DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
May 09, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from _____ to _____

Commission File Number: 000-50453

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

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

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(203) 678-2000

(Registrant s telephone number, including area code)

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

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

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of May 4, 2005 was 35,948,230.

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,632,862	$ 5,989,896
Marketable securities (Note 4)	48,148,826	53,145,106
Current portion of restricted cash	912,549	912,549
Accounts receivable, less allowances of $69,448 and $184,948, respectively	6,461,618	5,289,880
Costs in excess of billings on contracts in progress	2,162,381	719,103
Inventories (Note 5)	4,516,736	4,115,269
Deferred costs	3,450,057	3,731,140
Interest receivable	246,173	265,170
Other current assets	900,650	891,756
Total current assets	68,431,852	75,059,869
Fixed assets, net	19,956,829	20,244,045
Long-term portion of restricted cash	569,250	569,250
Intangible assets, net	3,662,603	3,782,115
Goodwill	24,755,962	24,755,962
Other assets, net	150,658	159,488
Total assets	$ 117,527,154	$ 124,570,729
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 370,650	$ 366,600
Current portion of capital lease	101,875	107,686
Accounts payable	3,777,894	3,742,794
Accrued expenses (Note 6 and 9)	1,036,687	1,179,140
Accrued compensation	1,584,087	2,036,906
Accrued taxes (Note 9)	284,751	558,642
Billings in excess of costs on contacts in progress	1,502,304	3,590,580
Deferred revenue	4,067,264	4,301,545
Customer advances	1,128,371	423,629
Total current liabilities	13,853,883	16,307,522
Long term liabilities:		
Deferred tax liability	564,775	564,775
Long-term debt	5,627,932	5,723,632

Long-term portion of capital lease	2,521,170	2,541,183
Total liabilities	22,567,760	25,137,112
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, undesignated, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 65,000,000 shares authorized; 35,930,804 and 35,609,794 shares issued and outstanding, respectively	359,308	356,098
Additional paid-in capital	220,254,577	220,129,697
Unearned compensation	(876,868)	(1,023,738)
Accumulated other comprehensive loss (Note 4)	(394,881)	(358,087)
Accumulated deficit	(124,382,742)	(119,670,353)
Total stockholders equity	94,959,394	99,433,617
Total liabilities and stockholders equity	$ 117,527,154	$ 124,570,729

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,	
	2005	**2004**
Contract revenue	$ 8,433,441	$ 1,778,480
Product revenue	1,102,515	175,816
Total revenues	9,535,956	1,954,296
Costs and expenses:		
Costs of contract revenue	7,434,668	1,603,239
Costs of production	1,406,970	572,622
Research and development:		
Noncash depreciation and amortization	231,583	224,237
Other research and development	1,108,993	1,701,420
Selling, general and administrative:		
Noncash depreciation, amortization and stock based compensation	443,545	943,863
Other selling, general and administrative	3,761,860	3,865,389
Total costs and expenses	14,387,619	8,910,770
Loss from operations	(4,851,663)	(6,956,474)
Interest income	264,683	289,952
Interest expense	(94,761)	(83,154)
Loss on disposal of fixed assets	(26,497)	
Loss on sale of marketable securities	(2,200)	
Loss on foreign exchange	(1,951)	(3,035)
Net loss	$ (4,712,389)	$ (6,752,711)
Basic and diluted net loss per share	$ (0.13)	$ (0.19)
Shares used in computing basic and diluted net loss per share	35,722,794	35,373,541

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,	
	2005	**2004**
Cash flows from operating activities:		
Net loss	$ (4,712,389)	$ (6,752,711)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	622,484	962,702
Provision for bad debts	4,264	35,019
Amortization of premiums on securities	(16,620)	266,772
Non-cash stock-based expense	174,250	343,158
Loss on sale of marketable securities	2,200	
Loss on disposal of assets	26,497	
Changes in operating assets and liabilities, excluding effect of acquisition:		
Accounts receivable	(1,176,002)	242,490
Inventories and deferred costs	(120,384)	(1,610,562)
Costs in excess of billings on contracts in progress	(1,443,278)	157,544
Other current assets and interest receivable	10,103	227,543
Other assets	2,073	(36,854)
Accounts payable and accrued expenses	(560,172)	(4,374,050)
Accrued taxes	(273,891)	(24,729)
Billings in excess of costs on contracts in progress	(2,088,276)	(118,696)
Deferred revenue and customer advances	470,461	1,197,596
Net cash used in operating activities	(9,078,680)	(9,484,778)
Cash flows from investing activities:		
Purchases of fixed assets	(239,996)	(113,567)
Proceeds from the sale of fixed assets	4,500	
Purchases of marketable securities	(3,073,894)	(21,997,294)
Proceeds from maturities and sales of marketable securities	8,047,800	38,531,000
Restricted cash		6,188,618
Net cash provided by investing activities	4,738,410	22,608,757
Cash flows from financing activities:		
Debt principal payments	(117,474)	(104,180)
Proceeds from sale of common stock, net	36,176	14,656
Proceeds from exercise of common stock warrants	38,301	
Proceeds from exercise of common stock options	26,233	15,796
Net cash used in financing activities	(16,764)	(73,728)

Net increase (decrease) in cash and cash equivalents	(4,357,034)	13,050,251
Cash and cash equivalents at beginning of period	5,989,896	4,275,468
Cash and cash equivalents at end of period	$ 1,632,862	$ 17,325,719
Cash paid during the period for interest	$ 94,586	$ 81,519

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 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.

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, 2005 and for the three-month periods ended March 31, 2005 and 2004 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 16, 2005.

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,	
	2005	**2004**
Net loss	$ (4,712,389)	$ (6,752,711)
Unrealized losses on marketable securities arising in period	(38,994)	(31,772)
Reclassification adjustments for losses included in net income	2,200	
Net unrealized losses on marketable securities	(36,794)	(31,772)
Total comprehensive loss	$ (4,749,183)	$ (6,784,483)

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Concentration of Risks

Concentration of credit risk exists with respect to cash and cash equivalents, accounts receivable, investments and vendors. The Company maintains its cash and cash equivalents and investments with high quality financial institutions. At times, amounts may exceed federally insured deposit limits. In addition, certain critical product components are only available from one source for which the source maintains proprietary rights. Concentration of credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising the Company s customer base and their geographic dispersion. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential credit losses.

