DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
August 08, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File Number: 000-50453

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

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

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(203) 678-2000

(Registrant s telephone number, including area code)

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

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

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

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

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of August 2, 2007 was 39,857,948.

Table of Contents

DISTRIBUTED ENERGY SYSTEMS CORP.

INDEX to FORM 10-Q

Table of Contents

DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11,130,652	$ 4,911,704
Marketable securities		13,256,116
Current portion of restricted cash	578,222	794,705
Accounts receivable, less allowances of $970,780 and $688,778, respectively	7,886,405	7,857,484
Costs in excess of billings on contracts in progress (Note 5)	5,200,162	4,102,573
Inventories, net (Note 5)	5,973,476	4,784,439
Deferred costs	1,114,272	810,508
Deferred financing costs, net (Note 4 and 13)	1,609,368	
Interest receivable		100,798
Other current assets	751,948	1,060,931
Total current assets	34,244,505	37,679,258
Fixed assets, net	19,454,095	22,740,210
Long-term portion of restricted cash	1,263,708	6,229,176
Intangible assets, net	2,675,932	3,012,321
Other assets, net	108,938	228,657
Total assets	$ 57,747,178	$ 69,889,622
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term debt, net of debt discount (Note 4 and 13)	$ 9,924,742	$
Current portion of long-term debt	907,187	1,379,460
Current portion of capital lease	214,124	208,556
Accounts payable	4,430,366	6,099,536
Accrued expenses (Note 6 and 12)	2,729,261	2,035,599
Accrued compensation	1,722,834	2,122,068
Accrued taxes (Note 12)	313,527	348,050
Billings in excess of costs on contracts in progress (Note 5)	840,630	1,723,988
Deferred revenue	1,308,206	836,607
Customer advances	160,041	60,344
Total current liabilities	22,550,918	14,814,208
Long term liabilities:		
Deferred revenue	168,076	168,076
Long-term debt	584,673	5,540,411
Long-term portion of capital lease	2,531,077	2,626,461
Total liabilities	25,834,744	23,149,156

Commitments and contingencies (Note 12)		
Stockholders equity (Note 10):		
Preferred stock, undesignated, $.01 par value per share; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 65,000,000 shares authorized; 39,856,931 and 39,442,180 shares issued and outstanding, respectively	398,568	394,421
Additional paid-in capital	245,701,684	235,624,657
Accumulated other comprehensive loss (Note 2)		(9,115)
Accumulated deficit	(214,187,818)	(189,269,497)
Total stockholders equity	31,912,434	46,740,466
Total liabilities and stockholders equity	$ 57,747,178	$ 69,889,622

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

1

Table of Contents

DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenue				
Contract	$ 4,889,106	$ 5,046,515	$ 11,141,644	$ 10,272,803
Product	667,945	1,824,598	1,314,771	2,939,906
Service	1,271,201	2,541,381	2,795,473	3,836,858
Total revenue	6,828,252	9,412,494	15,251,888	17,049,567
Cost of revenue				
Contract	6,659,517	5,138,983	13,135,991	9,990,162
Product	591,585	1,847,078	1,112,189	3,009,961
Service	1,404,318	2,336,368	3,197,528	3,515,656
Total cost of revenue	8,655,420	9,322,429	17,445,708	16,515,779
Gross margin	(1,827,168)	90,065	(2,193,820)	533,788
Operating expenses:				
Research and development:				
Depreciation and amortization	90,248	114,782	192,736	245,253
Other research and development (includes stock based compensation in the amount of $25,000, $47,000, $49,000 and $104,000 respectively)	426,384	1,075,928	1,089,231	1,628,115
Restructuring costs	139,513		701,888	
Selling, general and administrative:				
Depreciation and amortization	1,574,530	355,883	3,151,296	710,245
Other selling, general and administrative (includes stock based compensation in the amounts of $481,000, $939,000, $869,000 and $3,195,000, respectively)	5,644,255	5,368,409	17,142,233	12,389,752
Total operating expenses	7,874,930	6,915,002	22,277,384	14,973,365
Loss from operations	(9,702,098)	(6,824,937)	(24,471,204)	(14,439,577)
Interest income	132,165	396,011	382,607	744,942
Interest expense	(813,127)	(186,817)	(988,415)	(339,130)
Other income	94,176	80,105	158,691	152,503
Net loss	$ (10,288,884)	$ (6,535,638)	$ (24,918,321)	$ (13,881,262)
Basic and diluted net loss per share	$ (0.26)	$ (0.17)	$ (0.63)	$ (0.36)
Shares used in computing basic and diluted net loss per share	39,800,590	38,594,830	39,706,445	38,054,955

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

2

Table of Contents

DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30, 2007	2006
Cash flows from operating activities:		
Net loss	$ (24,918,321)	$ (13,881,262)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,795,821	1,246,094
Provision for bad debts	395,350	90,577
Amortization (accretion) of premiums/discounts on marketable securities	(47,021)	(226,031)
Non-cash stock-based expense	970,181	3,422,173
Amortization of debt discount	321,908	
Amortization of deferred financing cost	204,546	
Expense for warrants issued	5,960,000	
Loss from sale of marketable securities	2,175	
(Gain)/loss on disposal of assets	21,294	(39,276)
Changes in operating assets and liabilities:		
Accounts receivable	(424,271)	343,151
Costs in excess of billings	(1,097,589)	(662,134)
Inventories and deferred costs	(1,492,801)	(2,472,629)
Other curent and non-current assets	447,339	36,160
Accounts payable and accrued expenses	(1,374,743)	(1,099,402)
Accrued taxes payable	(34,523)	(61,699)
Billings in excess of costs	(883,358)	(644,476)
Deferred revenue and contract advances	571,296	(47,765)
Net cash used in operating activities	(17,582,717)	(13,996,519)
Cash flows from investing activities:		
Purchases of fixed assets	(112,449)	(1,670,862)
Proceeds from the sale of fixed assets		120,000
Cash paid for acquisition		(1,175,000)
Purchases of marketable securities		(26,863,012)
Proceeds from maturities and sales of marketable securities	13,310,077	20,196,632
Restricted cash	5,181,951	(479,132)
Net cash provided by (used in) investing activities	18,379,579	(9,871,374)
Cash flows from financing activities:		
Borrowings from long-term/short-term debt, net of deferred financing costs	10,686,086	260,296
Debt principal payments	(5,517,827)	(345,250)
Proceeds from sale of common stock, net	67,813	7,791,028
Proceeds from exercise of stock options	186,014	224,555
Proceeds from exercise of warrants		316,000
Net cash provided by financing activities	5,422,086	8,246,629
Net increase (decrease) in cash	6,218,948	(15,621,264)
Cash and cash equivalents at beginning of year	4,911,704	20,600,791

Cash and cash equivalents at end of period	$ 11,130,652	$ 4,979,527

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

Table of Contents

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. FORMATION AND OPERATIONS OF THE COMPANY

Distributed Energy Systems Corp. (the Company , we or Distributed Energy) was incorporated in Delaware on May 19, 2003 to create and deliver products and solutions to the new energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy 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.

To address the Company s need to raise additional working capital the Company entered into a Securities Purchase Agreement, or the Agreement with Perseus Partners VII, L.P. or Perseus, on June 1, 2007. Pursuant to the terms of the Agreement the Company closed on an initial $12.5 million loan by Perseus to the Company. In connection with this loan, the Company executed a senior secured promissory note in favor of Perseus, or the Initial Note, and issued to Perseus an initial investment warrant, or the Initial Warrant. The Initial Note bears interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due on March 1, 2008. The loan is secured by a security interest on all of the Company s assets and those of its material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the Company s common stock at an exercise price of $0.80 per share.

The Perseus Agreement also provides that, subject to approval by the Company s stockholders and other closing conditions, Perseus will subsequently make an additional loan of $15.0 million, which would be evidenced by a senior secured convertible promissory note, or the Subsequent Note. The proceeds from this subsequent loan will primarily be used to satisfy the obligation of the Initial Note, including accrued interest. The Subsequent Note will be convertible into shares of the Company s common stock at a conversion price of the lower of $1.20 per share or 75% of the market value of the Company s common stock at the time of closing of the subsequent loan. The Subsequent Note, when issued will bear interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due on November 30, 2008. The Company would also be obligated to issue a subsequent investment warrant to Perseus in connection with this second loan, or the Subsequent Warrant for the purchase of up to 34,989,629 shares of the Company s common stock at prices ranging from $0.80 to $3.00 per share.

