DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-Q
May 12, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2008

OR

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

Commission File Number: 000-50453

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

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

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(203) 678-2000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of May 5, 2008 was 40,050,228.

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DISTRIBUTED ENERGY SYSTEMS CORP.

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Part I - FINANCIAL INFORMATION

ITEM 1.

FINANCIAL STATEMENTS

DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,567,194	$ 5,085,462
Current portion of restricted cash	581,496	866,406
Accounts receivable, less allowances of $1,242,517 and $1,481,644, respectively	5,278,828	6,505,526
Costs in excess of billings on contracts in progress	1,065,166	1,982,783
Inventories, net	5,683,039	5,071,553
Deferred costs	511,392	863,833
Deferred financing costs, net	128,038	138,044
Other current assets	477,360	602,614
Total current assets	17,292,513	21,116,221
Fixed assets, net	18,013,093	18,429,042
Long-term portion of restricted cash	761,908	727,424
Intangible assets, net	1,190,065	1,290,275
Other assets, net	174,754	187,642
Total assets	$ 37,432,333	$ 41,750,604
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 1,440,171	$ 1,457,927
Current portion of capital leases	236,586	234,995
Perseus Senior Secured Convertible Promissory Note, net of debt discount	8,407,364	4,385,253
Accounts payable	3,175,252	3,716,182
Accrued expenses	2,848,033	3,327,268
Accrued compensation	636,707	982,671
Accrued taxes	394,752	414,937
Billings in excess of costs on contracts in progress	404,417	921,485
Deferred revenue	1,630,079	815,997
Customer advances	143,418	210,081
Total current liabilities	19,316,779	16,466,796
Long term liabilities:		
Deferred revenue	8,101	8,101
Long-term portion of capital leases	2,313,741	2,352,306

Total liabilities	21,638,621	18,827,203
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, undesignated, $.01 par value per share; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 250,000,000 shares authorized; 40,050,228 and 39,993,822 shares issued and outstanding, respectively	400,502	399,938
Additional paid-in capital	262,970,320	261,667,232
Accumulated deficit	(247,577,110)	(239,143,769)
Total stockholders equity	15,793,712	22,923,401
Total liabilities and stockholders equity	$ 37,432,333	$ 41,750,604

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

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31, 2008	2007
Revenue		
Contract	$ 2,338,759	$ 6,252,537
Product	2,102,005	646,825
Service	1,659,357	1,524,272
Total revenue	6,100,121	8,423,634
Cost of revenue		
Contract	2,506,933	6,476,474
Product	1,823,964	520,604
Service	1,688,658	1,793,210
Total cost of revenue	6,019,555	8,790,288
Gross margin	80,566	(366,654)
Operating expenses:		
Research and development:		
Depreciation and amortization	66,292	102,489
Other research and development (includes stock based compensation of $11,694 and $24,081, respectively)	924,512	662,846
Restructuring costs		562,375
Selling, general and administrative:		
Depreciation and amortization	337,653	1,576,765
Other selling, general and administrative (includes stock based compensation of $248,645 and $388,868, respectively)	4,112,486	11,497,980
Total operating expenses	5,440,943	14,402,455
Loss from operations	(5,360,377)	(14,769,109)
Interest income	41,972	250,442
Interest expense	(3,710,012)	(175,288)
Other income	595,076	64,515
Net loss	$ (8,433,341)	$ (14,629,440)
Basic and diluted net loss per share	$ (0.21)	$ (0.37)
Shares used in computing basic and diluted net loss per share	39,994,442	39,611,254

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

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2008	2007
Cash flows from operating activities:		
Net loss	$ (8,433,341)	$ (14,629,440)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	549,697	1,873,070
Provision for bad debts	(73,832)	61,049
Accretion of discounts on marketable securities		(45,314)
Amortization of debt discount	3,071,825	
Amortization of financing costs	10,006	
Non-cash stock-based expense	236,762	418,054
Warrants issued to MSW		5,841,471
(Gain)/loss on disposal of assets	(10,843)	21,294
Loss from sale of marketable securities		2,175
Changes in operating assets and liabilities, excluding effect of acquisition:		
Accounts receivable	1,300,530	103,178
Inventories and deferred costs	(259,045)	(488,315)
Costs in excess of billings	917,617	(553,924)
Other current and non-current assets	138,142	267,684
Accounts payable and accrued expenses	(870,388)	(352,685)
Accrued taxes payable	(20,185)	(84,071)
Billings in excess of costs	(517,068)	(732,741)
Deferred revenue and customer advances	747,419	(396,401)
Net cash used in operating activities	(3,212,704)	(8,694,916)
Cash flows from investing activities:		
Purchases of fixed assets	(22,695)	(102,218)
Proceeds from maturities and sales of marketable securities		5,935,077
Restricted cash	250,426	(80,926)
Net cash provided by investing activities	227,731	5,751,933
Cash flows from financing activities:		
Borrowings from long-term debt	1,500,000	
Debt principal payments	(54,730)	(223,004)
Proceeds from sale of common stock, net	21,435	44,657
Proceeds from exercise of stock options		167,164
Net cash provided by (used in) financing activities	1,466,705	(11,183)
Net decrease in cash	(1,518,268)	(2,954,166)
Cash and cash equivalents at beginning of year	5,085,462	4,911,704
Cash and cash equivalents at end of period	$ 3,567,194	$ 1,957,538

The accompanying notes are an integral part of the 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 , we or Distributed Energy) was incorporated in Delaware on May 19, 2003 to create and deliver products and solutions to the new energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy brought 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 wind turbine and fossil-fuel power systems.

Our financial condition has continued to deteriorate significantly since December 31, 2007. We incurred significant operating losses and used cash in our operating activities in the three months ended March 31, 2008. We do not expect that our existing capital resources will be sufficient to operate our business beyond early to mid-June 2008. We have been attempting for several months to secure alternative financing without success to date. We are continuing to seek alternatives that would allow us to continue to operate our business, including obtaining additional debt or equity financing, recapitalizing, reorganizing, and/or selling some or all of our assets. If we are unable to successfully secure additional capital by early to mid-June 2008, we will likely need to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. In that event, the potential for any residual value in our common stock is remote. Perseus has a security interest in all of our assets and those of our material subsidiaries. As a secured creditor, Perseus would have the right to be repaid ahead of our stockholders, as would our unsecured creditors. Perseus has expressly reserved all of its rights as a secured creditor.

In addition, the events of default under our debt agreements with Perseus include any time that our net working capital or our unrestricted cash and cash equivalents fall below specified levels. On May 8, 2008, we and Perseus amended our debt agreements to provide that a default would occur any time (1) our net working capital falls below $2.0 million or (2) our unrestricted cash and cash equivalents fall below $2.0 million, excluding proceeds from any sale of assets outside the ordinary course. After May 16, 2008, unless Perseus agrees to a further amendment to its agreements, these default levels will return to their original levels, such that a default will occur any time (1) our net working capital falls below $3.5 million or (2) our unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Perseus agreements would permit them to accelerate all the amounts we owe them, which as of May 8, 2008 totaled approximately $18.0 million. It is likely that we will fail to meet one of these two tests even before early to mid June 2008. In that case, if Perseus were unwilling to waive the default, we would likely be required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. As of May 8, 2008, our net working capital, as defined in the Perseus agreements, was approximately $3.0 million and our unrestricted cash and cash equivalents were approximately $3.3 million.