For the quarter ended March 31, 2005 sales to one international customer accounted for approximately 20% of total revenue. For the quarter ended March 31, 2004 sales to one international and one domestic customer accounted for approximately 19% and 11% of total revenue, respectively. For the quarters ended March 31, 2005 and 2004, accounts receivable from two customers accounted for approximately 34% and 43%, respectively, of total accounts receivable.

Stock-Based Compensation

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

The following table illustrates the effect on net loss and loss per share had compensation costs for the stock-based compensation plans 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	2004
Net loss attributable to common stockholders:		
As reported	$ (4,712,389)	$ (6,752,711)
Add: Stock-based employee compensation included in net loss	146,870	339,599
Less: Total stock-based employee compensation expense determined under fair value-based-method for all awards	(730,191)	(1,713,508)
Pro forma	$ (5,295,710)	$ (8,126,620)
Net loss per share applicable to common stockholders, basic and diluted		
As reported	$ (0.13)	$ (0.19)
Pro forma	$ (0.15)	$ (0.23)

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 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. SFAS No. 144 requires that impaired long-lived assets be written down to their fair value.

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Reclassifications

Certain amounts in the 2004 financial statements have been reclassified to conform to the 2005 presentation.

3. RECENT ACCOUNTING GUIDANCE

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment, (FAS 123(R)). This Statement requires companies to expense the estimated fair value of stock options and similar equity instruments issued to employees. Currently, companies are required to calculate the estimated fair value of these share-based payments and can elect to either include the estimated cost in earnings or disclose the pro forma effect in the footnotes to their financial statements. We have chosen to disclose the pro forma effect. The fair value concepts were not changed significantly in FAS 123(R); however, in adopting this statement, companies must choose among alternative valuation models and amortization assumptions. The valuation model and amortization assumption we have used continues to be available, but we have not yet completed our assessment of the alternatives.

On April 14, 2005 the U.S. Securities and Exchange Commission (the SEC) announced a deferral of the effective date of FAS 123(R). For calendar year companies compliance with FAS 123(R) is not required until the first quarter of 2006.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4 (FAS 151). FAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. This Statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47). FIN 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. The provision is effective for no later than the end of fiscal year ending December 15, 2005. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

4. MARKETABLE SECURITIES

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. As of March 31, 2005, the Company s investment portfolio consisted of U.S. government and agency securities held by two major banking institutions. The maturities of marketable securities are as follows:

	March 31, 2005	December 31, 2004
Less than and equal to one year	$ 47,013,116	$ 42,094,506
Greater than one year to five years	1,135,710	11,050,600
	$ 48,148,826	$ 53,145,106

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 $394,881 and $358,087 at March 31, 2005

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and December 31, 2004, respectively. At March 31, 2005, the Company had five callable agency securities with a fair market value totaling approximately $26.5 million. These securities generate a higher relative rate of interest for the Company, in return for the issuer s right to call, at par value, the security before its maturity date.

As of March 31, 2005, none of the Company s investments were determined to be other than temporarily impaired.

5. INVENTORIES AND COSTS AND BILLINGS ON CONTRACTS IN PROGRESS

Inventories are stated at the lower of cost or market value. Cost is determined by the first-in, first-out method.

	March 31, 2005	December 31, 2004
Raw materials	$ 1,809,064	$ 2,047,443
Work in process	1,916,638	1,458,574
Finished goods	791,034	609,252
	$ 4,516,736	$ 4,115,269

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $496,634 and $477,812 at March 31, 2005 and December 31, 2004, respectively.

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

	March 31, 2005	December 31, 2004
Costs incurred and estimated earnings on contracts in progress	$ 24,328,834	$ 16,825,598
Less: billings to date	23,668,757	19,697,075
Costs and earnings in excess of (less than) billings, net	$ 660,077	$ (2,871,477)

	March 31, 2005	December 31, 2004
Costs in excess of billings on contracts in progress	$ 2,162,381	$ 719,103
Billings in excess of costs on contracts in progress	(1,502,304)	(3,590,580)

Costs and earnings in excess of (less than) billings, net	$ 660,077	$ (2,871,477)

6. ACCRUED EXPENSES

Accrued expenses consist of the following:

	March 31, 2005	December 31, 2004
Accrued warranty	$ 314,563	$ 273,027
Accrued purchases	346,078	557,717
Other accruals	376,046	348,396
	$ 1,036,687	$ 1,179,140

7. LOSS PER SHARE

Net loss per share has been computed by dividing the net loss attributable to common stockholders by the weighted average common shares outstanding. No effect has been given to the exercise of 3,364,076 and

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2,712,112 common stock options outstanding for the three-month periods ending March 31, 2005 and 2004, respectively, and 1,797,767 and 2,155,394 common stock warrants outstanding for the three-month periods ending March 31, 2005 and 2004, respectively, since the effect would be antidilutive for all reporting periods.

8. STOCK OPTION GRANTS

During 2000 and 2003, the Company issued common stock options to employees at less than the fair value of its common stock. The compensation expense for such options is amortized over the vesting periods of the related options. Accordingly, the Company recorded employee related stock-based compensation expense of $146,870 and $339,599 for the three-month periods ended March 31, 2005 and 2004, respectively.

