DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006

OR

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

Commission File Number: 000-50453

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

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

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(Registrant s telephone number, including area code) (203) 678-2000

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

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

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

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

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of October 31, 2006 was 39,235,219.

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PART I. FINANCIAL INFORMATION

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,648,945	$ 20,600,791
Marketable securities (Note 4)	19,299,819	20,064,719
Current portion of restricted cash	802,005	290,373
Accounts receivable, less allowances of $207,149 and $72,772 respectively	13,726,185	8,802,419
Costs in excess of billings on contracts in progress	1,892,141	1,951,226
Inventories (Note 5)	5,186,125	3,092,784
Deferred costs	563,364	4,255,030
Interest receivable	241,375	134,127
Other current assets	697,368	1,032,111
Total current assets	44,057,327	60,223,580
Fixed assets, net	22,625,291	21,858,722
Long-term portion of restricted cash	6,151,405	715,750
Intangible assets, net	4,634,405	3,310,317
Goodwill	24,755,962	24,755,962
Other assets, net	330,545	281,465
Total assets	$ 102,554,935	$ 111,145,796
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 541,556	$ 545,141
Current portion of capital lease	206,328	141,448
Accounts payable	4,527,509	4,773,733
Accrued expenses (Note 6 and 12)	1,364,331	1,624,771
Accrued compensation	2,115,644	2,290,444
Accrued taxes (Note 12)	266,600	402,359
Billings in excess of costs on contracts in progress	4,223,233	1,159,968
Deferred revenue	822,105	4,563,164
Customer advances	41,602	654,541
Total current liabilities	14,108,908	16,155,569
Long term liabilities:		
Deferred tax liability	564,775	564,775
Deferred revenue	211,660	144,168
Long-term debt	6,574,854	6,674,802
Long-term portion of capital lease	2,600,321	2,550,115
Total liabilities	24,060,518	26,089,429
Commitments and contingencies (Note 12)		
Stockholders equity (Note 11):		

Preferred stock, undesignated, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 65,000,000 shares authorized; 39,122,834 and 37,181,632 shares issued and outstanding, respectively	391,228	371,817
Additional paid-in capital	234,235,216	221,111,515
Unearned compensation		(453,980)
Accumulated other comprehensive loss (Note 2)	(21,209)	(58,683)
Accumulated deficit	(156,110,818)	(135,914,302)
Total stockholders equity	78,494,417	85,056,367
Total liabilities and stockholders equity	$ 102,554,935	$ 111,145,796

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

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue				
Contract	$ 7,407,614	$ 7,956,580	$ 17,680,417	$ 26,534,925
Product	5,644,028	2,753,810	8,583,934	4,408,928
Service	1,703,661	1,566,226	5,540,519	3,035,986
Total revenue	14,755,303	12,276,616	31,804,870	33,979,839
Cost of revenue				
Contract	7,135,277	7,357,906	17,125,439	24,051,433
Product	5,262,627	2,347,208	8,272,588	4,375,606
Service	1,850,167	1,077,292	5,365,823	2,180,434
Total cost of revenue	14,248,071	10,782,406	30,763,850	30,607,473
Gross margin	507,232	1,494,210	1,041,020	3,372,366
Operating expenses				
Research and development:				
Noncash depreciation and amortization	103,399	131,128	348,652	605,054
Other research and development (includes stock based compensation of $55,000, $0, $159,000, and $0 respectively)	842,757	1,090,622	2,470,869	3,194,774
Selling, general and administrative:				
Noncash depreciation and amortization	387,183	285,041	1,104,185	814,872
Other selling, general and administrative (includes stock based compensation of $878,000, $104,000, $4,074,000, and $397,000 respectively)	5,722,482	3,704,828	18,105,477	11,961,592
Total operating expenses	7,055,821	5,211,619	22,029,183	16,576,292
Loss from operations	(6,548,589)	(3,717,409)	(20,988,163)	(13,203,926)
Interest income	357,550	238,550	1,102,492	750,296
Interest expense	(195,259)	(125,857)	(534,389)	(316,060)
Other income (expense)	71,044	18,149	223,544	(31,713)
Net loss	$ (6,315,254)	$ (3,586,567)	$ (20,196,516)	$ (12,801,403)
Basic and diluted net loss per share	$ (0.16)	$ (0.10)	$ (0.53)	$ (0.36)
Shares used in computing basic and diluted net loss per share	39,062,609	36,426,938	38,394,530	36,042,775

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

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net loss	$ (20,196,516)	$ (12,801,403)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,899,499	1,835,195
Provision for bad debts	134,376	29,049
Amortization of premiums/discounts on marketable securities	(311,246)	11,292
Non-cash stock-based expense	4,441,963	445,264
Loss on sale of marketable securities		2,200
(Gain) loss on disposal of assets	(18,930)	91,539
Changes in operating assets and liabilities:		
Accounts receivable	(5,058,142)	(5,593,387)
Inventories and deferred costs	1,598,325	(82,772)
Costs in excess of billings	59,085	(556,663)
Other current assets and interest receivable	227,495	331,501
Other assets	(69,348)	8,215
Accounts payable and accrued expenses	(681,464)	2,017,238
Accrued taxes	(135,759)	(181,757)
Billings in excess of costs	3,063,265	(1,934,249)
Deferred revenue and contract advances	(4,286,506)	635,177
Net cash used in operating activities	(19,333,903)	(15,743,561)
Cash flows from investing activities:		
Purchases of fixed assets	(2,193,508)	(1,200,965)
Proceeds from the sale of fixed assets	120,000	4,500
Restricted cash	(5,947,287)	
Cash paid for acquisition, including transaction costs	(1,175,000)	
Purchases of marketable securities	(26,863,012)	(9,803,161)
Proceeds from maturities and sales of marketable securities	27,976,632	28,786,800
Net cash (used in) provided by investing activities	(8,082,175)	17,787,174
Cash flows from financing activities:		
Borrowings from long-term debt, net of issuance costs	523,488	236,270
Debt principal payments	(511,935)	(371,004)
Proceeds from sale of common stock, net	7,860,295	137,150
Proceeds from exercise of common stock warrants	317,437	38,301
Proceeds from exercise of common stock options	274,947	278,946
Net cash provided by financing activities	8,464,232	319,663
Net (decrease) increase in cash and cash equivalents	(18,951,846)	2,363,276
Cash and cash equivalents at beginning of period	20,600,791	5,989,896
Cash and cash equivalents at end of period	$ 1,648,945	$ 8,353,172

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

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. FORMATION AND OPERATIONS OF THE COMPANY

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

On December 10, 2003, Distributed Energy announced the completion of its acquisition of Northern (the Acquisition). The acquisition was accounted for as a purchase of Northern by Distributed Energy; Proton was merged into Distributed Energy as a subsidiary. As part of the acquisition, each outstanding share of Proton was exchanged for a share of Distributed Energy common stock. At the close of the market on December 10, 2003, the NASDAQ National Market ceased trading of Proton shares. Effective December 11, 2003, NASDAQ began trading shares of Distributed Energy on the National Market under the ticker symbol DESC. The results of operations of Northern have been included in the financial statements of the Company as of December 11, 2003.

2. BASIS OF PRESENTATION

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

The condensed consolidated financial statements as of September 30, 2006 and for the three and nine-month periods ended September 30, 2006 and 2005 are unaudited. In the opinion of management, all adjustments, which consist solely of normal recurring adjustments, necessary to present fairly in accordance with accounting principles generally accepted in the United States of America, the financial position, results of operations and cash flows for all periods presented, have been made. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for the full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the Company s audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K filed with the SEC on March 10, 2006.

Comprehensive Income (Loss)

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

	Three Months Ended September 30,	
	2006	2005
Net loss	$ (6,315,254)	$ (3,586,567)
Unrealized gains on marketable securities arising in period	41,434	121,477
Total comprehensive loss	$ (6,273,820)	$ (3,465,090)

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	Nine Months Ended September 30, 2006	2005
Net loss	$ (20,196,516)	$ (12,801,403)
Unrealized gains on marketable securities arising in period	37,474	236,240
Reclassification adjustments for losses included in net loss	13,688	2,200
Total comprehensive loss	$ (20,145,354)	$ (12,562,963)

Concentration of Risks

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

For the quarter ended September 30, 2006, sales to five customers, three domestic and two international, accounted for approximately 40% of total revenues. For the quarter ended September 30, 2005, sales to five domestic customers accounted for approximately 41% of total revenues.