Our ability to secure additional capital or debt funding in the very near future on terms acceptable to us, or at all, is uncertain and will be subject to a number of factors, including market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors, together with the short amount of time we have to secure financing, may make the terms and conditions of additional funding unattractive. Any party who might provide us with additional equity or debt capital might condition that financing on our making a bankruptcy filing in conjunction with the financing. 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. If we secure additional debt financing, existing stockholders will be subordinate to the debtholders.

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On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

2. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements of the Company were prepared on a going concern basis, which contemplates the realization of assets and settlement of liabilities in the normal course of business. The circumstances discussed in Note 1 raise substantial doubt about our ability to continue as a going concern. The realization of assets and the settlement of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets, and we might receive significantly less than their carrying amounts as shown in our condensed consolidated financial statements. The accompanying consolidated financial statements do not include any adjustments that may result from the outcome of this uncertainty.

The accompanying condensed consolidated financial statements include the accounts of Distributed Energy and our wholly owned subsidiaries after elimination of significant intercompany transactions. The accompanying condensed consolidated financial statements as of March 31, 2008 and for the three months ended March 31, 2008 and 2007 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. The accompanying condensed consolidated balance sheet as of December 31, 2007 was derived from the audited financial statements for the year ended December 31, 2007.

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 our audited financial statements and notes thereto included in our Annual Report on Form 10-K filed with the SEC on March 17, 2008.

Comprehensive Loss

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

	Three months ended March 31, 2008	2007
Net loss	$ (8,433,341)	$ (14,629,440)
Reclassification adjustments for loss from the sale of marketable securities included in net loss		2,175
Unrealized gain arising during the period		1,585
Total comprehensive loss	$ (8,433,341)	$ (14,625,680)

Loss Per Share

Basic EPS is calculated by dividing net income or net 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 with a net loss, no effect is given to potentially dilutive securities because the effect would be anti-dilutive. Accordingly, no effect has been given to the assumed exercise of 762,314 and 944,871 common stock options outstanding, respectively, nor the assumed exercise of 15,189,629 and 3,868,524 common stock warrants outstanding for the quarters ended March 31, 2008 and 2007, respectively, since the effect would be anti-dilutive for the reporting periods.

Recent Accounting Guidance

There are no new accounting pronouncements that we expect will have a material effect on our consolidated financial statements at this time.

3. DEBT

Long-term debt consists of the following:

	March 31, 2008	December 31, 2007
Perseus Senior Secured Convertible Promissory Note, net of $8,761,296 and $10,804,815 debt discount at March 31, 2008 and December 31, 2007	$ 8,407,364	$ 4,385,253
VEDA Barre, Vermont facility mortgage	601,725	610,256
Waring Investments, Vermont facility mortgage	838,446	847,671
	9,847,535	5,843,180
Less current portion	9,847,535	5,843,180
	$	$

Perseus Senior Secured Convertible Promissory Note

On March 13, 2008, we entered into a First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement, or the Amendment, with Perseus. The Amendment amends the Securities Purchase Agreement and the related Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement agreements executed by us and Perseus in 2007.

Pursuant to the Amendment, we agreed to sell and issue to Perseus, and Perseus agreed to purchase, an Additional Investment Note, or the Additional Note. The Additional Note has an original principal amount of $1.5 million, bears interest at 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. At Perseus s election, the Additional Note and any Additional Notes issued to Perseus are convertible into shares of our common stock at a conversion price of $0.33 per share compared to the closing stock price of $0.56 of our common stock at the time the Additional Note was issued. As a result, the Additional Note contains a beneficial conversion feature. We accounted for the beneficial conversion feature under EITF 00-27, Application of Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features, to Certain Convertible Instruments . We calculated the Additional Note has a beneficial conversion of approximately $1.0 million. The beneficial conversion feature was recorded as a debt discount and an increase additional paid in capital. In addition, we recorded approximately $3.6 million of total interest expense related to the Perseus loans, including stated interest, amortization of debt discount and amortization of debt issuance costs for the three months ended March 31, 2008. Assuming that we pay all stated interest in kind and Perseus fully converts all loans made to us, Perseus would receive 35,745,888 shares of our common stock.

The Additional Note contains customary affirmative and negative covenants and is secured by a security interest in all of our assets and those of our material subsidiaries. In addition, pursuant to the Amendment, in the event of an investment by an investor approved by Perseus in a project, joint venture, partnership or other transaction for the purpose of developing our wind turbine products, we agreed to:

- if the project uses an entity other than Distributed Energy, issue to Perseus, for no additional consideration, a 5% fully-diluted interest in such entity; or

- if the investor makes an investment directly in Distributed Energy, issue to Perseus, for no additional consideration, a warrant to purchase, at an exercise price of $0.33 per share, up to 909,090 shares of our common stock.

Further, in the event of a sale of assets by us or any of our affiliates (other than sales in the ordinary course of business), we agreed to:

- use all or part of the net proceeds to repay some or all of our obligations to Perseus;

- deliver an irrevocable letter of credit to Perseus in the amount of the net proceeds less any repayment of obligations owed to Perseus;

- place the net proceeds less any repayment of obligations owed to Perseus in a restricted cash account; or

- otherwise secure the obligations owed to Perseus or make such other arrangements with respect to the net proceeds as requested by Perseus in each case as directed by Perseus.

Under the Securities Purchase Agreement, we had undertaken to use commercially reasonable efforts to sell our Proton subsidiary. The Amendment permits us to suspend active efforts to sell Proton, but Perseus retains the right to reinstate the requirement at any time.

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The events of default under our debt agreements with Perseus include any time that our net working capital or our unrestricted cash and cash equivalents fall below specified levels. On May 8, 2008, we and Perseus amended our debt agreements to provide that a default would occur any time (1) our net working capital falls below $2.0 million or (2) our unrestricted cash and cash equivalents fall below $2.0 million, excluding proceeds from any sale of assets outside the ordinary course. After May 16, 2008, unless Perseus agrees to a further amendment to its agreements, these default levels will return to their original levels, such that a default will occur any time (1) our net working capital falls below $3.5 million or (2) our unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Perseus agreements would permit them to accelerate all the amounts we owe them, which as of May 8, 2008 totaled approximately $18.0 million. It is likely that we will fail to meet one of these two tests even before early to mid June 2008. In that case, if Perseus were unwilling to waive the default, we would likely be required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. As of May 8, 2008, our net working capital, as defined in the Perseus agreements, was approximately $3.0 million and our unrestricted cash and cash equivalents were approximately $3.3 million.