The Company has undertaken in the Perseus Agreement to use commercially reasonable efforts to sell its Proton subsidiary, and the Company has engaged an investment bank to assist it in this process. The Company is in the process of providing information about Proton to prospective buyers. The Company is working toward the potential sale of Proton, subject to Board and possibly shareholder approval, by the end of the year. Perseus is entitled to have an observer at board meetings of the Company and also has the right to approve specified significant actions by the Company. The Company has also granted to Perseus a right of first refusal to fund any future financing transactions it might pursue, with limited exceptions. In addition, the Company has agreed to register for resale all the shares issuable to Perseus.

If the Subsequent Note is issued, the Company would be obligated to reduce the size of its board of directors to five and Perseus would be entitled to representation on the Company s board of directors equal to at least its percentage ownership in the Company, assuming exercise of all of its warrants and full conversion of its convertible note. Based upon our current capitalization, the Company believes Perseus would have the right to name three out of five directors.

The Company incurred significant operating losses and negative cash flow from operating activities in each of the last three years and during the six months ended June 30, 2007. Such circumstances raise substantial doubt about the Company s ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, the Company s ability to raise additional capital, to reduce its operating losses and operate profitably, to generate cash flow from operations, as well as the Company s ability to maintain credit under its current debt agreements adequate to conduct its business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

While we recently obtained funding as described, our ability to continue our operations in the long term will be subject to a number of factors that pose additional risk and uncertainty, including:

- Our ability to obtain shareholder approval that will allow the company to secure the subsequent $15 million loan from Perseus, expected to provide the company with approximately $2 million in additional cash.

- The occurrence of a material adverse change in our business that could allow Perseus to not make the subsequent loan.

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

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

- Our ability to successfully sell our Proton business.

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

- Our ability to complete a sale-leaseback transaction of our Wallingford, Connecticut facility.

- Our ability to control operating expenses.

2. BASIS OF PRESENTATION

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

The condensed consolidated financial statements as of June 30, 2007 and for the three months and six months ended June 30, 2007 and 2006 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 13, 2007.

Comprehensive Loss

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

	Three Months Ended June 30	
	2007	**2006**
Net loss	$ (10,288,884)	$ (6,535,638)
Unrealized gains (losses) on marketable securities arising in the period	5,355	(12,885)
Total comprehensive loss	$ (10,283,529)	$ (6,548,523)

Table of Contents

	Six Months Ended June 30 2007	2006
Net loss	$ (24,918,321)	$ (13,881,262)
Reclassification adjustments for loss from the sale of marketable securities included in net loss	2,175	13,688
Unrealized gains (losses) on marketable securities arising in the period	6,940	(3,960)
Total comprehensive loss	$ (24,909,206)	$ (13,871,534)

Concentration of Risks

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

For the quarter ended June 30, 2007, sales to the Company s five largest customers accounted for approximately 47% of total revenues. For the quarter ended June 30, 2006, sales to the Company s five largest customers accounted for approximately 29% of total revenues.

For the six months ended June 30, 2007, sales to the Company s five largest customers accounted for approximately 45% of total revenues. For the six months ended June 30, 2006, sales to the Company s five largest customers accounted for approximately 22% of total revenues.

At June 30, 2007 and December 31, 2006, accounts receivable from government-sponsored agencies accounted for approximately 13% and 8% of total Company accounts receivable, respectively. At June 30, 2007 and December 31, 2006, accounts receivable from international customers accounted for approximately 29% and 35% of total Company accounts receivable, respectively. At June 30, 2007 and December 31, 2006 accounts receivable from our five largest customers accounted for approximately 44% and 39% of total accounts receivables, respectively.

3. RECENT ACCOUNTING GUIDANCE

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

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

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

Table of Contents

4. DEBT

Perseus Senior Secured Promissory Note

On June 1, 2007, pursuant to the terms of the Perseus Agreement, the Company closed on a $12.5 million loan by Perseus to the Company. In connection with this loan, the Company executed the Initial Note and issued to Perseus the Initial Warrant. The Initial Note bears interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due in full on March 1, 2008. As a result, the Company recorded approximately $0.1 million of interest expense related to this note for the three and six months ended June 30, 2007.

The loan is secured by a security interest on all of the Company s assets and those of its material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the Company s common stock at an exercise price of $0.80 per share. The Company accounted for the Initial Note under APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants . The fair value of the Initial Warrant was determined to be $0.47 per share using a Black Scholes model resulting in a total fair value of $3.7 million. The Company used the following assumptions to estimate fair value of the warrants: expected term of five years; expected volatility of 80.8%; risk free rate of 4.92%; and no dividend yield. Accordingly, based on the relative fair values of the debt and the warrant at the time of issuance the Company allocated approximately $2.9 million of the $12.5 million proceeds to the Initial Warrant. The amount attributed to the Initial Warrant results in a discount on the Initial Note. The debt discount is amortized over the term of the Initial Note and accordingly the Company recognized approximately $0.3 million as interest expense related to this amortization during the three months ended June 30, 2007. Additionally, the Company incurred approximately $1.8 million of debt issuance costs associated with this financing which is being amortized over the life of the debt and recorded approximately $0.2 million as interest expense during the three months ended June 30, 2007. At June 30, 2007 the note payable is reflected net of unamortized debt discount of approximately $2.6 million.

Loan with Webster Bank National Association

On September 18, 2006, Technology Drive LLC, a subsidiary of Proton, or Technology Drive, entered into an amendment to the construction loan agreement with Webster Bank, National Association. This amendment related to a loan to Technology Drive from the bank made December 7, 2001 in the original principal amount of $6,975,000. The effect of the amendments was to change the interest rate on the loan from LIBOR plus 237.5 basis points to LIBOR plus 200 basis points and to eliminate the requirement that Technology Drive maintain cash and marketable securities of $20,000,000. The amendment further provided for the pledge by Technology Drive to the bank of an account with the bank having a balance equal to the amount payable under the loan. As of December 31, 2006, we had classified $400,200 as short-term restricted cash and $5,037,682 as long-term restricted cash as a result of this amendment. During the second quarter of 2007, the Company paid the note in full in the amount of $5,192,672.

5. INVENTORIES AND COSTS AND BILLINGS ON CONTRACTS IN PROGRESS

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

	June 30 2007	December 31, 2006
Raw materials	$ 3,660,425	$ 3,732,561
Work in process	1,882,528	923,435
Finished goods	430,523	128,443
	$ 5,973,476	$ 4,784,439

Table of Contents

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $590,872 and $493,951 at June 30, 2007 and December 31, 2006, respectively.

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

	June 30, 2007	December 31, 2006
Costs incurred and estimated earningson contracts in progress	$ 33,309,383	$ 20,969,341
Less: billings to date	28,949,851	18,590,756
Costs and earnings in excess of billings, net	$ 4,359,532	$ 2,378,585

	June 30, 2007	December 31, 2006
Costs in excess of billings on contracts in progress	$ 5,200,162	$ 4,102,573
Billings in excess of costs on contracts in progress	(840,630)	(1,723,988)
Costs and earnings in excess of billings, net	$ 4,359,532	$ 2,378,585

6. ACCRUED EXPENSES

Accrued expenses consist of the following:

	June 30, 2007	December 31, 2006
Accrued warranty	$ 590,594	$ 813,445
Accrued purchases	400,554	455,099
Accrued project losses	1,271,213	84,373
Other accruals	466,900	682,682
	$ 2,729,261	$ 2,035,599

7. LOSS PER SHARE

Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average common shares outstanding. Diluted EPS is calculated by adjusting weighted average common shares outstanding by assuming conversion of all potentially dilutive shares. In periods where a net loss is recorded, no effect is given to potentially dilutive securities because the effect would be antidilutive. Accordingly, no effect has been given to the assumed exercise of 523,065 and 3,528,173 common stock options outstanding for the quarters ended June 30, 2007 and 2006, respectively, nor the assumed exercise of 12,509,847 and 599,449 common stock warrants outstanding for the quarters ended June 30, 2007 and 2006, respectively, since the effect would be antidilutive for the reporting periods.