For the nine months ended September 30, 2006, sales to five customers, three international and two domestic, accounted for approximately 28% of total revenues. For the nine months ended September 30, 2005, sales to six customers, one international and five domestic, accounted for approximately 43% of total revenues.

At September 30, 2006 and December 31, 2005, accounts receivable from government-sponsored agencies accounted for approximately 5% and 16% of total Company accounts receivable, respectively. At September 30, 2006, accounts receivable from three customers, two domestic and one international, accounted for approximately 32% of total accounts receivables. At December 31, 2005, there was no individual customer accounts receivable greater than 10% of total receivables.

Stock-Based Compensation Employee Stock-Based Awards

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

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Condensed Consolidated Statements of Operations. The Company adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from January 1, 2006. The Condensed Consolidated Financial Statements, as of and for the nine months ended September 30, 2006, reflect the impact of SFAS 123(R). Non cash stock compensation expense for the three and nine month periods ended September 30, 2006 was $995,024 and $4,370,411, respectively, which consisted primarily of stock-based compensation expense related to employee stock options and restricted stock awards recognized under SFAS 123(R). In addition, stock-based compensation expense related to our ESPP was recognized for the three and nine month periods ended September 30, 2006 for $24,765 and $71,552, respectively.

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Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, generally no stock-based compensation expense for employee stock options had been recognized in the Company s Condensed Consolidated Statements of Operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method used in adopting SFAS 123(R), the Company s results of operations prior to 2006 have not been restated to reflect, and do not include, the 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 nine months ended September 30, 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. The amount of compensation expense recognized during a period is based on the value of the awards that are ultimately expected to vest. As stock-based compensation expense recognized in the Company s results for the nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, the Company accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in the Notes to Consolidated Financial Statements for the related periods.

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

Also see Note 8 for further discussion of stock-based compensation.

Stock-Based Compensation Non-Employee Stock Options

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

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The following table illustrates the effect on net loss and loss per share had compensation costs for the stock-based compensation plan been determined based on grant date fair values of awards under the provisions of SFAS No. 123, for the three and nine months ended September 30, 2005:

	Three Months September 30, 2005	Nine Months September 30, 2005
Net loss, before stock-based compensation for employees	$ (3,586,567)	$ (12,801,403)
Add: Stock-based compensation expense for employees previously determined under the intrinsic value method, net of tax effect	104,253	369,134
Less: Stock-based compensation expense for employees determined under the fair value based method, net of tax effect	(808,632)	(2,193,720)
Net loss, after effect of stock-based compensation for employees	$ (4,290,946)	$ (14,625,989)
Net loss per share applicable to common stockholders, basic and diluted		
As reported	$ (0.10)	$ (0.36)
Pro forma	$ (0.12)	$ (0.41)

Long-lived Assets

The Company evaluates potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets . SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable.

Reclassifications

Certain amounts in the 2005 financial statements have been reclassified to conform to the 2006 presentation.

3. RECENT ACCOUNTING GUIDANCE

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. We are currently evaluating the potential impact of this statement.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the first annual period ending after November 15, 2006. We are currently evaluating the impact of adopting SAB 108.

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4. MARKETABLE SECURITIES

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. As of September 30, 2006 and December 31, 2005, the Company s investment portfolio consisted of U.S. government and agency securities held by a major banking institution. The maturities of marketable securities of $19,299,819 and $20,064,719 at September 30, 2006 and December 31, 2005, respectively, are less than one year.

Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders equity. The unrealized loss from marketable securities was $21,209 and $58,683 at September 30, 2006 and December 31, 2005, respectively. At September 30, 2006, the Company had one callable agency security with a fair market value totaling approximately $4.5 million. This security generates a higher relative rate of interest for the Company, in return for the issuer s right to call, at par value, the security before its maturity date.

As of September 30, 2006, none of the Company s investments were determined to be other than temporarily impaired.

5. INVENTORIES AND COSTS AND BILLINGS ON CONTRACTS IN PROGRESS

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

	September 30, 2006	December 31, 2005
Raw materials	$ 3,633,017	$ 1,596,413
Work in process	1,171,900	1,083,747
Finished goods	381,208	412,624
	$ 5,186,125	$ 3,092,784

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $589,326 and $568,298 at September 30, 2006 and December 31, 2005, respectively.

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

	September 30, 2006	December 31, 2005
Costs incurred and estimated earnings on contracts in progress	$ 19,510,100	$ 25,785,091
Less: billings to date	21,841,192	24,993,833
Costs and earnings in excess of/(less than) billings, net	$ (2,331,092)	$ 791,258
Costs in excess of billings on contracts in progress	$ 1,892,141	$ 1,951,226
Billings in excess of costs on contracts in progress	(4,223,233)	(1,159,968)
Costs and earnings in excess of/(less than) billings, net	$ (2,331,092)	$ 791,258

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6. ACCRUED EXPENSES

Accrued expenses consist of the following:

	September 30, 2006	December 31, 2005
Accrued warranty	$ 414,169	$ 417,694
Accrued purchases	362,240	497,451
Other accruals	587,922	709,626
	$ 1,364,331	$ 1,624,771

7. LOSS PER SHARE

Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average common shares outstanding. Diluted EPS is calculated by adjusting weighted average common shares outstanding by assuming conversion of all potentially dilutive shares. In periods where a net loss is recorded, no effect is given to potentially dilutive securities since the effect would be antidilutive. Accordingly, no effect has been given to the assumed exercise of 2,117,943 and 3,044,950 common stock options outstanding for the nine months ended September 30, 2006 and 2005, respectively, nor the assumed exercise of 528,284 and 1,044,196 common stock warrants outstanding for the nine months ended September 30, 2006 and 2005, respectively, since the effect would be antidilutive for the reporting periods.

8. STOCK-BASED COMPENSATION

Stock Option Plans

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

A summary of stock option activity for the nine months ended September 30, 2006 under the Plans is as follows:

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term
Outstanding at December 31, 2005 (3,264,031 exercisable)	4,558,854	$ 5.60		
Granted	1,191,044	8.49		
Exercised	(266,840)	1.08		
Forfeited	(92,569)	5.26		
Expired	(34,101)	7.18		

Outstanding at September 30, 2006	5,356,388	$ 6.46	$ 2,681,189	6.54
Options Vested and Expected to Vest	5,161,014	$ 6.45	$ 2,631,024	6.45
Options Exercisable	3,616,202	$ 6.69	$ 2,068,556	5.55

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The total intrinsic value (the amount by which the stock price exceeds the exercise price of the option on the date of exercise) of the stock options exercised during the three months ended September 30, 2006 and 2005 was $0.05 million and $1.87 million, respectively and for the nine months ended September 30, 2006 and 2005 was $1.88 million and $2.67 million, respectively. The weighted average grant date fair value of the stock options granted during the nine months ended September 30, 2006 and 2005 was $5.95 and $2.36, respectively.

The following table summarizes additional information about stock options outstanding at September 30, 2006:

Range of Exercise Prices		Number Outstanding as of September 30, 2006	Weighted Average Remaining Contractual Term in Years	Weighted Average Exercise Price	Number Exercisable as of September 30, 2006
$ 0.05	$ 0.37	768,602	4.38	$ 0.29	648,426
0.50	2.63	609,869	7.95	2.29	206,502
2.65	2.99	634,288	7.12	2.87	490,301
3.00	4.41	587,334	7.93	3.48	472,596
4.42	7.38	669,244	5.72	6.45	577,746
7.50	8.84	757,594	8.73	8.64	229,424
8.90	10.75	630,457	6.95	10.34	292,207
11.10	16.88	43,500	4.39	13.62	43,500
17.00	17.00	655,000	4.00	17.00	655,000
24.13	24.13	500	4.04	24.13	500
$ 0.05	$ 24.13	5,356,388	6.54	$ 6.46	3,616,202

2000 and 2003 Employee Stock Purchase Plan

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

The Company measures the fair value of issuances under the employee stock purchase plan using the Black-Scholes option pricing model at the end of each reporting period. The compensation cost for the Plan consists of the discount (15% of the grant date stock price) and the fair value of the option features. For the nine months ended September 30, 2006, the Company issued 50,575 shares associated with the Plan and recorded compensation cost of $71,552. As of September 30, 2006, 300,207 shares remained available for future issuance under the 2003 ESPP Plan.