Classification of Debt

The Company s Vermont facility mortgage with Waring Investments contains a material adverse change clause which allows the bank, at its option, to declare the loan to be in default and immediately payable if they believe there has been a material adverse change in our financial condition. The Company s loan agreements with Perseus and the Vermont Economic Development Authority (VEDA) each contain cross-default provisions which provide that any event of default in any secured borrowing would result in the Perseus and VEDA loans being in default and immediately payable. Accordingly, the Merchant Bank loans, and the Perseus and VEDA loans with cross-default provisions, have been classified as short term.

4. INVENTORIES AND COSTS AND BILLINGS ON CONTRACTS IN PROGRESS

	March 31, 2008	December 31, 2007
Raw materials	$ 3,480,485	$ 2,752,230
Work in process	1,055,783	1,315,263
Finished goods	1,146,771	1,004,060
	$ 5,683,039	$ 5,071,553

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

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

	March 31, 2008	December 31, 2007
Costs incurred and estimated earnings on contracts in progress	$ 29,248,525	$ 36,212,634
Less: billings to date	28,587,776	35,151,336
Costs and earnings in excess of billings, net	$ 660,749	$ 1,061,298

	March 31, 2008	December 31, 2007
Costs in excess of billings on contracts in progress	$ 1,065,166	$ 1,982,783
Billings in excess of costs on contracts in progress	(404,417)	(921,485)
Costs and earnings in excess of billings, net	$ 660,749	$ 1,061,298

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	March 31, 2008	December 31, 2007
Accrued warranty	$ 612,043	$ 570,061
Accrued purchases	201,945	316,167
Accrued project losses	1,184,944	1,368,944
Accrued interest	497,551	472,602
Other accruals	351,550	599,494
	$ 2,848,033	$ 3,327,268

6. STOCK-BASED COMPENSATION

Director Compensation

In the first quarter of 2008, the Company granted a total of 511,800 common stock options to its non-employee directors at prices of $0.53 - $0.57 per share, all shares vesting immediately upon grant. In connection with the appointment in November 2007 of Bernard H. Cherry as the Company s interim chief executive officer, Mr. Cherry no longer receives compensation as chairman of the Company s board of directors. The non-cash stock compensation cost of approximately $267,000 for the three months ended March 31, 2008 is reflected in selling, general and administrative expenses.

In January 2007, the Company granted a total of 75,040 shares of restricted common stock to its non-employee directors at a price of $3.63 per share, all shares vesting monthly over a one-year period. The non-cash stock compensation cost of approximately $66,000 for the three months ended March 31, 2007 is reflected in selling, general and administrative expenses.

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7. RESTRUCTURING AND RELATED COSTS

In January 2007, the Company announced that it was combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. The Company also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility resulting in the elimination of about 60 jobs, or 20% of the workforce. In May 2007, the Company completed another reduction of its workforce resulting in the elimination of approximately 25 additional jobs.

As a result, during the year ended December 31, 2007, the Company recorded severance charges of approximately $703,000. These costs are accounted for under SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, and were included as a charge to the results of operations for the year ended December 31, 2007. For the quarter ended March 31, 2007, the Company recorded severance charges of approximately $562,000. Any subsequent changes to the estimates of executing the currently approved plans of restructuring will be reflected in current results of operations.

As a result of its decision to exit the Waitsfield facility and consolidate its Northern operations in Barre, Vermont by June 30, 2007, the Company revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated the related depreciation charges. Therefore, the Company recorded additional depreciation expense of approximately $2.4 million for the year ended December 31, 2007 to reduce the facility to its estimated net residual value of approximately $2.0 million. For the quarter ended March 31, 2007, the Company recorded additional depreciation expense of approximately $1.2 million. These depreciation charges are included in selling, general and administrative expenses.

8. STOCKHOLDERS EQUITY

Changes in stockholders equity were as follows (in thousands):

Balance at December 31, 2007	$ 22,923
Net loss	(8,433)
Issuance of common stock from ESPP program exercises	21
Beneficial conversion feature pursuant to Perseues Additional Note	1,046
Stock based compensation	237
Balance at March 31, 2008	$ 15,794

Warrants

On March 7, 2007, we entered into a Joint Venture Agreement with Morgan Stanley Wind LLC (MSW), a subsidiary of Morgan Stanley. This agreement established a framework for the Company and Morgan Stanley to work together to develop, finance, own and operate projects utilizing waste-to-energy technology, combined-heat-and-power technology and other advanced energy technologies.

In connection with the execution of the Morgan Stanley Wind LLC Joint Venture Agreement, we issued to MSW on March 7, 2007 a Common Stock Purchase Warrant entitling MSW to purchase up to 8% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. We estimated the fair value of the warrant issued under this arrangement using a binomial lattice model. The fair value of the warrants at March 7, 2007 was determined to be $1.51 per share. As a result we recorded a non-cash charge of approximately $5,841,000 associated with 3,868,524 shares issuable under this agreement during the three months ended March 31, 2007.

The joint venture agreement was terminated in January 2008 at which time we received a one-time payment of $500,000 from MSW for our entire ownership share of the joint venture. The one-time payment is included in other income for the three months ended March 31, 2008. The warrant to purchase up to 8% of our common stock survives the termination of the joint venture. As of March 31, 2008, the warrant issued to MSW allows them to purchase 10,551,602 shares of common stock.

Common stock warrants were issued in 2007 to Perseus pursuant to the Senior Secured Convertible Promissory Note. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of our common stock at an exercise price of $0.80 per share. The Subsequent Warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of our common stock at exercise prices ranging from $0.80 to $3.00 per share.

9. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

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

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

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In 2005, our Northern subsidiary entered into an Engineering Procurement and Construction Contract with Aarhus Karlshamn USA, Inc., or Aarhus, for the design and installation of a combined heat and power system for a facility located in Newark, New Jersey. The proposed system used Stirling engines manufactured by a third party, STM Power, Inc. On February 20, 2007, STM Power ceased operations. As a result of STM Power s cessation of operations, they are unable to provide the components and warranty assistance needed for the engines.

On October 19, 2007, Aarhus filed suit against us in the Superior Court of New Jersey, Essex County, alleging breach of contract, breach of warranty and negligence and seeking compensatory and consequential damages in excess of $4 million. We have two applicable insurance polices in an aggregate amount of $3 million, and both insurance carriers are participating in the defense of the claims. We believe we have meritorious defenses to the claims made in the complaint, and we intend to contest the lawsuit vigorously. There can be no assurances that we will be successful in our defense of the claims, however, and an adverse resolution of the lawsuit could exceed our insurance coverage and could have a material adverse effect on our financial position, results of operation and cash flows when resolved. The range of potential loss for this matter is $0 to $4 million. We have accrued approximately $0.8 million for this matter, which represents our best estimate of the potential loss in this matter. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

Warranty

The changes in the carrying amount of warranties are as follows:

	2008	2007
Balance as of December 31:	$ 570,061	$ 813,445
Warranties issued in period	281,587	175,281
Adjustments to provision	(180,535)	(36,590)
Warranty claims	(59,070)	(127,771)
Balance as of March 31:	$ 612,043	$ 824,365

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. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under the Agreement is $419,250. Proton was required under the Agreement to place $419,250 in escrow related to these recapture clauses. By agreement the amount held in escrow was reduced to $296,325 as of March 31, 2008 and is included in short-term restricted cash.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, tax accruals of approximately $395,000 and $415,000 for certain state income and sales tax contingencies for which there may be exposure at March 31, 2008 and December 31, 2007, 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. There were no significant changes in these estimates for any period presented.