9. 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 product. Proton is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach $25 million annually. However, prior to the achievement of milestones described in this agreement, these funds were subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling interest in Proton by a third party, the sale of substantially all of Proton s assets, the consolidation or merger of Proton with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, Proton records funds received as liabilities until it achieves the contract milestones, at which time such amounts are recognized as reductions in related costs and 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 5kW Regenerative Fuel Cell (RFC) for a telecommunications site in southwestern Connecticut. Proton has recorded a $471,700 advance related to this agreement through March 31, 2005. In October 2004, CCEF agreed to provide $485,000 of funding for a 15kW 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 the customer advances and milestone achievements utilized to offset certain costs and expenses incurred related to the UNIGEN product:

	CCEF Advance Balance
December 31, 2001	$ 200,000
Advances	400,000
Milestone achieved	(600,000)
December 31, 2002	$

Advances	900,000
Milestone achieved	(675,000)
December 31, 2003	$ 225,000
Advances	283,012
Milestone achieved	(225,000)
December 31, 2004	$ 283,012
Advances	188,688
Milestone achieved	
March 31, 2005	$ 471,700

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Warranty

In the first quarter of 2004 the Company was advised that two of its HOGEN 380 series units were not performing in accordance with the stated warranty. The Company recorded a warranty accrual of $200,000 related to the two units. In addition, as of March 31, 2004, the Company fully reserved for the unpaid receivables balance of approximately $35,000 related to these units. In the third quarter of 2004, the Company received an order for four HOGEN H series units from the customer. As settlement of the warranty obligation related to the two HOGEN 380 units, the Company agreed to accept a proportional reduction in the accounts receivable related to the eventual sale of the HOGEN H series units. As of December 31, 2004, the previously recorded warranty accrual on the HOGEN 380 units had been satisfied.

The changes in the carrying amount of warranties for the three-months ended March 31, 2005 and 2004 are as follows:

	2005	2004
Balance as of December 31:	$ 273,027	$ 326,290
Warranties issued in period	131,545	17,079
Adjustments to provision	(13,693)	195,685
Warranty claims	(76,316)	(63,594)
Balance as of March 31:	$ 314,563	$ 475,460

Retainage Provisions

Balances billed but not paid by the customer pursuant to retainage provisions in customer contracts are due either upon completion of the contracts and acceptance by the customer or expiration of the warranty period. At March 31, 2005 and December 31, 2004, the accounts receivable balance includes approximately $45,000 of retainage balances.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, a tax accrual of approximately $186,000 and $433,000 for certain state income and sales tax contingencies at March 31, 2005 and December 31, 2004, respectively. In addition, property and franchise tax accruals of approximately $99,000 and $126,000 are recorded within current liabilities at March 31, 2005 and December 31, 2004, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual are 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 (IPO) of common stock. All of the complaints were filed allegedly on behalf of persons who purchased the Company s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that 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,

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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 the Company to negotiate a settlement of the pending claims substantially consistent with a Memorandum of Understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. 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 agree to a modification narrowing the scope of the bar order set forth in the original settlement. The Company 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.

10. SEGMENT FINANCIAL DATA

Management views the enterprise as two distinct operating segments, Proton and Northern, and makes decisions to allocate resources based upon those operating segments. Proton develops and manufactures proton exchange membrane, or PEM, electrochemical products. Northern designs, builds and installs both stand-alone and grid-connected electric power systems for industrial, commercial and government customers. For management reporting and control, the Company is divided into the operating segments as presented below. Each segment has general autonomy over its business operations.

Financial information as of and for the quarter ended March 31, 2005 and 2004 (all amounts in $000s) is summarized below:

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Revenues:		
Proton	$ 1,766	$ 406
Northern	7,770	1,548
Eliminations and other		
Consolidated	$ 9,536	$ 1,954

Included within Northern s revenues for the three months ended March 31, 2005 and 2004 are sales to one international customer totaling approximately 20% (Russia) and 19% (United Kingdom) of consolidated revenues, respectively. The Company believes it has no risk of foreign dependence.

Three Months

	Ended March 31, 2005	Three Months Ended March 31, 2004
Loss from operations:		
Proton	$ (2,281)	$ (3,223)
Northern	(1,561)	(2,304)
Eliminations and other	(1,009)	(1,429)
Consolidated	$ (4,851)	$ (6,956)

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	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Net loss:		
Proton	$ (2,380)	$ (3,278)
Northern	(1,582)	(2,333)
Eliminations and other	(750)	(1,142)
Consolidated	$ (4,712)	$ (6,753)

	March 31, 2005	December 31, 2004
Total assets:		
Proton	$ 88,863	$ 91,384
Northern	41,934	41,073
Eliminations and other	(13,270)	(7,886)
Consolidated	$ 117,527	$ 124,571

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

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, 2004. 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, 2004, and below in this Form 10-Q under the Legal Proceedings and Certain Factors That May Affect Future Results captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

Overview

Formed in May 2003, Distributed Energy Systems Corp. is creating and delivering innovative products and solutions to the energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy was formed to be parent company of two established businesses: Proton Energy Systems, Inc. (Proton) and Northern Power Systems, Inc. (Northern). Distributed Energy believes the

acquisition of Northern s project integration experience strengthens near-term capabilities, accelerating entry into early energy-related markets and contributing to advancing the Company s vision of producing hydrogen from renewable sources.

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

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

Recent Developments

The following significant events occurred in the first quarter 2005:

Northern was awarded a master implementation contract by the New York Power Authority (NYPA) to design, engineer and install distributed generation projects at various NYPA customer sites over the next three years. The anticipated total value of the contract over the three-year time period is between $5 million and $10 million.

Proton was awarded a Phase II contract valued at nearly $1.2 million with the University of Nevada, Las Vegas Research Foundation, or UNLVRF. This is a follow-on to the Phase I contract under which Proton and the UNLVRF team are developing a hydrogen filling station capable of operating on solar power for installation in Las Vegas, Nevada.

Northern was awarded a $3.1 million contract by Honeywell to provide a turnkey on-site combined heat and power system for the United States Postal Service Margaret L. Sellers Processing and Distribution Center in San Diego, California.

Proton signed a three-year agreement with Airgas, Inc to market and distribute Proton s HOGEN® on-site hydrogen generation systems to customers in the United States.

Proton was highlighted in Power Engineering, a leading electric utility industry publication. The article, entitled, On-Site Hydrogen Production Means More Than Convenience, gives background on the efficiencies and cost savings that are driving growing power plant industry acceptance of Proton s HOGEN® Proton Exchange Membrane system for on-site hydrogen generation.

Proton was highlighted in a paper, The Positive Effects of Utilizing Continuous Hydrogen Replenishment in Electric Power Generators presented at ASME 2005 Electric Power Conference in Chicago.

