DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
May 10, 2006
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UNITED STATES

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, 2006

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (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, 2006 was 38,605,172.

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PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,881,132	$ 20,600,791
Marketable securities (Note 3)	25,856,503	20,064,719
Current portion of restricted cash	290,373	290,373
Accounts receivable, less allowances of $123,037 and $72,772 respectively	8,000,482	8,802,419
Costs in excess of billings on contracts in progress	2,667,753	1,951,226
Inventories (Note 4)	4,370,547	3,092,784
Deferred costs	4,631,335	4,255,030
Interest receivable	191,954	134,127
Other current assets	1,152,481	1,032,111
Total current assets	55,042,560	60,223,580
Fixed assets, net	21,653,477	21,858,722
Long-term portion of restricted cash	715,750	715,750
Intangible assets, net	3,209,556	3,310,317
Goodwill	24,755,962	24,755,962
Other assets, net	358,453	281,465
Total assets	$ 105,735,758	$ 111,145,796
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 551,801	$ 545,141
Current portion of capital lease	153,160	141,448
Accounts payable	3,960,111	4,773,733
Accrued expenses (Note 5 and 8)	1,358,388	1,624,771
Accrued compensation	1,909,945	2,290,444
Accrued taxes (Note 8)	272,171	402,359
Billings in excess of costs on contracts in progress	854,680	1,159,968
Deferred revenue	5,117,474	4,563,164
Customer advances	591,639	654,541
Total current liabilities	14,769,369	16,155,569
Long term liabilities:		
Deferred tax liability	564,775	564,775
Deferred revenue	303,493	144,168
Long-term debt	6,537,048	6,674,802
Long-term portion of capital lease	2,534,007	2,550,115
Total liabilities	24,708,692	26,089,429

Commitments and contingencies (Note 8)		
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; 37,652,976 and 37,181,632 shares issued and outstanding, respectively	376,530	371,817
Additional paid-in capital	223,960,216	221,111,515
Unearned compensation		(453,980)
Accumulated other comprehensive loss (Note 2)	(49,758)	(58,683)
Accumulated deficit	(143,259,922)	(135,914,302)
Total stockholders equity	81,027,066	85,056,367
Total liabilities and stockholders equity	$ 105,735,758	$ 111,145,796

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,	
	2006	2005
Revenue		
Contract	$ 5,226,288	$ 7,772,383
Product	1,115,307	1,054,180
Service	1,295,476	709,393
Total revenue	7,637,071	9,535,956
Cost of revenue		
Contract	4,856,685	6,969,519
Product	1,162,884	1,335,772
Service	1,173,788	536,347
Total cost of revenue	7,193,357	8,841,638
Gross margin	443,714	694,318
Operating expenses		
Research and development:		
Noncash depreciation and amortization	130,471	231,583
Other research and development	552,189	1,108,993
Selling, general and administrative:		
Noncash depreciation and amortization	361,119	443,545
Other selling, general and administrative (includes stock based compensation in the amounts of $2,114,584 and $174,251, respectively)	7,014,128	3,761,860
Total operating expenses	8,057,907	5,545,981
Loss from operations	(7,614,193)	(4,851,663)
Interest income	348,930	264,683
Interest expense	(152,313)	(94,761)
Other income (expense)	71,952	(30,648)
Net loss	$ (7,345,624)	$ (4,712,389)
Basic and diluted net loss per share	$ (0.20)	$ (0.13)
Shares used in computing basic and diluted net loss per share	37,509,080	35,722,794

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, 2006	2005
Cash flows from operating activities:		
Net loss	$ (7,345,624)	$ (4,712,389)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	595,957	622,484
Provision for bad debts	50,265	4,264
Amortization (accretion) of premiums/discounts on marketable securities	(103,723)	(16,620)
Non-cash stock-based expense	2,373,892	174,250
Loss on sale of marketable securities		2,200
(Gain) loss on disposal of assets	(37,063)	26,497
Changes in operating assets and liabilities:		
Accounts receivable	751,672	(1,176,002)
Inventories and deferred costs	(1,654,068)	(120,384)
Costs in excess of billings	(716,527)	(1,443,278)
Other current assets and interest receivable	(178,197)	10,103
Other assets	(89,910)	2,073
Accounts payable and accrued expenses	(1,460,500)	(560,172)
Accrued taxes	(130,188)	(273,891)
Billings in excess of costs	(305,288)	(2,088,276)
Deferred revenue and contract advances	650,733	470,461
Net cash used in operating activities	(7,598,569)	(9,078,680)
Cash flows from investing activities:		
Purchases of fixed assets	(354,966)	(239,996)
Proceeds from the sale of fixed assets	115,000	4,500
Purchases of marketable securities	(21,880,768)	(3,073,894)
Proceeds from maturities and sales of marketable securities	16,201,632	8,047,800
Net cash (used in) provided by investing activities	(5,919,102)	4,738,410
Cash flows from financing activities:		
Borrowings from long-term debt, net of issuance costs	40,453	
Debt principal payments	(175,943)	(117,474)
Proceeds from sale of common stock, net	566,753	36,176
Proceeds from exercise of common stock warrants	165,265	38,301
Proceeds from exercise of common stock options	201,484	26,233
Net cash provided by (used in) financing activities	798,012	(16,764)
Net decrease in cash and cash equivalents	(12,719,659)	(4,357,034)
Cash and cash equivalents at beginning of period	20,600,791	5,989,896
Cash and cash equivalents at end of period	$ 7,881,132	$ 1,632,862
Cash paid during the period for interest	$ 149,194	$ 94,586

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). Together, as subsidiaries of Distributed Energy, Proton and Northern offer an array of practical energy technologies, including Proton s advanced hydrogen generation products and Northern s renewable and fossil-fuel power systems.

On December 10, 2003, Distributed Energy announced the completion of its acquisition of Northern (the Acquisition). The acquisition 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 was exchanged for a share of Distributed Energy common stock. At the close of the 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 condensed consolidated financial statements as of March 31, 2006 and for the three-month periods ended March 31, 2006 and 2005 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 with the SEC on March 10, 2006.

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 tables set forth the components of comprehensive income (loss) resulting from our investment activities:

	Three Months Ended March 31,	
	2006	2005
Net loss	$ (7,345,624)	$ (4,712,389)
Unrealized gains (losses) on marketable securities arising in period	8,925	(38,994)
Reclassification adjustments for losses included in net income	13,688	2,200
Total comprehensive loss	$ (7,323,011)	$ (4,749,183)

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Concentration of Risks

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

For the quarter ended March 31, 2006 and 2005, sales to one international customer totaled approximately 12% and 20% of total Company revenue, respectively. At March 31, 2006 and December 31, 2005, accounts receivable from government-sponsored agencies accounted for approximately 12% and 16% of total Company accounts receivable, respectively. At March 31, 2006, accounts receivable from two customers accounted for approximately 24% of total Company accounts receivable. At December 31, 2005, there were no individual customer accounts receivables greater than 10% of total receivables.