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10. 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 wind turbine and power electronics business, is currently focused on the design and sale of direct drive wind turbines and associated power electronics for industrial, commercial and government customers. In 2007 and prior, Northern was engaged primarily in the design and installation of stand-alone and grid-connected electric power systems. 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 by operating segment is summarized below.

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Revenues:		
Proton	$ 4,540	$ 2,031
Northern	1,560	6,393
Consolidated	$ 6,100	$ 8,424

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Loss from operations:		
Proton	$ (522)	$ (1,413)
Northern	(2,980)	(5,513)
Eliminations and other	(1,858)	(7,843)
Consolidated	$ (5,360)	$ (14,769)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Net loss:		
Proton	$ (513)	$ (1,410)
Northern	(2,994)	(5,576)
Eliminations and other	(4,926)	(7,643)
Consolidated	$ (8,433)	$ (14,629)

	March 31, 2008	December 31, 2007
Total assets:		
Proton	$ 64,166	$ 65,473
Northern	14,095	15,648
Eliminations and other	(40,829)	(39,370)
Consolidated	$ 37,432	$ 41,751

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, 2007. 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, 2007, 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

Our Business

We do business through two subsidiaries. Proton designs, develops, sells and manufactures on-site hydrogen gas delivery systems. This business has its headquarters in Wallingford, Connecticut and conducts business worldwide. Northern has been in a broad range of businesses including the design and sale of power generation equipment, engineering, procurement and construction of distributed power systems, the design and sale of direct drive wind turbines, and the servicing of fossil fuel power generation equipment. As described above in Recent Developments, management of Northern is systematically narrowing its focus to the design and sale of direct drive wind turbines and associated power electronics. Throughout 2007, Northern completed projects in the distributed power and engineering, procurement and construction businesses, while declining to sign any new additional projects in this area. We are continuing to complete the final phases of a small number of projects and are evaluating the sustainability of our power generation service business.

Update on our Financial Condition

Our financial condition has continued to deteriorate significantly since December 31, 2007. We incurred significant operating losses and used cash in our operating activities in the three months ended March 31, 2008. We do not expect that our existing capital resources will be sufficient to operate our business beyond early to mid-June 2008. We have been attempting for several months to secure alternative financing without success to date. We are continuing to seek alternatives that would allow us to continue to operate our business, including obtaining additional debt or equity financing, recapitalizing, reorganizing, and/or selling some or all of our assets. If we are unable to successfully secure additional capital by early to mid-June 2008, we will likely need to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. In that event, the potential for any residual value in our common stock is remote. Perseus has a security interest in all of our assets and those of our material subsidiaries. As a secured creditor, Perseus would have the right to be repaid ahead of our stockholders, as would our unsecured creditors. Perseus has expressly reserved all of its rights as a secured creditor.

In addition, the events of default under our debt agreements with Perseus include any time that our net working capital or our unrestricted cash and cash equivalents fall below specified levels. On May 8, 2008, we and Perseus amended our debt agreements to provide that a default would occur any time (1) our net working capital falls below $2.0 million or (2) our unrestricted cash and cash

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equivalents fall below $2.0 million, excluding proceeds from any sale of assets outside the ordinary course. After May 16, 2008, unless Perseus agrees to a further amendment to its agreements, these default levels will return to their original levels, such that a default will occur any time (1) our net working capital falls below $3.5 million or (2) our unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Perseus agreements would permit them to accelerate all the amounts we owe them, which as of May 8, 2008 totaled approximately $18.0 million. It is likely that we will fail to meet one of these two tests even before early to mid June 2008. In that case, if Perseus were unwilling to waive the default, we would likely be required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. As of May 8, 2008, our net working capital, as defined in the Perseus agreements, was approximately $3.0 million and our unrestricted cash and cash equivalents were approximately $3.3 million.

Our ability to secure additional capital or debt funding in the very near future on terms acceptable to us, or at all, is uncertain and will be subject to a number of factors, including market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors, together with the short amount of time we have to secure financing, may make the terms and conditions of additional funding unattractive. Any party who might provide us with additional equity or debt capital might condition that financing on our making a bankruptcy filing in conjunction with the financing. 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. If we secure additional debt financing, existing stockholders will be subordinate to the debtholders.

On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

The circumstances discussed above raise substantial doubt about our ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets, and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared by us in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, depreciable lives of equipment, warranty obligations and contingency accruals. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in our Annual report on Form 10-K for the fiscal year ended December 31, 2007. Our audit committee has discussed our critical accounting policies with management and our independent registered public accounting firm.

Our critical accounting policies include the following:

Revenue Recognition Product Revenue

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

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

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

Revenue Recognition Contract Revenue

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines at our Northern 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, or SOP 81-1, based on the relationship of costs incurred to total estimated contract

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costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be subject to our judgment. For the three months ended March 31, 2008 and 2007, approximately 68% and 84% of our contract revenue, respectively, was recognized under the percentage-of-completion method.

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

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. During the three months ended March 31, 2008, we experienced increased estimated costs to complete on certain contracts which reduced or eliminated our estimated gross margin on these contracts. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our gross margin percentage for contract revenue may be affected by these changes in estimates and was (7)% and (4)% for the three months ended March 31, 2008 and 2007, respectively.

Revenue Recognition Service Revenue

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

Warranty Costs

Our warranty to customers is limited to replacement parts and services and generally expires one year from the date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. We record estimated warranty obligations in the period in which we recognize the related revenue. We quantify and record an estimate for warranty related costs; this estimate is principally based on historical experience. The accounting for warranties requires us to make assumptions and apply judgments when estimating product failure rates and expected material and labor costs. We make adjustments to accruals as warranty claim data and historical experience warrant. If

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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 March 31, 2008 would have affected our pre-tax loss by approximately $60,000 for the three months ended March 31, 2008.

Inventory

We record inventory at the lower of cost or market value. We determine cost by the first-in, first-out method. This policy requires us to write down our inventory for the excess of the carrying value, which is typically the original cost, over the amount we expect to realize from the ultimate sale or other disposal of the inventory based upon on our assumptions regarding forecasted consumer demand, market conditions, inventory aging and technological obsolescence. If any of our estimates are inaccurate, for example because of changes in technology that affect demand for certain products in an unforeseen manner, we may be exposed to losses or gains in excess of our established reserve, and those gains and losses could be material. A 10% change in our inventory reserve as of March 31, 2008 would have affected our pre-tax loss by approximately $58,000 for the three months ended March 31, 2008.

