

FUELCELL ENERGY INC
Form 10-Q
September 10, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended July 31, 2007

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the transition period from _____ to _____

Commission File Number 1-14204

FUELCELL ENERGY, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

06-0853042
(I.R.S. Employer
Identification Number)

**3 Great Pasture Road
Danbury, Connecticut**
(Address of Principal Executive Offices)

06813
(Zip Code)

(203) 825-6000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 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 No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

Common Stock, par value \$.0001 per share, outstanding at September 6, 2007: 67,996,271

FUELCELL ENERGY, INC.

FORM 10-Q

As of and For the Three and Nine Month Periods Ended July 31, 2007

Table of Contents

	Page	
PART I. FINANCIAL INFORMATION		
Item 1.	Consolidated Financial Statements (unaudited)	
	Consolidated Balance Sheets as of July 31, 2007 and October 31, 2006	3
	Consolidated Statements of Operations for the three months ended July 31, 2007 and 2006	4
	Consolidated Statements of Operations for the nine months ended July 31, 2007 and 2006	5
	Consolidated Statements of Cash Flows for the nine months ended July 31, 2007 and 2006	6
	Notes to Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	29
Item 4.	Controls and Procedures	30
PART II. OTHER INFORMATION		
Item 6.	Exhibits	31
	Signature	32

FUELCELL ENERGY, INC.
Consolidated Balance Sheets
(Unaudited)

(Dollars in thousands, except share and per share amounts)

	July 31, 2007	October 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 106,100	\$ 26,247
Investments: U.S. treasury securities	61,442	81,286
Accounts receivable, net of allowance for doubtful accounts of \$96 and \$43, respectively	10,161	9,402
Inventories, net	23,911	14,121
Other current assets	7,664	2,653
Total current assets	209,278	133,709
Property, plant and equipment, net		
Investments: U.S. treasury securities	—	13,054
Investment and loan to affiliate	12,438	11,483
Other assets, net	287	270
Total assets	\$ 262,863	\$ 206,652
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and other liabilities	\$ 1,005	\$ 653
Accounts payable	8,022	12,508
Accrued liabilities	7,790	6,418
Deferred license fee income	—	38
Deferred revenue and customer deposits	20,995	9,785
Total current liabilities	37,812	29,402
Long-term deferred revenue	4,844	5,162
Long-term debt and other liabilities	611	678
Total liabilities	43,267	35,242
Redeemable minority interest	11,464	10,665
Redeemable preferred stock (\$0.01 par value, liquidation preference of \$64,120 at July 31, 2007 and October 31, 2006.)	59,950	59,950
Shareholders' equity:		
Common stock (\$.0001 par value); 150,000,000 shares authorized at July 31, 2007 and October 31, 2006; 67,931,459 and 53,130,901 shares issued and outstanding at July 31, 2007 and October 31, 2006, respectively.	7	5
Additional paid-in capital	570,110	470,045
Accumulated deficit	(421,935)	(369,255)
Treasury stock, Common, at cost (12,282 and 15,583 shares in 2007 and 2006, respectively.)	(126)	(158)
Deferred compensation	126	158
Total shareholders' equity	148,182	100,795

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Total liabilities and shareholders' equity	\$	262,863	\$	206,652
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See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Operations
(Unaudited)
(Dollars in thousands, except share and per share amounts)

	Three Months Ended	
	July 31,	
	2007	2006
Revenues:		
Product sales and revenues	\$ 7,807	\$ 5,376
Research and development contracts	5,737	3,307
Total revenues	13,544	8,683
Costs and expenses:		
Cost of product sales and revenues	14,903	15,240
Cost of research and development contracts	4,718	2,647
Administrative and selling expenses	4,676	4,320
Research and development expenses	6,980	6,621
Total costs and expenses	31,277	28,828
Loss from operations	(17,733)	(20,145)
License fee expense, net	—	(7)
Interest expense	(24)	(22)
Loss from equity investments	(414)	(275)
Interest and other income, net	3,152	1,737
Loss before redeemable minority interest	(15,019)	(18,712)
Redeemable minority interest	(421)	—
Loss before provision for income taxes	(15,440)	(18,712)
Provision for income taxes	—	—
Net loss	(15,440)	(18,712)
Preferred stock dividends	(802)	(1,082)
Net loss to common shareholders	\$ (16,242)	\$ (19,794)
Loss per share basic and diluted:		
Net loss per share to common shareholders	\$ (0.24)	\$ (0.37)
Basic and diluted weighted average shares outstanding	67,939,527	53,116,670

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Operations
(Unaudited)
(Dollars in thousands, except share and per share amounts)

	Nine Months Ended	
	July 31,	
	2007	2006
Revenues:		
Product sales and revenues	\$ 21,567	\$ 14,863
Research and development contracts	10,194	9,298
Total revenues	31,761	24,161
Costs and expenses:		
Cost of product sales and revenues	44,679	40,332
Cost of research and development contracts	8,758	8,283
Administrative and selling expenses	13,866	13,238
Research and development expenses	20,489	17,898
Total costs and expenses	87,792	79,751
Loss from operations	(56,031)	(55,590)
License fee income, net	34	45
Interest expense	(72)	(76)
Loss from equity investments	(1,032)	(715)
Interest and other income, net	5,654	4,491
Loss before redeemable minority interest	(51,447)	(51,845)
Redeemable minority interest	(1,233)	—
Loss before provision for income taxes	(52,680)	(51,845)
Provision for income taxes	—	—
Net loss	(52,680)	(51,845)
Preferred stock dividends	(2,406)	(8,139)
Net loss to common shareholders	\$ (55,086)	\$ (59,984)
Loss per share basic and diluted:		
Net loss per share to common shareholders	\$ (0.92)	\$ (1.19)
Basic and diluted weighted average shares outstanding	59,967,137	50,341,771

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Nine Months Ended July 31,	
	2007	2006
Cash flows from operating activities:		
Net loss	\$ (52,680)	\$ (51,845)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	3,939	3,211
Loss in equity investments	1,032	715
Interest receivable from loan to affiliate	(23)	—
Loss on redeemable minority interest	1,233	—
Gain on derivative	65	—
Depreciation and amortization	7,004	6,820
Amortization (accretion) of bond premium (discount)	(574)	97
Provision for doubtful accounts	53	34
(Increase) decrease in operating assets:		
Accounts receivable	(812)	317
Inventories	(5,847)	(2,547)
Other assets	(4,981)	(550)
Increase (decrease) in operating liabilities:		
Accounts payable	(4,486)	3,289
Accrued liabilities	2,497	1,057
Deferred revenue and customer deposits	10,892	1,919
Deferred license fee income and other	(38)	74
Net cash used in operating activities	(42,726)	(37,409)
Cash flows from investing activities:		
Capital expenditures	(3,487)	(9,469)
Loan to affiliate	(2,000)	—
Treasury notes matured	270,609	149,900
Treasury notes purchased	(237,137)	(106,844)
Net cash provided by investing activities	27,985	33,587
Cash flows from financing activities:		
Repayment of debt	(318)	(458)
Proceeds from debt	354	—
Payment of preferred dividends	(2,840)	(8,129)
Net proceeds from sale of common stock	95,457	7,812
Common stock issued for option and stock purchase plans	1,941	1,375
Net cash provided by financing activities	94,594	600
Net increase in cash and cash equivalents	79,853	(3,222)
Cash and cash equivalents-beginning of period	26,247	22,702

Cash and cash equivalents-end of period	\$	106,100	\$	19,480
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See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Note 1. Summary of Significant Accounting Policies

Nature of Business

FuelCell Energy Inc. (“FuelCell” or the “Company”) develops, manufactures and markets ultra-clean power plants that generate electricity 24/7 with up to twice the efficiency of conventional fossil fuel plants with virtually no air pollution and reduced greenhouse gas emissions. Our DFC power plants use a variety of fuels including renewable biogas and readily-available fuels such as natural gas and have generated more than 180 million kilowatt hours of power for commercial, industrial, municipal and utility customers. FuelCell Energy’s fuel cells are generating power at over 50 locations worldwide.