8. STOCK-BASED COMPENSATION

On January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective transition method. SFAS 123(R) requires the measurement and recognition of compensation expense for all stock-based awards made to the Company s employees and directors including employee stock options, employee stock purchase plans, and other stock-based awards based on estimated fair values. As a result, for the three months and six months ended June 30, 2007 and 2006, our results of operations reflect compensation expense for new stock options and awards granted and vested under our stock incentive plans, and the unvested portion of previous

8

Table of Contents

stock option and award grants which vested during the three months and six months ended June 30, 2007 and 2006. Amounts recognized in the financial statements related to stock-based compensation were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Selling, General and Administrative	$ 481,000	$ 939,000	$ 869,000	$ 3,195,000
Research and Development	25,000	47,000	49,000	104,000
Cost of revenue	46,000	62,000	52,000	123,000
Total non-cash stock compensation	$ 552,000	$ 1,048,000	$ 970,000	$ 3,422,000

CEO Awards

In the first quarter of 2006 the Company granted its CEO, Mr. Schwallie 100,000 shares of restricted common stock at a price of $0.01 per share. The market value of these shares at the time of grant was $8.84 and vested one year from the date of grant. In addition, the Company granted Mr. Schwallie 28,280 shares of restricted common stock at a price of $0.01 per share. The fair market value of these shares at the date of grant was $8.84 and vested immediately. Additionally, in connection with the commencement of Mr. Schwallie s employment, the Company granted Mr. Schwallie an option to purchase 500,000 shares of common stock at an exercise price of $8.84 per share. The option vests as to 25% of the original number of shares on the first anniversary of the grant date and 25% of the original number of shares at the end of each successive year following the first anniversary of the grant date until the fourth anniversary of the grant date. The option agreement also contained a termination of relationship clause resulting in accelerated vesting during the first year of employment. As a result of these restricted stock and stock option awards, the Company recorded non-cash stock-based compensation charges of approximately $147,000 and $368,000 for the three months ended June 30, 2007 and 2006, respectively, as well as $295,000 and $1,738,000 for the six months ended June 30, 2007 and 2006, respectively.

Mr. Schwallie also had the ability to earn up to 300,000 shares of restricted stock, contingent upon achievement of various company wide performance goals, including certain revenue, cash flow and gross margin targets at various intervals through June 30, 2008. The shares subject to this agreement vest immediately upon the achievement of these performance goals. It is no longer possible to meet the goals for 200,000 of these shares, and the Company determined that as of June 30, 2007 it was not probable that the remaining 100,000 restricted shares would be issued. Therefore, no compensation cost has yet been recognized. If a change in control event, as described in our 2003 Stock Incentive Plan and meeting parameters to be determined by our board of directors, occurs, and Mr. Schwallie is still employed by the Company, the remaining restricted shares would be granted to Mr. Schwallie unless it is no longer possible for the remaining target to be met.

Director Compensation

In January 2007, the Company granted a total of 75,040 shares of restricted common stock to its non-employee directors at a price of $3.63 per share, all shares vesting monthly over a one-year period. In May, 2007, the Company granted 29,263 shares of restricted stock to Mr. Bernard H. Cherry in connection with his appointment as chairman of the board of directors. The non-cash stock compensation cost associated with these two restricted common stock grants of approximately $71,000 and $137,000, for the three months and six months ended June 30, 2007, respectively, is reflected in selling, general and administrative expenses.

9. RESTRUCTURING AND RELATED COSTS

In January 2007, the Company announced that it was combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. The Company also announced plans to exit the Waitsfield,

Table of Contents

Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility resulting in the elimination of about 60 jobs, or 20% of the workforce. In May 2007, the Company completed another reduction of its workforce resulting in the elimination of approximately 25 additional jobs.

As a result, during the three months and six months ended June 30, 2007, the Company recorded severance charges of approximately $140,000 and $702,000, respectively. These costs are accounted for under FAS 146, Accounting for Costs Associated with Exit or Disposal Activities, and were included as a charge to the results of operations for the three months and six months ended June 30, 2007. Any subsequent changes to the estimates of executing the currently approved plans of restructuring will be reflected in current results of operations. Severance payments will continue to be made through the third quarter of 2007.

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

	Northern	Proton	Other	Total
Provision	$ 559,803	$ 78,433	$ 63,652	$ 701,888
Amounts paid	(519,997)	(78,433)	(34,274)	(632,704)
Balance at June 30, 2007	$ 39,806	$	$ 29,378	$ 69,184

As a result of its decision to exit the Waitsfield facility and consolidate its Northern operations in Barre Vermont by June 30, 2007, the Company revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated the related depreciation charges. Therefore, the Company recorded additional depreciation expense of approximately $1.2 million and $2.4 million, respectively, for the three months and six months ended June 30, 2007 to reduce the facility to its estimated net residual value of approximately $2.0 million. These depreciation charges are included in selling, general and administrative expenses.

10. STOCKHOLDER S EQUITY

Changes in stockholder s equity for the six months ended June 30, 2007 were as follows (in thousands):

Balance at December 31, 2006	$ 46,740
Net loss	(24,918)
Issuance of common stock from exercise of stock options	186
Issuance of common stock from ESPP program exercises	68
Issuance of warrants	8,857
Stock based compensation	970
Change in unrealized loss on marketable securities	9
Balance at June 30, 2007	$ 31,912

11. JOINT VENTURE

On March 7, 2007, the Company entered into a Joint Venture Agreement with Morgan Stanley Wind LLC (MSW), a subsidiary of Morgan Stanley. This agreement establishes a framework for the Company and Morgan Stanley to work together to develop, finance, own and operate projects utilizing waste-to-energy technology, combined-heat-and-power technology and other advanced energy technologies. The agreement provides MSW the exclusive right, but not the obligation to provide financing for projects. No projects subject to the terms of the joint venture agreement have been entered into to date. In connection with the execution of the Joint Venture Agreement and as an inducement for Morgan Stanley to enter into the agreement, the Company issued to Morgan Stanley on March 7, 2007 a Common Stock Purchase Warrant entitling Morgan Stanley to purchase up to 10% of the Company s common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. The warrant may only be exercised in cash.

Table of Contents

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

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

The Company estimated the fair value of the warrant issued under this arrangement using a binomial lattice model. The fair value of the first tranche of the warrants at March 7, 2007 was determined to be $1.51 per share issuable upon exercise of the warrant. As a result the Company recorded a non-cash charge of $5,841,471 associated with 3,868,524 shares issuable under this first tranche during the six months ended June 30, 2007. The fair value of the shares issuable upon exercise of the warrant that become available in the four subsequent tranches will be recorded when each respective funding level is achieved.

As a result of the Perseus Agreement, the number of shares issuable upon the exercise of the warrants issued under the first tranche to MSW was increased by 686,787. The fair value of these additional warrants was determined to be $0.17 per share which resulted in a non-cash charge of approximately $119,000 during the quarter ended June 30, 2007.

12. COMMITMENTS AND CONTINGENCIES

Contracts

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

The Company has informed its customers that, due to STM s cessation of operations, it is likely that it would be unable to complete and maintain these power systems as planned. The Company is in the process of investigating proposed alternative solutions. These solutions will result in additional contract costs and as such in the three months ended, June 30, 2007 the Company recorded additional estimated project losses of approximately $1.0 million, which represents its current best estimate of the costs required to resolve the two contracts. Should an adverse resolution related to these contracts occur, the Company estimates that it could incur additional losses of up to approximately $1.5 million. Neither party has made any claim against us, however if they did, the additional costs to the Company of defending any litigation or other proceedings, even if resolved in the Company s favor, could be substantial.

In 2001, Proton entered into an agreement with the Connecticut Clean Energy Fund (CCEF). The agreement provides Proton with financial assistance for up to $1.5 million, $600,000 under Phase I and $900,000 under Phase II of the agreement, to accelerate commercial deployment of the UNIGEN backup power unit. Proton is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach $25 million annually. Prior to the achievement of milestones described in this agreement, these funds were subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling

Table of Contents

interest in Proton by a third party, the sale of substantially all of Proton s assets, the consolidation or merger of Proton with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, Proton records funds received as liabilities until it achieves the contract milestones, at which time such amounts are recognized as reductions in related costs and expenses.

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

	CCEF Advance Balance
December 31, 2004	$ 283,012
Advances	917,167
Milestone achieved	(933,300)
December 31, 2005	$ 266,879
Advances	276,370
Milestone achieved	(543,249)
December 31, 2006	$
Advances	162,140
Milestone achieved	(162,140)
June 30, 2007	$

Warranty

The changes in the carrying amount of warranties for the six months ended June 30, 2007 and 2006 are as follows:

	2007	2006
Balance as of December 31:	$ 813,445	$ 417,694
Warranties issued in period	301,813	303,855
Adjustments to provision	(44,137)	80,223
Warranty claims	(480,527)	(580,299)
Balance as of June 30:	$ 590,594	$ 221,473

Sales and Use Tax Relief Program Recapture

In connection with the construction of its Wallingford facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement (the Wallingford Agreement) with the Connecticut Development Authority (the Authority). The Wallingford Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. The recapture clauses for relocation and early disposition/ abandonment expire October 15, 2010; whereby the Company could be required to pay back a portion of the sales tax relief received. The employment threshold clause was subject to review by the Authority in the quarter

ended December 31, 2006. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under the Wallingford Agreement shall not exceed $419,250 (the maximum sales and use tax benefit possible under the terms of the Wallingford Agreement, plus a 7.5% penalty). Proton was required under the Wallingford Agreement to place $419,250 in escrow related to these recapture clauses. The Company did not meet the employment threshold recapture clause by the compliance date of December 31, 2006 and accordingly had accrued $152,000 related to this matter. During the three months ended June 30, 2007 the Company paid $155,000 to the Authority. As a result of the payment, the Authority agreed to reduce the required escrow amount to $291,000 which is included within long term restricted cash at June 30, 2007. At this time all the other conditions that would require payment are remote and the Company has not accrued any additional liability.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, tax accruals of approximately $314,000 and $348,000 for certain state income and sales tax contingencies for which there may be exposure at June 30, 2007 and December 31, 2006, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual is subject to change and the actual amount could be greater or less than the accrued amount.