Stock-Based Compensation Employee Stock-Based Awards

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the Employee Stock Purchase Plan (ESPP) based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal year 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) providing supplemental implementation guidance for SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

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

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

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the three months ended March 31, 2006, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the fair value on the grant date estimated in accordance

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with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 31, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all stock-based awards granted will be recognized using the ratable single-option method. The amount of compensation expense recognized during a period is based on the value of the awards that are ultimately expected to vest. As stock-based compensation expense recognized in the Company s results for the first quarter of 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, the Company accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in the Notes to Consolidated Financial Statements for the related periods.

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

Also see Note 7 for further discussion of stock-based compensation.

Stock-Based Compensation Non-Employee Stock Options

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

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, 2005:

	Three Months Ended March 31, 2005
Net loss, before stock-based compensation for employees, prior period	$ (4,712,389)
Add: Stock-based compensation expense for employees previously determined under the intrinsic value method, net of tax effect	146,870
Less: Stock-based compensation expense for employees determined under the fair value based method, net of tax effect	$ (730,191)
Net loss, after effect of stock-based compensation for employees	$ (5,295,710)
Net loss per share applicable to common stockholders, basic and diluted	
As reported	$ (0.13)
Pro forma	$ (0.15)
Pro forma	$ (5,879,031)

Long-lived Assets

The Company evaluates potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the

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Impairment or Disposal of Long-Lived Assets . SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable.

3. 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, 2006, the Company s investment portfolio consisted of U.S. government and agency securities held by a major banking institution. The maturities of marketable securities of $25,856,503 and $20,064,719 at March 31, 2006 and 2005 respectively, are less than one year.

Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders equity. The unrealized loss from marketable securities was $49,758 and $58,683 at March 31, 2006 and December 31, 2005, respectively. At March 31, 2006, the Company had one callable agency security with a fair market value totaling approximately $4.5 million. This security generates 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.

As of March 31, 2006, none of the Company s investments were determined to be other than temporarily impaired.

4. 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, 2006	December 31, 2005
Raw materials	$ 2,569,037	$ 1,596,413
Work in process	1,076,288	1,083,747
Finished goods	725,222	412,624
	$ 4,370,547	$ 3,092,784

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $573,757 and $568,298 at March 31, 2006 and December 31, 2005, respectively.

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

	March 31, 2006	December 31, 2005
Costs incurred and estimated earnings on contracts in progress	$ 19,067,170	$ 25,785,091
Less: billings to date	17,254,097	24,993,833
Costs and earnings in excess of (less than) billings, net	$ 1,813,073	$ 791,258

	March 31, 2006	December 31, 2005
Costs in excess of billings on contracts in progress	$ 2,667,753	$ 1,951,226
Billings in excess of costs on contracts in progress	(854,680)	(1,159,968)
Costs and earnings in excess of billings, net	$ 1,813,073	$ 791,258

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	March 31, 2006	December 31, 2005
Accrued warranty	$ 422,438	$ 417,694
Accrued purchases	319,805	497,451
Other accruals	616,145	709,626
	$ 1,358,388	$ 1,624,771

6. LOSS PER SHARE

Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average common shares outstanding. Diluted EPS is calculated by adjusting weighted average common shares outstanding by assuming conversion of all potentially dilutive shares. In periods of net loss as recorded, no effect is given to potentially dilutive securities since the effect would be antidilutive. Accordingly, no effect has been given to the assumed exercise of 3,361,414 and 3,364,076 common stock options outstanding for the quarters ended March 31, 2006 and 2005, respectively, nor the assumed exercise of 673,297 and 1,797,767 common stock warrants outstanding for the quarters ended March 31, 2006 and 2005, respectively, since the effect would be antidilutive for the reporting periods.

7. STOCK-BASED COMPENSATION

Stock Option Plan

The Company has four stock option plans: the Proton 1996 Stock Option Plan (the 1996 Plan), the Northern 1998 Stock Option Plan (the 1998 Plan), the Proton 2000 Stock Option Plan (the 2000 Plan) and the 2003 Stock Incentive Plan (the 2003 Plan) (collectively the Plans). The Company has reserved a total of 8,600,000 shares of common stock for issuance under the 1996, 1998, 2000 and 2003 Plans. Together the Plans provide for the grants of non-qualified and incentive stock options, restricted stock awards and other stock-based awards to its employees, officers, directors, consultants and advisors. As determined by the Board of Directors, options are generally granted at the fair market value of the common stock at the time of grant. However, the Board of Directors has determined that the exercise price for each incentive stock option shall not be less than the fair market value of the common stock at the time the incentive stock option is granted. Options generally vest ratably over four to five years and expire ten years from the date of grant. The Company has a policy of issuing new shares to satisfy option exercises.

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A summary of stock option activity for the three months ended March 31, 2006 under the Plans is as follows:

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term
Outstanding at December 31, 2005 (3,264,031 exercisable)	4,558,854	$ 5.60		
Granted	989,544	9.21		
Exercised	(208,798)	0.97		
Forfeited	(10,836)	4.75		
Expired	(3,343)	7.35		
Outstanding at March 31, 2006	5,325,421	$ 6.45	$ 13,624,429	6.88
Options Vested and Expected to Vest	5,077,042	$ 6.44	$ 13,143,608	6.77
Options Exercisable	3,520,811	$ 6.68	$ 9,578,194	5.86

The total intrinsic value (the amount by which the stock price exceeds the exercise price of the option on the date of exercise) of the stock options granted during the three months ended March 31, 2006 and 2005 was $1.7 million and $0.6 million, respectively. The weighted average grant date fair value of the stock options granted during the three months ended March 31, 2006 and 2005 was $6.46 and $1.94, respectively.

The following table summarizes additional information about stock options outstanding at March 31, 2006:

Range of Exercise Prices		Number Outstanding as of March 31, 2006	Weighted Average Remaining Contractual Term in Years	Weighted Average Exercise Price	Number Exercisable as of March 31, 2006	Weighted Average Exercise Price
$ 0.05	$ 0.37	809,150	4.93	$ 0.29	674,897	$ 0.27
0.50	2.63	633,578	8.45	2.29	177,706	2.24
2.65	2.99	665,210	7.61	2.87	499,698	2.86
3.00	4.65	532,961	7.99	3.48	464,658	3.51
4.80	7.38	560,021	5.38	6.63	529,646	6.63
7.50	8.84	762,494	8.93	8.64	178,199	8.24
8.90	10.75	662,007	7.54	10.33	296,007	10.65
11.10	16.88	44,500	4.89	13.60	44,500	13.60
17.00	17.00	655,000	4.50	17.00	655,000	17.00
24.13	24.13	500	4.55	24.13	500	24.13
$ 0.05	$ 24.13	5,325,421	6.88	$ 6.45	3,520,811	$ 6.68

2000 and 2003 Employee Stock Purchase Plan

The Company has two Employee Stock Purchase Plans: the 2000 Employee Stock Purchase Plan (the 2000 ESPP Plan) and the 2003 Employee Stock Purchase Plan (the 2003 ESPP Plan) (collectively the ESPP Plans). A total of 550,000 shares of common stock are available for issuance under these ESPP Plans. Eligible employees can purchase common stock pursuant to payroll deductions at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each three-month offering period.