Stock-Based Compensation

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

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For the three and nine month periods ended September 30, 2006, the adoption of SFAS 123(R) had the following effect on reported amounts that would have been reported using the intrinsic value method under APB No. 25:

	Three Months Ended September 30, 2006		
	Using APB No. 25 Accounting	SFAS 123(R) Adjustments	As Reported
Loss from operations	$ (5,826,191)	$ (722,398)	$ (6,548,589)
Loss before income taxes	(5,592,856)	(722,398)	$ (6,315,254)
Net loss	(5,592,856)	(722,398)	$ (6,315,254)
Basic and diluted net loss per share	(0.14)	(0.02)	(0.16)

	Nine Months Ended September 30, 2006		
	Using APB No. 25 Accounting	SFAS 123(R) Adjustments	As Reported
Loss from operations	$ (17,856,961)	$ (3,131,202)	$ (20,988,163)
Loss before income taxes	(17,065,314)	(3,131,202)	$ (20,196,516)
Net loss	(17,065,314)	(3,131,202)	$ (20,196,516)
Basic and diluted net loss per share	(0.45)	(0.08)	(0.53)

Total non-cash stock compensation, including the impact of SFAS 123(R) for the three and nine-month periods ended September 30, 2006 was $1,020,000 and $4,442,000, respectively. This amount was recognized as follows:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Selling, General and Administrative	$ 878,000	$ 4,074,000
Research and Development	55,000	159,000
Cost of revenue	87,000	209,000
Total non-cash stock compensation	$ 1,020,000	$ 4,442,000

As of September 30, 2006, total unamortized stock-based compensation cost, net of estimated forfeitures, related to non-vested stock options was $4.6 million, which is expected to be recognized over the remaining weighted average vesting period of 35 months. Compensation costs for all stock-based awards granted on or prior to December 31, 2005 and all stock-based awards granted subsequent to December 31, 2005 will be recognized using the ratable single-option method.

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

	Nine Months Ended September 30,	
	2006	2005
Risk free interest rate	4.67% - 5.07%	3.72%
Expected dividend yield	None	None
Expected term of option	5.75 - 6 years	5 years
Expected volatility	76% - 78%	91%

Beginning January 1, 2006, the Company estimated the volatility of its stock using historical volatility in accordance with guidance in SFAS 123(R) and SAB 107. Management determined that historical volatility is most reflective of market conditions and the best indicator of expected

volatility. In calculating its volatility the

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Company excluded the period from the IPO on September 29, 2000 to June 30, 2001 due to significant fluctuations in its stock price. The Company will continue to monitor these and other relevant factors used to measure expected volatility for future option grants. Prior to the adoption of SFAS 123(R), the Company had used historical stock price volatility in accordance with SFAS 123 for purposes of pro forma information disclosed in the Notes to Consolidated Financial Statements for prior periods.

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

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

As stock-based compensation expense recognized in our results for the three and nine-month periods ended September 30, 2006, is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our

historical experience. Prior to 2006, the Company accounted for forfeitures as they occurred for the purposes of its pro forma information under SFAS 123, as disclosed in Notes to Consolidated Financial Statements for the related periods.

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 $.01 per share. The fair market value of these shares at the date of grant was $8.84 and the shares vest one year from the date of grant. In addition, the Company granted Mr. Schwallie 28,280 shares of restricted common stock at a price of $.01 per share. The fair market value of these shares at the date of grant was $8.84 and vest immediately. The total compensation cost reflected in selling, general and administrative expenses associated with these two grants is approximately $221,000 for the three months ended September 30, 2006 and $912,000 for the nine months ended September 30, 2006.

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

Other Stock-Based Compensation

In connection with the grant of certain stock options to Northern optionholders as part of the merger consideration on December 10, 2003 (the merger options), the Company recorded unearned stock compensation representing the difference between the deemed fair market value of the common stock on the date of grant and the exercise price. Compensation related to merger options that vest over time was recorded as unearned compensation, a component of stockholders equity, and was being amortized over the vesting periods

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of the related merger options. Beginning January 1, 2006, the Company fair valued these options using the same assumptions as those previously described. During the three-month periods ended September 30, 2006 and 2005 the Company recorded non-cash compensation expense relating to these merger options totaling $66,486 and $104,253, respectively and $230,618 and $369,134 for the nine months ended September 30, 2006 and 2005, respectively. Previously, forfeitures associated with these merger options were recorded as incurred, however, FAS123(R) requires that an estimated forfeiture rate be applied to outstanding awards. As a result, in the first quarter of 2006, the Company reversed approximately $35,000 of previously recognized compensation cost associated with these estimated forfeitures which is reflected in selling, general, and administrative expenses. This amount was reduced by $1,249 for the nine months ended September 30, 2006 for actual forfeitures. The Company s deferred stock compensation balance of $453,980 as of December 31, 2005 was reclassified into additional paid-in capital upon the adoption of SFAS 123(R).

During the three-month periods ended September 30, 2006 and 2005 the Company granted non-qualified stock options with a ten-year term to non-employees to purchase 3,000 shares and 10,500 shares, respectively, of common stock. The Company recognized compensation expense during the three-month periods ended September 30, 2006 and 2005 based on the fair value of these options of $10,155 and $48,750, respectively. For the nine months ended September 30, 2006 and 2005 the Company granted non-qualified stock options with a ten-year term, to non-employees to purchase 29,794 and 20,500 of common stock, respectively. The Company recognized compensation expense based on the fair value of these options of $166,933 and $76,130, respectively.

9. ACQUISITION

On April 3, 2006, Northern acquired the operations and maintenance business of Crown Engineering and Construction, Inc. (or Crown) for $1,175,000 in cash and 105,000 shares of the Company s common stock. The fair market value of the common stock was $702,450. Transaction costs incurred as a result of this acquisition were not material and were expensed as incurred.

The purchase price was allocated to the estimated fair value of the Crown net assets acquired. The following table sets forth the calculation of the purchase price.

Fair value of common stock	$ 702,450
Cash	1,175,000
	$ 1,877,450

Under the purchase method of accounting, the total purchase price was allocated to Crown s net tangible and intangible assets based on their fair value as of April 3, 2006, as adjusted for negative goodwill.

The purchase price allocation is as follows:

Tangible assets acquired:	
Vehicles	$ 61,000
Other assets	43,545
Tangible assets acquired	104,545
Amortizable intangible assets acquired:	
Service contracts	1,458,155
Non-compete agreement	314,750
Amortizable intangible assets acquired	1,772,905
Total assets acquired	$ 1,877,450

The amortizable intangible assets consisting of service contracts and non-compete agreement have useful lives not exceeding eight years. The weighted average useful life of the amortizable assets acquired was approximately 81 months at April 3, 2006.

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The intangible assets acquired were valued using the Income Approach Discounted Cash Flow Method and consist of the following:

Service Contracts: Northern acquired the right, title and interest in eight operation and maintenance contracts from Crown. The remaining contract lives range from one to ten years with an average of five years remaining. An 18% discount rate was utilized based on Northern s estimated weighted average cost of capital.

Non-compete Agreement: In connection with the acquisition, Crown agreed that it will not directly or indirectly compete with Northern or Distributed Energy for engineering, procurement and construction of natural gas engine or turbine driven cogeneration projects under 10 megawatts in the State of California for a period of three years. The fair value of the agreement was determined using the Lost Profits method. An 18% discount rate was used based on Northern Power s estimated weighted average cost of capital.

