

FUELCELL ENERGY INC

Form 424B5

April 03, 2007

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The information in this prospectus supplement is not complete and may change. This prospectus supplement is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

**Filed Pursuant to Rule 424(b)(5)  
Registration No. 333-128088**

**SUBJECT TO COMPLETION, DATED APRIL 3, 2007  
PROSPECTUS SUPPLEMENT (TO PROSPECTUS DATED JANUARY 23, 2007)**

**9,000,000 Shares**

Common Stock

We are selling 9,000,000 shares of our common stock.

Our common stock is listed on The NASDAQ National Market under the symbol **FCEL** . The closing price on April 2, 2007 was \$7.73 per share.

The underwriters have an option to purchase a maximum of 1,350,000 additional shares to cover over-allotments of shares.

**Investing in our common stock involves risks. See **Risk Factors** beginning on page S-6 of this prospectus supplement.**

	<b>Price to Public</b>	<b>Underwriting Discounts and Commissions</b>	<b>Proceeds to FuelCell</b>
Per Share	\$	\$	\$
Total	\$	\$	\$

Delivery of the shares of common stock will be made on or about April , 2007.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement is accurate or complete. Any representation to the contrary is a criminal offense.

<b>Canaccord Adams</b>	<b>Credit Suisse Lazard Capital Markets</b>	<b>RBC Capital Markets</b>
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**The date of this prospectus supplement is April , 2007.**

This document is in two parts. The first part is this prospectus supplement, which describes, adds to, updates and changes information contained in the accompanying prospectus and the documents incorporated by reference. The second part is the accompanying prospectus, which gives more general information. To the extent the information contained in this prospectus supplement differs or varies from the information contained in the accompanying prospectus or any document incorporated by reference, the information in this prospectus supplement will control.

**You should rely only on the information contained in or incorporated by reference into this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information that is different. This prospectus supplement is not an offer to sell or solicitation of an offer to buy these shares of common stock in any circumstances under which the offer or sale is unlawful. You should not assume that the information we have included in this prospectus supplement or the accompanying prospectus is accurate as of any date other than the date of this prospectus supplement or the accompanying prospectus or that any information we have incorporated by reference is accurate as of any date other than the date of the document incorporated by reference regardless of the time of delivery of this prospectus supplement or of any such shares of our common stock. Our financial condition, results of operations and business prospects may have changed since that date.**

Information contained on our website does not constitute part of this prospectus supplement or the accompanying prospectus. FuelCell Energy®, the FuelCell Energy logo, Direct FuelCell® and DFC® are our trademarks. All other trademarks that may appear or be incorporated by reference into this prospectus supplement are the property of their respective owners.

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**SUMMARY**

*This summary highlights information contained elsewhere or incorporated by reference into this prospectus supplement and accompanying prospectus. This summary does not contain all the information that you should consider before investing in our common stock. You should carefully read the entire prospectus supplement and the accompanying prospectus, including the Risk Factors section, starting on page S-6 of this prospectus supplement, as well as the financial statements and the other information incorporated by reference herein before making an investment decision.*

**Overview**

We are a world leader in the development and manufacture of fuel cell power plants for ultra-clean, efficient and reliable electric power generation using renewable and domestic fuels. Our products are designed to meet the 24/7 baseload power needs of commercial, industrial, government and utility customers. To date our products have generated over 150 million kilowatt hours of electricity and we have over 60 power plant installations worldwide.

Our executive offices are located at 3 Great Pasture Road, Danbury, Connecticut 06813. Our telephone number is (203) 825-6000. We maintain a web site at the following Internet address: [www.fuelcellenergy.com](http://www.fuelcellenergy.com). The information on our web site is not part of this prospectus.

Unless the context otherwise requires, references in this prospectus to FuelCell, we, us and our refer to FuelCell Energy, Inc.