The Company measures the fair value of issuances under the employee stock purchase plan using the Black-Scholes option pricing model at the end of each reporting period. The compensation cost for the Plan consists of the discount (15% of the grant date stock price) and the fair value of the option features. For the quarter ended March 31, 2006, the Company issued 10,840 shares associated with the Plan and recorded compensation cost of $23,788. As of March 31, 2006, 339,942 shares remained available for future issuance under the 2003 ESPP Plan.

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Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective transition method. SFAS 123(R) requires the measurement and recognition of compensation expense for all stock-based awards made to the Company s employees and directors including employee stock options, employee stock purchase plans, and other stock-based awards based on estimated fair values. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, generally no stock-based compensation expense for employee stock options had been recognized in the Company s results of operations in the prior period, because the exercise price of the stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method that we used in adopting SFAS 123(R), the Consolidated Statements of Operations prior to 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R).

For the period ended March 31, 2006, the adoption of SFAS 123(R) had the following effect on reported amounts that would have been reported using the intrinsic value method under APB No. 25:

	Three Months Ended March 31, 2006		
	Using APB No. 25 Accounting	**SFAS 123(R) Adjustments**	**As Reported**
Loss from operations	$ (5,946,302)	$ (1,667,891)	$ (7,614,193)
Loss before income taxes	(5,677,733)	(1,667,891)	(7,345,624)
Net loss	(5,677,733)	(1,667,891)	(7,345,624)
Basic and diluted earnings per share	(0.15)	(0.05)	(0.20)

Total non cash stock compensation, including the impact of SFAS 123(R) for the three months ended March 31, 2006 was $2,374,000. Of this amount $2,256,000 is recognized in selling, general and administrative expenses, $57,000 in research and development expenses and the remainder of $61,000 has been capitalized as a component of inventory.

In the first quarter of 2006 the Company granted its CEO, Mr. Schwallie 100,000 shares of restricted common stock at a price of $.01 per share. The fair market value of these shares at the date of grant was $8.84 and the shares vest one year from the date of grant. In addition, the Company granted Mr. Schwallie 28,280 shares of restricted common stock at a price of $.01 per share. The fair market value of these shares at the date of grant was $8.84 and vest immediately. The total compensation cost reflected in selling, general and administrative expenses associated with these two grants is approximately $470,000.

Mr. Schwallie also has the ability to earn up to 300,000 restricted stock awards whereby vesting is contingent upon meeting various company wide performance goals, including certain revenue, cash flow and gross margin targets at various intervals through June 30, 2008. The fair market value of these restricted stock awards was $8.84 per share. The number of shares subject to this agreement vest immediately upon the achievement of these performance goals. The Company determined that as of March 31, 2006 it was not probable that these restricted stock awards would be issued and therefore no compensation cost has been recognized in the three months ended March 31, 2006. If a change in control event, as described in our 2003 Stock Incentive Plan and meeting parameters to be determined by our board of directors, occurs, and Mr. Schwallie is still employed by the Company, these restricted stock awards would be granted to Mr. Schwallie unless it is no longer possible for the respective targets to be met.

As of March 31, 2006, total unamortized stock-based compensation cost, net of estimated forfeitures, related to non-vested stock options was $5.3 million, which is expected to be recognized over the remaining weighted average vesting period of 35 months. Compensation costs for all stock-based awards granted on or prior to December 31, 2005 and all stock-based awards granted subsequent to December 31, 2005 will be recognized using the ratable single-option method.

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Upon adoption of SFAS 123(R), the Company selected the Black-Scholes option pricing model as the most appropriate model for determining the estimated fair value for stock-based awards. The use of the Black-Scholes model requires the use of extensive actual employee exercise behavior data and the use of a number of complex assumptions including expected volatility, risk-free interest rate, and expected dividends. The assumptions used to value options granted are as follows.

	Three Months Ended March 31,	
	2006	2005
Risk free interest rate	4.72%	3.72%
Expected dividend yield	None	None
Expected term of option	5.75-6 years	5 years
Expected volatility	78%	91%

Beginning January 1, 2006, the Company estimated the volatility of its stock using historical volatility in accordance with guidance in SFAS 123(R) and SAB 107. Management determined that historical volatility is most reflective of market conditions and the best indicator of expected volatility. In calculating its volatility the Company excluded the period from the IPO on September 29, 2000 to June 30, 2001 due to significant fluctuations in its stock price. The Company will continue to monitor these and other relevant factors used to measure expected volatility for future option grants. Prior to the adoption of SFAS 123(R), the Company had used historical stock price volatility in accordance with SFAS 123 for purposes of pro forma information disclosed in the Notes to Consolidated Financial Statements for prior periods.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the expected term of the company s employee stock options. The dividend yield assumption is based on the Company s history and expected dividend payouts.

The expected term of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding. The Company derived the expected term assumption based on its historical settlement experience, while giving consideration to vesting schedules and stock options that have life cycles less than the contractual terms, in accordance with guidance in SFAS 123(R) and SAB 107. Prior to the adoption of SFAS 123(R), the Company used its historical settlement experience to derive the expected term for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

As stock-based compensation expense recognized in our results for the three months ended March 31, 2006, is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience. Prior to 2006, the Company accounted for forfeitures as they occurred for the purposes of its pro forma information under SFAS 123, as disclosed in Notes to Consolidated Financial Statements for the related periods.

Other Stock-Based Compensation

In connection with the grant of certain stock options to Northern optionholders as part of the merger consideration on December 10, 2003 (the merger options), the Company recorded unearned stock compensation representing the difference between the deemed fair market value of the common stock on the date of grant and the exercise price. Compensation related to merger options that vest over time was recorded as unearned compensation, a component of stockholders equity, and was being amortized over the vesting periods of the related merger options. Beginning January 1, 2006, the Company fair valued these options using the same assumptions as those previously described. During the three months ended March 31, 2006 and 2005 the Company recorded non-cash compensation expense relating to these merger options totaling $93,811 and $146,870, respectively. Previously, forfeitures associated with these merger options were recorded as incurred,

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however, FAS123(R) requires that an estimated forfeiture rate be applied to outstanding awards. As a result, in the first quarter of 2006, the Company reversed approximately $35,000 of previously recognized compensation cost associated with these estimated forfeitures which is reflected in selling, general, and administrative expenses. Our deferred stock compensation balance of $453,980 as of December 31, 2005 was reclassified into additional paid-in capital upon the adoption of SFAS 123(R).

During the three months ended March 31, 2006 and 2005 the Company granted non-qualified stock options with a ten-year term, to non-employees to purchase 22,794 and 10,000 shares of common stock, respectively. The Company recognized compensation expense based on the fair value of these options of $141,728 and $27,380, respectively, for the three months ended March 31, 2006 and 2005.