Legal Proceedings

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

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court s certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit s decision. On April 6, 2007, the Second Circuit denied plaintiffs Petition for Rehearing but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On June 25, 2007, the District Court signed an Order terminating the settlement. Proton believes it has meritorious defenses to the claims made in the complaints and intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

13. SEGMENT FINANCIAL DATA

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

Financial information as of and for the three months and six months ended June 30, 2007 and 2006, (in thousands) is summarized below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues:				
Proton	$ 2,442	$ 2,538	$ 4,473	$ 4,429
Northern	4,386	6,875	10,779	12,620
Consolidated	$ 6,828	$ 9,413	$ 15,252	$ 17,049

Included within Northern s revenues for the quarters ended June 30, 2007 and 2006 are sales to its largest international customer totaling approximately 3% and 13% of consolidated revenues, respectively. The Company believes it has no risk of foreign dependence.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Loss from operations:				
Proton	$ (1,072)	$ (2,345)	$ (2,485)	$ (4,202)
Northern	(6,751)	(2,819)	(12,264)	(5,402)
Eliminations and other	(1,879)	(1,661)	(9,722)	(4,836)
Consolidated	$ (9,702)	$ (6,825)	$ (24,471)	$ (14,440)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net loss:				
Proton	$ (1,062)	$ (2,341)	$ (2,472)	$ (4,182)
Northern	(6,820)	(2,875)	(12,395)	(5,479)
Eliminations and other	(2,407)	(1,319)	(10,051)	(4,220)
Consolidated	$ (10,289)	$ (6,535)	$ (24,918)	$ (13,881)

	June 30, 2007	December 31, 2006
Total assets:		
Proton	$ 65,888	$ 73,488
Northern	24,285	25,380

Eliminations and other	(32,426)	(28,978)
Consolidated	$ 57,747	$ 69,890

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

Table of Contents

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto appearing elsewhere in this Form 10-Q and with our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2006. This Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar 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, 2006, and below in this Form 10-Q under the Risk Factors and Legal Proceedings captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

OVERVIEW

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

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

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

Table of Contents

Update on our Financial Condition; Perseus Transaction

Since December 31, 2006, our financial condition has deteriorated significantly. We had anticipated that our previously announced revenue initiatives would improve sales and margins, but our sales and gross margins in the quarter ended June 30, 2007 were below our expectations. Our previously announced joint venture with Morgan Stanley Wind LLC has not generated any new business to date. Accordingly, we were required to raise additional funds and significantly cut our costs in order for our business to survive.

On June 1, 2007, pursuant to the terms of the Securities Purchase Agreement, or the Perseus Agreement, between us and Perseus Partners VII, L.P., or Perseus, we closed on an initial $12.5 million loan by Perseus to us. In connection with this loan, we executed a senior secured note, or the Initial Note and issued to Perseus an initial investment warrant, or Initial Warrant. The Initial Note bears interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due in full on March 1, 2008. The loan is secured by a security interest on all of our assets and those of our material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the our common stock at an exercise price of $0.80 per share. The value of these warrants was determined to be $0.47 per share using a Black-Scholes model yielding an effective interest rate of 63%.

Based on the relative fair values of the debt and the warrants at the time of issuance, we allocated approximately $2.9 million of the $12.5 million proceeds to the Initial Warrant. The amount attributed to the Initial Warrant results in a discount on the Initial Note. The debt discount is amortized over the term of the Initial Note and accordingly we recognized approximately $0.3 million as interest expense related to this amortization during the three month and six months ended June 30, 2007.

The Perseus Agreement also provides that, subject to approval by our stockholders and other closing conditions, Perseus will subsequently make an additional loan of $15.0 million, which would be evidenced by the Subsequent Note. The proceeds from this subsequent loan will primarily be used to satisfy the obligation of the Initial Note, including accrued interest. The Subsequent Note will be convertible into shares of the Company s common stock at a conversion price of the lower of $1.20 per share or 75% of the market value of the Company s common stock at the time of closing of the subsequent loan. The Subsequent Note, when issued will bear interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due on November 30, 2008. We would also be obligated to issue a subsequent investment warrant, or the Subsequent Warrant, to Perseus in connection with this second loan, for the purchase of up to 34,989,629 shares of our common stock at prices ranging from $0.80 to $3.00 per share.

We have undertaken in the Perseus Agreement to use commercially reasonable efforts to sell our Proton subsidiary, and we have engaged an investment bank to assist us in this process. The Company is in the process of providing information about Proton to prospective buyers. The Company is working toward the potential sale of Proton, subject to Board and possibly shareholder approval, by the end of the year. Perseus is entitled to have an observer at our board meetings and also has the right to approve specified significant actions by us. We have also granted to Perseus a right of first refusal to fund any future financing transactions we might pursue, with limited exceptions. In addition, we have agreed to register for resale all the shares issuable to Perseus.

If the Subsequent Note is issued, we would be obligated to reduce the size of our board of directors to five and Perseus would be entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of all of its warrants and full conversion of its convertible note. Based upon our current capitalization, we believe Perseus would have the right to name three out of five directors.

While we recently obtained funding as described, our ability to continue our operations in the long term will be subject to a number of factors that pose additional risk and uncertainty, including:

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

Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues. We are working to win two significant new Northern contracts with an aggregate value of approximately $8 million. Our plan will be adversely impacted if we do not secure those contracts.

Our ability to successfully sell our Proton business.

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

Our ability to control operating expenses.

Our ability to complete a sale-leaseback transaction of our facility in Wallingford, Connecticut.

The potential acceleration of debt service payments by one of our lenders as the result of subjective acceleration clauses in our debt agreements.

CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

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

Our critical accounting policies include the following:

Revenue Recognition Product Revenue

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

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

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

Revenue Recognition Contract Revenue

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines at our Northern segment. For projects with a duration of greater than three months where we have the ability to reasonably estimate total project costs to complete the contract, we recognize revenue utilizing the percentage-of-completion method as prescribed by SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1), based on the relationship of costs incurred to total estimated contract costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be subject to our judgment. For the six months ended June 30, 2007 and 2006, approximately 78% and 60% of our contract revenue, respectively, was recognized under the percentage-of-completion method.

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

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. During the three months ended June 30, 2007, we experienced increased estimated costs to complete on certain contracts which reduced our estimated gross margin on these contracts. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our gross margin percentage for contract revenue may be affected by these changes in estimates and has fluctuated from negative 18% to 3% for the six months ended June 30, 2007 and 2006, respectively.

Revenue Recognition Service Revenue

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

Warranty Costs

Our warranty to customers is limited to replacement parts and services and generally expires one year from the date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. We record estimated warranty obligations in the period in which we recognize the related revenue. We quantify and record an estimate for warranty related costs; this estimate is principally based on historical experience. The accounting for warranties requires us to make assumptions and apply judgments when estimating product failure rates and expected material and labor costs. We make adjustments to accruals as warranty claim data and historical experience warrant. If actual results are not consistent with the assumptions and judgments used to calculate our warranty liability, because either failure rates or repair costs differ from our assumptions, we may be exposed to gains or losses that could be material. A 10% change in the warranty reserve at June 30, 2007 would have affected our pre-tax loss by approximately $59,000 for the six months ended June 30, 2007.

Inventory

We record inventory at the lower of cost or market value. We determine cost by the first-in, first-out method. This policy requires us to write down our inventory for the excess of the carrying value, which is typically the original cost, over the amount we expect to realize from the ultimate sale or other disposal of the inventory based upon on our assumptions regarding forecasted consumer demand, market conditions, inventory aging and technological obsolescence. If any of our estimates are inaccurate, for example because of changes in technology that affect demand for certain products in an unforeseen manner, we may be exposed to losses or gains in excess of our established reserve, and those gains and losses could be material. A 10% change in our inventory reserve as of June 30, 2007 would have affected our pre-tax loss by approximately $59,000 for the six months ended June 30, 2007.