As used in this prospectus, all degrees refer to Fahrenheit (°F), and kilowatt and megawatt numbers designate nominal or rated capacity of the referenced power plant. As used in this prospectus, kilowatt (kW) means 1,000 watts; megawatt (MW) means 1,000,000 watts; kilowatt hour (kWh) is equal to 1 kW of power supplied to or taken from an electric circuit steadily for one hour; and BTU is equal to one million British Thermal Units, which is the amount of heat necessary to raise one pound of pure water from 59°F to 60°F at a specified constant pressure. All dollar amounts are in U.S. dollars unless otherwise noted.

**Summary of Business**

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, to reduce costs and to 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) quiet operation,

Lower cost to generate electricity, and

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 are designed to 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, manufacturing facilities, universities, hospitals, telecommunications/data centers,

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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 to meet the needs of utilities and Renewable Portfolio Standard mandates.

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 CO<sub>2</sub> 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 products. Electric generation without combustion significantly reduces harmful pollutants such as nitrogen oxide, sulfur oxide 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 ultraclean 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 Renewable Portfolio Standard markets, the growth of the California market and continuing product cost reduction, we are well positioned to move to profitability.

## **Recent Developments**

### *Expanded distribution agreement with POSCO Power*

On February 20, 2007, we announced a ten-year manufacturing and distribution agreement with POSCO Power, a subsidiary of our Korean strategic distribution partner, POSCO. For the first two years of the agreement, we will sell complete Direct FuelCell power plants to POSCO Power. Beginning in year three, POSCO Power will buy fuel cell modules manufactured by us in Connecticut and build its own balance of plants in South Korea using its design, procurement and manufacturing expertise to achieve further cost savings. Under the terms of the agreement, we will receive a 4.1 percent royalty on sales made by POSCO Power payable in a combination of cash and common stock. As part of the transaction, POSCO Power also purchased approximately 3.8 million shares of our common stock for an aggregate consideration of \$29 million.

### *Connecticut Project 100*

On March 26, 2007, the Connecticut Clean Energy Fund ( CCEF ) announced that it had screened and selected six energy projects, incorporating 68 megawatts of FuelCell Energy, Inc. 's fuel cell products. The state 's two electric distribution companies will review CCEF 's recommendations and perform additional analyses leading to their selection of the projects to receive long-term power purchase agreements.

Projects incorporating our products are as follows:

ERG Milford, LLC A 7.9 MW DFC-ER® project that pairs 7.2 MW of DirectFuel Cell® (DFC®) power plants with a 1.5 MW pipeline turbo expander. FuelCell Energy, Inc. is partnered with Enbridge, Inc. (NYSE: ENB) and Southern Connecticut Gas Company for the project which is expected to achieve an electrical efficiency of approximately 60 percent. When natural gas is transferred from transcontinental pipelines to local distribution pipelines, the gas cools. The DFC-ERG system will capture the heat byproduct

from FuelCell Energy's DFC3000 fuel cell and use the heat to warm the gas to its proper distribution temperature. Excess power from the DFC-ERG system will be exported to the grid.

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**Elemental Power Group Danbury** A 19.6 MW project consisting of 8 DFC power plant units which incorporate organic rankine cycles to convert excess thermal energy from the fuel cells to deliver additional low-emissions electrical output. Achieving an electrical efficiency of over 47 percent, the project will deliver electrical grid power to Connecticut Light and Power for the southwestern part of the state. Elemental Power Group, LLC, an entity formed by Marubeni Power of New York, and Catamount Energy of Vermont are the developers for this project.

**Hospital Energy Development LLC/EMCOR** A 4.6 MW project for Stamford Hospital will use 2 DFC3000 power plants in a combined heat and power application providing lower cost thermal energy to the hospital as well as ultra-clean electricity to the utility grid. The project is expected to achieve a combined heat and power efficiency and will be developed by EMCOR Energy Services and Hospital Energy Development LLC.

**Hospital Energy Development, LLC./EMCOR** A 2.3 MW project for Waterbury Hospital that will use 1 DFC3000 power plant in a combined heat and power applications providing lower cost thermal energy to the hospital as well as electricity to the grid. The project is expected to achieve a combined heat and power efficiency of over 60 percent.