Recent Accounting Guidance

There are no new accounting pronouncements that we expect will have a material effect on our consolidated financial statements at this time.

Results of Operations

Comparison of the Three Months Ended March 31, 2008 and the Three Months Ended March 31, 2007

Revenues:

	Quarter Ended			
Net revenues	**March 31, 2008**	**March 31, 2007**	**Increase (decrease)**	
Contract	$ 2,338,759	$ 6,252,537	$ (3,913,778)	-63%
Product	2,102,005	646,825	1,455,180	225%
Service	1,659,357	1,524,272	135,085	9%
Total	$ 6,100,121	$ 8,423,634	$ (2,323,513)	-28%

The net decrease in contract revenues is a result of decreased revenue associated with our Northern subsidiary, offset in part by increased revenue associated with our Proton subsidiary. Northern s contract revenues decreased approximately $4.7 million in the first quarter of 2008 compared to the same period in 2007. Throughout 2007 our deteriorating financial condition made orders difficult to obtain and our products in the power distributor, oil and gas and contract research and development businesses were not competitive. Accordingly, we concluded in 2007 that Northern s primary focus would be on the design and sale of its 100 kilowatt direct drive wind turbines and associated power electronics. As a result of this decision, we have been completing our in-process projects in the distributed power and engineering, procurement and construction businesses; fewer contracts remain active in 2008 and we did not sign any new contracts in these areas in the first quarter of 2008. The decrease in Northern s contract revenue was partially offset by an approximate $0.8 million increase in Proton s contract revenue resulting from a consistent government contract base and the expansion of a hydrogen refueling project in the first quarter of 2008 compared to the first quarter of 2007.

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The increase in product revenue of $1.5 million in the first quarter of 2008 compared to the first quarter of 2007 relates to increased shipments of Proton HOGEN S series units, HOGEN H series units, and laboratory generators.

The following table presents hydrogen generator unit shipment details:

Hydrogen generator unit shipments	Quarter Ended March 31, 2008	Quarter Ended March 31, 2007	Increase (decrease)
S series	7	2	5
H series	8	3	5
Laboratory generators	18	12	6
Total	33	17	16

As of March 31, 2008, our backlog was valued at approximately $11.3 million, consisting of contract and service backlog valued at approximately $1.2 million for Proton and $1.0 million for Northern and product backlog valued at approximately $2.3 million for Proton and $6.8 million for Northern.

Costs of revenue:

Cost of revenues	Quarter Ended March 31, 2008	Quarter Ended March 31, 2007	Increase (decrease)	
Contract	$ 2,506,933	$ 6,476,474	$ (3,969,541)	-61%
Product	1,823,964	520,604	1,303,360	250%
Service	1,688,658	1,793,210	(104,552)	-6%
Total	$ 6,019,555	$ 8,790,288	$ (2,770,733)	-32%

Cost of contract revenues as a percentage of contract revenues increased from 104% in the first quarter of 2007 to 107% in the first quarter of 2008. Northern s costs of contract revenues as a percentage of revenues increased from 111% in the first quarter of 2007 to 246% in the first quarter of 2008. This increase in costs as a percentage of contract revenues and decrease in gross margins is due to additional cost overruns due to changing conditions particularly in Northern s on-site power distributor business and increased warranty expenses in 2008. Proton s cost of contract revenue as a percentage of contract revenue increased from 70% for the three months ended March 31, 2007 to 76% for the comparable 2008 period. The decrease in gross margin on Proton s contracts was due to a change in contract mix from higher margin fixed-price and cost-plus-fixed-fee contracts to lower margin cost-share arrangements.

Cost of product revenue as a percentage of product revenue increased from 80% in the first quarter of 2007 to 87% in the first quarter of 2008. The increase in cost of product revenue as a percentage of revenue was primarily attributable to certain competitive international sales with Proton s hydrogen generators in 2008 as compared to the 2007 period.

Cost of service revenue as a percentage of service revenue decreased from 118% in the first quarter of 2007 to 102% in the first quarter of 2008. The decrease in cost of service revenue as a percentage of service revenue was due to infrastructure cost reductions related to our 2007 strategic reorganization *(Refer to Note 7 of the financial statements for information related to our 2007 strategic reorganization)* offset in part by increased service costs as a percentage of service revenue due to the change in Northern s mix of service contracts from higher margin international field service contracts to lower margin long-term domestic operating and maintenance contracts.

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Research and development expenses:

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

	Quarter Ended			
Research and development	**March 31, 2008**	**March 31, 2007**	**Increase (decrease)**	
Employee related	$ 653,884	$ 620,032	$ 33,852	5%
Project material	132,972	77,868	55,104	71%
Depreciation and amortization	66,292	102,489	(36,197)	-35%
Stock based compensation	11,694	24,081	(12,387)	-51%
Other	125,962	(59,135)	185,097	313%
Total	$ 990,804	$ 765,335	$ 225,469	29%

The increase in other research and development results from a $162,000 credit received from the Connecticut Clean Energy Fund in the first quarter of 2007. We did not receive a similar credit from the Connecticut Clean Energy Fund in the first quarter of 2008.

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	**March 31, 2008**	**March 31, 2007**	**Increase (decrease)**	
Employee related	$ 1,682,910	$ 3,020,469	$ (1,337,559)	-44%
Marketing and advertising	190,767	225,156	(34,389)	-15%
Depreciation, amortization	337,653	1,576,765	(1,239,112)	-79%
Stock based compensation	248,645	388,868	(140,223)	-36%
Legal, consulting and accounting	1,130,618	961,147	169,471	18%
Other	859,546	6,902,340	(6,042,794)	-88%
Total	$ 4,450,139	$ 13,074,745	$ (8,624,606)	-66%

The decrease in employee-related costs for the three months ended March 31, 2008 is directly related to our 2007 strategic reorganization. Depreciation and amortization decreased in the first quarter of 2008 as compared with the same period of 2007 at which time we accelerated the depreciation related to our Waitsfield, VT facility based on our plan to cease using the facility by June 30, 2007. The decrease in other selling, general and administrative primarily relates to $5.8 million of non-cash charges associated with warrants issued to Morgan Stanley Wind, LLC in connection with the Joint Venture Agreement.

Interest income: Interest income decreased from $250,000 for the three months ended March 31, 2007 to $42,000 for the comparable period in 2008. The decrease is attributable to lower cash balances and lower interest rates. The average interest rates for the three months ended March 31, 2008 and 2007 were approximately 4.4% and 5.1%, respectively. The average cash and marketable securities balances for the three months ended March 31, 2008 and 2007 were approximately $3.9 million and $14.1 million, respectively.

***Interest expense**:* Interest expense increased from $175,000 for the three months ended March 31, 2007 to $3.7 million for the comparable period in 2008. The increase was primarily the result of interest charges associated with our notes payable to Perseus described in the Update on our Financial Condition section above. These charges include amortization of the debt discount, debt issuance costs, and beneficial conversion feature related to these notes.