Intangible Assets

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

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

Long-Lived Assets

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

In January 2007, we announced that we were combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. We also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility. As a result of our decision to exit the Waitsfield facility and consolidate our Northern operations in Barre, Vermont by June 30, 2007, we revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated depreciation charges. Therefore, we recorded additional depreciation expense of approximately $1.2 million and $2.4 million, respectively, for the three months and six months ended June 30, 2007.

Table of Contents

Stock-Based Compensation

Stock-Based Compensation Employee Stock-Based Awards

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

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. We adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from January 1, 2006. Our Condensed Consolidated Financial Statements, as of and for the three-month and six-month periods ended June 30, 2007 and 2006, reflect the impact of SFAS 123(R). Non-cash stock compensation expense for the three months ended June 30, 2007 and 2006 was $546,846 and $1,025,282, respectively. Non-cash stock compensation expense for the six months ended June 30, 2007 and 2006, was $954,627 and $3,375,386, respectively, which consisted primarily of stock-based compensation expense related to employee stock options and restricted stock recognized under SFAS 123(R). In addition, stock-based compensation expense for the three-month period ended June 30, 2007 and 2006 of $5,274,and $22,999, respectively, were recognized related to our ESPP. Stock-based compensation expense for the six-month period ended June 30, 2007 and 2006 of $15,554 and $46,787, respectively, were recognized related to our ESPP.

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

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the three months and six months ended June 30, 2007 and 2006, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the fair value on the grant date estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 31, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all stock-based awards granted will be recognized using the ratable single-option method. As stock-based compensation expense recognized in our results for the first two quarter of 2007 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

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

Table of Contents

determined that historical volatility is most reflective of the market conditions and the best indicator of expected volatility.

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

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

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

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

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

Impact of Inputs to Value of Stock Options

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

(A) presumes exercise price is less than fair value

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

Table of Contents

Stock-Based Compensation Non-Employee Stock Options

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

Recent Accounting Guidance

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

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

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

Results of Operations

Comparison of the Three Months Ended June 30, 2007 and June 30, 2006

Revenues:

	Quarter Ended			
Net revenues	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Contract	$ 4,889,106	$ 5,046,515	$ (157,409)	-3%
Product	667,945	1,824,598	(1,156,653)	-63%
Service	1,271,201	2,541,381	(1,270,180)	-50%
Total	$ 6,828,252	$ 9,412,494	$ (2,584,242)	-27%

The decrease in contract revenues is a result of decreased revenue associated with our Northern subsidiary, offset by increased revenue associated with our Proton subsidiary. Northern contract revenues decreased approximately $1.2 million in the second quarter of 2007 compared to the comparable 2006 quarter. This decrease relates to decreases of approximately $1.5 million and $0.8 million associated with Northern s oil and gas and contract research and development contracts, respectively, due to fewer contracts in process compared to the prior year s quarter. This decrease is offset by revenue increases of approximately $1.1 million related to

Table of Contents

Northern s power distributor and wind business due to new contracts entered into this quarter. The decreases in Northern s revenue is partially offset by an approximately $1.0 million increase in Proton s contract revenue due to the increased number and size of contracts in the second quarter of 2007 compared to the second quarter of 2006.

The decrease in product revenue in the first quarter of 2007 compared to the comparable 2006 quarter relates to decreased HOGEN S series revenue of approximately $0.6 million due to fewer unit shipments as well as a decrease in HOGEN H series revenue of approximately $0.8 million. In the second quarter of 2006 we recognized revenue upon the expiration of the related product warranty period, generally twelve months from shipment, whereas in the second quarter of 2007 HOGEN H series we recognized revenue when units shipped during the quarter. These decreases were partially offset by increased revenue associated with higher shipments of laboratory generators and revenue associated with Proton s new Stable Flow product.

The decrease in service revenue relates to Northern s decreased operating and maintenance business of approximately $0.8 million, as well as a decrease of approximately $0.5 million associated with Northern s spare parts and international field service business.

As of June 30, 2007, our backlog was valued at approximately $15.4 million, consisting of contract and service backlog valued at approximately $9.0 million for Northern and $3.9 million for Proton and product backlog for Proton valued at approximately $2.5 million.

Costs of revenue:

	Quarter Ended			
Cost of revenues	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Contract	$ 6,659,517	$ 5,138,983	$ 1,520,534	30%
Product	591,585	1,847,078	(1,255,493)	-68%
Service	1,404,318	2,336,368	(932,050)	-40%
Total	$ 8,655,420	$ 9,322,429	$ (667,009)	-7%

Cost of contract revenues as a percentage of contract revenues increased from 102% in the second quarter of 2006 to 136% in the second quarter of 2007. Northern s costs of contract revenues as a percentage of revenues increased from 100% in the second quarter of 2006 to 169% in the second quarter of 2007. This increase is partially due to the recognition of project loss reserves of approximately $1.0 million associated with additional costs expected to be incurred related to contracts utilizing Stirling engine technology. On February 16, 2007 we were notified that the manufacturer of these engines, STM Power Inc. had ceased operations. These additional costs represent our estimate of the additional costs it will incur to satisfy these contracts. Additionally, Northern s gross margins decreased due to higher than expected costs, particularly in its on-site contracts. Proton s cost of contract revenue as a percentage of contract revenue decreased from 115% for the three months ended June 30, 2006 to 64% for the comparable 2007 period. The increase in gross margin on Proton s contracts is due to a change in contract mix from lower margin cost-share arrangements to higher margin fixed-price and cost-plus-fixed-fee contracts.

Product cost of revenue as a percentage of product revenue decreased from 101% in the second quarter of 2006 to 89% in the second quarter of 2007. The decrease in cost of product revenue as a percentage of revenue was primarily attributable to a reduction in warranty costs associated with Proton s HOGEN H series hydrogen generators in 2007 as compared to the 2006 period.

Service cost as a percentage of service revenue increased from 92% in the second quarter of 2006 to 110% in the second quarter of 2007. This increase in cost of service revenue as a percentage of service revenue is due

Table of Contents

to the change in Northern s mix of service contracts from higher margin international field service contracts to lower margin long-term domestic operating and maintenance contracts. For the three months ended June 30, 2007 approximately 69% of Northern s service contract revenues were related to domestic operating and maintenance contracts compared to approximately 60% of service contract revenues for the comparable 2006 period. Additionally, cost of service revenue for the three months ended June 30, 2007 reflects approximately $0.2 million of infrastructure cost reductions related to our 2007 strategic reorganization.

Hydrogen generator units shipped:

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

	Quarter Ended		
Hydrogen generator unit shipments	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**
S series	4	18	(14)
H series	1	5	(4)
StableFlow	1		1
Laboratory generators	21	16	5
Total	27	39	(12)

	Quarter Ended		
Revenue deferred on units shipped	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**
S series	$	$	$
H series		742,760	(742,760)
Laboratory generators			
Total	$	$ 742,760	$ (742,760)

	Quarter Ended		
Cost deferred on units shipped	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**
S series	$	$	$
H series		672,253	(672,253)
Laboratory generators			
Total	$	$ 672,253	$ (672,253)

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

Table of Contents

Research and development expenses:

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

	Quarter Ended			
Research and development	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Employee related	$ 316,369	$ 609,257	$ (292,888)	-48%
Project material	1,064	332,598	(331,534)	-100%
Depreciation and amortization	90,248	114,782	(24,534)	-21%
Stock based compensation	25,193	46,889	(21,696)	100%
Other	83,758	87,184	(3,426)	100%
Total	$ 516,632	$ 1,190,710	$ (674,078)	-57%

Employee-related research and development costs and project material costs decreased as a result of fewer employees, less developmental efforts associated with Proton s hydrogen generators, and lower project material costs at Northern, related to development of its power distributor products.

Restructuring costs:

During the three months ended June 30, 2007, our recorded severance charges of approximately $140,000, resulting from our work force reduction in May, 2007.

Selling, general and administrative expenses:

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

	Quarter Ended			
Selling, general and administrative	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Employee related	$ 2,589,163	$ 2,735,972	$ (146,809)	-5%
Marketing and advertising	171,073	290,751	(119,678)	-41%
Depreciation, amortization	1,574,530	355,883	1,218,647	342%
Stock based compensation	480,563	939,445	(458,882)	-49%
Legal, consulting and accounting	737,634	275,053	462,581	168%
Other	1,665,822	1,127,188	538,634	48%
Total	$ 7,218,785	$ 5,724,292	$ 1,494,493	26%

The increase in depreciation and amortization of $1.2 million is the result of our decision to accelerate the depreciation related to our Waitsfield, VT facility based on our plan to exit that facility by June 30, 2007. The decrease in stock based compensation primarily relates to restricted stock granted to our CEO in January 2006 as part of his employment arrangement. These restricted stock awards vested over one year and accordingly $0.2 million was recorded in the second quarter of 2006. No amount was recorded in the second quarter of 2007 related to these awards as they are fully vested. The additional decrease in stock based compensation relates to fewer unvested stock options outstanding as a result of employee terminations. The increase in legal, consulting and accounting primarily relates to legal costs associated with the consolidation of our Vermont operations as well as an increase in activity from general corporate matters. The increase in other relates to an increase in bad debt expense of $0.3 million, primarily at Northern and $0.1 million of non-cash charges associated with additional warrants issued to MSW that arose as a result of our agreement with Perseus. Additionally, employee-related costs for the three months ended June 30, 2007 reflects approximately $0.2 million of cost reductions related to our 2007 strategic reorganization.