Critical Accounting Judgments and Estimates

Distributed Energy s discussion and analysis of its financial condition and results of operations is based upon its consolidated financial statements, which have been prepared by Distributed Energy in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires Distributed Energy to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Distributed Energy s estimates include those related to revenue recognition, income taxes, depreciable lives of equipment, warranty obligations and contingency accruals. Distributed Energy bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The audit committee of Distributed Energy s board of directors has discussed Distributed Energy s critical accounting policies with management and Distributed Energy s independent accountants. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in the Company s Annual Report on Form 10-K filed on March 16, 2004.

Recent Accounting Guidance

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment, (FAS 123(R)). This Statement

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requires companies to expense the estimated fair value of stock options and similar equity instruments issued to employees. Currently, companies are required to calculate the estimated fair value of these share-based payments and can elect to either include the estimated cost in earnings or disclose the pro forma effect in the footnotes to their financial statements. We have chosen to disclose the pro forma effect. The fair value concepts were not changed significantly in FAS 123(R) however, in adopting this statement, companies must choose among alternative valuation models and amortization assumptions. The valuation model and amortization assumption we have used continues to be available, but we have not yet completed our assessment of the alternatives.

On April 14, 2005 the U.S. Securities and Exchange Commission (the SEC) announced a deferral of the effective date of FAS 123(R). For calendar year companies compliance with FAS 123(R) is not required until the first quarter of 2006.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4 (FAS 151). FAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. This Statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47). FIN 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. The provision is effective for no later than the end of fiscal year ending December 15, 2005. The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

Results of Operations

Comparison of the Three Months Ended March 31, 2005 and March 31, 2004

Revenues:

Net revenues	March 31, 2005	March 31, 2004	Increase (decrease)	
Contract	$ 8,433,441	$ 1,778,480	$ 6,654,961	374%
Product	1,102,515	175,816	926,699	527%
Total	$ 9,535,956	$ 1,954,296	$ 7,581,660	388%

The following chart provides comparative contract revenues by operating segment:

Contract revenue	March 31, 2005	March 31, 2004	Increase (decrease)	
Northern	$ 7,770,304	$ 1,547,991	$ 6,222,313	402%
Proton	663,137	230,489	432,648	188%
Total	$ 8,433,441	$ 1,778,480	$ 6,654,961	374%

The increase in Northern s contract revenue is due to the recognition of revenue on 35 active and/or completed contracts in the first quarter 2005 versus revenue recognized on 16 active and/or completed contracts

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in the first quarter 2004. In the first quarter 2005, five contracts, the SC Johnson, 201 Mission and 717 5th Avenue on-site power system projects, and the Sakhalin I and Papua New Guinea integrated power system contracts accounted for approximately $4.5 million or 58% of the total Northern contract revenue. In the first quarter 2004, five contracts, AGT, Niagara Mohawk and Lockheed Martin integrated power system contracts, and the WINPAC and LWT government sponsored contracts, accounted for approximately $1.0 million or 67% of the total Northern contract revenue.

The increase in Proton s contract revenue is due to an increase in active contracts rising from five in the first quarter 2004 to eight in the first quarter 2005. In the first quarter 2005, four contracts, E-Vermont, DARPA, UNLV Phase II and NASA Phase II accounted for approximately $532,000 or 80% of the total Proton contract revenue recognized. In the first quarter 2004, two contracts, DOE/SEP and UNLV Phase I, accounted for approximately $162,000 or 70% of the total Proton contract revenue recognized.

The following chart provides comparative product revenues within the Proton segment:

Product revenue	March 31, 2005	March 31, 2004	Increase (decrease)	
Hydrogen generators	$ 1,031,782	$ 89,564	$ 942,218	1052%
Rental, Service and Other	70,733	86,252	(15,519)	-18%
Total	$ 1,102,515	$ 175,816	$ 926,699	527%

The increase in product revenues is due to the recognition of $430,000 in HOGEN S series unit revenues upon the expiration of the product warranty in the first quarter 2005. The Company began recognizing HOGEN S series unit revenue upon the expiration of the product warranty beginning in the second quarter of 2004. Additionally, in the first quarter of 2005, the Company determined it now had adequate warranty history on its laboratory generators sold with a two-year warranty to begin recognizing revenue upon shipment. Prior to this quarter, revenue on such laboratory generators was recognized at the end of the warranty period. Accordingly, the first quarter 2005 product revenue includes $437,000 of previously deferred laboratory generator revenue recognized within the warranty period, and $163,000 of laboratory generator revenue recognized upon shipment in the first quarter of 2005.

Costs of revenue:

Cost of revenues	March 31, 2005	March 31, 2004	Increase (decrease)	
Contract	$ 7,434,668	$ 1,603,239	$ 5,831,429	364%
Product	1,406,970	572,622	834,348	146%
Total	$ 8,841,638	$ 2,175,861	$ 6,665,777	306%

The following chart provides comparative cost of contract revenues by operating segment:

Cost of revenues contract	March 31, 2005	March 31, 2004	Increase (decrease)	
Northern	$ 6,952,113	$ 1,382,693	$ 5,569,420	403%
Proton	482,555	220,546	262,009	119%
Total	$ 7,434,668	$ 1,603,239	$ 5,831,429	364%

The increase in Northern cost of contract revenue is due directly to the previously noted increase in active and/or completed contracts. In the first quarter 2005 and 2004, the previously noted contracts, accounted for approximately $3.9 million and $859,000, or 56% and 62%, of the total Northern cost of contract revenue, respectively.

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The increase in Proton cost of contract revenue is due directly to the previously noted increase in active contracts. In the first quarters 2005 and 2004, the previously noted contracts accounted for approximately $326,000 and $198,000 or 67% and 90% of the total Proton cost of contract revenue recognized, respectively.