We have been developing fuel cell technology since our founding in 1969. Our core carbonate fuel cell products (“Direct FuelCell®” or “DFC Power Plants”), offer stationary applications for customers. In addition to our current commercial products, we continue to develop our next generation of carbonate fuel cell and hybrid products as well as planar solid oxide fuel cell (“SOFC”) technology with our own and government research and development funds.

Basis of Presentation - Interim Consolidated Financial Statements

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), for interim financial information, and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not contain all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary to present fairly our financial position as of July 31, 2007 have been included. The balance sheet as of October 31, 2006 has been derived from the audited financial statements at that date.

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and revenues and expenses during the period reported. Actual results could differ from those estimates.

The results of operations and cash flows for the three and nine months ended July 31, 2007 are not necessarily indicative of the results to be expected for the full year. The reader should supplement the information in this document with prior disclosures in our 2006 Annual Report on Form 10-K.

Consolidation

The consolidated financial statements include our accounts and those of our subsidiaries, including our Canadian subsidiary, FuelCell Energy, Ltd., and a subsidiary formed in April 2006, Bridgeport Fuel Cell Park, LLC, for the purpose of developing a 10 MW fuel cell park to be located in Bridgeport, Connecticut. Alliance Monterrey, LLC; Alliance Star Energy, LLC; and Alliance TST Energy, LLC are joint ventures with Alliance Power, Inc. to construct fuel cell power plants and sell power under power purchase agreements to the following customers: the City of Santa Barbara, the Sheraton San Diego Hotel & Marina, the Westin San Francisco Airport Hotel and TST, Inc., respectively.

Alliance Chico, LLC is another joint venture with Alliance Power, Inc for the development and sale of power plants for California customers. The financial results of the joint ventures are consolidated with those of the Company, which owns 80 percent of each entity. Cumulative minority interest in these Alliance entities is not material to the consolidated financial statements. Intercompany accounts and transactions have been eliminated. In January 2007, we formed a new subsidiary, Long Beach Clean Energy, LLC, for bids in New York state. We also formed an entity called DFC-ERG Milford, LLC for project activity under the Connecticut Clean Energy Fund's Project 100. No significant activity was recorded in either of these entities during the nine months ended July 31, 2007.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Certain reclassifications have been made to our prior year amounts to conform to the 2007 presentation.

Foreign Currency Translation

Our Canadian subsidiary, FuelCell Energy, Ltd., is financially and operationally integrated and therefore the temporal method of translation of foreign currencies is followed. The functional currency is U.S. dollars. Foreign currency gains and losses are classified in interest and other income on our consolidated statement of operations.

There was not a material amount of foreign currency gains or losses during the three and nine months ended July 31, 2007 and 2006.

Comprehensive Loss

Our comprehensive loss equals net loss (as reported before preferred dividends) on our consolidated statement of operations of \$15.4 million and \$52.7 million for the three and nine months ended July 31, 2007, respectively, and \$18.7 million and \$51.8 million for the three and nine months ended July 31, 2006, respectively. Comprehensive income (loss) is defined as the increase or decrease in equity from sources other than owners.

Recent Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertain Income Taxes ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements. FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 is effective for fiscal years beginning after December 16, 2006 (beginning of our fiscal 2008 on November 1, 2007). The Company is currently evaluating FIN 48 and we do not anticipate that it will have a material impact on our financial statements upon adoption due to the Company's current income tax position.

Note 2. Equity investments

Versa Power Systems, Inc. ("Versa") is one of our sub-contractors under the Department of Energy ("DOE") large-scale hybrid project to develop a coal-based, multi-megawatt solid oxide fuel cell-based hybrid system. Our equity investment in Versa totaled approximately \$10.4 million and \$11.5 million as of July 31, 2007 and October 31, 2006, respectively. Our ownership interest at July 31, 2007 was 39 percent and we account for Versa under the equity method of accounting.

During the three months ended July 31, 2007, the Company invested \$2.0 million in Versa in the form of a convertible note. This investment would bring the Company's ownership percentage in Versa to approximately 43% should this note be converted into common stock. In conjunction with this investment the Company also received warrants for the right to purchase an additional 2,286 shares of common stock with an exercise price of \$175 per share. The fair value of the warrants was approximately \$0.2 million as of July 31, 2007 and is included within Investment and loan to affiliate on the consolidated balance sheet. Changes in the fair value of the warrants will be included in the consolidated statement of operations each period.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Note 3. Investments

Our short-term investments are in U.S. treasury securities, which are held to maturity. The following table summarizes the amortized cost basis and fair value at July 31, 2007 and October 31, 2006:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
At July 31, 2007				
U.S. government obligations	\$ 61,442	\$ 13	\$ (37)	\$ 61,418
At October 31, 2006				
U.S. government obligations	\$ 94,340	\$ 24	\$ (345)	\$ 94,019

Reported as:

	July 31, 2007	October 31, 2006
Short-term investments	\$ 61,442	\$ 81,286
Long-term investments	—	13,054
Total	\$ 61,442	\$ 94,340

As of July 31, 2007, short-term investment securities have maturity dates ranging from August 15, 2007 to May 15, 2008, and estimated yields ranging from 3.02 percent to 5.59 percent. There were no long-term investment securities as of July 31, 2007. Our weighted average yield on our short-term investments was 4.37 percent as of July 31, 2007.

Note 4. Inventories

The components of inventory at July 31, 2007 and October 31, 2006 consisted of the following:

	July 31, 2007	October 31, 2006
Raw materials	\$ 10,814	\$ 5,571
Work-in-process	13,097	8,550
Total	\$ 23,911	\$ 14,121

Our inventories are stated at the lower of recoverable cost or market price. We provide for a lower of cost or market adjustment against gross inventory values. Our lower of cost or market adjustment, reducing gross inventory values to the reported amounts, was approximately \$14.2 million and \$10.8 million at July 31, 2007 and October 31, 2006, respectively.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
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Note 5. Property, Plant and Equipment

Property, plant and equipment at July 31, 2007 and October 31, 2006 consisted of the following:

	July 31, 2007	October 31, 2006	Estimated Useful Life
Land	\$ 524	\$ 524	—
Building and improvements	6,453	5,996	10-30 years
Machinery, equipment and software	52,892	50,645	3-8 years
Furniture and fixtures	2,466	2,456	6-10 years
Equipment leased to others	2,063	2,063	3 years
Power plants for use under power purchase agreements	17,743	20,576	10 years
Construction in progress ⁽¹⁾	4,636	6,316	
	\$ 86,777	\$ 88,576	
Less accumulated depreciation	(45,917)	(40,440)	
Total	\$ 40,860	\$ 48,136	

(1) Included in construction in progress are costs of approximately \$0.6 million and \$3.0 million at July 31, 2007 and October 31, 2006, respectively, to build power plants for servicing power purchase agreement contracts.