25

Table of Contents

Interest income: Interest income decreased from $396,000 for the three months ended June 30, 2006 to $132,000 for the comparable period in 2007. The decrease resulted from lower cash balances. The average interest rates for the three months ended June 30, 2007 and 2006 were approximately 4.7% and 4.7%, respectively. The average cash and marketable securities balances for the six months ended June 30, 2007 and 2006 were approximately $8.2 million and $33.8 million, respectively.

Interest expense*:* Interest expense increased from $187,000 for the three months ended June 30, 2006 to $813,000 for the comparable period in 2007. The increase was primarily the result of interest associated with our Initial Note payable to Perseus including amortization of debt discount and deferred financing costs related to this note.

Comparison of the Six Months Ended June 30, 2007 and June 30, 2006

Revenues:

	Year To Date			
Net revenues	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Contract	$ 11,141,644	$ 10,272,803	$ 868,841	8%
Product	1,314,771	2,939,906	(1,625,135)	-55%
Service	2,795,473	3,836,858	(1,041,385)	-27%
Total	$ 15,251,888	$ 17,049,567	$ (1,797,679)	-11%

The increase in contract revenue is the result of higher contract revenue of $1.6 million associated with Proton contracts offset by a decrease in contract revenues of $0.7 million associated with Northern contracts. Proton s contract revenue increased approximately $1.6 million related to an increased number and size of contracts in the first half of 2007 compared to the first half of 2006. The decrease in Northern s contract revenue relates primarily to decreases in its oil and gas, and contract research and development businesses of approximately $3.0 million and $1.4 million, respectively, as fewer contracts remained active during 2007 compared to the prior year. These decreases were partially offset by increases in Northern s power distributor and wind businesses of approximately $1.2 and $2.5 million respectively.

Product revenue that is associated with Proton s HOGEN S series and H series hydrogen generators decreased from the comparable 2006 period by approximately $1.0. million and $0.8 million, respectively. The decrease in HOGEN S series revenue relates to fewer units shipped during the six months ended June 30, 2007 compared to the comparable 2006 period. During the six months ended June 30, 2006 we recognized revenue associated with Proton s HOGEN H series generators upon the expiration of the related product warranty period, generally twelve months from shipment, whereas in the six months ended June 30, 2007 we recognized revenue on units shipped during the period. These decreases were partially offset by revenue associated with Proton s new Stable Flow product.

The $1.0 million decrease in service revenue in the first half of 2007 relates primarily to Northern s spare parts and field service business.

As of June 30, 2007, our backlog was valued at approximately $15.4 million, consisting of contract and service backlog valued at approximately $9.0 million for Northern and $3.9 million for Proton and product backlog for Proton valued at approximately $2.5 million.

Table of Contents

Costs of revenue:

	Year To Date			
Cost of revenues	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**	
Contract	$ 13,135,991	$ 9,990,162	$ 3,145,829	31%
Product	1,112,189	3,009,961	(1,897,772)	-63%
Service	3,197,528	3,515,656	(318,128)	-9%
Total	$ 17,445,708	$ 16,515,779	$ 929,929	6%

Cost of contract revenues as a percentage of contract revenues increased from 97% in the first six months of 2006 to 118% in the first six months of 2007. Northern s costs of contract revenues as a percentage of revenues increased from 97% in the first six months of 2006 to 134% in the first six months of 2007. Proton s cost of contract revenue as a percentage of contract revenue decreased from 98% for the six months ended June 30, 2006 to 66% for the comparable 2007 period. The increase in Northern s contract costs is partially due to the recognition of loss reserves of approximately $1.0 million associated with additional costs expected to be incurred related to contracts utilizing Stirling engine technology. On February 16, 2007 we were notified that the manufacturer of these engines, STM Power Inc., had ceased operations. These additional costs are our estimate of the additional costs we will incur to satisfy these contracts. Additionally, Northern s gross margins decreased due to cost overruns on contracts, particularly in its on-site business as well as from fewer, less profitable contracts in its oil and gas business compared to the comparable 2006 period. Proton s cost of contract revenue as a percentage of revenue decreased as a result of the increase in the number of active contracts as well as a change in contract mix from lower margin cost-share arrangements to higher margin fixed-price and cost-plus-fixed-fee contracts.

Product cost of revenue as a percentage of product revenue decreased from 102% in the first six months of 2006 to 85% in the first six months of 2007. The decrease in cost of product revenue as a percentage of revenue was primarily attributable to a reduction in warranty costs associated with Proton s HOGEN H series hydrogen generators in 2007 as compared to the 2006 period.

Service cost as a percentage of service revenue increased from 92% in the first half of 2006 to 114% in the first half of 2007. This increase in cost of service revenue was primarily attributable to a change in Northern s mix of service contracts. In the first six months of 2006, 36% of service revenues were primarily from higher margin international field service time and material contracts. In the first six months of 2007, 70% of service revenues were from the lower margin long-term domestic operating and maintenance contracts. Additionally, cost of service revenue for the first half of 2007 reflects approximately $0.2 million of infrastructure cost reductions related to the 2007 strategic reorganization.

Hydrogen generator units shipped:

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

	Year To Date		
Hydrogen generator unit shipments	**June 30, 2007**	**June 30, 2006**	**Increase (decrease)**
S series	6	26	(20)
H series	4	9	(5)
StableFlow	1		1
Laboratory generators	33	34	(1)
Total	44	69	(25)

Table of Contents

Revenue deferred on units shipped	Year To Date June 30, 2007	June 30, 2006	Increase (decrease)
S series	$	$	$
H series		1,507,745	(1,507,745)
Laboratory generators			
Total	$	$ 1,507,745	$ (1,507,745)

Cost deferred on units shipped	Year To Date June 30, 2007	June 30, 2006	Increase (decrease)
S series	$	$	$
H series		1,280,226	(1,280,226)
Laboratory generators			
Total	$	$ 1,280,226	$ (1,280,226)

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

Research and development expenses:

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

Research and development	Year To Date June 30, 2007	June 30, 2006	Increase (decrease)	
Employee related	$ 936,401	$ 1,349,054	$ (412,653)	-31%
Project material	78,932	553,357	(474,425)	-86%
Depreciation and amortization	192,736	245,253	(52,517)	-21%
Stock based compensation	49,274	104,230	(54,956)	-53%
Other	24,624	(378,526)	403,150	-107%
Total	$ 1,281,967	$ 1,873,368	$ (591,401)	-32%

Employee-related research and development costs and project material costs decreased related to fewer employees, less developmental efforts associated with Proton s hydrogen generators, and lower project material costs at Northern, related to development of its power distributor products. Other costs increased primarily due to the recognition of $0.5 million of credits in the first half of 2006, as a result of achieving certain specified milestones on Proton s Connecticut Clean Energy Fund programs. Only $0.16 million related to these programs were recognized in the first half of 2007.

Restructuring costs:

During the six months ended June 30, 2007, we recorded severance charges of approximately $702,000, resulting from the strategic re-organization announced in January 2007. The re-organization effort eliminated about 60 jobs in January and an additional 25 jobs in May.

Table of Contents

General and administrative expenses:

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

	Six months ended June 30,	June 30,		
Selling, general and administrative	**2007**	**2006**	**Increase (decrease)**	
Employee related	$ 5,609,632	$ 5,707,658	$ (98,026)	-2%
Marketing and advertising	396,229	501,891	(105,662)	-21%
Depreciation, amortization	3,151,296	710,245	2,441,051	344%
Stock based compensation	869,438	3,195,756	(2,326,318)	-73%
Legal, consulting and accounting	1,698,783	735,948	962,835	131%
Other	8,568,151	2,248,499	6,319,652	281%
Total	$ 20,293,529	$ 13,099,997	$ 7,193,532	55%

The increase in depreciation and amortization of $2.4 million is the result of our decision to accelerate the depreciation related to our Waitsfield, VT facility based on our plan to exit that facility by June 30, 2007. The decrease in stock based compensation primarily relates to restricted stock charges of approximately $1.4 million recorded in the first six months of 2006 associated with the employment agreement of our CEO. The additional $0.9 million decrease in stock based compensation relates to fewer unvested stock options outstanding as a result of employee terminations. The increase in legal, consulting and accounting expenses primarily relates to the legal fees associated with the Joint Venture Agreement with Morgan Stanley Wind LLC and costs associated with financing efforts and real estate advice related to our Waitsfield building exit plan. The increase in other primarily relates to $0.3 million bad debt expense at Northern and $6.0 million of non-cash charges associated with warrants issued to Morgan Stanley Wind LLC in connection with our Joint Venture Agreement. Additionally, employee related costs for the first half of 2007 reflects approximately $0.2 million of cost reductions related to our 2007 strategic reorganization.