**Elemental Power Group Bridgeport** A 19.6 MW project consisting of 8 DFC power plant units which incorporate organic rankine cycles to convert excess thermal energy from the fuel cells to deliver added low-emissions electrical output. Achieving an electrical efficiency of over 47 percent, the project will augment electrical grid power provided by United Illuminating Company for the southwestern part of the state. Elemental Power Group, LLC, an entity formed by Marubeni Power of New York, and Catamount Energy of Vermont are the developers for this project.

**Bridgeport Fuel Cell Park** A 13.7 MW project consisting of 6 DFC3000 power plants that will deliver power to the United Illuminating Company in an area key to easing the power-constraint challenges in southwestern Connecticut. The project is using a remediated brownfield site in a key urban development area. Project participants include FuelCell Energy, PurePower, LLC and Pinpoint Power, LLC.

Established under state law, Project 100 provides contracts with terms of 10 to 20 years for power projects providing a predictable revenue stream for project developers and financiers. Project 100 proposals were submitted to the CCEF pursuant to a competitive bidding process and selections were made based on the technical attributes and cost of the various proposals.

**City of Riverside Power plant Sale**

In March 2007, we announced the sale of a DFC1500MA power plant to operate on anaerobic digester gas from a sewage treatment facility serving the southern California city of Riverside. The facility treats 30 million gallons of wastewater daily. Riverside will own and operate the DFC1500MA at Riverside's Water Quality Control Plant through its Public Works Department. California's Self-Generation Incentive Program (SGIP) is providing \$4.5 million for the project through the Southern California Gas Company.

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**The Offering**

Common Stock offered by us	9,000,000 Shares
Common stock to be outstanding after this offering	66,249,158 Shares
Use of proceeds	We intend to use the net proceeds from this offering for market and product development, project financing and general corporate purposes. We may invest the net proceeds temporarily in money-market funds or U.S. treasuries until we use them for their stated purpose.
Dividend Policy	We currently intend to retain any future earnings to fund the development and growth of our business and do not anticipate paying cash dividends in the foreseeable future.
Nasdaq National Market Symbol	FCEL

Unless we indicate otherwise, all information in this prospectus supplement is based on 57,249,158 shares outstanding as of March 30, 2007, assumes the underwriters will not exercise their over-allotment option and excludes the following:

approximately 5,457,022 shares of our common stock issuable upon conversion of 64,120 shares of our 5% Series B Cumulative Convertible Perpetual Preferred Stock at March 31, 2007,

207,952 shares of our common stock issuable upon conversion of the Series 1 preferred shares issued by FuelCell Energy, Ltd., our wholly-owned Canadian subsidiary (formerly known as FCE Canada, Inc.) at March 31, 2007;

1,200,000 shares of our common stock issuable upon the exercise of warrants outstanding at January 31, 2007;

6,016,929 shares of our common stock issuable upon the exercise of options outstanding at January 31, 2007 under our stock option plans;

2,667,989 shares of our common stock available for future issuance under our stock option plans; and

332,837 shares of our common stock available for future issuance under our employee stock purchase plan.

**Risk Factors**

See the Risk Factors section of this prospectus supplement and the accompanying prospectus for a discussion of certain factors that should be considered in evaluating an investment in our common stock.

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**FORWARD LOOKING STATEMENTS**

Some of the statements contained in this prospectus supplement or incorporated by reference into this prospectus supplement are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by the Securities Litigation Reform Act of 1995. We have based these forward-looking statements largely on our expectations and projections about future events and financial trends affecting the financial condition and/or operating results of our business. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, the negative of these words, or similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any forward-looking statements. The risks and uncertainties include those noted under the heading Risk Factors below and in the accompanying prospectus. There are important factors that could cause actual results to be substantially different from the results expressed or implied by these forward-looking statements including, among other things:

our ability to become profitable and attain positive cash flow;

our ability to successfully implement our cost reduction strategy and increase our production;

the impact of competition and technological change on our business;

the effect of market conditions on our long-term power purchase and service agreements with our customers;

our ability to successfully market and commercialize our Direct FuelCell® products and our other products and product candidates;