The following chart provides comparative cost of product revenues within the Proton segment:

Cost of revenues product	March 31, 2005	March 31, 2004	Increase (decrease)	
Hydrogen generators	$ 1,311,017	$ 461,609	$ 849,408	184%
Rental, Service and Other	95,953	111,013	(15,060)	-14%
Total	$ 1,406,970	$ 572,622	$ 834,348	146%

In the first quarter of 2005, the Company determined it had adequate warranty history on its laboratory generators sold with a two-year warranty to recognize revenue and associated cost of revenue upon shipment. The first quarter 2005 laboratory generator cost of revenue, accordingly, represents $430,000 of previously deferred cost of revenue recognized within the warranty period, and $153,000, first quarter 2005 laboratory generator cost of revenue recognized upon shipment. Additionally, the increase in cost of product revenues is due to the recognition of $297,000 in HOGEN S series unit costs upon the expiration of the product warranty in the first quarter 2005. The Company began recognizing HOGEN S series unit cost of revenue upon the expiration of the product warranty beginning in the second quarter of 2004. The remaining increase is due to increased lower cost of market reserves in 2005 of approximately $200,000, primarily associated with our HOGEN H series units, offset by lower warranty related costs of approximately $170,000. The first quarter of 2004 contained HOGEN 380 associated warranty costs of approximately $265,000. The HOGEN 380 series has been replaced by the HOGEN H series.

Hydrogen generator units shipped:

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

Hydrogen generator unit shipments	March 31, 2005	March 31, 2004	Increase (decrease)
S series	5	12	(7)
H series	1		1
Laboratory generators	20	18	2
Total	26	30	(4)

Revenue deferred on units shipped	March 31, 2005	March 31, 2004	Increase (decrease)

S series	$ 209,390	$ 649,125	$ (439,735)
H series	105,000		105,000
Laboratory generators	4,500	28,400	(23,900)
Total	$ 318,890	$ 677,525	$ (358,635)

Cost deferred on units shipped	**March 31, 2005**	**March 31, 2004**	**Increase (decrease)**
S series	$ 175,015	$ 428,478	$ (253,463)
H series	105,000		105,000
Laboratory generators	4,088	28,400	(24,312)
Total	$ 284,103	$ 456,878	$ (172,775)

As of March 31, 2005 the hydrogen generator unit backlog at Proton was 13 S series, 10 H series and 8 laboratory generator units valued at approximately $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:

Research and development	March 31, 2005	March 31, 2004	Increase (decrease)	
Employee related	$ 832,640	$ 1,169,417	$ (336,777)	-29%
Project material	198,660	581,369	(382,709)	-66%
Depreciation and amortization	231,583	224,237	7,346	3%
Other	77,693	(49,366)	127,059	-257%
Total	$ 1,340,576	$ 1,925,657	$ (585,081)	-30%

Employee related costs and project material costs decreased due to fewer active projects in the first quarter of 2005, with the first quarter 2004 costs primarily associated with Proton s cell development and the development of the HOGEN H series product. The increase in other costs is due primarily to the inclusion of a $150,000 CCEF credit associated with the achievement of certain project milestones in the first quarter of 2004.

General and administrative expenses:

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

Selling, general and administrative	March 31, 2005	March 31, 2004	Increase (decrease)	
Employee related	$ 2,262,113	$ 2,171,500	$ 90,613	4%
Marketing and advertising	208,516	331,784	(123,268)	-37%
Depreciation, amortization and stock based compensation	443,545	943,863	(500,318)	-53%
Legal, consulting and accounting	454,579	436,814	17,765	4%
Other	836,652	925,291	(88,639)	-10%
Total	$ 4,205,405	$ 4,809,252	$ (603,847)	-13%

The decrease in marketing and advertising is generally due to decreased costs associated with the marketing of Proton s HOGEN H series product. Depreciation, amortization and stock based compensation decreased primarily due to decreased deferred stock based compensation costs of $169,000 and intangible asset amortization of $342,000.

Interest income: Interest income decreased from $290,000 for the three months ended March 31, 2004 to $265,000 for the comparable period in 2005. The decrease resulted from decreased cash and marketable securities balances as well as lower average interest rates. The average cash and marketable securities balances for the three months ended March 31, 2005 and 2004 were approximately $54.1 million and $71.6 million, respectively. The average interest rates for the three months ended March 31, 2005 and 2004 were approximately 2.0% and 1.6%, respectively.

Interest expense*:* Interest expense increased from $83,000 for the three months ended March 31, 2004 to $95,000 for the comparable period in 2005. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations.

Liquidity and Capital Resources

Since its inception in August 1996 through March 2005, Proton has financed its operations through convertible preferred stock issuances and an initial public offering that, in total, raised approximately $187.4 million. As of March 31, 2005, Distributed Energy had $49.8 million in cash, cash equivalents and marketable securities.

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Cash used in operating activities was $9.0 million for the three months ended March 31, 2005 and was primarily attributable to the Company s net loss and decreases in billings in excess of costs on contracts in progress, increases in costs in excess of billings on contracts in progress, and increases in receivables. Cash used in operating activities was $9.5 million for the three months ended March 31, 2004 and was primarily attributable to the Company s net loss and decreases in accounts payable and accrued expenses, increases in inventory and deferred costs, offset by increases in deferred revenues and customer advances, as well as the add back of certain non-cash related expenditures.

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

Cash used in financing activities was $17,000 for the three months ended March 31, 2005 and was primarily attributable to payments under Proton s and Northern s debt agreements offset by proceeds received in conjunction with the employee stock purchase plan, exercised incentive stock options, and exercised common stock warrants. Cash used in financing activities was $74,000 for the three months ended March 31, 2004 and was primarily attributable to payments under Proton s and Northern s debt agreements.

Distributed Energy anticipates that its cash and marketable securities on hand as of March 31, 2005 will be adequate to fund its operations, working capital and capital expenditure requirements for at least the next 12 months. Over the next 12 months, Distributed Energy expects to continue to fund the production of its hydrogen generators and fund on-going project costs as well as continuing its research and development activities. Distributed Energy cannot ensure that it will not require additional financing to fund its operations or that, if required, any further financing will be available to Distributed Energy on acceptable terms, or at all. If sufficient funds are not available, Distributed Energy may be required to delay, reduce or eliminate some of its research and development, manufacturing, or contract programs. The terms of any additional financing may require Distributed Energy to relinquish rights to its technologies or potential products or other assets.