Interest income: Interest income decreased from $745,000 for the six months ended June 30, 2006 to $383,000 for the comparable period in 2007. The decrease resulted from lower cash balances, partially offset by higher average interest rates. The average interest rates for the six months ended June 30, 2007 and 2006 were approximately 4.8% and 4.2%, respectively. The average cash and marketable securities balances for the six months ended June 30, 2007 and 2006 were approximately $11.4 million and $35.8 million, respectively.

Interest expense*:* Interest expense increased from $339,000 for the six months ended June 30, 2006 to $988,000 for the comparable period in 2007. The increase was primarily the result of interest associated with our note payable to Perseus as well as amortization of debt discount and closing costs.

LIQUIDITY AND CAPITAL RESOURCES

Since inception in August 1996 through June 2007, we and our predecessor, Proton, have financed our operations through convertible preferred stock issuances, an initial public offering, an equity distribution agreement and debt that, in total, raised approximately $207.7 million. As of June 30, 2007, we had $11.1 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was $17.6 million for the six months ended June 30, 2007 and was primarily attributable to our net loss, increases in inventories, increases in costs in excess of billings, and decreases in account payables and accrued expenses, partially offset by non-cash depreciation, amortization, expense for warrants issued and stock compensation expense. Cash used in operating activities was $14.0 million for the six months ended June 30, 2006 and was primarily attributable to our net loss, increases in inventories as a result of less than expected demand for HOGEN hydrogen generators in the first half of 2006, and increases in deferred costs, and partially offset by non-cash depreciation, amortization and stock compensation expense.

Table of Contents

Cash provided by investing activities was $18.4 million for the six months ended June, 2007 and was primarily attributable to the proceeds from the maturities and sales of marketable securities. Cash used in investing activities was $9.9 million for the six months ended June 30, 2006 and was primarily attributable to purchases of marketable securities, the acquisition of the operations and maintenance business of Crown and the purchase of fixed assets, offset by proceeds from the maturity of marketable securities.

Cash provided by financing activities was approximately $5.4 million for the six months ended June 30, 2007 and was primarily attributable to borrowings from Perseus and proceeds received from exercised incentive stock options offset by the payoff of our Wallingford mortgage. Cash provided by financing activities was $8.2 million for the six months ended June 30, 2006 and was primarily attributable to proceeds received in conjunction with the sale of stock under an equity distribution agreement. The Company sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in net proceeds to the Company of $7,485,648. Additional proceeds were received from exercised incentive stock options and exercised common stock warrants.

We incurred significant operating losses and negative cash flow from operating activities in each of the last three years and during the six months ended June 30, 2007. Such circumstances raise substantial doubt about the our ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, to reduce our operating losses and operate profitably, to generate cash flow from operations, as well as the our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the value at which they are carried on our consolidated financial statements.

Management has developed a plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance. This plan includes the following actions:

- We received additional funding from Perseus as described below.
- We announced a 60 person (approximately 20%) reduction of our workforce on January 31, 2007 and approximately 25 person reduction of our workforce in May 2007. We will make additional workforce reduction actions in the future if business conditions warrant.
- We have nearly exited our Waitsfield, Vermont facility and combined our Vermont operations into our Barre, Vermont facility.
- We have engaged an investment banker to assist us in the sale of our Proton Energy Systems subsidiary. We expect to use the cash generated from this sale to fund operations and service our debt.
- We have engaged a commercial real estate broker to identify parties that would be interested in purchasing our Connecticut facility and leasing it back to us. We have received multiple offers and expect to close on a transaction in the third quarter of 2007.
- We have redesigned our sales opportunity management and contract negotiation process and with such changes expect to be more selective about the contracts we enter into. To date we have not increased revenue. In particular, we expect that revenues associated with our on-site business will continue to decrease as we focus on other areas of our business with more profit potential.

On June 1, 2007, pursuant to the terms of the Perseus Agreement, we closed on a $12.5 million loan by Perseus to us. In connection with this loan, we executed the Initial Note, and issued to Perseus the Initial Warrant. The Initial Note bears interest at 12.5% per annum, compounded quarterly, payable in cash or in kind at our discretion, and is due on March 1, 2008. The loan is secured by a security interest on all of our assets and those of our material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the our common stock at an exercise price of $0.80 per share. The value of these warrants was determined to be $0.47 per share using a Black-Scholes model yielding an effective interest rate of 63%.

The Perseus Agreement also provides that, subject to approval by our stockholders and other closing conditions, Perseus will subsequently make an additional loan of $15.0 million, which would be evidenced by a senior secured convertible promissory note, the Subsequent Note . The proceeds from this subsequent loan will primarily be used to satisfy the obligation of the Initial Note, including accrued interest. The Subsequent Note will be convertible into shares of the Company s common stock at a conversion price of the lower of $1.20 per share or 75% of the market value of the Company s common stock at the time of closing of the subsequent loan. The Subsequent Note, when issued will bear interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and is due on November 30, 2008. We would also be obligated to issue, the Subsequent Warrant, for the purchase of up to 34,989,629 shares of our common stock at prices ranging from $0.80 to $3.00 per share

If stockholder approval is not obtained, we would not be permitted to issue the Subsequent Note or grant the Subsequent Warrant. Perseus would have no obligation to fund the subsequent investment or provide any alternative funding. As a result, we would be required to repay the initial $12.5 million loan and any accrued but unpaid interest on March 1, 2008 using other funds, which may not be available to us on acceptable terms or at all. We have been pursuing various sources of equity and debt funding over the last several months, but to date the we have not been successful in locating a party other than Perseus willing to provide financing on acceptable terms and conditions. If we are unable to raise other funds, we might be required to liquidate or seek protection from creditors in a bankruptcy proceeding.

We have undertaken in the Perseus Agreement to use commercially reasonable efforts to sell our Proton subsidiary, and we have engaged an investment bank to assist us in this process. We are in the process of providing information about Proton to prospective buyers. We are working toward the potential sale of Proton, subject to Board and possibly shareholder approval, by the end of the year. Perseus is entitled to have an observer at our board meetings and also has the right to approve specified significant actions by us. We have also granted to Perseus a right of first refusal to fund any future financing transactions we might pursue. In addition, we have agreed to register for resale all the shares issuable to Perseus.

If the Subsequent Note is closed, we would be obligated to reduce the size of our board of directors to five and Perseus would be entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of its convertible note. Based upon our current capitalization, we believe Perseus would have the right to name three out of five directors.

A number of factors however, pose risk and uncertainty in the execution of our plan, including:

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

- Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues. We are working to win two significant new Northern contracts with an aggregate value of approximately $8 million. Our plan will be adversely impacted if we do not secure those contracts.

- Our ability to successfully sell our Proton business.

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

- Our ability to control operating expenses.

Table of Contents

Our ability to complete a sale-leaseback transaction of our Wallingford Connecticut facility.

The potential acceleration of debt service payments by one of our lenders as the result of subjective acceleration clauses in our debt agreements.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

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

At June 30, 2007, we had $0.6 million outstanding under our ten-year term note that is subject to a variable interest rate. The note bears interest at a variable rate equal to two percentage points less than VEDA s prevailing rate for taxable financing, which was 6.50% per annum at June 30, 2007, with a maturity date of October 6, 2015. If our variable interest rate were to increase or decrease by 10%, we do not believe such a change would have a material impact on our financial position or results of operations.

ITEM 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of the Company s principal executive officer and principal financial and accounting officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of June 30, 2007. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial and accounting officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company s disclosure controls and procedures as of June 30, 2007, the Company s principal executive officer and principal financial and accounting officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes in Internal Control over Financial Reporting

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the six months ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

Table of Contents

PART II.

OTHER INFORMATION

ITEM 1. Legal Proceedings

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

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court s certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit s decision. On April 6, 2007, the Second Circuit denied plaintiffs Petition for Rehearing but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On June 25, 2007, the District Court signed an Order terminating the settlement. Proton believes it has meritorious defenses to the claims made in the complaints and 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.