Depreciation expense was approximately \$7.0 million and \$6.6 million for the nine months ended July 31, 2007 and 2006, respectively.

In December 2006, we completed the sale of the 1 MW power plant that had been operating under a power purchase agreement to the Sierra Nevada Brewing Co. This resulted in a \$5.5 million decrease in gross property, plant and equipment, a \$1.5 million decrease in accumulated depreciation and a \$2.2 million decrease in liabilities related to the California Self-Generation Incentive Program which were assumed by the Sierra Nevada Brewing Co. Net cash proceeds from this transaction were \$1.8 million.

Note 6. Share-Based Compensation

The Company has shareholder approved equity incentive plans and a shareholder approved Section 423 Stock Purchase Plan (the "ESPP"), which are described in more detail below.

The compensation cost that has been charged against income for Share-Based Plans was \$1.2 million and \$1.1 million for the three months ended July 31, 2007 and 2006, respectively, and \$3.9 million and \$3.2 million for the nine months ended July 31, 2007 and 2006, respectively. Share-based compensation included in the consolidated statements of operations for the three and nine months ended July 31, 2007 and 2006 was as follows:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2007	2006	2007	2006
Cost of product sales and revenues	\$ 160	\$ 162	\$ 539	\$ 472

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Cost of research and development contracts	78	47	216	139
General and administrative expense	737	680	2,334	2,063
Research and development expense	264	201	821	530
Total share-based compensation	\$ 1,239	\$ 1,090	\$ 3,910	\$ 3,204

10

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
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Equity Incentive Plans

The Board adopted the 1998 and 2006 Equity Incentive Plans (collectively, “the Plans”). Under the terms of the Plans, 8.5 million shares of common stock may be granted as options or stock to our officers, key employees and directors. As of July 31, 2007, 2.1 million shares were available for grant. Pursuant to the Plans, the Board is authorized to grant incentive stock options or nonqualified options and stock appreciation rights to our officers and key employees and may grant nonqualified options and stock appreciation rights to our directors. Stock options and stock appreciation rights have restrictions as to transferability. The option exercise price shall be fixed by the Board but in the case of incentive stock options, shall not be less than 100 percent of the fair market value of the shares subject to the option on the date the option is granted. Stock appreciation rights may be granted in conjunction with options granted under the Plans. Stock options that have been granted are generally exercisable commencing one year after grant at the rate of 25 percent of such shares in each succeeding year and have a ten-year maximum term. There were no stock appreciation rights outstanding at July 31, 2007 or October 31, 2006.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. Expected volatility is based on a combination of the historical volatility of the Company’s stock and the implied volatility from traded options. We use historical data to estimate the expected term of options granted.

	Three Months Ended		Nine Months Ended	
	July 31,		July 31,	
	2007	2006	2007	2006
Expected life (in years)	6.62	6.27	6.53	6.31
Risk-free interest rate	4.81%	4.91%	4.55%	4.57%
Volatility	57.1%	58.1%	61.3%	56.6%
Dividend yield	—	—	—	—

The following table summarizes the Plans’ stock option activity for the nine months ended July 31, 2007:

	Number of	Weighted
	options	average
		option price
Outstanding at October 31, 2006	6,453,404	\$ 10.33
Granted	897,712	7.00
Exercised	(1,260,500)	1.69
Forfeited/Cancelled	(791,350)	15.25
Outstanding at July 31, 2007	5,299,266	11.12

The weighted average grant-date fair value of options granted during the three and nine months ended July 31, 2007 was \$4.60 and \$4.44, respectively, and was \$5.47 and \$5.92, respectively, for the three and nine months ended July 31, 2006. The total intrinsic value of options outstanding and options exercisable at July 31, 2007 was \$3.0 million and \$2.6 million, respectively. The total intrinsic value of options exercised during the three and nine months ended July 31, 2007 was \$0.01 million and \$7.2 million, respectively, and was \$0.2 million and \$2.1 million, respectively, for the three and nine months ended July 31, 2006, respectively.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

The following table summarizes information about stock options outstanding and exercisable at July 31, 2007:

Range of exercise prices	Number outstanding	Options Outstanding		Options Exercisable	
		Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$0.28 - \$5.10	343,800	1.4	\$ 1.72	343,800	\$ 1.72
\$5.11 - \$9.92	2,453,192	7.8	7.60	1,010,344	7.40
\$9.93 - \$14.74	1,677,656	6.6	12.21	1,108,350	12.79
\$14.75 - \$19.56	328,618	3.6	16.82	324,743	16.83
\$19.57 - \$24.39	237,000	3.7	23.00	237,000	23.00
\$24.40 - \$29.21	27,000	3.5	26.15	27,000	26.15
\$29.22 - \$34.03	168,000	3.4	29.91	168,000	29.91
\$34.04 - \$48.49	64,000	3.2	38.50	64,000	38.50
	5,299,266	6.3	\$ 11.12	3,283,237	\$ 12.60

As of July 31, 2007, total compensation cost related to nonvested stock options not yet recognized was \$9.1 million, which is expected to be recognized over the next 1.2 years on a weighted-average basis.

During the nine months ended July 31, 2007, we issued 8,391 shares of common stock with a value of \$0.07 million to directors as compensation in lieu of cash. During the nine months ended July 31, 2006, we issued 6,965 shares of common stock with a value of \$0.06 million to directors as compensation in lieu of cash. These 2006 shares were fully vested at the date of grant.

Employee Stock Purchase Plan

Our shareholders adopted the Employee Stock Purchase Plan (“ESPP”) on July 31, 1993, which has been amended from time to time by the Board. The total shares allocated to the ESPP are 900,000. Under the ESPP, eligible employees have the right to subscribe to purchase shares of common stock at the lesser of 85 percent of the high and low market prices on the first day of the purchase period or the last day of the purchase period and such purchased shares have a six month vesting period. As of July 31, 2007, there were 308,270 shares of Common Stock reserved for issuance under the ESPP.

Activity in the ESPP for the nine months ended July 31, 2007 was as follows:

	Number of Shares
Balance at October 31, 2006	355,587
Issued at \$5.63	(22,750)
Issued at \$5.61	(24,567)
Balance at July 31, 2007	308,270

The weighted-average grant date fair value of shares issued under the ESPP during the nine months ended July 31, 2007 was \$1.94.

12

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

The fair value of shares under the ESPP are determined at the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Nine months ended July 31, 2007
Expected life (in years)	0.5
Risk-free interest rate	5.06%
Volatility	46.7%
Dividend yield	—

Incentive Compensation

Stock may be issued to employees as part of FuelCell's annual incentive bonus. During the nine months ended July 31, 2007, 133,419 shares of common stock with a value of \$0.9 million were issued as incentive bonus (in lieu of cash). During the nine months ended July 31, 2006, we issued 75,585 shares of common stock with a value of \$0.7 million as incentive bonus (in lieu of cash).

Note 7. Shareholders' Equity

Changes in shareholders' equity were as follows for the nine months ended July 31, 2007:

Balance at October 31, 2006	\$ 100,795
Sale of common stock	95,512
Increase in additional paid-in-capital for stock-based compensation	3,939
Increase in additional paid-in-capital for stock issued under employee benefit plans	3,010
Increase in additional paid-in-capital for issuance of warrants	10
Series B preferred dividends	(2,406)
Change in common stock, par	2
Net loss	(52,680)
Balance at July 31, 2007	\$ 148,182

Sale of Common Stock

In April 2007, we completed a public offering of 9.4 million shares of our common stock for net proceeds of \$65.4 million. In February 2007, POSCO Power purchased approximately 3.8 million shares of our common stock, which was restricted for six months, for \$29.0 million. Additionally, we have sold 160,000 shares of our common stock on the open market during the nine months ended July 31, 2007 resulting in net proceeds of approximately \$1.1 million.