The fair value of the assets acquired from Crown exceed the cost of the acquisition by $568,126. This excess amount was allocated as a pro rata reduction of the values assigned to the intangible assets acquired. The result of the allocation of the excess is as follows:

	Fair Values	Allocation of Excess	Final Asset Value
Service Contracts	$ 1,925,420	$ (467,265)	$ 1,458,155
Non Compete	415,611	(100,861)	314,750
	$ 2,341,031	$ (568,126)	$ 1,772,905

Intangible assets related to Crown recorded on the balance sheet of Northern Power, the reportable segment to whom all intangibles of the Company are assigned as of September 30, 2006, are comprised of the following:

	Gross Amount	Accumulated Amortization
Service Contracts	$ 1,458,155	$ (94,074)
Non Compete	314,750	(52,458)
	$ 1,772,905	$ (146,532)

10. DEBT

On September 18, 2006, Technology Drive LLC, a subsidiary of Proton Energy Systems, Inc., which is a subsidiary of Distributed Energy Systems Corp., entered into an Amendment to Construction Loan Agreement and a Pledge Agreement, each effective as of September 11, 2006, with Webster Bank, National Association. These amendments relate to a loan to Technology Drive from the bank made December 7, 2001 in the original principal amount of $6,975,000. As of September 30, 2006, the outstanding principal balance of the loan is $5,437,882. The effect of the amendments is 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 provides 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 September 30, 2006, the Company has classified $395,850 as short-term restricted cash and $5,042,032 as long-term restricted cash as a result of this amendment.

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11. STOCKHOLDER S EQUITY

Changes in stockholder s equity for the nine months ended were as follows (in thousands):

Balance at December 31, 2005	$ 85,056
Net loss	(20,197)
Issuance of common stock from exercise of stock options and warrants	592
Issuance of common stock from ESPP program exercises	198
Issuance of common stock through equity distribution program, net of expenses	7,162
Stock based compensation	4,442
Issuance of common stock for Crown acquisition	702
Change in unrealized gain on marketable securities	37
Sale of common stock	502
Balance at September 30, 2006	$ 78,494

On April 10, 2006, the Company entered into an equity distribution agreement with UBS Securities LLC. The equity distribution agreement provides that the Company may offer and sell up to 3,000,000 shares of the Company s common stock from time to time through UBS Securities LLC, as sales agent or principal. The compensation to UBS Securities LLC for acting as sales agent was 4% of the first $15 million of gross sales price of the shares sold, and 3% of the gross sales price of the shares in excess of $15 million. From April 12, 2006 to May 5, 2006, the Company sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in net proceeds to the Company of $7,485,648. On May 17, 2006, the Company completed sales under the equity distribution agreement.

12. COMMITMENTS AND CONTINGENCIES

Contracts

In 2001, Proton entered into an agreement with the Connecticut Clean Energy Fund (CCEF). The agreement provides Proton with financial assistance for up to $1.5 million, $600,000 under Phase I and $900,000 under Phase II of the agreement, to accelerate commercial deployment of the UNIGEN backup power unit. Proton is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach $25 million annually. Prior to the achievement of milestones described in this agreement, these funds were subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling interest in Proton by a third party, the sale of substantially all of Proton s assets, the consolidation or merger of Proton with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, Proton records funds received as liabilities until it achieves the contract milestones, at which time such amounts are recognized as reductions in related costs and expenses.

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

	CCEF Advance Balance
December 31, 2002	$
Advances	900,000
Milestone achieved	(675,000)
December 31, 2003	$ 225,000
Advances	283,012
Milestone achieved	(225,000)
December 31, 2004	$ 283,012
Advances	917,167
Milestone achieved	(933,300)
December 31, 2005	$ 266,879
Advances	276,370
Milestone achieved	(543,249)
September 30, 2006	$

Warranty

The changes in the carrying amount of warranties for the nine months ended September 30, 2006 and 2005 are as follows:

	2006	2005
Balance as of December 31:	$ 417,693	$ 273,027
Warranties issued in period	649,129	497,139
Adjustments to provision	76,521	1,263
Warranty claims	(729,174)	(149,291)
Balance as of September 30:	$ 414,169	$ 622,138

Sales and Use Tax Relief Program Recapture

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

Authority). The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. The recapture clauses for relocation and early disposition/abandonment expire October 15, 2010; whereby the Company could be required to pay back a portion of the sales tax relief received. The employment threshold clause is subject to review by the Authority in the quarter ended December 31, 2006. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under

the Agreement shall not exceed $419,250 (the maximum sales and use tax benefit possible under the terms of the Agreement, plus a 7.5% penalty). Proton was required under the Agreement to place $419,250 in escrow related to these recapture clauses. This $419,250 is included within restricted cash as part of long-term assets. The Company does not anticipate meeting the employment threshold recapture clause by the compliance

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date of December 31, 2006 and as such accrued $143,000 during the fourth quarter of 2005 for possible tax repayments and penalties. At this time all the other conditions that would require payment are remote and the Company has not accrued any additional liability.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, tax accruals of approximately $267,000 and $402,000 for certain state income and sales tax contingencies for which there may be exposure at September 30, 2006 and December 31, 2005, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual is subject to change and the actual amount could be greater or less than the accrued amount.

Legal Proceedings

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

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

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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 quarters ended September 30, 2006 and 2005, (all amounts in 000s) is summarized below.

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Revenues:				
Proton	$ 6,596	$ 3,460	$ 11,025	$ 6,362
Northern	8,159	8,817	20,780	27,618
Consolidated	$ 14,755	$ 12,277	$ 31,805	$ 33,980

Included within Northern s revenues for the quarters ended September 30, 2006 and 2005 are sales to one international customer totaling approximately 9.3% and 7% of consolidated revenues. The Company believes it has no risk of foreign dependence.

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Loss from operations:				
Proton	$ (1,647)	$ (1,637)	$ (5,849)	$ (6,250)
Northern	(3,197)	(1,275)	(8,599)	(4,175)
Eliminations and other	(1,704)	(805)	(6,540)	(2,779)
Consolidated	$ (6,548)	$ (3,717)	$ (20,988)	$ (13,204)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net loss:				
Proton	$ (1,644)	$ (1,720)	$ (5,826)	$ (6,524)
Northern	(3,256)	(1,329)	(8,735)	(4,260)
Eliminations and other	(1,416)	(538)	(5,636)	(2,017)
Consolidated	$ (6,316)	$ (3,587)	$ (20,197)	$ (12,801)

	September 30, 2006	December 31, 2005
Total assets:		
Proton	$ 74,123	$ 85,198
Northern	55,922	47,018
Eliminations and other	(27,490)	(21,070)

Consolidated	$ 102,555	$ 111,146

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

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

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto appearing elsewhere in this Form 10-Q and with our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2005. This Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar word statements that contain these words carefully because they discuss our future expectations and contain projections of our future results of operation or of our financial position or state other forward-looking information. However, there may be events in the future that we are unable to predict accurately or control. The factors in the section captioned Critical Accounting Policies contained in our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2005, and below in this Form 10-Q under the Risk Factors and Legal Proceedings captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

OVERVIEW

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

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

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

CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared by us in accordance with accounting principles

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

Our critical accounting policies include the following:

Revenue Recognition Product Revenue

All of our product revenue is derived from the operations of our Proton segment. For product sales for which adequate product warranty information exists, we record revenue when a firm sales agreement is in place, 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, the Company determined it had adequate warranty history on its HOGEN H-series generators to recognize revenue and establish an accurate warranty accrual upon shipment. Prior to the third quarter 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment.

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

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

Revenue Recognition Contract and Service Revenue

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines at our Northern Power segment. For projects with a duration of greater than three months where we have the ability to reasonably estimate total project costs to complete the contract, we recognize revenue utilizing the percentage-of-completion method as prescribed by SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1), based on the relationship of costs incurred to total estimated contract costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be judgmental. For the nine months ended September 30, 2006 and 2005 approximately 61% and 82%, respectively, of our contract revenue was recognized under the percentage-of-completion method.

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

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our gross margin percentage for contract revenue may be affected by these changes in estimates and has fluctuated from 3% to 9% for the nine months ended September 30, 2006 and 2005, respectively.

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 September 30, 2006 would have affected our pre-tax loss by approximately $41,000 for the nine months ended September 30, 2006.

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

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gains in excess of our established reserve, and those gains and losses could be material. A 10% change in our inventory reserve as of September 30, 2006 would have affected our pre-tax loss by approximately $59,000 for the nine months ended September 30, 2006.

Goodwill and Intangible Assets

We have adopted the provisions of SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets, applicable to business combinations completed after June 30, 2001. Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations. The only identifiable intangible asset, other than goodwill, included in our balance sheet is an indefinite-lived tradename related to our Northern Power acquisition.