Certain Factors That May Affect Future Results

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

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

Distributed Energy faces many risks and uncertainties. If it is unsuccessful in addressing these risks and uncertainties, it may be unable to generate revenue and grow its business. Proton was formed in 1996 to research and develop PEM electrochemical products. Proton has begun shipping commercial models of its hydrogen generators only over the last few years and has not yet manufactured commercial regenerative fuel cell systems. Accordingly, there is only a limited basis upon which you can evaluate Proton s business and prospects, and Proton s future success is uncertain. You should consider the challenges, expenses, delays and other difficulties typically involved in the establishment of a new business, including the continued development of Proton s products, development of fully functioning manufacturing operations, refinement of processes and components for Proton s commercial products, recruitment of qualified personnel, ability to manufacture a product which meets cost, reliability and efficiency needs, and achievement of market acceptance for Proton s products.

As an engineering, procurement and construction contractor, Distributed Energy s Northern subsidiary, designs and builds a relatively small number of projects for a small number of customers each year. For many of these customers, Northern will deliver a single system with little or no opportunity for repeat business. A small

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number of very large projects often accounts for the majority of Northern s revenue in any given year. Sales cycles are very long and projects can be delayed or cancelled for reasons beyond Northern s control. Implementation of large projects can take over twelve months. During that time, numerous factors can contribute to cost overruns and schedule delays that impact profitability. Generally accepted accounting principles require Northern to defer revenue on a significant portion of its contracts until the project is completed. As a result of these factors and others discussed later in this section, Northern s revenue and operating results may vary significantly from year to year and from quarter to quarter within a year.

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

Distributed Energy has incurred substantial losses since it was founded and anticipates it will continue to incur substantial losses in the future. As of March 31, 2005, Distributed Energy had an accumulated deficit of approximately $124.3 million. Distributed Energy cannot predict when it will operate profitably, if ever. Distributed Energy expects to continue to incur expenses related to research and development activities, expansion of its manufacturing facilities and selling, general and administrative functions. As a result, Distributed Energy anticipates that it will continue to incur losses until it can achieve high enough volumes to cost-effectively produce and sell Proton hydrogen generators or achieve enough business at favorable margins at Northern. Even if Distributed Energy does achieve profitability, Distributed Energy may be unable to sustain or increase its profitability in the future.

Proton has experienced performance problems with its hydrogen generators.

In the past Proton has experienced performance problems with certain components of its hydrogen generators, specifically hydrogen sensor modules, power supplies, and cell stacks, which have required component replacement. We cannot guarantee that further problems related to these or other components may occur and require additional corrective measures. If Proton is unable to solve these problems, potential purchasers of Proton products may decline to purchase them.

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

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

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

Proton intends to market its hydrogen generators to small and medium volume users of delivered hydrogen. Proton s business depends on the widespread commercial acceptance of its hydrogen generators, and Proton may

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be unable to grow its business if Proton s targeted customers do not purchase substantial numbers of Proton s hydrogen generators. Proton s targeted customers, or the distributors whom Proton intends to use to market to these customers, may not purchase Proton s hydrogen generators at all or in sufficient quantities to support the growth of Proton s business. Proton s hydrogen generators will require its target customers to make a substantial initial investment, currently ranging from approximately $10,000 to $135,000 per unit for Proton s HOGEN GC, S and H series models. Proton s method of supplying hydrogen by producing it on-site using PEM electrolysis represents a significant departure from conventional means of supplying hydrogen to end users. PEM electrolysis is a new technology in the markets Proton is targeting, and Proton does not know if its targeted customers will accept Proton s product.

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

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

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

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

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

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

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

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

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

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

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

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

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

Although Proton generally attempts to use standard components for its products, the proton exchange membrane material, hydrogen purification system, and customer designed power supplies used in Proton s products are currently available only from limited sources. Some of Proton s suppliers are small and medium size companies which may not be able to increase production in an acceptable time period or at acceptable

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

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

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

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

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

Northern has depended on a small number of large projects for a majority of its revenue in any given year. Contracts for many of these large projects are awarded by competitive bid. The sales cycle from identification of a project opportunity to award of a contract often exceeds one year. With multiple other bidders on most large project opportunities, Northern often cannot accurately assess its probability of winning the contract prior to its award by the customer. Most large domestic distributed generation project opportunities are discretionary purchases for the customer, and as a result, at the end of the sales cycle many such projects may never materialize for reasons beyond Northern s control. During this lengthy sales cycle, Northern may incur significant expense and expend significant management effort. These factors make it very difficult for Northern to generate firm backlog well in advance of the actual projects and to accurately forecast future sales. If Northern s sales forecasts from a specific project or customer for a particular period are not realized in that period, it may be unable to compensate for the shortfall, which could harm its operating results.

Northern conducts business in many countries that are politically and economically unstable.

The potential for political unrest, acts of terrorism and war, and economic collapse exists in many countries in which Northern does business. The occurrence of any such events at or near the site of Northern s projects could lead to delay, cancellation, or significant damage to Northern s projects or equipment. The occurrence of any such events could also cause harm, injury or death to Northern personnel working on such projects. Any such events could expose Northern to significant liabilities and would therefore adversely impact Northern s operating results and growth.

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

While Northern does not derive any revenue from the sale of any products today, its business plan contemplates that a portion of its future revenue will be derived from the sale and/or licensing of new wind turbine and power electronics products which are currently under development and not yet commercially available. Many of these future products and technologies are based on new and unproven designs and it is difficult to predict whether they will be commercially viable. If Northern fails to successfully develop and commercialize these products and technologies, it will be unable to recover the investments it has made in their development and will be unable to grow its revenue from their sales and/or licensing. In addition, Northern is likely to face significant competition in the market for these future products. Many of Northern s

competitors in the markets for these products are larger and better capitalized than Northern, are better established with a worldwide presence, and are already selling competing products in these markets. New technology developments

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or cost reductions in existing technologies may delay or prevent the development and/or sale of some or all of Northern s planned products or make its planned products uncompetitive or obsolete.