LIQUIDITY AND CAPITAL RESOURCES

Since inception in August 1996 through March 2008, we and our predecessor, Proton, have financed our operations through convertible preferred stock issuances, an initial public offering, an equity distribution agreement and debt that, in total, raised approximately $224.2 million. As of March 31, 2008, we had $3.6 million in cash and cash equivalents.

Our financial condition has continued to deteriorate significantly since December 31, 2007. We incurred significant operating losses and used cash in our operating activities in the three months ended March 31, 2008. We do not expect that our existing capital resources will be sufficient to operate our business beyond early to mid-June 2008. We have been attempting for several months to secure alternative financing without success to date. We are continuing to seek alternatives that would allow us to continue to operate our business, including obtaining additional debt or equity financing, recapitalizing, reorganizing, and/or selling some or all of our assets. If we are unable to successfully secure additional capital by early to mid-June 2008, we will likely need to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. In that event, the potential for any residual value in our common stock is remote. Perseus has a security interest in all of our assets and those of our material subsidiaries. As a secured creditor, Perseus would have the right to be repaid ahead of our stockholders, as would our unsecured creditors. Perseus has expressly reserved all of its rights as a secured creditor.

In addition, the events of default under our debt agreements with Perseus include any time that our net working capital or our unrestricted cash and cash equivalents fall below specified levels. On May 8, 2008, we and Perseus amended our debt agreements to provide that a default would occur any time (1) our net working capital falls below $2.0 million or (2) our unrestricted cash and cash equivalents fall below $2.0 million, excluding proceeds from any sale of assets outside the ordinary course. After May 16, 2008, unless Perseus agrees to a further amendment to its agreements, these default levels will return to their original levels, such that a default will occur any time (1) our net working capital falls below $3.5 million or (2) our unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Perseus agreements would permit them to accelerate all the amounts we owe them, which as of May 8, 2008 totaled approximately $18.0 million. It is likely that we will fail to meet one of these two tests even before early to mid June 2008. In that case, if Perseus were unwilling to waive the default, we would likely be required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business. As of May 8, 2008, our net working capital, as defined in the Perseus agreements, was approximately $3.0 million and our unrestricted cash and cash equivalents were approximately $3.3 million.

Our ability to secure additional capital or debt funding in the very near future on terms acceptable to us, or at all, is uncertain and will be subject to a number of factors, including market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors, together with the short amount of time we have to secure financing, may make the terms and conditions of additional funding unattractive. Any party who might provide us with additional equity or debt capital might condition that financing on our making a bankruptcy filing in conjunction with the financing. 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. If we secure additional debt financing, existing stockholders will be subordinate to the debtholders.

Cash used in operating activities was $3.2 million for the three months ended March 31, 2008 and was primarily attributable to our net loss, partially offset by non-cash charges to income such as depreciation, amortization, amortization of debt discount and financing costs, and stock compensation, as well as decreases in accounts receivable and costs in excess of billings and an increase in deferred revenue and customer advances. The one-time cash payment received in the first quarter of 2008 from Morgan Stanley Wind LLC for our entire ownership share of the terminated joint venture generated operating cash of $0.5 million in the first quarter of 2008 and is included in other income. Cash used in operating activities was $8.7 million for the three months ended March 31, 2007 and was primarily attributable to our net loss, increases in inventories as a result of less than expected demand for HOGEN hydrogen generators in the first quarter of 2007 and increases in costs in excess of billings, partially offset by non-cash depreciation, amortization, expense for warrants issued and stock compensation expense, and a decrease in billings in excess of costs.

Cash provided by investing activities was $228,000 for the three months ended March 31, 2008 and was primarily attributable to the release of restricted cash. Cash provided by investing activities was $5.8 million for the three months ended March 31, 2007 and was primarily attributable to the proceeds from the maturity and sales of marketable securities.

Cash provided by financing activities was approximately $1.5 million for the three months ended March 31, 2008 and was primarily attributable to borrowings from Perseus. Cash used in financing activities was approximately $11,000 for the three months ended March 31, 2007 and was primarily attributable to payments under Proton s and Northern s debt agreements partially offset by proceeds received from exercised incentive options.

To address our need to raise additional working capital, we entered into three loan transactions with Perseus Partners VII, L.P., or Perseus, which are described in Notes 1 and 10 to our consolidated financial statements included in our Annual Report on Form 10-K, as well as in the notes to our condensed consolidated financial statements included in this Form 10-Q.

On March 13, 2008, we and our subsidiaries, Northern, Proton and Technology Drive, L.L.C., entered into a First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement, or the Amendment, with Perseus. The Amendment amends the securities purchase agreement and the related Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement.

Pursuant to the Amendment, we agreed to sell and issue to Perseus, and Perseus agreed to purchase, an Additional Investment Note, or the Additional Note. The Additional Note has an original principal amount of $1.5 million, bears interest at 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. At Perseus s election, the principal and any unpaid interest under the Additional Note are convertible into shares of our common stock at a conversion price of $0.33 per share. Assuming that (a) we pay all interest in kind and (b) Perseus fully converts the Additional Note and all of the Additional Convertible Notes, Perseus would receive 4,966,213 shares of our common stock. The Additional Note contains customary affirmative and negative covenants and is secured by a security interest in all of our assets and those of our material subsidiaries.

In addition, pursuant to the Amendment, in the event of an investment by an investor approved by Perseus in a project, joint venture, partnership or other transaction for the purpose of developing our wind turbine products, we agreed to:

- if the project uses an entity other than Distributed Energy, issue to Perseus, for no additional consideration, a 5% fully-diluted interest in such entity; or

- if the investor makes an investment directly in Distributed Energy, issue to Perseus, for no additional consideration, a warrant to purchase, at an exercise price of $0.33 per share, up to 909,090 shares of our common stock.

Further, in the event of a sale of assets of us or any of our affiliates (other than sales in the ordinary course of business), we agreed to:

- use all or part of the net proceeds to repay some or all of our obligations to Perseus;

- deliver an irrevocable letter of credit to Perseus in the amount of the net proceeds less any repayment of obligations owed to Perseus;

- place the net proceeds less any repayment of obligations owed to Perseus in a restricted cash account; or

- otherwise secure the obligations owed to Perseus or make such other arrangements with respect to the net proceeds as requested by Perseus in each case as directed by Perseus.

Under the Securities Purchase Agreement, we had undertaken to use commercially reasonable efforts to sell our Proton subsidiary. The Amendment permits us to suspend active efforts to sell Proton, but Perseus retains the right to reinstate the requirement at any time.

The circumstances discussed above raise substantial doubt about our ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under our current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

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

At March 31, 2008, 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 the Vermont Economic Development Authority s prevailing rate for taxable financing, which was 5% per annum at March 31, 2008, 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.

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ITEM 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial and accounting officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2008. 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 us in the reports that we file or submit 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 our disclosure controls and procedures as of March 31, 2008, our principal executive officer and principal financial and accounting officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended March 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II.