We review goodwill and the Northern Power tradename for potential impairment annually and when events or changes in circumstances indicate the carrying value of the goodwill or the Northern Power tradename might exceed their current fair value. To assist in the process of reviewing goodwill and the Northern Power tradename for impairment, we obtain appraisals from an independent valuation firm. The appraisal requires us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies. It is our policy to conduct impairment testing based on our current business strategy in light of present industry and economic conditions, as well as future expectations.

In the fourth quarter of fiscal year 2005, we completed our annual impairment testing of goodwill and the Northern Power tradename using this methodology, and determined there was no impairment. On a quarterly basis, we review a number of factors around our business to assess whether there are any events or changes in circumstances that would more likely than not reduce the fair value of the Northern reporting unit below its carrying value (interim triggering events), and thus warrant an interim impairment test of goodwill. The factors we consider include whether there is significant underperformance relative to historical or projected future operating results, significant negative industry trends or changes in business climate, adverse changes in our regulatory environment, unanticipated competition or significant changes in the manner in which we use the acquired assets. While the current year results of Northern for the nine months ended September 30, 2006 have been below the forecast used in our 2005 annual impairment test, we do not believe this represents a significant underperformance relative to historical or projected operating results, or a change in circumstances that warrants an interim impairment test of goodwill. The Northern segment has a strong backlog and its revenues have improved in each of the last three successive quarters. We do not believe there are any significant industry, market, or regulatory barriers that would prevent the Company from achieving its long term operating plan. However if actual results were to continue being less than our projected future operating results, or if we ever were to discontinue the use of the Northern Power trade name, it is possible that we would need to record an impairment charge relating to goodwill or the trade name. Actual results at Northern may be less than our projected future operating results if we enter into fewer contracts than anticipated, if completion of our current contracts takes longer than anticipated, or if we incur higher costs than we are currently forecasting. The carrying value of goodwill as of September 30, 2006 and December 31, 2005 was $24,755,962. The carrying value of the Northern Power tradename as of September 30, 2006 and December 31, 2005 was $1,450,000.

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

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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.

Stock-Based Compensation

Stock-Based Compensation Employee Stock-Based Awards

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the ESPP based on estimated fair values. SFAS 123(R) supersedes our previous accounting under APB 25, Accounting for Stock Issued to Employees 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 and nine month periods ended September 30, 2006, reflect the impact of SFAS 123(R). Non-cash stock compensation expense for the three months ended September 30, 2006, was $995,024, and for the nine months ended September 30, 2006 was $4,370,411, which consisted primarily of stock-based compensation expense related to employee stock options recognized under SFAS 123(R). In addition, stock-based compensation expense for the three and nine-month periods ended September 30, 2006 of $24,765 and $71,552, respectively was recognized related to our ESPP.

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

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

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

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awards, including the option s expected term and the price volatility of the underlying stock. The Company has determined that historical volatility is most reflective of the market conditions and the best indicator of expected volatility.

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

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

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

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

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

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 Consolidated Financial Statements on Stock-Based Compensation.

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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

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. We are currently evaluating the potential impact of this statement.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the first annual period ending after November 15, 2006. We are currently evaluating the impact of adopting SAB 108.

Results of Operations

Comparison of the Three Months Ended September 30, 2006 and September 30, 2005

Revenues:

	Quarter Ended			
Net revenues	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Contract	$ 7,407,614	$ 7,956,580	$ (548,966)	-7%
Product	5,644,028	2,753,810	2,890,218	105%
Service	1,703,661	1,566,226	137,435	9%
Total	$ 14,755,303	$ 12,276,616	$ 2,478,687	20%

Northern s on-site revenues declined approximately $2.4 million in the third quarter of 2006 compared to the comparable 2005 quarter due to the timing and size of the contracts for which revenue was recognized in each period. Northern s industrial infrastructure revenues increased approximately $1.2 million in the third quarter of 2006 from the 2005 quarter due to several projects in the full construction stage in 2006 compared to primarily end stage projects in 2005. Additionally, revenue associated with Northern s power distributor products increased approximately $0.7 million from the comparable 2005 quarter.

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In the third quarter of 2006, the Company determined it had adequate warranty history on its HOGEN H-series generators to recognize revenue and establish an accurate warranty accrual upon shipment. Prior to the third quarter 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, in the third quarter of 2006 product revenue includes approximately $4.5 million of previously deferred H-series revenue, and $0.7 million of H-series revenue recognized upon shipment in the third quarter of 2006. This represents an increase of $4.8 million over the $0.4 million H-series revenue recognized in the third quarter of 2005.

In the third quarter 2006 the Company recognized $0.4 million of revenue associated with its HOGEN S-series generators upon shipment. In the third quarter 2005, the Company determined it had adequate warranty history on its HOGEN S-series generators to recognize revenue shipment. Prior to the third quarter 2005, revenue on such S-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, the third quarter 2005 revenue includes approximately $1.8 million of previously deferred S-series revenue that was recognized within the warranty period, and $0.3 million of S-series cost of revenue that was recognized upon shipment in the third quarter 2005. This represents a $1.7 million decrease in HOGEN S-series revenue for the 2006 period.

The increase in service revenue is primarily attributable to Northern s domestic operating and maintenance services and additional service revenues recognized relating to its acquisition of Crown in the second quarter of 2006.

As of September 30, 2006, product backlog had a total value of approximately $1.8 million and contract backlog had a total value of approximately $30.6 million for Northern and $2.5 million for Proton.

Costs of revenue:

	Quarter Ended			
Cost of revenues	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Contract	$ 7,135,277	$ 7,357,906	$ (222,629)	-3%
Product	5,262,627	2,347,208	2,915,419	124%
Service	1,850,167	1,077,292	772,875	72%
Total	$ 14,248,071	$ 10,782,406	$ 3,465,665	32%

Cost of contract revenues as a percentage of contract revenues increased from 92% in the third quarter of 2005 to 96% in the third quarter of 2006. The increase in contract costs as a percentage of contract revenue primarily relates to the mix and timing of contracts in 2006 compared to the 2005 quarter.

In the third quarter 2006, the Company determined it had adequate warranty history on its HOGEN H- series generators to recognize revenue and associated cost of revenue upon shipment. Prior to the third quarter 2006, revenue and cost on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, the third quarter 2006 product cost of revenue includes approximately $4.1 million of previously deferred H-series cost of revenue that was recognized within the warranty period, and $0.6 million of H-series cost of revenue that was recognized upon shipment in the third quarter 2006. This represents a $4.3 million increase over the $0.4 million in H-series cost of revenue that was recognized in the third quarter 2005 upon the expiration of the product warranty.

In the third quarter of 2006 the Company recognized $0.2 million of cost associated with its HOGEN S-series generators upon shipment. In the third quarter 2005, the Company determined it had adequate warranty history on its HOGEN S series generators to recognize revenue and associated cost of revenue upon shipment. Prior to the third quarter 2005, revenue and cost on such S-series units was recognized at the end of the warranty

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period, generally one year from the date of shipment. Accordingly, the third quarter 2005 product cost of revenue includes approximately $1.2 million of previously deferred S-series cost of revenue that was recognized within the warranty period, and $0.1 million of S-series cost of revenue that was recognized upon shipment in the third quarter 2005. This represents a $1.1 million decrease in S-series cost of revenue for the 2006 period. Other decreases in cost relate to fewer laboratory generators shipped in the third quarter of 2006 compared to the comparable 2005 quarter.

Product cost of revenue as a percentage of product revenue increased from 85% for the quarter ended September 30, 2005 to 93% in the comparable 2006 period. This increase in product cost of revenue as a percentage of product revenue is primarily attributable to a shift from higher margin S-series revenue recognized in the third quarter of 2005 to a larger proportion of lower margin H-series revenue recognized in the third quarter of 2006.

Service cost of revenue as a percentage of service revenue increased from 69% in the third quarter of 2005 to 109% in the third quarter of 2006. This increase in cost of service revenue was primarily attributable to a change in Northern s mix of service contracts. In the third quarter of 2005, service revenues were primarily from one-time higher margin international field service time and material contracts. In the third quarter of 2006, revenue is attributed to longer term, multi year domestic operating and maintenance contracts which tend to have lower margins. Additionally, 2006 costs include additional overhead costs associated with the Company s growing service business. We expect these overhead costs as a percentage of revenue to decrease as our service business grows. We do not believe the negative gross margins in the third quarter of 2006 are indicative of loss contracts.