Note 8. Segment Information and Major Customers

Under SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," we use the "management" approach to reporting segments. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of reportable segments. SFAS

No. 131 also requires disclosures about products and services, geographic areas, and major customers. Under SFAS No. 131, we have identified one business segment: fuel cell power plant production and research.

13

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Enterprise-wide Information

Enterprise-wide information provided on geographic revenues is based on the customer's ordering location. The following table presents revenues (greater than ten percent of our total revenues) for geographic areas:

	Three months ended July 31,		Nine months ended July 31,	
	2007	2006	2007	2006
Revenues:				
United States	\$ 9,429	\$ 6,606	\$ 21,591	\$ 18,686
Canada	*	*	3,562	*
Korea	1,643	*	*	*
Germany	2,316	1,215	4,033	4,084

Information about Major Customers

We contract with a small number of customers for the sales of our products or research and development contracts. Those customers that accounted for greater than ten percent of our total revenues during the three and nine months ended July 31, 2007 and 2006 are as follows:

	Three months ended July 31,		Nine months ended July 31,	
	2007	2006	2007	2006
U.S. Government (1)	42%	37%	31%	37%
Enbridge, Inc.	*%	*%	11%	*%
MTU CFC Solutions, GmbH	17%	14%	13%	17%
Chevron Energy Solutions	11%	*%	*%	*%
POSCO Power	12%	*%	*%	*%
Alliance Power, Inc.	*%	18%	*%	*%
Logan Energy	*%	11%	*%	11%

* Less than 10 percent of total revenues in period.

(1) - Includes government agencies such as the U.S. Department of Energy and the U.S. Navy either directly or through prime contractors.

Note 9. Earnings Per Share

Basic and diluted earnings per share are calculated using the following data:

	Three months ended July 31,		Nine months ended July 31,	
	2007	2006	2007	2006
	67,939,527	53,116,670	59,967,137	50,341,771

Weighted average basic common shares				
Effect of dilutive securities ⁽¹⁾	—	—	—	—
Weighted average basic common shares adjusted for diluted calculations	67,939,527	53,116,670	59,967,137	50,341,771

(1) We computed earnings per share without consideration to potentially dilutive instruments because losses incurred would make them antidilutive. Future potentially dilutive stock options that were in-the-money at July 31, 2007 and 2006 totaled 1.6 and 2.8 million, respectively. Future potentially dilutive stock options that were not in-the-money at July 31, 2007 and 2006 totaled 3.7 million for each period. We also have future potentially dilutive warrants issued, which vest and expire over time. As of July 31, 2007, 37,500 warrants were vested with an exercise price of \$9.89 and we also had 867,500 unvested warrants.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2007 and 2006
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Note 10. Supplemental Cash Flow Information

The following represents supplemental cash flow information:

	Nine Months Ended	
	2007	2006
Cash paid during the period for:		
Interest	\$ 72	\$ 75
Supplemental disclosure of non-cash investing and financing activities:		
Accrued Employee Stock Purchase Plan	\$ 128	\$ 140
Accrued Common Stock Issued for Bonus Incentive	\$ 942	\$ 718
Impact on investing activities resulting from the sale of a power plant to Sierra Nevada Brewing Co. ⁽¹⁾	\$ (3,943)	\$ —

(1) In December 2006, we completed the sale of the 1 MW power plant that had been operating under a power purchase agreement to the Sierra Nevada Brewing Co. The net book value of the asset of approximately \$3.9 million, which was recorded in property, plant and equipment as of October 31, 2006, was recorded in cost of product sales and revenues upon the sale of the asset. In addition, this sale resulted in the assumption by the buyer of certain of our incentive fund liabilities resulting in a \$2.2 million decrease in deferred revenue liabilities, which was recorded in cost of product sales and revenues. Net cash proceeds from this transaction were \$1.8 million, which is included within operating activities on the consolidated statement of cash flows. Refer also to Note 5 - Property, Plant and Equipment.

Note 11. Commitments and Contingencies***Legal proceedings***

On November 14, 2005, Zoot Properties, LLC and Zoot Enterprises, Inc. ("Zoot") commenced an action in the U.S. District Court for the District of Montana, Butte Division against the Company and one of our distribution partners, PPL Energy Services Holding, LLC. The lawsuit alleged that the plaintiffs purchased fuel cells from PPL that were manufactured by the Company, and that these fuel cells failed to perform as represented and warranted. Zoot sought rescission of the contract with PPL, totaling approximately \$2.5 million. We reached a settlement agreement on this lawsuit resulting in payments by the Company during the third quarter of 2007, net of insurance, of \$0.8 million in exchange for the power plants. There was no impact on the Company's consolidated statement of operations as a result of this settlement.

Restricted cash and cash equivalents

Approximately \$2.4 million of our cash and cash equivalents have been pledged as collateral and letters of credit for certain banking relationships and customer contracts. Approximately \$1.9 million of this collateral supports letters of

credit, which have expiration dates on or before December 31, 2007.

15

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is provided as a supplement to the accompanying financial statements and footnotes to help provide an understanding of our financial condition, changes in our financial condition and results of operations. The MD&A is organized as follows:

Caution concerning forward-looking statements. This section discusses how certain forward-looking statements made by us throughout the MD&A are based on management's present expectations about future events and are inherently susceptible to uncertainty and changes in circumstances.

Overview and recent developments. This section provides a general description of our business. We also briefly summarize any significant events occurring subsequent to the close of the reporting period.

Critical accounting policies and estimates. This section discusses those accounting policies and estimates that are both considered important to our financial condition and operating results and require significant judgment and estimates on the part of management in their application.

Results of operations. This section provides an analysis of our results of operations for the three and nine months ended July 31, 2007 and 2006. In addition, a description is provided of transactions and events that impact the comparability of the results being analyzed.

Liquidity and capital resources. This section provides an analysis of our cash position and cash flows.

Recent accounting pronouncements. This section summarizes recent accounting pronouncements and their impact on the Company.

CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

The following discussion should be read in conjunction with the accompanying Consolidated Financial Statements and Notes thereto included within our 2006 Form 10-K. In addition to historical information, this Form 10-Q and the following discussion contain forward-looking statements. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. Factors that could cause such a difference include, without limitation, general risks associated with product development, manufacturing, changes in the utility regulatory environment, potential volatility of energy prices, rapid technological change, ability to reach product cost objectives, and competition, as well as other risks set forth in our filings with the Securities and Exchange Commission including those set forth under the caption "Risk Factors" in this report.

OVERVIEW

FuelCell Energy develops, manufactures and markets ultra-clean power plants that generate electricity 24/7 with up to twice the efficiency of conventional fossil fuel plants with virtually no air pollution and reduced greenhouse gas emissions. Our DFC power plants use a variety of fuels including renewable biogas and readily-available fuels such as natural gas and have generated more than 180 million kilowatt hours of power for commercial, industrial, municipal and utility customers. FuelCell Energy's fuel cells are generating power at over 50 locations worldwide.