our dependence on government research and development contracts and the effect that a negative government audit could have on our business;

our dependence on a limited number of third-party suppliers for our Direct FuelCell® products;

our dependence on our intellectual property and ability to protect our proprietary rights and operate our business without conflicting with the rights of others;

the effect that any intellectual property litigation or product liability claims may have on our business and operating and financial performance;

our ability to attract and retain key, qualified management and technical personnel;

the negative effect of the imposition of customer fees or interconnection requirements on our customers by utility companies;

the effect that environmental litigation or remediation requirements may have on our business and operating and financial performance; and

other factors set forth under **Risk Factors** below and in the accompanying prospectus, as well as in all filings incorporated by reference into this prospectus supplement.

We do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Past financial or operating performance is not necessarily a reliable indicator of future performance and you should not use our historical performance to anticipate results or future period trends.

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**RISK FACTORS**

*Investing in our securities involves risks. You should carefully consider the risks described below and in the accompanying prospectus, together with all other information contained in or incorporated by reference into this prospectus supplement before purchasing our common stock. Some of these risks relate principally to our business and the industry in which we operate. Other risks relate principally to the securities markets and ownership of our common stock. Additional risks and uncertainties not presently known to us, or risks that we currently consider immaterial, may also impair our operations or results. If any of the following risks actually occurs, we may not be able to conduct our business as currently planned, and our financial condition and operating results could be seriously harmed. In that case, the market price of our common stock could decline, and you could lose all or part of your investment.*

***We have recently incurred losses and anticipate continued losses and negative cash flow.***

We have been transitioning from a contract research and development company to a commercial products developer and manufacturer. As such, we have not been profitable since our fiscal year ended October 31, 1997. We expect to continue to incur net losses and generate negative cash flow until we can produce sufficient revenues to cover our costs. We may never become profitable. Even if we do achieve profitability, we may be unable to sustain or increase our profitability in the future. For the reasons discussed in more detail below, there are substantial uncertainties associated with our achieving and sustaining profitability.

***Our cost reduction strategy may not succeed or may be significantly delayed, which may result in our inability to offer our products at competitive prices and may adversely affect our sales.***

Our cost reduction strategy is based on the assumption that a significant increase in production will result in economies of scale. In addition, our cost reduction strategy relies on advancements in our manufacturing process, global competitive sourcing, engineering design and technology (including projected power output) that are currently not ascertainable. Failure to achieve our cost reduction targets would have a material adverse effect on our commercialization plans and, therefore, our business, prospects, results of operations and financial condition.

***Our products will compete with products using other energy sources, and if the prices of the alternative sources are lower than energy sources used by our products, sales of our products will be adversely affected.***

Our Direct FuelCell® has been operated using a variety of hydrocarbon fuels, including natural gas, methanol, diesel, biogas, coal gas, coal mine methane and propane. If these fuels are not readily available or if their prices increase such that electricity produced by our products costs more than electricity provided by other generation sources, our products would be less economically attractive to potential customers. In addition, we have no control over the prices of several types of competitive energy sources such as oil, gas or coal. Significant decreases (or short term increases) in the price of these fuels could also have a material adverse effect on our business because other generation sources could be more economically attractive to consumers than our products.

***We have signed long-term power purchase and service agreements with customers which are subject to market conditions and operating risks that may affect our operating results.***

Under the terms of our power purchase agreements ( PPA ), customers agree to purchase power from our fuel cell power plants at negotiated rates, generally for periods of five to ten years. Electricity rates are generally a function of the customer's current and future electricity pricing available from the grid. Revenues are earned and collected under

these PPAs as power is produced. As owner of the power plants in these PPA entities, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel, generally natural gas, to run the power plants. Should electricity rates decrease or operating costs increase from our original estimates, our results of operations could be negatively impacted. We have qualified for incentive funding for these projects in

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California under the state's Self Generation Incentive Funding Program and from other government programs. Funds are payable upon commercial installation and demonstration of the plant and may require return of the funds for failure of certain performance requirements. Revenue related to these incentive funds is recognized ratably over the performance period. We are not required to produce minimum amounts of power under our PPA agreements and we have the right to terminate PPA agreements by giving written notice to the customer, subject to certain exit costs.