8. COMMITMENTS AND CONTINGENCIES

Contracts

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

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

	CCEF Advance Balance
December 31, 2002	$
Advances	900,000
Milestone achieved	(675,000)
December 31, 2003	$ 225,000
Advances	283,012
Milestone achieved	(225,000)
December 31, 2004	$ 283,012
Advances	917,167
Milestone achieved	(933,300)
December 31, 2005	$ 266,879
Advances	276,370
Milestone achieved	(543,249)
March 31, 2006	$

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Warranty

The changes in the carrying amount of warranties for the three-months ended March 31, 2006 and 2005 are as follows:

	2006	2005
Balance as of December 31:	$ 417,694	$ 273,027
Warranties issued in period	107,190	131,545
Adjustments to provision	79,058	(13,693)
Warranty claims	(181,504)	(76,316)
Balance as of March 31:	$ 422,438	$ 314,563

Sales and Use Tax Relief Program Recapture

In connection with the construction of its Wallingford facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement (the Agreement) with the Connecticut Development Authority (the Authority). The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. The recapture clauses for relocation and early disposition/abandonment expire October 15, 2010; the employment threshold clause is subject to review by the Authority in the quarter ended December 31, 2006. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under the Agreement shall not exceed $419,250 (the maximum sales and use tax benefit possible under the terms of the Agreement, plus a 7.5% penalty). Proton was required under the Agreement to place $419,250 in escrow related to these recapture clauses. This $419,250 is included within restricted cash as part of long-term assets. The Company does not anticipate meeting the employment threshold recapture clause by the compliance date of December 31, 2006 and as such accrued $143,000 during the fourth quarter of 2005 for possible tax repayments and penalties.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, tax accruals of approximately $272,000 and $402,000 for certain state income and sales tax contingencies for which there may be exposure at March 31, 2006 and December 31, 2005, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual is subject to change and the actual amount could be greater or less than the accrued amount.

Legal Proceedings

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

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prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. The settlement provides, among other things, for a release of Proton and the individual defendants for the conduct alleged in the amended complaint to be wrongful. Proton has agreed to undertake other responsibilities under the settlement, including agreeing to assign, or not assert, certain potential claims that it may have against its underwriters. Any direct financial impact of the settlement is expected to be borne by our insurers. Proton believes it has meritorious defenses to the claims made in the complaints and, if the settlement is not finalized and approved, Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

9. SEGMENT FINANCIAL DATA

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

Financial information as of and for the quarters ended March 31, 2006 and 2005, (all amounts in 000s) is summarized below.

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Revenues:		
Proton	$ 1,892	$ 1,766
Northern	5,745	7,770
Consolidated	$ 7,637	$ 9,536

Included within Northern s revenues for the quarters ended March 31, 2006 and 2005 are sales to one international customer totaling approximately 12% and 20% of consolidated revenues. The Company believes it has no risk of foreign dependence.

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Loss from operations:		
Proton	$ (1,856)	$ (2,281)
Northern	(2,584)	(1,561)
Eliminations and other	(3,174)	(1,009)
Consolidated	$ (7,614)	$ (4,851)

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	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Net loss:		
Proton	$ (1,840)	$ (2,380)
Northern	(2,604)	(1,582)
Eliminations and other	(2,902)	(750)
Consolidated	$ (7,346)	$ (4,712)

	March 31, 2006	December 31, 2005
Total assets:		
Proton	$ 83,460	$ 85,197
Northern	47,466	47,018
Eliminations and other	(25,190)	(21,070)
Consolidated	$ 105,736	$ 111,145

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

11. SUBSEQUENT EVENT

In April 2006, Northern acquired the engineering, procurement and construction business, as well as the operations and maintenance service business, of a California-based firm Crown Engineering & Construction. The transaction adds to Northern s capabilities in California and includes eight long-term service contracts with an estimated aggregate value of $2 million per year over the next several years. Under the terms of the Asset Purchase Agreement, the Company is to pay Crown $1,025,000 in cash and issue 105,000 shares of the Company s Common Stock, to a shareholder of Crown. The fair market value at the date of grant was $702,450.

On April 10, 2006, the Company entered into an equity distribution agreement with UBS Securities LLC. The equity distribution agreement provides that the Company may offer and sell up to 3,000,000 shares of the Company s common stock from time to time through UBS Securities LLC, as sales agent or principal. The compensation to UBS Securities LLC for acting as sales agent shall be 4% of the first $15 million of gross sales price of the shares sold, and 3% of the gross sales price of the shares in excess of $15 million. From April 12, 2006 to May 05, 2006, the Company sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in net proceeds to the Company of $7,485,648.

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, 2005. 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, 2005, and below in this Form 10-Q under the Risk Factors and Legal Proceedings captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

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OVERVIEW

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

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

Our hydrogen generator systems utilize proprietary proton exchange membrane, or PEM, electrochemical technology to produce hydrogen through the electrolysis of water. Our hydrogen generators have been designed to address the existing demand for industrial hydrogen in a safer and more cost-effective manner than truck-delivered hydrogen. We have installed over 750 hydrogen generators in more than 41 countries over more than five years of operations. Our hydrogen generators are also being used in demonstration projects to supply fuel to fuel cell vehicles. We are developing core PEM technology to combine our hydrogen generator technology with a fuel cell power generator to create an energy device that is able to produce and store hydrogen fuel that it can later use to generate electricity, which we refer to as a regenerative fuel cell system. In the longer term, we believe our regenerative fuel cell systems will enable renewable energy solutions by facilitating the storage of energy produced by non-depleting, non-polluting energy sources, such as solar, wind and hydroelectric power.

CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared by us in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, depreciable lives of equipment, warranty obligations and contingency accruals. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in our Annual report on Form 10-K for the fiscal year ended December 31, 2005. Our audit committee has discussed our critical accounting policies with management and our independent registered public accounting firm.

Our critical accounting policies include the following:

Revenue Recognition Product Revenue

All of our product revenue is derived from the operations of our Proton segment. For product sales for which adequate product warranty information exists, we record revenue when a firm sales agreement is in place,

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

We currently defer revenue on HOGEN H series delivered products until the related warranty costs can be reasonably estimated. We only defer production costs on our delivered products to the extent that such production costs are not in excess of the sales price and realization is reasonably assured.

During 2005, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN S Series and our laboratory generators. Therefore, in the first quarter of 2005, we began recognizing product revenue related to sales of laboratory generators with a two-year warranty upon shipment, and in the third quarter of 2005, we began recognizing product revenue related to sales of our HOGEN S-Series hydrogen generators upon shipment.

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

Revenue Recognition Contract and Service Revenue

The majority of our contract revenue is derived from the operations of our Northern segment. Contract costs may be incurred over a period of several months to several years, and the estimation of these costs requires management s judgment. The long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. As a result, we review and update our costs estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. Losses expected to be incurred on contracts in progress are charged to operations in the period such losses are determined.

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

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines. For projects with a duration of greater than three months where the Company has the ability to reasonably estimate total project costs to complete, revenue is recognized utilizing the percentage-of-completion method, which is based on the relationship of costs incurred to total estimated contract costs.

For service and repair, revenue is recorded as work is performed. For operating and maintenance contracts, revenue is recognized over the service period.

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Warranty Costs

Our warranty policy is limited to replacement parts and services and generally expires one year from date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. Estimated warranty obligations are recorded in the period in which the related revenue is recognized. We quantify and record an estimate for warranty related costs based on our actual historical warranty experience and the current repair costs. Adjustments are made to accruals as warranty claim data and historical experience warrant. Should we experience actual repair costs that are higher than the estimated repair costs used to calculate the provision, our results of operations for the period or periods in which such additional costs materialize will be adversely affected.