We have been developing fuel cell technology since our founding in 1969. Our core carbonate fuel cell products ("Direct FuelCell[®]" or "DFC[®]Power Plants"), offer stationary applications for customers. In addition to our current commercial products, we continue to develop our next generation of carbonate fuel cell and hybrid products as well as

planar solid oxide fuel cell (“SOFC”) technology with our own and government research and development funds.

Our proprietary carbonate DFC power plants electrochemically (meaning without combustion) produce electricity directly from readily available hydrocarbon fuels, such as natural gas and biomass fuels. Customers buy fuel cells to improve reliability, reduce costs and reduce emissions.

We believe our products offer significant advantages compared to other power generation technologies:

- Reliable 24/7 baseload power,
 - High fuel efficiency,
 - Ultra-clean (e.g. virtually zero emissions) and quiet operation,
 - Lower cost to generate electricity,
 - The ability to site units locally, and
- provide high temperature heat for cogeneration applications.

Our core products, the DFC300MA, DFC1500MA and DFC3000, are currently rated in capacity at 300 kW, 1.2 MW and 2.4 MW, respectively and are designed for applications up to 50 MW. Our products meet the baseload power requirements of a wide range of customers, including wastewater treatment plants (municipal, such as sewage treatment facilities, and industrial, such as breweries and food processors), hotels and manufacturing facilities, universities, hospitals, telecommunications/data centers, government facilities, as well as grid support applications for utility customers. Our DFC power plants can be part of a total onsite power generation solution for customers with our high efficiency products providing the baseload power with grid-delivered electricity and intermittent power, such as solar, or less efficient combustion-based equipment providing peaking and load following energy needs. Our fuel cells offer flexible siting and easy permitting. Our products are also ideal for meeting the needs of utilities and the Renewable Portfolio Standards (“RPS”) clean energy mandates now in 25 states and Washington D.C.

The market is beginning to recognize the advantages of stationary fuel cell power. Volatile fuel and energy prices, the ratification of the Kyoto Protocol by over 160 countries since 2005, and worldwide efforts to minimize greenhouse gases like CO₂ and other harmful emissions with mandates for significant increases in clean electric power generation, are placing greater emphasis on ultra-clean, high efficiency distributed generation power. Electric generation without combustion significantly reduces harmful pollutants such as NO_x, SO_x and particulates. Higher fuel efficiency results in lower emissions of carbon dioxide, a major contributor of harmful greenhouse gases, and also results in less fuel needed per kWh of electricity generated and Btu of heat produced, thereby reducing exposure to volatile natural gas costs and minimizing operating costs. With increasing demand for renewable and ultra-clean power options, and increased volatility and uncertainty in electric markets, our customers gain control of power generation economics, reliability and emissions.

Our business strategy is to expand our leadership position in key markets, build multi-megawatt markets and continue to reduce the costs of our products. We believe that with the emergence of the RPS markets, the growth of the California and Asian markets and continuing product cost reduction, we are well positioned to move to profitability. We are currently ramping our annual production rate from 11 MW to 25 MW. At a sustained annual order and production volume of approximately 35 MW to 50 MW, depending on product mix, geographic location and other variables such as fuel prices, we can reach gross margin breakeven. Our net income break-even can be achieved at a sustained annual order and volume production of approximately 75-100 MW assuming a mix of sub-MW and MW sales. With the multi-MW order potential of Asia, Connecticut and California, our 2.4 MW DFC 3000 is expected to become gross margin profitable with volume. Thus, if product mix trends more toward MW and multi-MW orders, we believe that profitability can be achieved at annual volumes lower than 75 MW.

Customers buy our fuel cells for reliability, cost and environmental demands. There are currently strong incentive programs in our target markets including California and the Northeast in the U.S., South Korea and Japan in Asia and Germany in Europe that make the cost of clean power solutions including fuel cells, wind and solar, competitive. We believe that with continued cost reduction of our products and increased volume, our products will be cost competitive

on an unsubsidized basis against the grid and other distributed generation products, such as engines.

17

Recent Developments

Versa Investment

In June 2007, we invested \$2.0 million in Versa Power Systems, Inc. (“Versa”) in the form of a convertible note. This investment would bring the Company’s ownership percentage in Versa to approximately 43% should this note be converted into common stock. In conjunction with this investment we also received warrants for the right to purchase an additional 2,286 shares of Versa common stock with an exercise price of \$175 per share. Versa is a leading planar solid-oxide technology developer and is a subcontractor on the Company’s DOE large-scale project to develop a coal-based, multi-megawatt solid oxide fuel cell-based hybrid system.

Increase in Production Rate

The Company is currently ramping its annual production rate from 11 MW to 25 MW and increasing physical plant capacity for MW class products in response to the current and anticipated demand from Asia and California. We expect to invest approximately \$10 - 15 million over the next fifteen months to increase the physical plant capacity to approximately 60 MW of annual production volume.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports will be made available free of charge through the Investor Relations section of our Internet website (<http://www.fuelcellenergy.com>) as soon as practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission. Material contained on our website is not incorporated by reference in this report. Our executive offices are located at 3 Great Pasture Road, Danbury, CT 06813.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

We contract with our customers to perform research and development, manufacture and install fuel cell components and power plants under long-term contracts, and provide services under contract. We recognize revenue on a method similar to the percentage-of-completion method.

Revenues on fuel cell research and development contracts are recognized proportionally as costs are incurred and compared to the estimated total research and development costs for each contract. In many cases, we are reimbursed only a portion of the costs incurred or to be incurred on the contract. Revenues from government funded research, development and demonstration programs are generally multi-year, cost reimbursement and/or cost shared type contracts or cooperative agreements. We are reimbursed for reasonable and allocable costs up to the reimbursement limits set by the contract or cooperative agreement.

While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress has authorized the funds. As of July 31, 2007, research and development sales backlog totaled \$22.1 million, of which 47 percent is funded. Should funding be temporarily delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

Product sales and revenues include revenues from power plant sales, service contracts, electricity sales under power purchase agreements (“PPAs”) and incentive funding. Revenues from power plant sales are recognized proportionally as costs are incurred and assigned to a customer contract by comparing the estimated total manufacture and installation costs for each contract to the total contract value. For contracts under which there are contractual contingencies (e.g. receipt of incentive funding), revenue is deferred until such contingencies are cleared. Revenues from service contracts are generally recognized ratably over the contract term. For service contracts that include a fuel cell stack replacement, a portion of the total contract value is recognized as revenue at the time of the stack replacement and the remainder of the contract value is recognized ratably over the contract term. Revenues from electricity sales under power purchase agreements are recognized as power is produced. Revenues from incentive funding are recognized ratably over the term of the incentive funding agreement.

As our fuel cell products are in their initial stages of development and market acceptance, actual costs incurred could differ materially from those previously estimated. Once we have established that our fuel cell products have achieved commercial market acceptance and future costs can be reasonably estimated, then estimated costs to complete an individual contract, in excess of revenue, will be accrued immediately.

Warrant Value Recognition

Warrants have been issued as sales incentives to certain of our distribution partners. These warrants vest as orders from our business partners exceed stipulated levels. Should warrants vest, or when management estimates that it is probable that warrants will vest, we will record a proportional amount of the fair value of the warrants against related revenue as a sales discount.

Inventories

During the procurement and manufacturing process of a fuel cell power plant, costs for material, labor and overhead are accumulated in raw materials and work-in-process inventory until they are transferred to a customer contract, at which time they are recorded in cost of sales.