OTHER INFORMATION

ITEM 1. Legal Proceedings

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

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

In 2005, our Northern subsidiary entered into an Engineering Procurement and Construction Contract with Aarhus Karlshamn USA, Inc., or Aarhus, for the design and installation of a combined heat and power system for a facility located in Newark, New Jersey. The proposed system used Stirling engines manufactured by a third party, STM Power, Inc. On February 20, 2007, STM Power ceased operations. As a result of STM Power s cessation of operations, they are unable to provide the components and warranty assistance needed for the engines.

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On October 19, 2007, Aarhus filed suit against us in the Superior Court of New Jersey, Essex County, alleging breach of contract, breach of warranty and negligence and seeking compensatory and consequential damages in excess of $4 million. We have two applicable insurance polices in an aggregate amount of $3 million, and both insurance carriers are participating in the defense of the claims. We believe we have meritorious defenses to the claims made in the complaint, and we intend to contest the lawsuit vigorously. There can be no assurances that we will be successful in our defense of the claims, however, and an adverse resolution of the lawsuit could exceed our insurance coverage and could have a material adverse effect on our financial position and results of operation in the period in which it is resolved. The range of potential loss for this matter is $0 to $4 million. We have accrued approximately $0.8 million for this matter, which represents our best estimate of the potential loss in this matter. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

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. Except for the first and third risk factors under the heading Risks Relating to Our Company, and the first risk factor under the heading Risks Relating to Our Industry, there have been no material changes from the risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2007.

RISKS RELATING TO OUR COMPANY

We need to raise sufficient additional funds by early to mid-June to continue operations, and we may experience an event of default under our secured debt even sooner.

Our financial condition has continued to deteriorate significantly since December 31, 2007. We incurred significant operating losses and used cash in our operating activities in the three months ended March 31, 2008. We do not expect that our existing capital resources will be sufficient to operate our business beyond early to mid-June 2008. If we are unable to successfully secure additional capital by early to mid-June 2008, we will likely need to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business.

In addition, the events of default under our debt agreements with Perseus include any time that our net working capital or our unrestricted cash and cash equivalents fall below specified levels. Any event of default under the Perseus agreements would permit them to accelerate all the amounts we owe them, which as of May 8, 2008 totaled approximately $18.0 million. It is likely that we will fail to meet one of these levels even before early to mid-June 2008. In that case, if Perseus were unwilling to waive the default, we would likely be required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business.

Perseus has a security interest in all of our assets and those of our material subsidiaries. As a secured creditor, Perseus would have the right to be repaid ahead of our stockholders, as would our unsecured creditors. Perseus has expressly reserved all of its rights as a secured creditor. If we are required to seek protection from our creditors in a bankruptcy proceeding to reorganize or liquidate our business, the potential for any residual value in our common stock is remote.

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We may not be able to execute our plan to increase revenue, improve margins and raise additional capital.

As we attempt to execute our plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance, a number of factors pose risk and uncertainty, including:

- Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues;
- Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow;
- Our ability to control operating expenses;
- Our ability to sell our Waitsfield, Vermont facility or to find additional suitable tenants;
- The potential acceleration of debt service payments by one of our lenders as the result of subjective acceleration clauses in our debt agreements;
- Our ability to secure additional equity capital funding or debt funding in the near future 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, investor sentiment, and the rights of our current creditors, including Perseus. 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. If we secure additional debt financing, existing stockholders will be subordinate to the debtholders.

If we are unable to execute our plan, we may have to cease operations.

As a secured creditor, Perseus has rights not available to our stockholders.

We received funding from Perseus in June and August 2007 and March 2008 in an aggregate amount of $16.5 million. We will need to repay these convertible notes with accrued interest due to Perseus in November 2008 in the amount of approximately $19.2 million. Under the terms of the securities purchase agreement, as amended, and the notes issued or issuable pursuant thereto, Perseus has rights as a secured creditor that would allow it to be repaid ahead of our stockholders, grant it veto rights over certain of our actions and permit Perseus, in its discretion, to appoint a majority of our board of directors. Perseus has a lien on the assets securing their loan. In the event that we fail to repay any of our debt as it becomes due, become insolvent or become involved in an insolvency proceeding, Perseus, as well as our other secured creditors, would have the right to foreclose on our assets. Perseus and our other secured creditors would be entitled to receive all of the proceeds from liquidating our assets ahead of our stockholders until our obligations to them are repaid in full. Additionally, Perseus s consent is required before we can, among other things, (i) incur any debt in excess of $1,000,000, (ii) recapitalize or reorganize ourselves or any of our subsidiaries, (iii) authorize, declare or pay any dividend, (iv) redeem or repurchase any shares of our stock, except in certain limited instances, (v) make any material change in the principal line of business of ourselves or any of our subsidiaries, (vi) acquire assets or make capital expenditures in excess of $1,500,000, (vii) institute or settle any material litigation or claim, (viii) approve our annual budget, and (ix) hire a chief executive officer. We have granted Perseus a right of first refusal to fund any future financing transactions we might pursue, with limited exceptions, and we have agreed to register for resale all the shares issuable to Perseus. Perseus also has the right to appoint a majority of our board of directors. Currently, Perseus has no representatives on our board of directors.

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Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2007 with respect to our ability to continue as a going concern.

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2007 with respect to our ability to continue as a going concern. This modification may negatively affect our stock price, our capital-raising efforts or our ability to enter into new contracts with customers. Even after our Perseus funding, there remains substantial doubt about our ability to continue as a going concern. Our consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. If we became unable to continue as a going concern, our secured creditors, including Perseus, would have the right to foreclose on our assets. As secured creditors, they would be entitled to the proceeds received from liquidating our assets ahead of our stockholders until our obligations to them are repaid in full.

Perseus has the right to acquire a controlling share of our stock and to appoint a majority of our board of directors, and Perseus s interests may differ from other stockholders.

Perseus, through its right to convert its convertible notes into our common stock and to exercise its warrants, could acquire enough shares of our common stock to raise its ownership to greater than 50% of our total outstanding common stock. In addition, under the terms of the securities purchase agreement, Perseus is entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of its convertible notes. Based upon our current capitalization, Perseus now has the right under this provision to name a majority of the directors on our board. Pursuant to subsequent agreements between us and Perseus, Perseus has not exercised its right to name a majority of our directors, but it retains the right to do so at any time.

Through its right to obtain majority ownership of our common stock or to name a majority of our directors, Perseus would be able to control all key decisions regarding our company, including mergers or other business combinations and acquisitions, dispositions of assets, future issuances of our common stock or other securities, the incurrence of debt by us and amendments to our certificate of incorporation and bylaws. In addition, Perseus s right to acquire a controlling interest could discourage a change of control that our other stockholders may favor. If Perseus exercises its rights, it could also use such control for its own advantage to the detriment of our other stockholders and our company. This in turn could have an adverse effect on the market price of our common stock.

The warrant we issued to Morgan Stanley Wind LLC allows them to purchase up to 8% of our common stock outstanding from time to time; accordingly, any dilution resulting from future issuances of our common stock, options, warrants or other convertible securities will be increased by the effect of this warrant.