Inventory

Inventory is recorded at the lower of cost or market value. Cost is determined by the first-in, first-out method. This policy requires us to write down our inventory for the difference between the cost of inventory and the estimated market value to reflect assumptions about future demand and market conditions. If future demand and market conditions become less favorable than anticipated, or, if our ability to realize value on our inventory is less favorable than assumed, additional inventory write-downs may be required.

Goodwill and Intangible Assets

We have adopted the provisions of SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets, applicable to business combinations completed after June 30, 2001. These standards require the use of the purchase method of accounting for business combinations, set forth the accounting for the initial recognition of acquired intangible assets and goodwill, and describe the accounting for intangible assets and goodwill subsequent to initial recognition. Under the provisions of these standards, goodwill and intangible assets deemed to have indefinite lives are no longer subject to amortization. All other intangible assets are amortized over their estimated useful lives. Goodwill and intangible assets with indefinite lives are subject to annual impairment testing and will also be tested for impairment between annual tests if changes in circumstances indicate that the carrying amount may be impaired. The annual impairment test compares the carrying values of the reporting unit to its fair value, which is estimated using the Income Approach Discounted Cash Flow Method, and, if the carrying value is less than its fair value, an impairment is recognized.

Long-Lived Assets

We evaluate potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. An impairment loss is recognized if the carrying amount of long-lived assets is not recoverable based on its undiscounted cash flows. The measurement of impairment loss is then based on the difference between the carrying amount and the fair value of the asset.

Stock-Based Compensation

Stock-Based Compensation Employee Stock-Based Awards

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the ESPP based on estimated fair values. SFAS 123(R) supersedes our previous accounting under APB 25, Accounting for Stock Issued to Employees

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for periods beginning in fiscal year 2006. In March 2005, the SEC issued SAB 107 providing supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

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

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

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

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

If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. Therefore, we believe it is important for investors to be aware of the high degree of subjectivity involved when using option pricing models to estimate share-based compensation under SFAS 123(R). There is risk that our estimates of the fair values of our share-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those share-based payments in the future. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally

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estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly in excess of the fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with SFAS 123(R) and the Securities and Exchange Commission s Staff Bulletin No. 107 (SAB 107) using an option pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

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

The guidance in SFAS123(R) and SAB 107 is relatively new, and best practices are not well established. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimate of share-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

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

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

Impact of Inputs to Value of Stock Options

Volatility of Stock	Higher the volatility	Higher the value
Expected Term	Longer the term	Higher the value
Risk Free Rate	Higher the rate	Higher the value
Dividend Yield	Lower the yield	Higher the value
Exercise Price	Lower the exercise price (A)	Higher the value
Stock Price (fair value)	Higher the stock price	Higher the value

(A) presumes exercise price is less than fair value

Also see Note 7 to the Consolidated Financial Statements on Stock-Based Compensation.

Stock-Based Compensation Non-Employee Stock Options

We account for stock-based compensation issued to non-employees in accordance with SFAS No. 123(R) and the consensus in Emerging Issues Task Force 96-18. These pronouncements require the fair value of equity instruments given as consideration for services rendered to be recognized as a non-cash charge to income over the shorter of the vesting or service period. The equity instruments must be revalued on each subsequent reporting date until performance is complete with a cumulative catch-up adjustment recognized for any changes in their fair value.

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Results of Operations

Comparison of the Three Months Ended March 31, 2006 and March 31, 2005

Revenues:

	Quarter Ended			
Net revenues	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**	
Contract	$ 5,226,288	$ 7,772,383	$ (2,546,095)	-33%
Product	1,115,307	1,054,180	61,127	6%
Service	1,295,476	709,393	586,083	83%
Total	$ 7,637,071	$ 9,535,956	$ (1,898,885)	-20%

The decrease in contract revenues was a result of lower revenue associated with Northern s industrial infrastructure business of approximately $1.2 million and its on-site business of approximately $1.3 million. These decreases were due to record high natural gas prices which impeded Northern s ability to close new orders in its on-site business, as well as the timing and size of the contracts in the first quarter of 2006 compared to the comparable period in 2005.

Product revenue that is associated with Proton s HOGEN S-Series and H-Series hydrogen generators increased from the comparable 2005 quarter by approximately $0.2 million and $0.3 million respectively. No HOGEN H-Series hydrogen generator revenue was recognized in the first quarter of 2005 as revenue associated with the HOGEN H-Series hydrogen generators is deferred until the expiration of the related warranty period. These increases were offset by a revenue decrease relating to Proton s laboratory generators of approximately $0.4 million. In the first quarter of 2005 Proton determined it had adequate warranty history on its laboratory generators sold with a two-year warranty and began recognizing revenue upon shipment. As a result $0.4 million of previously deferred laboratory generator revenue was recognized in the first quarter of 2005.

The increase in service revenue relates to an increase of approximately $0.4 million associated with Northern s operating and maintenance and spare parts business which was not fully implemented in the first quarter of 2005, as well as an increase in Proton s service revenue of $0.2 million associated with additional HOGEN hydrogen generators in the field.

Costs of revenue:

	Quarter Ended			
Cost of revenues	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**	
Contract	$ 4,856,685	$ 6,969,519	$ (2,112,834)	-30%
Product	1,162,884	1,335,772	(172,888)	-13%
Service	1,173,788	536,347	637,441	119%
Total	$ 7,193,357	$ 8,841,638	$ (1,648,281)	-19%

Cost of contract revenues as a percentage of contract revenues increased from 90% in the first quarter of 2005 to 93% in the first quarter of 2006. The decreased contract margins primarily relate to an increase in unabsorbed overhead costs as a result of less contract activity at Northern in the first quarter of 2006 compared to the first quarter of 2005.

Product cost of revenue as a percentage of product revenue decreased from 127% in the first quarter of 2005 to 104% in the first quarter of 2006. The decrease in cost of product revenue as a percentage of revenue was

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primarily attributable to a $0.2 million reduction in lower of cost or market charges associated with Proton s H-Series hydrogen generators in 2006 as compared to the 2005 period.

Service cost as a percentage of service revenue increased from 76% in the first quarter of 2005 to 91% in the first quarter of 2006. This increase in cost of service revenue was primarily attributable to Northern s lower margin operating and maintenance business as a result of scheduled preventative maintenance costs incurred in the first quarter of 2006, prior to the summer utility peak season.

Hydrogen generator units shipped:

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

	Quarter Ended		
Hydrogen generator unit shipments	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**
S series	8	5	3
H series	4	1	3
Laboratory generators	18	20	(2)
Total	30	26	4

	Quarter Ended		
Revenue deferred on units shipped	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**
S series	$	$ 209,390	$ (209,390)
H series	559,340	105,000	454,340
Laboratory generators		4,500	(4,500)
Total	$ 559,340	$ 318,890	$ 240,450

	Quarter Ended		Increase
Cost deferred on units shipped	**March 31, 2006**	**March 31, 2005**	**(decrease)**
S series	$	$ 175,015	$ (175,015)
H series	485,705	105,000	380,705
Laboratory generators		4,088	(4,088)
Total	$ 485,705	$ 284,103	$ 201,602

During 2005, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN S Series and our laboratory generators. Therefore, in the first quarter of 2005, we began recognizing product revenue related to sales of laboratory generators with a two-year warranty upon shipment, and in the third quarter of 2005 we began recognizing product revenue related to sales of our HOGEN S Series hydrogen generators upon shipment.