Our inventories and advance payments to vendors are stated at the lower of cost or market (“LCM”) price. As we currently sell products at or below cost, we provide for an LCM adjustment to the cost basis of inventory and advances to vendors. This adjustment is computed by comparing the current sales prices of our power plants to estimated costs of completed power plants. In certain circumstances, for long-lead time items, we will make advance payments to vendors for future inventory deliveries, which are recorded as a component of other current assets on the consolidated balance sheet.

As of July 31, 2007 and October 31, 2006, the LCM adjustment to the cost basis of inventory and advance payments to vendors was approximately \$15.9 million and \$11.3 million, respectively, which equates to a reduction of approximately 36 and 43 percent, respectively, of the gross inventory and advanced payments to vendors value. The decline in this LCM percentage is due to a shift in inventory mix to MW-class products, which have a lower cost. As of July 31, 2007, our gross inventory and advances to vendors’ balances increased from the October 31, 2006 balances, which resulted in higher reserve balances. As inventory levels increase or decrease, appropriate adjustments to the cost basis are made.

Internal Research and Development Expenses

We conduct internally funded research and development activities to improve current or anticipated product performance and reduce product life-cycle costs. These costs include improving manufacturing processes, cost reduction, technology improvement and technology development, as we work to develop new products to meet the needs of customers. These costs are classified as research and development expenses on our consolidated statements

of operations.

19

Share-Based Compensation

On November 1, 2005, we adopted Statement of Financial Accounting Standard No. 123R, "Share-Based Payments" (SFAS 123R). Share-based payment transactions with employees, which primarily consist of stock options, and third parties requires the application of a fair value methodology that involves various assumptions. The fair value of our options awarded to employees is estimated on the date of grant using the Black-Scholes option valuation model that uses the following assumptions: expected life of the option, risk-free interest rate, expected volatility of our common stock price and expected dividend yield. We estimate the expected life of the options using historical data and the volatility of our common stock is estimated based on a combination of the historical volatility and the implied volatility from traded options. Share-based compensation of \$1.2 million and \$3.9 million was recognized in the consolidated statement of operations for the three and nine months ended July 31, 2007, respectively, compared to \$1.1 million and \$3.2 million for the three and nine months ended July 31, 2006, respectively. Refer to Note 6 of the consolidated financial statements for additional information.

RESULTS OF OPERATIONS

Management evaluates the results of operations and cash flows using a variety of key performance indicators. Indicators that management uses include revenues compared to prior periods and internal forecasts, costs of our products and results of our "cost-out" initiatives and operating cash use. These are discussed throughout the 'Results of Operations' and 'Liquidity and Capital Resources' sections.

Comparison of Three Months ended July 31, 2007 and July 31, 2006**Revenues and costs of revenues**

The following tables summarize the components of our revenues and cost of revenues for the three months ended July 31, 2007 and 2006 (dollar amounts in thousands), respectively:

	Three Months Ended July 31, 2007		Three Months Ended July 31, 2006		Percentage Increase / (Decrease) in Revenues
	Revenues	Percent of Revenues	Revenues	Percent of Revenues	
Revenues:					
Product sales and revenues	\$ 7,807	58%	\$ 5,376	62%	45%
Research and development contracts	5,737	42%	3,307	38%	73%
Total	\$ 13,544	100%	\$ 8,683	100%	56%

	Three Months Ended July 31, 2007		Three Months Ended July 31, 2006		Percentage Increase / (Decrease) in Cost of Revenues
	Cost of Revenues	Percent of Cost of Revenues	Cost of Revenues	Percent of Cost of Revenues	
Cost of revenues:					
Product sales and revenues	\$ 14,903	76%	\$ 15,240	85%	(2)%
Research and development contracts	4,718	24%	2,647	15%	78%
Total	\$ 19,621	100%	\$ 17,887	100%	10%

Total revenues for the three months ended July 31, 2007 increased by \$4.9 million, or 56 percent, to \$13.5 million from \$8.7 million during the same period last year.

Product sales and revenues

Product sales and revenue increased \$2.4 million to \$7.8 million for the three months ended July 31, 2007, compared to \$5.4 million for the same period in 2006. Revenue during the quarter included approximately \$6.3 million of power plant and component sales, \$0.5 million related to service agreements and approximately \$1.0 million of revenue related to power purchase agreements. Higher product sales and revenues was due to an increase in component sales and power plant sales, including production of MW-class units for POSCO, an increase in service agreement revenue and higher revenues from power purchase agreements.

Cost of product sales and revenues decreased to \$14.9 million for the three months ended July 31, 2007, compared to \$15.2 million during the same period in 2006. The ratio of product cost to sales improved to 1.9-to-1 in the third quarter of 2007, compared to 2.8-to-1 in the third quarter of 2006. The decrease in the cost ratio is due to higher product and component revenue and lower product unit costs, more favorable results from power purchase and service agreements, and a decrease in the lower of cost or market on our inventory due to lower inventory build during the third quarter of 2007, compared to 2006, and the shift to lower cost MW and sub-MW production.

As of July 31, 2007, product sales backlog totaled approximately \$49.6 million including approximately \$12.5 million related to long-term service agreements. This compares to a product sales backlog of \$20.0 million that included \$6.5 million related to long-term service agreements as of July 31, 2006. The increase in product backlog is related to orders from South Korean and California customers.

Our products do not ship on an even production schedule. The shipment date to customers depends on a number of factors that are outside of our control, including siting requirements, timing of construction and permits. We do not have the sales or order history to quantify trends as of yet. We expect to continue to sell our DFC products at prices lower than our production costs until such time as we are able to reduce product costs through our engineering and manufacturing efforts and production volumes increase.

Research and development contracts

Research and development revenue increased \$2.4 million to \$5.7 million for the three months ended July 31, 2007, compared to \$3.3 million for the same period in 2006. Cost of research and development contracts increased to \$4.7 million during the third quarter of 2007, compared to \$2.6 million for 2006, and the cost ratio was essentially the same at 0.8-to-1 in both quarters. Research and development contract revenue and costs were primarily related to the DOE's large-scale SOFC hybrid program, the Electrochemical Hydrogen Separation contract with the U.S. Army and the U.S. Navy contract for high temperature ship service fuel cell development.

As of July 31, 2007, research and development sales backlog totaled approximately \$22.1 million of which Congress has authorized funding of \$10.5 million, compared to \$9.8 million (\$7.2 million funded) as of July 31, 2006. The increase in research and development sales backlog is primarily related to a 10-year U.S. Department of Energy project to develop a solid oxide fuel cell-based, large scale hybrid system which we entered into in 2006.

Administrative and selling expenses

Administrative and selling expenses increased \$0.4 million to \$4.7 million during the three months ended July 31, 2007, compared to \$4.3 million in the same period of the prior year. This increase is primarily due to higher bid and proposal and other marketing activities and higher stock-based compensation.

Research and development expenses

Research and development expenses increased to \$7.0 million during the three months ended July 31, 2007, compared to \$6.6 million recorded in the same period of the prior year. The increase in the quarter is due primarily to development costs for MW-class cost reduction, costs related to continuing technology development including increasing stack life and power output and higher stock-based compensation.

Loss from operations

Loss from operations for the three months ended July 31, 2007 totaling \$17.7 million, compared to \$20.1 million recorded in the comparable period last year. The decrease in the loss from operations is due primarily to improving margins on product sales, partially offset by higher administrative and selling and research and development expenses discussed above.