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	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	6	7	(1)
H-series	5	11	(6)
Laboratory generators	13	23	(10)
Total	24	41	(17)

	Quarter Ended		
Revenue deferred on units shipped	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	$	$	$
H-series		1,426,433	(1,426,433)
Laboratory generators			
Total	$	$ 1,426,433	$ (1,426,433)

	Quarter Ended		
Cost deferred on units shipped	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	$	$	$
H-series		1,298,947	(1,298,947)
Laboratory generators			
Total	$	$ 1,298,947	$ (1,298,947)

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

Research and development expenses:

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

	Quarter Ended			
Research and development	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Employee related	$ 414,348	$ 633,267	$ (218,919)	-35%
Project material	276,728	312,255	(35,527)	-11%
Depreciation and amortization	103,399	131,128	(27,729)	-21%
Stock based compensation	54,570		54,570	100%
Other	97,111	145,100	(47,989)	-33%
Total	$ 946,156	$ 1,221,750	$ (275,594)	-23%

Employee related research and development costs and project material costs decreased primarily related to less developmental efforts associated with Proton s hydrogen generators, offset by increases of project material costs at Northern, related to development of its power distributor products.

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	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Employee related	$ 2,861,657	$ 2,150,494	$ 711,163	33%
Marketing and advertising	262,013	235,491	26,522	11%
Depreciation and amortization	387,183	285,041	102,142	36%
Stock based compensation	878,500	104,253	774,247	743%
Legal, consulting and accounting	557,684	249,335	308,349	124%
Other	1,162,628	965,255	197,373	20%
Total	$ 6,109,665	$ 3,989,869	$ 2,119,796	53%

The increase in employee-related expenses is primarily attributable to an increase in the number of employees particularly at Northern Power, travel costs, employee-related selling expenses as well as expenses associated with the addition of our new Chief Executive Officer in January 2006. The increase in depreciation and amortization is primarily due to increased capital expenditures in the fourth quarter of 2005, relating to our Barre, Vermont facility. The increase in legal, consulting and accounting expenses relates to the timing of legal and audit related fees in 2006.

Stock-based compensation: On January 1, 2006, we adopted SFAS 123(R), which requires recognition of compensation expense for all stock-based awards made to employees in our Condensed Consolidated Statements

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

Stock-based compensation cost for the 2005 period was related to non-employee stock options and the amortization of options related to the Northern merger. Also see Note 8 to the Condensed Consolidated Financial Statements on Stock-Based Compensation.

We currently estimate our total stock-based compensation cost to be approximately $0.8 million to $1.2 million in the fourth quarter of 2006.

Interest income: Interest income increased from $239,000 for the three months ended September 30, 2005 to $358,000 for the comparable period in 2006. The increase resulted from higher average interest rates, partially offset by lower cash balances. The average interest rates for the three months ended September 30, 2006 and 2005 were approximately 5.2% and 2.1%, respectively. The average cash and marketable securities balances for the three months ended September 30, 2006 and 2005 were approximately $27.6 million and $44.4 million, respectively.

Interest expense: Interest expense increased from $126,000 for the three months ended September 30, 2005 to $195,000 for the comparable period in 2006. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations and a greater amount of average debt outstanding.

Comparison of the Nine Months Ended September 30, 2006 and September 30, 2005

Revenues:

	Year To Date			
Net revenues	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Contract	$ 17,680,417	$ 26,534,925	$ (8,854,508)	-33%
Product	8,583,934	4,408,928	4,175,006	95%
Service	5,540,519	3,035,986	2,504,533	82%
Total	$ 31,804,870	$ 33,979,839	$ (2,174,969)	-6%

Northern s on-site revenues declined approximately $7.1 million in the first nine months of 2006 compared to the comparable 2005 period due to the timing and size of the contracts for which revenue was recognized in each period. Specifically, in the 2005 period, several projects were in the full construction stage. Northern s industrial infrastructure revenues declined approximately $1.1 million in the first nine months of 2006 compared to 2005 due to the impact of fewer contracts and the recognition of revenue in 2005 associated with one large contract accounted for under the completed contract method of accounting. Additionally, revenue associated with wind contracts decreased approximately $1.7 million from the comparable 2005 period, offset by increases in power distributor contract sales of $0.8 million.

In the third quarter of 2006, the Company determined it had adequate warranty history on its HOGEN H-series generators to recognize revenue and establish an accurate warranty accrual upon shipment. Prior to the third quarter 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, the 2006 product revenue includes approximately $5.5 million of previously deferred H-series revenue and $0.7 million upon shipment. This represents an increase in H-series revenue of $5.8 million over the $0.4 million H-series revenue recognized upon expiration of the warranty period during the nine months ended September 30, 2005.

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For the nine months ended September 30, 2006 the Company recognized $1.7 million of revenue associated with its HOGEN S-series generators upon shipment. In the third quarter 2005, the Company determined it had adequate warranty history on its HOGEN S-series generators to recognize revenue upon shipment. Prior to the third quarter 2005, revenue on such S-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, for the nine months ended September 30, 2005 the Company recognized $2.7 million of previously deferred S-series revenue and recognized $0.2 million upon shipment. This represents a $1.3 million decrease in HOGEN S-series revenue for the 2006 period. In addition due to the recognition of previously deferred revenue on the laboratory generator product in 2005, the Company recognized approximately $0.5 million more laboratory generator revenue in the first nine months of 2005 compared to 2006.

The increase in service revenue is primarily attributable to Northern s entry into the long-term domestic operating and maintenance contract business in the third quarter of 2005. In addition, revenues for the first nine months of 2006 include operating and maintenance revenues of approximately $1.5 million relating to Northern s acquisition of Crown in the second quarter of 2006.

As of September 30, 2006, product backlog had a total value of approximately $1.8 million and contract backlog had a total value of approximately $30.6 million for Northern and $2.5 million for Proton.

Costs of revenue:

	Year To Date			
Cost of revenues	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Contract	$ 17,125,439	$ 24,051,433	$ (6,925,994)	-29%
Product	8,272,588	4,375,606	3,896,982	89%
Service	5,365,823	2,180,434	3,185,389	146%
Total	$ 30,763,850	$ 30,607,473	$ 156,377	1%

Cost of contract revenues as a percentage of contract revenues increased from 91% in the first nine months of 2005 to 97% in the first nine months of 2006. The decreased contract margins primarily relate to an increase in unabsorbed overhead costs. The increase in unabsorbed overhead costs is a result of less contract activity at Northern in the first nine months of 2006 compared to the first nine months of 2005 and increased hiring in anticipation of increased contract volume.

In the third quarter of 2006, the Company determined it had adequate warranty history on its HOGEN H-series generators to recognize revenue and associated cost of revenue upon shipment. Prior to the third quarter 2006, revenue and cost on such H-series units was recognized at the end of the warranty period, generally one year for the date of shipment. Accordingly, the 2006 product cost of revenue includes approximately $5.2 million of previously deferred H-series cost of revenue and $0.6 million of H-series cost of revenue recognized upon shipment in the third quarter of 2006. This represents a $5.4 million increase in H-series cost of revenue over the $0.4 million H-series cost of revenue recognized upon expiration of the warranty period during the nine months ended September 30, 2005.

For the nine months ended September 30, 2006 the Company recognized $1.0 million of cost of revenue associated with its HOGEN S-series generators upon shipment. In the third quarter 2005, the Company determined it had adequate warranty history on its HOGEN S-series generators to recognize revenue and associated cost of revenue upon shipment. Prior to the third quarter 2005, revenue and cost on such S- series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, the 2005 product cost of revenue includes approximately $1.8 million of previously deferred S-series cost of revenue and $0.2 million of S-series cost of revenue that was recognized upon shipment in the third quarter 2005. This

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represents a $1.0 million decrease in HOGEN S-series cost of revenue for the 2006 period. In addition due to the recognition of previously deferred cost of revenue on the laboratory generator product in 2005, the Company recognized approximately $0.5 million more laboratory generator cost of revenue in the first nine months of 2005 compared to 2006.