We currently defer revenue on HOGEN H Series delivered products until the related warranty costs can be reasonably estimated.

As of March 31, 2006 the hydrogen generator unit backlog at Proton was 12 S Series, 3 H Series and 3 laboratory generator units with a total value of approximately $1.2 million.

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Research and development expenses:

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

	Quarter Ended			
Research and development	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**	
Employee related	$ 710,469	$ 832,640	$ (122,171)	-15%
Project material	220,759	198,660	22,099	11%
Depreciation and amortization	130,471	231,583	(101,112)	-44%
Stock based compensation	57,340		57,340	100%
Other	(436,379)	77,693	(514,072)	-662%
Total	$ 682,660	$ 1,340,576	$ (657,916)	-49%

The decrease in employee-related costs is the result of fewer active projects in the first quarter of 2006. Research and development related depreciation and amortization decreased due to certain capitalized project costs achieving their estimated useful lives in 2005. Other costs decreased primarily due to the recognition of $0.5 million of credits in the first quarter of 2006, as a result of achieving certain specified milestones on Proton s Connecticut Clean Energy Fund programs. No credits related to these programs were recognized in the first quarter of 2005.

General and administrative expenses:

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

	Quarter Ended			
Selling, general and administrative	**March 31, 2006**	**March 31, 2005**	**Increase (decrease)**	
Employee related	$ 2,971,249	$ 2,262,113	$ 709,136	31%
Marketing and advertising	211,118	208,516	2,602	1%
Depreciation and amortization	361,119	269,294	91,825	34%
Stock based compensation	2,256,370	174,251	2,082,119	1195%
Legal, consulting and accounting	319,108	454,579	(135,471)	-30%
Other	1,256,283	836,652	419,631	50%
Total	$ 7,375,247	$ 4,205,405	$ 3,169,842	75%

The increase in employee-related expenses is primarily attributable to an increase in employee-related selling expenses as well as expenses associated with the addition of our new CEO in January 2006. The increase in other costs relates to facility expenses primarily associated with our Barre, Vermont location.

Stock-based compensation: On January 1, 2006, we adopted SFAS 123(R), which requires recognition of compensation expense for all stock-based awards made to employees in our Condensed Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25, and under this method, no stock-based compensation expense for employee stock options was recognized in the prior period in our Condensed Consolidated Statements of Operations because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method we used in adopting SFAS 123(R), our results of operations prior to fiscal year 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R).

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Stock-based compensation cost for the first quarter of 2005 was related to non-employee stock options and the amortization of options related to the Northern merger. Also see Note 7 to the Condensed Consolidated Financial Statements on Stock-Based Compensation.

We currently estimate our total stock-based compensation cost to be approximately $0.8 million to $1.2 million per quarter through the remainder of 2006. The decrease in estimated future stock compensation expense is the result of the additional expense incurred in the first quarter of 2006 related to the hiring of our new CEO, Ambrose Schwallie.

Interest income: Interest income increased from $265,000 for the three months ended March 31, 2005 to $349,000 for the comparable period in 2006. The increase resulted from higher average interest rates. The average interest rates for the three months ended March 31, 2006 and 2005 were approximately 3.7% and 2.0%, respectively. The average cash and marketable securities balances for the three months ended March 31, 2006 and 2005 were approximately $37.4 million and $54.1 million, respectively.

Interest expense*:* Interest expense increased from $95,000 for the three months ended March 31, 2005 to $152,000 for the comparable period in 2006. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations and a greater amount of average debt outstanding.

LIQUIDITY AND CAPITAL RESOURCES

Since inception in August 1996 through March 2006, we and our predecessor, Proton, have financed our operations through convertible preferred stock issuances and an initial public offering that, in total, raised approximately $187.4 million. As of March 31, 2006, we had $33.7 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was $7.6 million for the three months ended March 31, 2006 and was primarily attributable to our net loss, increases in inventories as a result of less than expected demand for HOGEN hydrogen generators in the first quarter of 2006, increases in deferred costs, decreases in accounts payable as a result of timing of payments to vendors and decreases in accrued expenses. Cash used in operating activities was $9.1 million for the three months ended March 31, 2005 and was primarily attributable to our net loss, increases in accounts receivable, increases in costs in excess of billings, and decreases in billings in excess of costs.

Cash used in investing activities was $5.9 million for the three months ended March 31, 2006 and was primarily attributable to purchases of marketable securities, offset by proceeds from the maturity of marketable securities. Cash provided by investing activities was $4.7 million for the three months ended March 31, 2005 and was primarily attributable to proceeds from the maturity of marketable securities, offset by purchases of marketable securities.

Cash provided by financing activities was $798,000 for the three months ended March 31, 2006 and was primarily attributable to proceeds received in conjunction with the sale of stock, primarily to our new CEO, Ambrose Schwallie, our employee stock purchase plan and exercised incentive stock options, offset by payments under Proton s and Northern s debt agreements. Cash used in financing activities was $17,000 for the three months ended March 31, 2005.

We anticipate that our cash and marketable securities on hand as of March 31, 2006 will be adequate to fund our operations, working capital and capital expenditure requirements for at least the next 12 months. Over the next 12 months, we expect to continue to fund the production of our hydrogen generators and fund on-going project costs as well as continuing our research and development activities. We cannot ensure that we will not require additional financing to fund our operations beyond those raised through our sale of stock under the equity distribution agreement described in Item 5 of Part II or that, if required, any further financing will be available to us on acceptable terms, or at all. If sufficient funds are not available, we may be required to delay, reduce or

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eliminate some of our research and development, manufacturing, or contract programs. The terms of any additional financing may require us to relinquish rights to our technologies or potential products or other assets.

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

We invest in marketable securities consisting of U.S. government and agency securities that are held by one major banking institution. Distributed Energy s marketable securities portfolio of approximately $25.9 million includes one callable agency security with a fair market value totaling approximately $4.5 million. This security generates a higher relative rate of interest for Distributed Energy; 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.

The following table provides information about Distributed Energy s financial instruments, stated at the fair value as of March 31, 2006, that are sensitive to changes in interest rates:

	2006	Total
Investments		
Fixed rate investments	$ 25,856,503	$ 25,856,503
Average Interest	3.70%	

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

At March 31, 2006, we had $5.6 million outstanding under our seven year term note that is subject to a variable interest rate. The note bears interest at one month LIBOR plus 2.375%, which was 7.01% per annum at March 31, 2006. At March 31, 2006, we had $0.4 million outstanding under our ten year term note that is subject to a variable interest rate. The note bears interest at a variable rate equal to two percentage points less than VEDA s prevailing rate for taxable financing, which was 4.25% per annum at March 31, 2006, with a maturity date of October 6, 2015. If our variable interest rate were to increase or decrease by 10%, we do not believe such a change would have a material impact on our financial position or results of operations.