Loss from equity investments

Our equity investment in Versa totaled approximately \$10.4 million and \$11.5 million as of July 31, 2007 and October 31, 2006, respectively. Our ownership interest at July 31, 2007 was 39%. We account for Versa under the equity method. Our share of equity losses for the three months ended July 31, 2007 and 2006 were \$0.4 million and \$0.3 million, respectively.

During the three months ended July 31, 2007, the Company invested \$2.0 million in Versa in the form of a convertible note. This investment would bring the Company's ownership percentage in Versa to approximately 43% should this note be converted into common stock. In conjunction with this investment the Company also received warrants for the right to purchase an additional 2,286 shares of common stock. The fair value of the warrants was approximately \$0.2 million as of July 31, 2007 and is included within Investment and loan to affiliate on the consolidated balance sheet. Changes in the fair value of the warrants will be included in the consolidated statement of operations each period.

Interest and other income, net

Interest and other income, net, was \$3.2 million for the three months ended July 31, 2007, compared to \$1.7 million for the same period in 2006. Interest and other income increased due to higher state research and development tax credits which totaled \$1.2 million for the three months ended July 31, 2007, compared to \$0.2 million for the three months ended July 31, 2006, respectively, as well as an increase in interest income on higher average invested balances. The Company records state research and development tax credits in the period in which the return is filed.

Provision for income taxes

We believe that due to our efforts to commercialize our DFC products, we will continue to incur losses. Based on projections for future taxable income over the period in which the deferred tax assets are realizable, management believes that significant uncertainty exists surrounding the recoverability of the deferred tax assets. Therefore, no tax benefit has been recognized related to current or prior year losses and other deferred tax assets.

Comparison of Nine Months ended July 31, 2007 and July 31, 2006**Revenues and costs of revenues**

The following tables summarize the components of our revenues and cost of revenues for the nine months ended July 31, 2007 and 2006 (dollar amounts in thousands), respectively:

	Nine Months Ended July 31, 2007		Nine Months Ended July 31, 2006		Percentage Increase / (Decrease) in Revenues
	Revenues	Percent of Revenues	Revenues	Percent of Revenues	
Revenues:					
Product sales and revenues	\$ 21,567	68%	\$ 14,863	62%	45%
Research and development contracts	10,194	32%	9,298	38%	10%
Total	\$ 31,761	100%	\$ 24,161	100%	31%

	Nine Months Ended July 31, 2007		Nine Months Ended July 31, 2006		Percentage Increase / (Decrease) in Cost of Revenues
	Cost of Revenues	Percent of Cost of Revenues	Cost of Revenues	Percent of Cost of Revenues	
Cost of revenues:					
Product sales and revenues	\$ 44,679	84%	\$ 40,332	83%	11%
Research and development contracts	8,758	16%	8,283	17%	6%
Total	\$ 53,437	100%	\$ 48,615	100%	10%

Total revenues for the nine months ended July 31, 2007 increased by \$7.6 million, or 31 percent, to \$31.8 million from \$24.2 million during the same period last year.

Product sales and revenues

Product sales and revenue increased \$6.7 million to \$21.6 million for the nine months ended July 31, 2007, compared to \$14.9 million for the same period in 2006. Revenue during the nine months ended July 31, 2007 included approximately \$15.9 million of power plant and component sales, \$2.3 million related to service agreements and approximately \$3.3 million of revenue related to power purchase agreements. Higher product sales and revenues were due to an increase in power plant sales, including production of MW-class units, an increase in service agreement revenue and higher revenues from power purchase agreements.

Cost of product sales and revenues increased to \$44.7 million for the nine months ended July 31, 2007, compared to \$40.3 million during the same period in 2006. The ratio of product cost to sales improved to 2.1-to-1 during the nine months ended July 31, 2007, compared to 2.7-to-1 during the same period a year ago. The cost ratio was favorably impacted in the period by the shift to MW production and lower cost sub-MW units, as well as a lower cost ratio on service agreements and power purchase agreements. The cost ratio was unfavorably impacted by an increase in inventory resulting in a higher lower of cost or market adjustment in the nine month period ended July 31, 2007, compared to the same period in 2006.

Research and development contracts

Research and development revenue increased \$0.9 million to \$10.2 million for the nine months ended July 31, 2007, compared to \$9.3 million for the same period in 2006. Cost of research and development contracts increased to \$8.8 million during the nine months ended July 31, 2007, compared to \$8.3 million for 2006, and the cost ratio was essentially the same at 0.9-to-1 in both periods. Research and development contract revenue and costs were primarily related to the DOE's large-scale SOFC hybrid program, the U.S. Navy contract for high temperature ship service fuel cell development and the Electrochemical Hydrogen Separation contract with the U.S. Army.

Administrative and selling expenses

Administrative and selling expenses increased \$0.7 million to \$13.9 million during the nine months ended July 31, 2007, compared to \$13.2 million in the same period of the prior year. This increase is primarily due to higher bid and proposal and other marketing activities and higher stock-based compensation.

Research and development expenses

Research and development expenses increased to \$20.5 million during the nine months ended July 31, 2007, compared to \$17.9 million recorded in the same period of the prior year. The increase in the period is due to development costs for MW-class cost reduction efforts, costs related to our technology development to extend stack life and increase the power output of our power plants and higher stock-based compensation.

Loss from operations

Loss from operations for the nine months ended July 31, 2007 totaled \$56.0 million, compared to \$55.6 million recorded in the comparable period last year. The increase in the loss from operations is primarily due to higher research and development and administrative and selling expenses discussed above. This was almost entirely offset by a favorable change in product margin resulting from the shift to MW production and lower cost sub-MW units, as well as a lower cost ratio on service agreements and power purchase agreements.

Loss from equity investments

Our equity investment in Versa totaled approximately \$10.4 million and \$11.5 million as of July 31, 2007 and October 31, 2006, respectively. Our ownership interest at July 31, 2007 was 39% and we account for Versa under the equity method of accounting. Our share of equity losses for the nine months ended July 31, 2007 and 2006 were \$1.0 million and \$0.7 million, respectively.

During the nine months ended July 31, 2007, the Company invested \$2.0 million in Versa in the form of a convertible note. This investment would bring the Company's ownership percentage in Versa to approximately 43% should this note be converted into common stock. In conjunction with this investment the Company also received warrants for the right to purchase an additional 2,286 shares of common stock with an exercise price of \$175 per share. The fair value of the warrants was approximately \$0.2 million as of July 31, 2007 and is included within Investment and loan to affiliate on the consolidated balance sheet. Changes in the fair value of the warrants will be included in the consolidated statement of operations each period.

Interest and other income, net

Interest and other income, net, was \$5.7 million for the nine months ended July 31, 2007, compared to \$4.5 million for the same period in 2006. Interest and other income increased due to higher state research and development tax credits which totaled \$1.2 million, compared to \$0.2 million for the nine months ended July 31, 2007 and 2006, respectively. The Company records state research and development tax credits in the period in which the return is filed.

Provision for income taxes

We believe that due to our efforts to commercialize our DFC products, we will continue to incur losses. Based on projections for future taxable income over the period in which the deferred tax assets are realizable, management believes that significant uncertainty exists surrounding the recoverability of the deferred tax assets. Therefore, no tax benefit has been recognized related to current or prior year losses and other deferred tax assets.

