (Results of Operations and Financial Condition).

On February 20, 2004, the Registrant filed a Report on Form 8-K/A, reporting that Proton Energy Systems, Inc. and Northern Power Systems, Inc. combined their businesses by merging with and into separate acquisition subsidiaries of Distributed Energy Systems Corp.

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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 5, 2004

DISTRIBUTED ENERGY SYSTEMS CORP.

(Registrant)

By: /s/ *WALTER W. SCHROEDER*

Walter W. Schroeder
President

By: /s/ *JOHN A. GLIDDEN*

John A. Glidden
Principal Financial and Accounting Officer