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

(a) Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of the Company s principal executive officer and principal financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of March 31, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company s disclosure controls and procedures as of March 31, 2006, the Company s principal executive officer

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and principal financial officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes in Internal Control over Financial Reporting

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended March 31, 2006 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 August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton s IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. The settlement provides, among other things, for a release of Proton and the individual defendants for the conduct alleged in the amended complaint to be wrongful. Proton has agreed to undertake other responsibilities under the settlement, including agreeing to assign, or not assert, certain potential claims that it may have against its underwriters. Any direct financial impact of the settlement is expected to be borne by our insurers. Proton believes it has meritorious defenses to the claims made in the complaints and, if the settlement is not finalized and approved, Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

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

RISK FACTORS

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

RISKS RELATING TO OUR COMPANY

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

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

- the status of development of our technology, products and manufacturing capabilities;
- the cost and availability of raw materials and key components;
- warranty and service cost for products in the field;
- the introduction, timing and market acceptance of new products introduced by us or our competitors;
- the development of strategic relationships and distribution channels;
- general economic conditions, which can affect customers capital investments and the length of sales cycles;
- the development of vehicular PEM fuel cells and renewable energy markets; and
- government regulation.

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

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

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of March 31, 2006, we had an accumulated deficit of $143 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing facilities and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at

favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators. Even if we achieve profitability, we may be unable to sustain or increase our profitability in the future.

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

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

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

As an engineering, procurement and construction contractor, we design and build a relatively small number of projects for a small number of customers each year. For many of these customers, we will deliver a single system with little or no opportunity for repeat business. Contracts for many of these large projects are awarded by competitive bid. With multiple other bidders on most large project opportunities, we often cannot accurately assess the probability of winning the contract prior to its award by the customer. Sales cycles are very long and projects can be delayed or cancelled for reasons beyond our control. Most large domestic distributed generation and hydrogen generation project opportunities are discretionary purchases for the customer, and, as a result, at the end of the sales cycle many such projects may never materialize for reasons beyond our control. During this lengthy sales cycle, we may incur significant expense and expend significant management effort. Implementation of projects that we are awarded can sometimes take over twelve months. During that time, numerous factors can contribute to cost overruns and schedule delays that affect profitability or result in a net loss. Generally accepted accounting principles may require us to defer revenue on a significant portion of our contracts until the project is completed, depending on contract terms. These factors make it very difficult for us to generate firm backlog well in advance of the actual projects and to accurately forecast future sales. If our sales forecasts from a specific project or customer for a particular period are not realized in that period, we may be unable to compensate for the shortfall, which could harm our results of operations. In addition, our revenue and results of operations may vary significantly from year to year and from quarter to quarter within a year.

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

Typically, sales of our distributed generation systems are made to customers under single contracts to provide highly specialized on-site power systems designed and built to meet customer specifications. For the first quarter of 2006, our largest five customers accounted for 35% of our revenues and our largest ten customers accounted for 54% of our revenues. Because such a high percentage of our sales are concentrated in so few contracts, failure by us or our customers to perform or deliver on any one of these contracts could have a major impact on our annual results of operations. In addition, most of our customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects us to a high degree of customer credit risk and risk of non-performance by our vendors. A single vendor s late delivery of a key component required for a project, for example, could significantly delay our completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in our contracts with our customers.

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

In the past, we have experienced performance problems with some components of our hydrogen generators, specifically hydrogen sensor modules, power supplies and cell stacks, which have required component

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replacement. We cannot guarantee that further problems related to these or other components or products will not occur and require additional corrective measures. If we are unable to solve these problems, potential purchasers of our products may decline to purchase them, which could affect our ability to grow our revenues. We could also face liability to our customers and harm to our reputation as a result.

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

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

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

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

- the inability to purchase parts or components in adequate quantities or sufficient quality, including from sole source vendors;
- the cost and availability of raw materials;
- the failure to increase assembly and test operations;
- the failure to hire and train additional manufacturing personnel; and
- the failure to develop and implement cost-efficient manufacturing processes and equipment.

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

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

We anticipate that a portion of our future revenue from our distributed generation business will be derived from the sale or licensing of regenerative fuel cell, wind turbine and power electronics products and technologies which we are currently developing or have only recently made commercially available. Many of these new products and technologies are based on new and unproven designs, and it is difficult to predict whether they will be commercially viable. If we fail to successfully develop and commercialize these products and technologies on the timetable we anticipate or at all, we will be unable to recover the investments we have made in their development and will be unable to grow our revenue from their sale or licensing. In addition, we may not be

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successful in developing product designs and manufacturing processes that permit the manufacture of our hydrogen generators and fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, we sell some of our products for less than it costs to produce them. New technology developments or cost reductions in existing technologies may also delay or prevent the development or sale of some or all of our planned products or make our planned products uncompetitive or obsolete.

If we provide financing to our customers, we will be subject to default risk, interest rate risks and liquidity risk.

We intend to offer project and lease financing to some of our customers. Providing such financing would involve a number of risks, including the following:

- Our customers may default on their payments to us, and we may be unable to collect all, or any, of the financed amount;
- Whether we provide customer financing at a fixed rate or a floating rate of interest, we will be subject to a degree of interest rate risk. Providing financing at a fixed rate may commit us to a below-market return in the event of a rise in interest rates, while providing financing at a floating rate may produce less income than expected if interest rates fall; and
- Using our capital resources to provide customer financing would reduce our liquidity, and may prevent us from engaging in other beneficial uses of such resources, such as business development, facilities expansions or acquisitions.

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

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

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

Market factors affect our costs and availability of materials.

Our products contain a number of materials, from metals to computer components. In particular, platinum is a key component of our PEM fuel cells. Platinum is a scarce natural resource and we are dependent upon a sufficient supply of this commodity. Decreases in the availability or increases in the prices of the commodities or other components of our products could impair our ability to acquire the materials necessary to meet our

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manufacturing requirements and result in significantly higher prices for those materials, either of which could cause delayed or lost sales and an increase in our manufacturing costs.

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

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

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

Our failure to manage growth could harm our business.

We intend to introduce new products, increase our production capacity and develop additional distributor relationships. If we are successful, a significant strain on our senior management team and other resources may result. In addition, we may be required to hire additional senior management personnel. Our ability to manage growth will depend in part on our ability to continue to enhance our operating, financial and management information systems. Our personnel, systems and controls may be unable to support our growth.

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

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

We may not be able to obtain sufficient additional funds to grow our business.

We have regularly needed to raise funds to operate our businesses. It may become necessary to raise additional funds to achieve full commercialization of some or all of our products. Our project-based distributed generation business requires a significant amount of capital in order to increase the number and size of projects we can undertake and therefore increase our revenues. If we are unable to raise additional funds on commercially reasonable terms when needed, our ability to operate and grow our businesses could be impaired. We do not

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know whether we will be able to secure additional funding or funding on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

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

Our backlog was approximately $21.0 and $20.5 million as of December 31, 2005 and March 31, 2006. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of December 31, 2005 and March 31, 2006 from which we expect to recognize revenue in fiscal 2006 is likely to be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog. The actual accrual of revenue on engagements included in backlog may never occur or may change because a contract could be reduced, modified or terminated early. If we fail to realize revenue from engagements included in our backlog as of December 31, 2005 and March 31, 2006, our revenue and results of operations for fiscal 2006 as well as future reporting periods may be materially harmed.