LIQUIDITY AND CAPITAL RESOURCES

We had approximately \$167.5 million of cash, cash equivalents and investments as of July 31, 2007, compared to \$120.6 million as of October 31, 2006. During the nine months ended July 31, 2007, we sold shares of our common stock to POSCO for \$29.0 million, completed a public offering with net proceeds of \$65.4 million and sold shares on the open market for \$1.1 million. Excluding these stock sales, cash and investments used during the nine months ended July 31, 2007 totaled \$48.6 million and include dividend payments on our preferred stock of \$2.8 million and \$2.0 million in the form of a convertible note made to Versa, partially offset by proceeds of \$2.2 million from the sale of a power plant being used to service a power purchase agreement (includes \$0.4 million from the sale of a long-term service agreement on this power plant), receipt of incentive funds related to our power purchase agreements of \$1.5 million and proceeds from common stock issued for benefit plans of \$1.9 million.

Cash Inflows and Outflows

Cash and cash equivalents as of July 31, 2007 totaled \$106.1 million, reflecting an increase of \$79.9 million from the balance reported as of October 31, 2006. The key components of our cash inflows and outflows from continuing operations were as follows:

Operating Activities: During the nine months ended July 31, 2007, we used \$42.7 million in cash for operating activities, compared to operating cash usage of \$37.4 million during the comparable period of 2006. Cash used in operating activities during the first nine months of fiscal 2007 consists of a net loss for the period of approximately \$52.7 million, offset by non-cash adjustments totaling \$12.7 million, including \$3.9 million of share-based compensation and depreciation expense of \$7.0 million.

In addition, cash used in working capital totaled approximately \$2.8 million, including higher net inventories of approximately \$5.8 million due to higher production levels and lower accounts payable and accrued liabilities of \$2.0 million due to timing of production and vendor payments during the quarter. These amounts were partially offset by higher accounts receivable of \$0.8 million due to the timing of production and shipping milestones and higher deferred revenue and customer deposits of \$10.9 million.

Investing Activities: During the nine months ended July 31, 2007, net cash provided by investing activities totaled \$28.0 million, compared with approximately \$33.6 million in the comparable period of 2006. Capital expenditures totaled \$3.5 million for 2007 and approximately \$270.6 million of investments in U.S. Treasury Securities matured and new treasury purchases totaled \$237.1 million during the first nine months of fiscal 2007. The Company also invested \$2.0 million in the form of a convertible note made to Versa.

Financing Activities: During the nine months ended July 31, 2007, net cash provided by financing activities was approximately \$94.6 million, compared to \$0.6 million in 2006. The first nine months of fiscal 2007 included \$95.5 million from the sale of common stock and \$1.9 million from common stock issued for benefit plans. This was partially offset by \$2.8 million for the payment of dividends on preferred stock.

Sources and Uses of Cash and Investments

We continue to invest in new product development and market development and, as such, we are not currently generating positive cash flow from our operations. Our operations are funded primarily through sales of equity securities and cash generated from customer contracts, including cash from government research and development contracts, product sales, power purchase agreements, incentive funding and interest earned on investments. Our future cash requirements depend on numerous factors including future involvement in research and development contracts, implementing our cost reduction efforts and increasing annual order volume.

Future involvement in research and development contracts

Our research and development contracts are generally multi-year, cost reimbursement type contracts. The majority of these are U.S. Government contracts that are dependent upon the government's continued allocation of funds and may be terminated in whole or in part at the convenience of the government. We will continue to seek research and development contracts. To obtain these contracts, we must continue to prove the benefits of our technologies and be successful in our competitive bidding.

Implementing cost reduction efforts on our fuel cell products

Cost reduction is critical to attaining profitability in future periods and is essential for us to penetrate the market for our fuel cell products. Cost reductions will reduce and/or eliminate the need for incentive funding programs and allow our product pricing to better compete with grid-delivered power and other distributed generation products. Our multi-disciplined cost reduction program focuses on value engineering, manufacturing process improvements, and technology improvements to increase power plant output and stack life.

Our 2 MW Santa Clara 'proof-of-concept' project in 1996-1997 cost more than \$20,000/kW to produce. In 2003, we shipped our first commercial product, a DFC300 to the Kirin Brewery which cost approximately \$10,000/kW. At that time, we implemented our commercial cost-out program hiring additional engineers who focused on reducing the total life cycle costs of our power plants. Since 2003, we have made significant progress primarily through value engineering our products and increasing the power output by 20%. We entered fiscal 2007 with a current manufactured cost of approximately \$3,250 /kW for our multi-MW power plant, \$4,300/kW for our MW plant and \$4,800/kW for the sub-MW product. Our cost out program has resulted in lower cost-to-revenue ratios with a third quarter 2007 product cost-to-revenue ratio of 1.91, compared with 2.83 in the same period a year ago. To date, the primary drivers have been value engineering and technology development.

With the multi-MW order potential of Asia, Connecticut and California, our 2.4 MW DFC 3000 product is expected to become gross margin profitable with volume. This will come through supply chain efficiencies, purchasing power and process improvements. To drive costs lower, our 2007 cost out program is focused on global sourcing, technology development, continued value engineering and manufacturing efficiencies.

Increasing annual order volume

In addition to the cost reduction initiatives discussed above, we need to increase annual order volume. Increased production volumes are necessary to lower costs by leveraging supplier/purchasing opportunities, incorporating manufacturing process improvements and spreading fixed costs over higher units of production. Our manufacturing and conditioning facilities have the equipment in place to accommodate 50 MW of annual production volume, but the higher production volume will require increasing the manufacturing workforce.

As of July 31, 2007, we had 13.4 MW in backlog. We see near term opportunities for increased order volume in our key markets, including California, Connecticut and Asia. California is a leading market for our ultra-clean products with approximately 40% of our installed capacity at July 31, 2007. In Connecticut, our fuel cells are incorporated into 68 MW of large-scale multi-MW projects that have been recommended by the Connecticut Clean Energy Fund for development under Connecticut's RPS Program, Project 100. These projects are currently being evaluated by the Department of Utility Control, which is expected to announce its decision in December. In Asia, the South Korean government has initiated a subsidy program with initial subsidies ranging from \$0.23 to 0.28/kilowatt hour (kWh). This program was put in place to encourage utilities to buy highly efficient, ultra-clean, low-emission, fuel cell-produced electricity, thus helping the country to meet its carbon dioxide (CO₂) reduction and clean air goals. In February, we signed a 10-year manufacturing and distribution agreement with POSCO Power. We expect that this partnership will allow us to capture significant opportunities in the South Korean market.

Combined with historical cost out achievements and successful completion of our new targets, we believe we can reach gross margin breakeven on product sales at a sustained annual order and production volume of approximately 35 MW to 50 MW, depending on product mix, geographic location and other variables such as fuel prices. We believe that the Company net income breakeven can be achieved at a sustained annual order and volume production of approximately 75 to 100 MW assuming a favorable mix of sub-MW and MW sales. If this mix trends more toward MW and multi-MW orders, we believe that the gross margin and net income breakeven volumes can be lower.

The Company is currently ramping its annual production rate from 11 MW to 25 MW and increasing physical plant capacity for MW class products in response to the current and anticipated demand from Asia and California. We expect to invest approximately \$10 - 15 million over the next fifteen months to increase the physical plant capacity to approximately 60 MW of annual production volume.

We anticipate that our existing capital resources, together with anticipated revenues will be adequate to satisfy our financial requirements and agreements through at least the next twelve months.

Commitments and Significant Contractual Obligations

A summary of our significant future commitments and contractual obligations as of July 31, 2007 and the related payments by fiscal year is summarized as follows (in thousands):

Payments Due by Period