Product cost of revenue as a percentage of product revenue decreased from 99% in the first nine months of 2005 to 96% in the first nine months of 2006. This decrease in product cost of revenue as a percentage of product revenue is primarily attributable to the increased sales volume of Proton s higher margin HOGEN S-series hydrogen generators offset by reduced lower of cost or market charges associated with our HOGEN H-series hydrogen generators in 2006 as compared to the 2005 period.

Service cost as a percentage of service revenue increased from 72% for the first nine months of 2005 to 97% for the first nine months of 2006. This increase in cost of service revenue was primarily attributable to a change in Northern s mix of service contracts. In 2005 service revenues were primarily from one-time higher margin international field service time and material contracts. In the first nine months of 2006 the lower margin reflects a greater proportion of lower margin long-term domestic operating and maintenance contracts. While these operating and maintenance contracts have lower margins, they provide a base recurring revenue stream and opportunities for additional higher margin project work. Additionally, service cost of sales in 2006 includes additional overhead costs associated with the Company s growing service business. We expect these overhead costs as a percentage of revenue to decrease as our service business grows.

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	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	32	19	13
H-series	14	19	(5)
Laboratory generators	47	58	(11)
Total	93	96	(3)

	Year To Date		
Revenue deferred on units shipped	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	$	$	$
H-series		2,380,703	(2,380,703)
Laboratory generators			
Total	$	$ 2,380,703	$ (2,380,703)

	Year To Date		
Cost deferred on units shipped	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**
S-series	$	$	$
H-series		2,233,522	(2,233,522)
Laboratory generators			
Total	$	$ 2,233,522	$ (2,233,522)

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. During 2005, we

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

Research and development expenses:

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

	Year To Date			
Research and development	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Employee related	$ 1,763,402	$ 2,069,956	$ (306,554)	-15%
Project material	830,085	837,872	(7,787)	-1%
Depreciation and amortization	348,652	605,054	(256,402)	-42%
Stock based compensation	158,800		158,800	100%
Other	(281,418)	286,946	(568,364)	-198%
Total	$ 2,819,521	$ 3,799,828	$ (980,307)	-26%

Employee related research and development costs and project material costs decreased primarily related to less developmental efforts associated with Proton s H-series product. Material decreases are primarily the result of Proton s decreasing H-series product development costs offset by increases of project material costs at Northern, related to development of its power distributor products. Research and development related depreciation and amortization decreased due to certain capitalized project costs achieving their estimated useful lives in 2005. Other costs decreased primarily due to the recognition of $0.5 million of credits in the first quarter of 2006, as a result of achieving certain specified milestones on Proton s Connecticut Clean Energy Fund programs. No credits related to these programs were recognized in the first half of 2005.

Selling, general and administrative expenses:

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

	Year To Date			
Selling, general and administrative	**September 30, 2006**	**September 30, 2005**	**Increase (decrease)**	
Employee related	$ 8,568,878	$ 7,015,001	$ 1,553,877	22%
Marketing and advertising	763,882	682,739	81,143	12%
Depreciation and amortization	1,104,185	814,872	289,313	36%
Stock based compensation	4,074,315	396,515	3,677,800	928%
Legal, consulting and accounting	1,151,845	1,040,886	110,959	11%
Other	3,546,557	2,826,451	720,106	25%
Total	$ 19,209,662	$ 12,776,464	$ 6,433,198	50%

The increase in employee-related expenses is primarily attributable to an increase in the number of employees particularly at Northern Power, employee-related selling expenses, travel, and expenses associated with the addition of our new CEO in January 2006. The increase in depreciation and amortization is primarily due to increased capital expenditures in the fourth quarter of 2005 related to our Barre, Vermont facility. Legal, consulting and accounting costs increased primarily related to the timing of legal and audit related fees in 2006. The increase in other costs relates primarily to increases in recruiting expenses, facility repairs and maintenance, and non-capitalizable software implementation costs.

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

We currently estimate our total stock-based compensation cost to be approximately $0.8 million to $1.2 million in the fourth quarter of 2006.

Interest income: Interest income increased from $750,000 for the nine months ended September 30, 2005 to $1,102,000 for the comparable period in 2006. The increase resulted from higher average interest rates, offset by lower average cash and marketable securities balances. The average interest rates for the nine months ended September 30, 2006 and 2005 were approximately 4.5% and 2.0%, respectively. The average cash and marketable securities balances for the nine months ended September 30, 2006 and 2005 were approximately $33.0 million and $49.0 million, respectively.

Interest expense: Interest expense increased from $316,000 for the nine months ended September 30, 2005 to $534,000 for the comparable period in 2006. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations and a greater amount of average debt outstanding.

LIQUIDITY AND CAPITAL RESOURCES

Since inception in August 1996 through March 2006, we and our predecessor, Proton, have financed our operations through convertible preferred stock issuances, an initial public offering, and an equity distribution agreement that, in total, raised approximately $195.2 million. As of September 30, 2006, we had $20.9 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was $19.3 million for the nine months ended September 30, 2006 and was primarily attributable to our net loss, increases in accounts receivable and decreases in deferred revenue and contract advances, partially offset by non-cash depreciation, amortization and stock compensation expense, and an increase in billings in excess of costs. Cash used in operating activities was $15.7 million in the nine months ended September 30, 2005 primarily attributable to our net loss, increases in accounts receivable, contract costs not yet billed and decreases in billings in excess of costs.

Cash used in investing activities was $8.1 million for the nine months ended September 30, 2006 and was primarily attributable to the reservation of restricted cash as a result of our amended Webster Bank agreement, the acquisition of the operations and maintenance business of Crown, and the purchase of fixed assets, partially offset by net proceeds from the maturity of marketable securities. The amended Webster Bank agreement helped us lower our interest cost and eliminated the requirement to maintain a $20 million cash balance. Cash provided by investing activities was $17.8 million for the nine months ended September 30, 2005 and was primarily attributable to net proceeds from the maturity and sale of marketable securities, partially offset by purchases fixed assets.

Cash provided by financing activities was $8.5 million for the nine months ended September 30, 2006 and was primarily attributable to proceeds received in conjunction with the sale of stock, partially offset by payments under Proton s and Northern s debt agreements. The Company sold an aggregate of 1,171,297 shares under an 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

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options and exercised common stock warrants. Cash provided by financing activities was $320,000 for the nine months ended September 30, 2005 and was primarily attributable to proceeds received in conjunction with the employee stock purchase plan, exercised incentive stock options, and exercised common stock warrants offset by payments under Proton s and Northern s debt agreements. We expect payments under our debt agreements to be approximately $0.8 million over the next 12 months.

As described above, our cash balances have decreased significantly from December 31, 2005. We anticipate that our cash and marketable securities on hand as of September 30, 2006 will be adequate to fund our operations, working capital, capital expenditure, and debt service requirements for at least the next 12 months. Over the next 12 months we expect our cash used in operating activities to decrease as a result of (i) our expected increase in Northern Power s contract and service business which will result in improved margins and decreased net losses, and (ii) our expected increase in the sales of Proton s hydrogen generator product line, reduction in its cost of products sold, and increase in its government contract business. If the Company is unable to achieve its revenue, cost, and cash flow targets within a reasonable range of its operating plan, the Company will need to raise additional funds through the public or private sale of its equity or debt securities or from other sources to fund operations. We cannot ensure that if we do require additional financing, that any further financing will be available to us on acceptable terms, or at all. If sufficient funds are not available we may be required to delay, reduce or eliminate some of our research and development, manufacturing, or contract programs. The terms of any additional financing may require us to relinquish rights to our technologies or potential products or other assets.

On September 18, 2006, Technology Drive LLC, a subsidiary of Proton Energy Systems, Inc., which is a subsidiary of Distributed Energy Systems Corp., entered into an Amendment to Construction Loan Agreement and a Pledge Agreement, each effective as of September 11, 2006, with Webster Bank, National Association. These amendments relate to a loan to Technology Drive from the bank made December 7, 2001 in the original principal amount of $6,975,000. As of September 30, 2006, the outstanding principal balance of the loan is $5,437,882. The effect of the amendments is 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 provides 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 September 30, 2006, the Company has classified $395,850 as short-term restricted cash and $5,042,032 as long-term restricted cash as a result of this amendment.