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

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

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

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

The distributed generation market is highly competitive and evolving rapidly. We face a wide variety of competitors, including equipment manufacturers, distributors, packagers, system integrators, general contractors, engineering firms, project developers and energy service companies. Many of our competitors are significantly larger and better capitalized than we are and have greater access to financial and other resources, and therefore

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may be able to devote more resources to the following activities that may allow them to establish a competitive advantage in the marketplace:

- sales and marketing of their products and services;
- seller financing for the sale of their products or services;
- development and commercialization of new technologies;
- partnering and other collaborative efforts with sales channel partners, vendors and technology providers;
- adaptation to changes in customer requirements;
- expanded design, engineering and other performance and service capabilities; and
- systems and other infrastructure development that reduces costs.

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

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

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

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

Most of our intellectual property is not covered by any patent or patent application. We seek to protect this proprietary intellectual property, which includes intellectual property that may not be patented or patentable, in

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part by confidentiality agreements with our contractors, distributors, employees and others. These agreements afford only limited protection and may not provide us with adequate remedies for any breach or prevent other persons or institutions from asserting rights to intellectual property arising out of these relationships.

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

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

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

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

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

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

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

We might not be successful in developing non-infringing technologies. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, or at all, and could significantly harm our business and results of operations. A successful claim of infringement against us or our failure or inability to license the infringed or similar technology could require us to pay substantial damages and could harm our business because

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we would not be able to sell the affected product without redeveloping the product or incurring significant additional expense. In addition, to the extent we agree to indemnify customers or other third parties against infringement of the intellectual property rights of others, a claim of infringement could require us to incur substantial time, effort and expense to indemnify these customers and third parties and could disrupt or terminate their ability to use, market or sell our products.

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

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

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

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

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

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

The potential for political unrest, acts of terrorism and war, and economic collapse exists in many countries in which we currently, or may in the future, do business. The occurrence of any such events at or near the site of our projects could lead to delay, cancellation or significant damage to our projects or equipment. The occurrence of any such events could also cause harm, injury or death to our personnel working on such projects. Any such events could expose us to significant liabilities and would therefore adversely affect our results of operations and growth.

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

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

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

- exchange controls;
- complying with U.S. legal requirements for the exporting of goods;
- complying with the commercial, regulatory and legal requirements of foreign markets, particularly in developing countries;
- obtaining and/or enforcing intellectual property protection;
- overcoming trade barriers such as duties, tariffs and taxes;
- enforcing contract terms and conditions;
- collecting receivables;
- managing operations and staff across disparate geographic areas; and
- currency risks.

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

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

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

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

- the anticipated benefits from any acquisition may not be achieved;

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

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

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

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

RISKS RELATING TO OUR INDUSTRY

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

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

utility electric rates;

changes in federal, state and local regulatory requirements;

changes in federal and state incentives and subsidies;

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

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

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

customer reluctance to try new products and technology;

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

economic downturns and related reductions in capital spending;

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

the emergence of newer, more competitive technologies.

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

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

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

We require experienced engineers, technicians and machinists to conduct our business. No assurance can be given that the supply of these skilled persons will always be adequate to meet our requirements or that we will be able to attract an adequate number of skilled persons. Labor disputes could also occur at our manufacturing facilities, which may affect our business. While our employees are not currently represented by labor unions or organized under collective bargaining agreements, labor disputes could occur at any of our facilities.

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

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

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

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

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

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

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

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

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

A large portion of our current revenue is generated from the sale of remote power systems to the international oil and gas industry for use on remote pipelines and offshore platforms. Demand for our power

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systems from this market segment depends in part on the current and future commodity price of oil and gas. Higher oil and gas prices stimulate increased development of remote oil and gas fields and related infrastructure, which in turn stimulates increased demand for remote power systems of the type we supply. Conversely, lower oil and gas prices would reduce demand for current systems and have a negative impact on our growth.

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

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

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

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

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

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

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

Electricity generation and delivery are both heavily regulated by federal and state governments. While deregulation and restructuring of the U.S. power industry may ultimately expand the market for distributed generation systems of the type that we sell, recent problems associated with deregulation in key domestic markets like California may impose additional barriers to distributed generation. California and other states, for example, allow utilities to impose exit fees, standby charges and other penalties on customers who install distributed generation systems. Federal and state regulations regarding air quality and interconnection to the utility grid also impose additional costs and potential liabilities on our business. Changes in these regulations could reduce or eliminate our access to certain of our target markets. Changes in regulatory standards or policies

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could reduce the level of investment in the research and development of alternative power sources. Any reduction or termination of such programs can increase the cost to our potential customers, making our systems less desirable, and thereby adversely affecting our revenue and results of operations.

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

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

OTHER RISKS

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

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

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

our perceived prospects;

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

changes in securities analysts recommendations or earnings estimates;

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

announcements of new products by us or our competitors;

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

trading of options or other derivatives on our common stock;

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

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

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

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

Our directors, executive officers and individuals or entities affiliated with our directors as a group beneficially own, approximately 8.9% of our outstanding common stock at March 2, 2006. The interests of these stockholders may differ substantially from the interests of other stockholders. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of our directors, and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation and mergers or sales of substantially all of our assets. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us or our other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire us at a price per share that is above the then-current market price.

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

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

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

- only one of the three classes of directors is elected each year;
- stockholders have limited ability to remove directors;
- stockholders cannot take actions by written consent;
- stockholders cannot call a special meeting of stockholders; and
- stockholders must give advance notice to nominate directors or submit proposals for consideration at stockholder meetings.

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

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

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

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ITEM 5. ***Other Information***

On April 10, 2006, the Company entered into an equity distribution agreement with UBS Securities LLC. The equity distribution agreement provides that the Company may offer and sell up to 3,000,000 shares of the Company s common stock from time to time through UBS Securities LLC, as sales agent or principal. The compensation to UBS Securities LLC for acting as sales agent shall be 4% of the first $15 million of gross sales price of the shares sold, and 3% of the gross sales price of the shares in excess of $15 million. From April 12, 2006 to May 5, 2006, the Company sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in net proceeds to the Company of $ 7,485,648. We currently intend to use the net proceeds from the sale of the securities for working capital and other general purposes, including:

for acquisition of businesses, products and technologies that complement or expand our business;

for capital expenditures made in the ordinary course of business, including facilities expansion; and

to repay existing indebtedness.

ITEM 6. ***Exhibits***

Exhibit 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

Date: May 10, 2006

DISTRIBUTED ENERGY SYSTEMS CORP.

(Registrant)

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

Chief Executive Officer

(Principal Executive Officer)

By: /s/ *John A. Glidden*
John A. Glidden

Vice President of Finance

(Principal Financial and Accounting Officer)