We have contracted with certain customers to provide service of fuel cell power plants over terms ranging from one to thirteen years. Under the provisions of these contracts, we provide services to maintain, monitor and repair customer power plants. Pricing for service contracts is based upon estimates of future costs, which given the early stage of development could be materially different from actual expenses.

***We extend product warranties which could affect our operating results.***

We warranty our products for a specific period of time against manufacturing or performance defects. As we have limited operating experience, warranty costs are expensed as incurred. As a result operating results could be negatively impacted should there be product manufacturing or performance defects.

***We currently face and will continue to face significant competition.***

Our Direct FuelCell® currently faces, and will continue to face, significant competition. We compete on the basis of our products' reliability, fuel efficiency, environmental considerations and cost. Technological advances in alternative energy products or improvements in the electric grid or other sources of power generation, or other fuel cell technologies may negatively affect the development or sale of some or all of our products or make our products non-competitive or obsolete prior to commercialization or afterwards. Other companies, some of which have substantially greater resources than ours, are currently engaged in the development of products and technologies that are similar to, or may be competitive with, our products and technologies.

Several companies in the U.S. are involved in fuel cell development, although we believe we are the only domestic company engaged in significant manufacturing and commercialization of carbonate fuel cells. Emerging fuel cell technologies (and companies developing them) include proton exchange membrane fuel cells (Ballard Power Systems, Inc.; United Technologies Corp. or UTC Fuel Cells; and Plug Power), phosphoric acid fuel cells (UTC Fuel Cells) and solid oxide fuel cells (Siemens Westinghouse Electric Company, SOFCo, General Electric, Delphi, Rolls Royce and Acumentrics). Each of these competitors has the potential to capture market share in our target markets.

There are other potential carbonate fuel cell competitors internationally. In Europe, a company in Italy, Ansaldo Fuel Cells, is actively engaged in carbonate fuel cell development and is a potential competitor.

Other than fuel cell developers, we must also compete with such companies as Caterpillar, Cummins, and Detroit Diesel, which manufacture more mature combustion-based equipment, including various engines and turbines, and have well-established manufacturing, distribution, and operating and cost features. Significant competition may also come from gas turbine companies like General Electric, Ingersoll Rand, Solar Turbines and Kawasaki, which have recently made progress in improving fuel efficiency and reducing pollution in large-size combined cycle natural gas fueled generators. These companies have also made efforts to extend these advantages to smaller sizes.

***We have large and influential stockholders, which may make it difficult for a third party to acquire our common stock.***

As of February 20, 2007, our largest two institutional shareholders each own more than 5%, but less than 10%, of our outstanding common stock. POSCO Power owns approximately 7% of our outstanding common stock. MTU

Friedrichshafen GmbH ( MTU ) owns approximately 5% of our outstanding common stock and MTU is the sole owner of our European licensee, CFC Solutions GmbH. MTU was acquired by the private equity fund EQT IV in March 2006, which now operates under the name Tognum GmbH. James D. Gerson

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beneficially owns approximately 2% of our outstanding common stock. Loeb Investors Co. LXXV and Warren Bagatelle (a managing director of an affiliate of Loeb Investors Co. LXXV) collectively beneficially own approximately 2% of our outstanding common stock. These ownership levels could make it difficult for a third party to acquire our common stock or have input into the decisions made by our board of directors, which include Michael Bode (Chief Executive Officer of CFC Solutions GmbH), James D. Gerson, Warren Bagatelle and Thomas L. Kempner (Chairman and Chief Executive Officer of an affiliate of Loeb Investors Co. LXXV). CFC is also a licensee of our technology and a purchaser of our Direct FuelCell® products. Therefore, it may be in CFC's interest to possess substantial influence over matters concerning our overall strategy and technological and commercial development.