In connection with our execution of the joint venture agreement with MSW in March 2007, we issued to MSW a warrant entitling them to purchase up to 10% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. We exited the joint venture agreement with MSW in February 2008, however the warrant we issued to MSW, which now allows them to purchase up to 8% of our common stock, remains in place. Accordingly, if we issue any new shares of our common stock, or issue any options or warrants to purchase our common stock or other securities convertible into our common stock, this will trigger a right of MSW under its warrant to acquire additional shares equal to 8% of the new issuance. This feature of the warrant has the effect of increasing the dilution to current stockholders that would result from any issuances of our common stock or securities related to our common stock, including an issuance in connection with any financing transaction we may undertake.

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

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

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

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

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

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of March 31, 2008, we had an accumulated deficit of $247.6 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing capability and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators and wind turbine products. 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. We began shipping commercial models of our 100 kilowatt wind turbine in 2004 and have shipped in very low volumes since that time. 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.

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Our businesses are 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 are made to customers under single contracts. For the quarter ended March 31, 2008, our largest 5 customers accounted for 46% of our revenues and our largest 10 customers accounted for 62% 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 wind turbine 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 business will be derived from the sale or licensing of regenerative fuel cell, wind turbine and power electronics products and technologies which we are currently developing or have only recently made commercially available. Many of these new products and technologies are based on new and unproven designs, and it is difficult to predict whether they will be commercially viable. If we fail to successfully develop and commercialize these products and technologies on the timetable we anticipate or at all, we will be unable to recover the investments we have made in their development and will be unable to grow our revenue from their sale or licensing. In addition, we may not be successful in developing product designs and manufacturing processes that permit the manufacture of our hydrogen generators and fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, we sell some of our products for less than it costs to produce them. New technology developments or cost reductions in existing technologies may also delay or prevent the development or sale of some or all of our planned products or make our planned products uncompetitive or obsolete.

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

Many of the components in our distributed generation and hydrogen generation systems, including the proton exchange membrane material used in our PEM products, hydrogen purification system and custom-designed power supplies used in our products, are available only from a limited number of suppliers and in some cases only a single supplier. Some of our suppliers are small- and medium-size companies that may not be able to increase production in an acceptable time period or at acceptable prices or quality levels. In addition, to the extent these components are proprietary products of our suppliers, or the processes used by our suppliers to manufacture these components are proprietary, we may be unable to obtain licenses on commercially reasonable terms or at all, and we may be unable to obtain comparable components from alternative suppliers. Often our 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 have an agreement with one customer providing for construction of power systems that utilize Stirling engine technology. On February 16, 2007, we were notified that the manufacturer of these engines, STM Power, Inc., had ceased operations. We informed the customer that, due to STM s cessation of operations, we are likely unable to complete and maintain these power systems as planned and on October 19, 2007, the customer filed suit against us alleging breach of contract, breach of warranty and negligence and seeking compensatory and consequential damages in excess of $4.0 million. The range of potential loss for this mater is $0 to $4.0 million. We have accrued approximately $0.8 million for this matter, which represents our best estimate of the potential loss in this matter. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

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 and wind turbine businesses; 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 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, 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. In addition, our third-party distributors may require us to provide volume price discounts and other allowances, or customize our products, either of which could reduce the potential profitability of these relationships.

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

Our backlog was approximately $11.3 million as of March 31, 2008. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of March 31, 2008 from which we expect to recognize revenue in fiscal 2008 may 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 March 31, 2008, our revenue and results of operations for fiscal 2008 as well as future reporting periods may be materially harmed.

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

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

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

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

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

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

The markets for delivered hydrogen and reliable backup power are highly competitive. There are a number of companies located in the United States, Canada and abroad that deliver hydrogen, sell hydrogen generation equipment or are developing PEM fuel cell technology. There are a number of

companies that are large, established and well capitalized wind turbine manufacturers. 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 and wind turbines are among 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 products.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The potential for political unrest, acts of terrorism and war, and economic collapse exists in many countries in which we currently, or may 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 their 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 portion of our revenue is generated from sales of equipment and projects in foreign markets. Many of these projects are delivered to distant locations, such as the Middle East, Eurasia, Africa and South America. In addition, we intend to market our hydrogen generators to small- and medium-volume users of delivered hydrogen worldwide. Selling our services and products internationally exposes us to many additional costs, risks and potential liabilities, which, if improperly managed, could limit our ability to grow in these markets and adversely affect our results of operations. These include:

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

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

RISKS RELATING TO OUR INDUSTRY

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

Our future growth will be based in part on increased demand for wind generation equipment, 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 wind and hydrogen generation products 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 wind and hydrogen generation technologies are out of our control. Some of these factors that we cannot control are:

utility electric rates;

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

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

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

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

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

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

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utility power. If the costs of these alternative technologies do not continue to fall or subsidies are no longer available, our ability to sell systems and services based on these technologies will be diminished.

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

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

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

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

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

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.

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All these federal and state incentive and subsidy programs have specific expiration dates and there can be no assurance that these programs will be extended. Termination of one or more of these programs may have an adverse impact on our future growth. Additionally, there can be no assurance that new programs will be created. In an economic downturn, with resulting budget deficits, funding for many of the state programs may be at risk of being diverted to other needs.

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

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

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

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

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

OTHER RISKS

Our stock may be delisted, which would affect its ability to be readily traded

On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

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As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

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

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

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

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

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

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

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5,000,000 shares of preferred stock. The board of directors can fix the price, rights, preferences, privileges and restrictions of the preferred stock without any further vote or action by our stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. As a result, the market price of our common stock and the voting and other rights of our stockholders may be adversely affected. The issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

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

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

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

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

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

ITEM 6. Exhibits

Exhibit 10.1 Termination Agreement between the registrant and Morgan Stanley Wind LLC, dated as of January 16, 2008 (incorporated by reference to Exhibit 99.1 to the registrant s Current Report on Form 8-K filed on January 18, 2008).

Exhibit 10.2 Written description of the registrant s compensation program for non-employee directors.

Exhibit 10.3 First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement between the registrant, Northern Power Systems, Inc., Proton Energy Systems, Inc., Technology Drive, L.L.C. and Perseus Partners VII, L.P. dated March 13, 2008, including exhibits (incorporated by reference to Exhibit 10.1 to the registrant s Current Report on Form 8-K filed on March 13, 2008).

Exhibit 10.4 Additional Investment Senior Secured Convertible Promissory Note dated March 13, 2008 (incorporated by reference to Exhibit 10.2 to the registrant s Current Report on Form 8-K filed on March 13, 2008).

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Exhibit 10.5 First Amendment to Additional Investment Senior Secured Convertible Promissory Notes dated May 8, 2008.

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

SIGNATURES

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

Date: May 12, 2008

DISTRIBUTED ENERGY SYSTEMS CORP.
(Registrant)

By: */s/ Bernard H. Cherry*
Bernard H. Cherry
Interim chief executive officer
(Principal Executive Officer)

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