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

We invest in marketable securities consisting of U.S. government and agency securities that are held by one major banking institution. Distributed Energy s marketable securities portfolio of approximately $19.3 million includes one callable agency security with a fair market value totaling approximately $4.5 million. This security generates a higher relative rate of interest for Distributed Energy; in return, the embedded call option gives the issuer the right to buy back the security. Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

The following table provides information about Distributed Energy s financial instruments, stated at the fair value as of September 30, that are sensitive to changes in interest rates:

	2006	Total
Investments		
Fixed rate investments	$ 19,299,819	$ 19,299,819
Average interest rate	3.44%	

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

At September 30, 2006, we had $5.4 million outstanding under our seven-year term note that is subject to a variable interest rate. The note bears interest at one month LIBOR plus 2.00%, which was 7.32% per annum at September 30, 2006. At September 30, 2006, 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 4.25% per annum at September 30, 2006, with a maturity date of October 6, 2015. If our variable interest rate were to increase or decrease by 10%, we do not believe such a change would have a material impact on our financial position or results of operations.

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

(a) Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of the Company s principal executive officer and principal financial and accounting officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of September 30, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial 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 September 30, 2006, the Company s principal executive officer and principal financial and accounting officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes in Internal Control over Financial Reporting

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II.

OTHER INFORMATION

ITEM 1. ***Legal Proceedings***

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton s IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed

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separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

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

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

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

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

- the status of development of our technology, products and manufacturing capabilities;
- the cost and availability of raw materials and key components;
- warranty and service cost for products in the field;
- the introduction, timing and market acceptance of new products introduced by us or our competitors;
- the development of strategic relationships and distribution channels;

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

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

government regulation.

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

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

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of September 30, 2006, we had an accumulated deficit of $156.1 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing facilities and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators. Even if we achieve profitability, we may be unable to sustain or increase our profitability in the future.

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

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

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

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

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project or customer for a particular period are not realized in that period, we may be unable to compensate for the shortfall, which could harm our results of operations. In addition, our revenue and results of operations may vary significantly from year to year and from quarter to quarter within a year.

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

Typically, sales of our distributed generation systems are made to customers under single contracts to provide highly specialized on-site power systems designed and built to meet customer specifications. For the third quarter of 2006, our largest five customers accounted for 40% of our revenues. Because such a high percentage of our sales are concentrated in so few contracts, failure by us or our customers to perform or deliver on any one of these contracts could have a major impact on our annual results of operations. In addition, most of our customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects us to a high degree of customer credit risk and risk of non-performance by our vendors. A single vendor s late delivery of a key component required for a project, for example, could significantly delay our completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in our contracts with our customers.

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

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

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

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

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

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

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

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- the cost and availability of raw materials;
- the failure to increase assembly and test operations;
- the failure to hire and train additional manufacturing personnel; and
- the failure to develop and implement cost-efficient manufacturing processes and equipment.

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

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

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

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

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

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

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

Many of the components in our distributed generation and hydrogen generation systems, including the proton exchange membrane material used in our PEM products, hydrogen purification system and custom-designed power supplies used in our products, are available only from a limited number of suppliers and in some cases only a single supplier. Some of our suppliers are small- and medium-size companies that may not be able to increase production in an acceptable time period or at acceptable prices or quality levels. In addition, to the

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extent these components are proprietary products of our suppliers, or the processes used by our suppliers to manufacture these components are proprietary, we may be unable to obtain licenses on commercially reasonable terms or at all and we may be unable to obtain comparable components from alternative suppliers. Often our suppliers custom engineer components to our specifications for use in our systems. Delayed deliveries, poor quality and warranty issues can delay production of our products or completion of our projects, reduce our profits and damage our relationships with our customers.

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

Market factors affect our costs and availability of materials.

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

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

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

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

Our failure to manage growth could harm our business.

We intend to introduce new products, increase our production capacity and develop additional distributor relationships. If we are successful, a significant strain on our senior management team and other resources may

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result. In addition, we may be required to hire additional senior management personnel. Our ability to manage growth will depend in part on our ability to continue to enhance our operating, financial and management information systems. Our personnel, systems and controls may be unable to support our growth.

We 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 be able to obtain sufficient additional funds to grow our business.

We have regularly needed to raise funds to operate our businesses. It may become necessary to raise additional funds to achieve full commercialization of some or all of our products. Our project-based distributed generation business requires a significant amount of capital in order to increase the number and size of projects we can undertake and therefore increase our revenues. If we are unable to raise additional funds on commercially reasonable terms when needed, our ability to operate and grow our businesses could be impaired. We do not know whether we will be able to secure additional funding or funding on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

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

Our backlog was approximately $35 million as of September 30, 2006. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of September 30, 2006 from which we expect to recognize revenue in fiscal 2006 is likely to be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog. The actual accrual of revenue on engagements included in backlog may never occur or may change because a contract could be reduced, modified or terminated early. If we fail to realize revenue from engagements included in our backlog as of September 30, 2006, our revenue and results of operations for fiscal 2006 as well as future reporting periods may be materially harmed.

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

Our government contracts relate to research and development on renewable energy technologies, hybrid system architectures and advanced power electronics. Changes in government policy toward distributed generation or budget restrictions may reduce or eliminate funding for these types of research and development activities. Generally, our U.S. government research and development contracts are subject to the risk of termination at the convenience of the contracting agency and require us to obtain or produce components for our systems from sources located in the United States rather than foreign countries. There can be no assurance that our current contracts will be fully funded or that we will be able to secure additional government contracts for similar activities in the future. If such funding were discontinued, we may not have sufficient internal funding to continue with these development efforts and may therefore have to reduce our development of these products, delay their development or abandon them altogether. Discontinuation or delay in our development of proprietary

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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
- systems and other infrastructure development that reduces costs.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Since our products are power-producing devices, it is possible that consumers could be injured or killed by our products, whether by product malfunctions, defects, improper installation or other causes. In particular,

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

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

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

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

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

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

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

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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.

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;

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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.

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.

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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 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

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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.

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

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

OTHER RISKS

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

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

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

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

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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.

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 9% of our outstanding common stock at October 31, 2006. The interests of these stockholders may differ substantially from the interests of other stockholders. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of our directors, and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation and mergers or sales of substantially all of our assets. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us or our other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire us at a price per share that is above the then-current market price.

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

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

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

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

stockholders have limited ability to remove directors;

stockholders cannot take actions by written consent;

stockholders cannot call a special meeting of stockholders; and

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

In addition, we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which regulates corporate acquisitions. These provisions could discourage potential acquisition

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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.

ITEM 5. ***Other Information***

As previously reported in a Form 8-K filed on April 6, 2006, we revised our compensation program for non-employee directors effective April 1, 2006. Our board of directors subsequently determined to defer the commencement of this revised program until July 1, 2006.

As part of this revised program, each non-employee director will receive annually restricted common stock of the Company having a value of $40,000. Such shares will vest over a one-year period and be issued on the condition that the director attends at least 75% of scheduled meetings during the year. The director may elect to receive $12,000 of this compensation in cash. In addition, the chairman of the board of directors of the Company will receive quarterly restricted common stock of the Company having a value of $8,000. Such shares will vest at the end of each quarter. The chairman may elect to receive $2,400 of this compensation in cash. The chairmen of the audit, compensation and nominating and corporate governance committees of the board of directors will also receive quarterly restricted common stock of the Company having a value of $4,000, in the case of the audit committee, $3,000 in the case of the compensation committee, and $2,000 in the case of the nominating and corporate governance committee. Such shares will vest at the end of each quarter. Each committee chairman may elect to receive 30% of the value of the restricted stock award in cash.

On October 31, 2006, our board of directors determined that, as a matter of administrative convenience, these annual and quarterly compensation amounts will be paid entirely in cash for 2006. The board also determined that the revised program, as described above, will recommence in its original form beginning in 2007.

In addition, the program provides for the grant of options to purchase 20,000 shares of common stock to each new non-employee director upon his or her appointment to the board of directors. These options will have an exercise price equal to the fair market value of the common stock at the date of grant and vest over a three-year period.

ITEM 6. ***Exhibits***

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

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

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

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

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SIGNATURES

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

Date: November 9, 2006

DISTRIBUTED ENERGY SYSTEMS CORP.

(Registrant)

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

By: /s/ ROBERT B. NIESZCZEZEWSKI
Robert B. Nieszczezewski
Corporate Controller
(Principal Financial and Accounting Officer)