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

Northern s future growth is based in part on increased use of distributed generation technologies. Distributed generation is an emerging market, and it is difficult to predict the rate at which it will develop. If a sustainable market for distributed generation fails to develop or develops more slowly than Northern anticipates, its ability to grow and achieve profitability will be negatively impacted. Many of the factors that influence the rate of adoption of distributed generation technologies are out of Northern s control. Some such factors that Northern cannot control are:

- utility electric rates;
- changes in federal, state and local regulatory requirements;
- changes in federal and state incentives and subsidies;
- cost, quality, performance and availability of the alternative generating technologies that Northern uses in its onsite power systems;
- costs and availability of natural gas and other fuels used in alternative generating technologies;
- changes in commercial and industrial customers perceptions regarding distributed generation
- availability of financing for distributed generation vendors, developers and users;
- economic downturns and related reductions in capital spending; and
- demand for and valuation of emissions trading credits generated by distributed generation systems.

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

Northern competes mainly on price per delivered kilowatt hour of electricity to the end user. In its domestic markets, Northern is competing against the cost of electricity delivered by the local utilities through the electric grid. The cost of electricity varies widely from utility to utility and from state to state and is subject to change based on factors beyond Northern s control. Northern cannot accurately predict what future electric rates will be and whether or not it can compete effectively against these rates.

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

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

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

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For reciprocating engine or turbines based power systems, fuel is the largest operating cost. The predominant fuel for these systems is natural gas. The price of natural gas has been highly volatile and is currently projected to remain high for years to come based on increased demand and limited domestic supply. Sustained high gas prices reduce the economic benefit of the onsite power systems Northern sells and may therefore result in reduced sales and revenue growth for Northern.

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

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

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

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

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

Typically the sales to these customers come from single contracts to provide highly specialized onsite power systems custom designed and built to meet their specifications. Because such a high percentage of Northern s sales are concentrated in so few contracts, failure on the part of Northern or Northern s customers to perform or deliver on any one of these contracts could have a major impact on Northern s annual operating results. In addition, most of Northern s customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects Northern to a high degree of customer credit risk and risk of non-performance by its vendors. A single vendor s late delivery of a key component required for a project, for example, could significantly delay Northern s completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in Northern s contracts with its customers.

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

Current uncertainty among Northern s target customers over the health of the economy and its impact on their business has restricted their capital spending and made it harder for Northern to sell its systems and services. Other market uncertainties that also impact Northern s ability to

increase sales include the future of deregulation of the domestic electricity market, the future price of oil and natural gas, political instability in the Middle East and other regions where it does business, and domestic and international policy responses to the threat of global warming.

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

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

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

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

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

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

Distributed generation systems designed and installed by Northern often use new and untested technologies. Many of these new technologies have limited operating histories and may be subject to malfunction or failure when subjected to prolonged use in non-test conditions. Should these new technologies fail to perform as specified by their vendors, Northern may incur additional warranty and other costs and its relationships with its customers may suffer. Also, many vendors of these new technologies have limited financial resources and may not be able to adequately support their products in the field. All these issues would reduce Northern s growth and profitability.

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

Northern s government contracts relate to research and development on renewable energy technologies, hybrid system architectures, and advanced power electronics. Changes in government policy toward distributed generation or budget restrictions may reduce or eliminate funding for these types of research and development activities. There can be no assurance that Northern s current contracts will be fully funded or that Northern will be able to secure additional government contracts for similar activities in the future. Northern is also subject to annual audits of its incurred costs on its government contracts by the Defense Contracting Audit Agency. If Northern s actual overhead cost included in its incurred costs are less than the allowable overhead costs billed on these contracts, Northern may be required to refund the excess overhead costs to the

government upon completion of the DCAA audit. Such a refund would negatively impact Northern s financial position and its revenue and profits in the year in which such costs were incurred.

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

Distributed Energy s success depends upon the continued service of its executive officers and other key employees such as manufacturing and research and development personnel. The loss of any of Distributed

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Energy s executive officers or key employees, especially Walter W. Schroeder, Mark Murray, or Clint Coleman could impair Distributed Energy s ability to pursue its growth strategy. Distributed Energy does not have employment agreements with any of its key executives. Distributed Energy may not be able to attract, assimilate or retain additional highly qualified personnel in the future.

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

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

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

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

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

- sales and marketing of their products and services;
- seller financing for the sale of their product or services;
- development and commercialization of new technologies;
- partnering and other collaborative efforts with sales channel partners, vendors and technology providers;

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

systems and other infrastructure development that reduces costs.

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

If Distributed Energy is unable to protect its intellectual property, Distributed Energy s competitors could use its intellectual property to market products similar to its products, which could reduce demand for Distributed

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

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

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

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

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

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

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

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

proceeding.

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

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

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

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

Any liability for damages resulting from malfunctions or failures of Distributed Energy s products or systems could be substantial and could increase Distributed Energy s expenses and prevent Distributed Energy from growing its business. In particular, hydrogen is a flammable gas and can pose safety risks if not handled properly. Proton has experienced instances with its 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. Although Proton has taken steps to improve safety and reliability in its products, Proton cannot be certain that future similar instances will not occur. In addition, Proton s products may require modifications to operate properly under extreme temperatures. Potential customers will also rely upon Proton s products for critical needs, such as backup power. A malfunction of Proton s products could result in significant tort or warranty claims. In addition, a well-publicized actual or perceived problem could adversely affect the market s perception of Proton s products. This could result in a decline in demand for Proton s products, which would reduce Proton s revenue and harm its business.

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

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

Distributed Energy s products and projects are potentially subject to federal, local and foreign laws and regulations governing, among other things, emissions to air as well as laws relating to occupational health and safety. Distributed Energy may incur substantial costs or liabilities in complying with governmental regulations. Distributed Energy s potential customers must also comply with numerous laws and regulations, which could affect their interest in Distributed Energy s products and projects. Distributed Energy 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.

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

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

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

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

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

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

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

- the status of development of Distributed Energy s technology, products and manufacturing capabilities;
- the cost of raw materials and key components;

warranty and service cost for products in the field;

the introduction, timing and market acceptance of new products introduced by Distributed Energy or its competitors;

the development of strategic relationships and distribution channels;

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

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

government regulation.