Table of Contents

ITEM 1A. Risk Factors

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

RISKS RELATING TO OUR COMPANY

We may require funding in order to continue to operate.

Our cash and marketable securities on hand as of June 30, 2007, together with our 2007 forecasted revenues and existing backlog may not be sufficient to fund operations through December 31, 2007.

Management may need to take additional actions to further reduce operating expenses. If additional funding is required, sufficient funds may not be available to us thereafter or on terms that we deem acceptable, if they are available at all.

Management has developed a plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance. However, a number of factors pose risk and uncertainty in the execution of our plan, including:

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

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

- Our ability to control operating expenses.

- Our ability to complete a sale-leaseback transaction of our Wallingford, Connecticut facility.

- The potential acceleration of debt service payments by one of our lenders as the result of subjective acceleration clauses in our debt agreements.

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

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

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2006 with respect to our ability to continue as a going concern. This modification may negatively affect our stock price, our capital-raising efforts or our ability to enter into new contracts with customers. Our consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. If we became unable to continue as a going concern, we would have to liquidate our assets and we might receive significantly less than the values at which they are carried on our consolidated financial statements.

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

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

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

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

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

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

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

We expect to continue make investments in all areas of our business, particularly in research and product development and in expanding our manufacturing and project finance capability. Because the investments associated with these activities are relatively fixed in the short-term, we may be unable to adjust our spending quickly enough to offset any unexpected shortfall in our revenue growth. In addition, because we are in the very

Table of Contents

early stages of selling our products and have a limited number of customers, we expect our order flow to be uneven from period to period.

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

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of June 30, 2007, we had an accumulated deficit of $214 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing capability and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators. Even if we achieve profitability, we may be unable to sustain or increase our profitability in the future.

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

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

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

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

Table of Contents

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

Typically, sales of our distributed generation systems are made to customers under single contracts to provide highly specialized on-site power systems designed and built to meet customer specifications. For six months ended June 30, 2007, our largest 5 customers accounted for 45% of our revenues and our largest 10 customers accounted for 60% of our revenues. Because such a high percentage of our sales are concentrated in so few contracts, failure by us or our customers to perform or deliver on any one of these contracts could have a major impact on our annual results of operations. In addition, most of our customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects us to a high degree of customer credit risk and risk of non-performance by our vendors. A single vendor s late delivery of a key component required for a project, for example, could significantly delay our completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in our contracts with our customers.

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

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

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

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

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

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

- the inability to purchase parts or components in adequate quantities or sufficient quality, including from sole source vendors;
- the cost and availability of raw materials;
- the failure to increase assembly and test operations;

the failure to hire and train additional manufacturing personnel; and

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

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

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

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

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

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

We have agreements with two customers providing for construction of power systems that utilize Stirling engine technology. On February 16, 2007, we were notified that the manufacturer of these engines, STM Power, Inc., had ceased operations. We have informed the customers that, due to STM s cessation of operations, we are likely unable to complete and maintain these power systems as planned. We are in the process of investigating proposed alternative solutions. These solutions will result in additional contract costs and as such, as of June 30, 2007 the Company recorded additional estimated project losses of approximately $1.0 million, which represents its current best estimate of the costs required to resolve the two contracts. Should an adverse resolution related to these contracts occur, the Company estimates that it could incur additional losses of approximately $1.5 million. Neither party has made any claim against us, however if they did, the additional costs to the Company of defending any litigation or other proceedings, even if resolved in the Company s favor, could be substantial.

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

Market factors affect our costs and availability of materials.

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

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

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

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

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

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

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

Our backlog was approximately $15.4 million as of June 30, 2007. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of

June 30, 2007 from which we expect to recognize revenue in fiscal 2007 is likely to be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog. The actual accrual of revenue on engagements included in backlog may never occur or may change because a contract could be reduced, modified or terminated early. If we fail to realize revenue from engagements included in our backlog as of June 30, 2007, our revenue and results of operations for fiscal 2007 as well as future reporting periods may be materially harmed.

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

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

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

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

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

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

- adaptation to changes in customer requirements;
- expanded design, engineering and other performance and service capabilities; and
- system and other infrastructure development that reduces costs.

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We also subcontract work or may hire temporary and permanent employees in countries that are politically and economically unstable. It is more difficult to perform background checks on these foreign workers or to be

Table of Contents

sure that conduct and performance are in the best interests of our company and in full compliance with applicable laws.

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

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

RISKS RELATING TO OUR INDUSTRY

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

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

- utility electric rates;
- changes in federal, state and local regulatory requirements;
- changes in federal and state incentives and subsidies;
- cost, quality, performance and availability of the alternative power generation technologies used or supported by our power systems and hydrogen generators;
- costs and availability of natural gas, diesel, hydrogen and other fuels used in distributed energy technologies;
- changes in customers perceptions regarding distributed generation, PEM fuel cells and alternative energy;
- customer reluctance to try new products and technology;
- availability of financing for distributed generation vendors, developers and users;
- economic downturns and related reductions in capital spending;
- demand for and valuation of emissions trading credits generated by distributed generation systems; and
- the emergence of newer, more competitive technologies.

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

Most of our wind turbine products are sold for use in power systems used by remote communities to replace or augment internal combustion engines. Demand for our wind turbines from this market segment depends in

Table of Contents

part on the current and future commodity prices of oil and gas. Higher oil and gas prices provide incentives for customers to invest in technologies such as wind turbines that reduce their need for petroleum-based fuels. Conversely, lower oil and gas prices would tend to reduce the incentive for customers to invest in capital equipment to produce electrical power.

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

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

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

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

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

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

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

Table of Contents

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

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

OTHER RISKS

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

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

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

- our perceived prospects;
- variations in our operating results and achievement of key business targets;
- changes in securities analysts recommendations or earnings estimates;
- the inclusion of a going concern modification in our independent registered public accountant s audit report;
- differences between our reported results and those expected by investors and securities analysts;
- announcements of new products by us or our competitors;
- market sentiment toward power technology and alternative energy stocks in general or to us in particular;
- trading of options or other derivatives on our common stock;
- market reaction to any acquisition, joint venture or strategic investments announced by us or our competitors; and

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

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

Table of Contents

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

Our directors, executive officers and individuals or entities affiliated with our directors as a group beneficially own, approximately 6.7% of our outstanding common stock at August 2, 2007. The interests of these stockholders may differ substantially from the interests of other stockholders. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of our directors, and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation and mergers or sales of substantially all of our assets. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us or our other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire us at a price per share that is above the then-current market price.

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

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

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

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

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

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

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

Table of Contents

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

On June 1, 2007, pursuant to the terms of the Perseus Agreement we closed on an initial $12.5 million loan by Perseus to us. In connection with this loan, we executed the Initial Note, and issued to Perseus the Initial Warrant. The Initial Note has an original principal amount of $12.5 million, bears interest at a rate of 12.5% per annum, compounded quarterly, and is due on March 1, 2008. The loan is secured by a security interest on all of our assets and those of our material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of our common stock at an exercise price of $0.80 per share. These issuances were made in a private placement in reliance upon an exemption from registration under Section 4(2) of the Securities Act. Jefferies & Company, Inc., acted as sole placement agent in connection with the transaction.

ITEM 5. Other Information

Table of Contents

ITEM 6. Exhibits

Exhibit 10.1	Securities Purchase Agreement dated May 10, 2007 between the registrant and Perseus Partners VII, L.P. (incorporated herein by reference to exhibit 1.1 of the registrant s report on Form 8-K filed May 16, 2007)
Exhibit 10.2	Senior Secured Promissory Note dated June 1, 2007 between the registrant and Perseus Partners VII, L.P. (incorporated herein by reference to exhibit 10.1 of the registrant s report on Form 8-K filed June 6, 2007)
Exhibit 10.3	Initial Investment Warrant dated June 1, 2007 between the registrant and Perseus Partners VII, L.P. (incorporated herein by reference to exhibit 10.2 of the registrant s report on Form 8-K filed June 6, 2007)
Exhibit 31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 99.1	Form of Senior Secured Convertible Promissory Note (incorporated herein by reference to exhibit 99.2 of the registrant s report on Form 8-K filed June 6, 2007)
Exhibit 99.2	Form of Subsequent Investment Warrant (incorporated herein by reference to exhibit 99.3 of the registrant s report on Form 8-K filed June 6, 2007)

Table of Contents

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: August 8, 2007

DISTRIBUTED ENERGY SYSTEMS CORP.
(Registrant)

By: /s/ AMBROSE L. SCHWALLIE
Ambrose L. Schwallie
Chief Executive Officer
(Principal Executive Officer)

By: /s/ PETER J. TALLIAN
Peter J. Tallian
Chief Financial Officer
(Principal Financial Officer)

52