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

Distributed Energy may not receive the full amount of its backlog, which could harm its business.

Our backlog was approximately $25 million as of December 31, 2004 and March 31, 2005. 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, 2004 and March 31, 2005 from which we expect to recognize revenue in fiscal 2005 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, 2004 and March 31, 2005, our revenue and operating results for fiscal 2005 as well as future reporting periods may be materially harmed.

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

In the past, Northern has generated a majority of its revenue from sales of remote power projects in the oil and gas and telecommunications markets. Many of these projects are sold to foreign entities and are delivered to locations outside of the United States, such as the Middle East, Eurasia, Africa, and South America. Selling Northern s services internationally exposes it to many additional costs, risks, and potential liabilities, which, if improperly managed, could limit its ability to grow in these markets and adversely impact its operating results. In addition Proton intends to market its hydrogen generators to small and medium volume users of delivered hydrogen worldwide. Proton s business depends on the widespread commercial acceptance of its hydrogen generators, and Proton may be unable to grow its business if Proton s targeted customers do not purchase substantial numbers of Proton s hydrogen generators. Proton s targeted customers, or the distributors whom Proton intends to use to market to these customers, may not purchase Proton s hydrogen generators at all or in sufficient quantities to support the growth of Proton s business. Costs, risks and potential liabilities faced by distributed energy as a result of international operations include:

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

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

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

Distributed Energy receives significant external funding from the Department of Energy, the National Renewable Energy Laboratory and other public and private entities for the development of its proprietary products and technology. Changes in government policy toward distributed generation, alternative energy, or

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

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

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

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

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

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

Distributed Energy s perceived prospects;

variations in Distributed Energy s operating results and achievement of key business targets;

changes in securities analysts recommendations or earnings estimates;

differences between Distributed Energy s reported results and those expected by investors and securities analysts;

announcements of new products by Distributed Energy or its competitors;

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

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

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

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

Distributed Energy s directors, executive officers and individuals or entities affiliated with Distributed Energy s directors as a group beneficially own, approximately 12% of Proton s outstanding common stock at

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March 31, 2005. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of Distributed Energy s directors, and the approval of any other action requiring the approval of Distributed Energy s stockholders, including any amendments to Distributed Energy s certificate of incorporation and mergers or sales of substantially all of Distributed Energy s assets. In addition, without the consent of these stockholders, Distributed Energy could be prevented from entering into transactions that could be beneficial to it or its other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire Distributed Energy at a price per share that is above the then-current market price.

The provisions of Distributed Energy s certificate of incorporation and bylaws and Delaware law could inhibit a takeover that stockholders may consider favorable and diminish the voting rights of the holders of Distributed Energy common stock.

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

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

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

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

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

Distributed Energy s common stock is traded on the NASDAQ National Market. Under NASDAQ s listing maintenance standards, if the closing bid price of Distributed Energy common stock is under $1.00 per share for 30 consecutive trading days, NASDAQ will notify Distributed Energy that it may be delisted from the NASDAQ National Market. If the closing bid price of Distributed Energy common stock does not thereafter regain compliance for a minimum of 10 consecutive trading days during the 90 days following notification by NASDAQ, NASDAQ may delist Distributed Energy s common stock from trading on the NASDAQ National Market. There can be no assurance that Distributed Energy s common stock will remain eligible for trading on the NASDAQ National Market. In addition, if Distributed Energy s common stock is delisted, Distributed Energy s stockholders would not be able to sell Distributed Energy common stock on the NASDAQ National Market, and their ability to sell any of Distributed Energy s common stock would be severely if not completely limited.

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

The Company holds marketable securities consisting of U.S. government and agency securities that are held by two major banking institutions. The Company s marketable securities portfolio of approximately $48.1 million includes five callable agency securities with a fair market value totaling approximately $26.5 million. These securities generate a higher relative rate of interest for the Company; in return, the embedded call option gives the issuer the right to buy back the security. Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

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

The Company s management, with the participation of the Company s chief executive officer and chief financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of March 31, 2005. 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 a 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, 2005, the Company s chief executive officer and the chief financial officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

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, 2005 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II.

OTHER INFORMATION

ITEM 1. ***Legal Proceedings***

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering (IPO) of common stock. All of the complaints were filed allegedly on behalf of persons who purchased the Company s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that 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 the Company to negotiate a settlement of the pending claims substantially consistent with a Memorandum of Understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. 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 agree to a modification narrowing the scope of the bar order set forth in the original settlement. The Company believes it has meritorious defenses to the claims made in the complaints and, if the settlement is not finalized and approved, Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

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

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

After deducting underwriting discounts and commissions and offering expenses, our net proceeds from the offering were approximately $125.8 million. The net proceeds have been allocated for general corporate purposes and capital expenditures, including purchase of equipment for and leasehold improvements to our manufacturing facility, and the possible acquisition of businesses, products or technologies that are complementary to our business. As of March 31, 2005, approximately $75.8 million of the net proceeds of the offering had been used to fund operations and purchase fixed assets and $20.3 million has been used in the acquisition of Northern Power Systems, Inc. (the Acquisition). The remaining net proceeds are invested in U.S. Government and Agency securities. We made a cash distribution of $1.00 per share payable on June 20, 2003 to stockholders of record as of June 6, 2003. The aggregate amount of this distribution was $33,927,297. No other portion of the proceeds of Proton s initial public offering were paid directly or indirectly to any director, officer or general partner of us or our associates,

persons owning ten percent or more of any class of our equity securities, or an affiliate of us.

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

Not Applicable.

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

Not Applicable.

ITEM 5. ***Other Information***

Not Applicable.

ITEM 6. ***Exhibits***

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

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

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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 6, 2005

DISTRIBUTED ENERGY SYSTEMS CORP.
(Registrant)

By: /s/ WALTER W. SCHROEDER

Walter W. Schroeder
President
(Principal Executive Officer)

By: /s/ JOHN A. GLIDDEN

John A. Glidden
Vice President of Finance
(Principal Financial and Accounting Officer)