### ***CFC may develop competing technologies.***

CFC Solutions GmbH is currently developing carbonate fuel cell technology. If this technology does not use DFC know-how, CFC must use good faith efforts to license the technology to us. If CFC is successful but does not grant us a license, it may be directly competing with us while having a significant ownership interest in us, and a seat on our board of directors. We have agreed with CFC to continue developing products with as much commonality as possible. However, the license agreement between us and CFC provides that each of us retains the right to independently pursue the development of carbonate fuel cell technologies.

### ***We have limited experience manufacturing our Direct FuelCell® products on a commercial basis, which may adversely affect our planned increases in production capacity and our ability to satisfy customer requirements.***

We have limited experience manufacturing our Direct FuelCell® products on a commercial basis. Our manufacturing, testing and conditioning facilities have equipment in place for a production capacity of 50 MW per year. We expect that we will then increase our manufacturing capacity based on market demand. We cannot be sure that we will be able to achieve any planned increases in production capacity. Also, as we scale up our production capacity, we cannot be sure that unplanned failures or other technical problems relating to the manufacturing process will not occur.

Even if we are successful in achieving our planned increases in production capacity, we cannot be sure that we will do so in time to meet our product commercialization schedule or to satisfy the requirements of our customers. Additionally, we cannot be sure that we will be able to develop efficient, low-cost manufacturing capabilities and processes (including automation) that will enable us to meet our cost goals and profitability projections. Our failure to develop advanced manufacturing capabilities and processes, or meet our cost goals, could have a material adverse effect on our business, prospects, results of operations and financial condition.

### ***Unanticipated increases or decreases in business growth may result in adverse financial consequences for us.***

If our business grows more quickly than we anticipate, our existing and planned manufacturing facilities may become inadequate and we may need to seek out new or additional space, at considerable cost to us. If our business does not grow as quickly as we expect, our existing and planned manufacturing facilities would, in part, represent excess capacity for which we may not recover the cost; in that circumstance, our revenues may be inadequate to support our committed costs and our planned growth and our gross margins and business strategy would be adversely affected.

### ***Our plans are dependent on market acceptance of our Direct FuelCell® products.***

Our plans are dependent upon market acceptance of, as well as enhancements to, those products. Fuel cell systems represent an emerging market, and we cannot be sure that potential customers will accept fuel cells as a replacement for traditional power sources. As is typical in a rapidly evolving industry, demand and market acceptance for recently introduced products and services are subject to a high level of uncertainty and risk. Since the distributed generation market is still evolving, it is difficult to predict with certainty the size of



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the market and its growth rate. The development of a market for our Direct FuelCell® products may be affected by many factors that are out of our control, including:

- the cost competitiveness of our fuel cell products;
- the future costs of natural gas and other fuels used by our fuel cell products;
- consumer reluctance to try a new product;
- perceptions of the safety of our fuel cell products;
- the market for distributed generation;
- local permitting and environmental requirements; and
- the emergence of newer, more competitive technologies and products.

If a sufficient market fails to develop or develops more slowly than we anticipate, we may be unable to recover the losses we will have incurred in the development of Direct FuelCell® products and may never achieve profitability.

As we continue to commercialize our Direct FuelCell® products, we will continue to develop warranties, production guarantees and other terms and conditions relating to our products that will be acceptable to the marketplace, and continue to develop a service organization that will aid in servicing our products and obtain self-regulatory certifications, if available, with respect to our products. Failure to achieve any of these objectives may also slow the development of a sufficient market for our products and, therefore, have a material adverse effect on our results of operations.

***Our government research and development contracts are subject to the risk of termination by the contracting party and we may not realize the full amounts allocated under the contracts due to the lack of Congressional appropriations.***

A portion of our fuel cell revenues have been derived from long-term cooperative agreements and other contracts with the U.S. Department of Energy ( DOE ), the U.S. Department of Defense, the U.S. Navy and other U.S. government agencies. These agreements are important to the continued development of our technology and our products.

Generally, our U.S. government research and development contracts are subject to the risk of termination at the convenience of the contracting agency. Furthermore, these contracts, irrespective of the amounts allocated by the contracting agency, are subject to annual Congressional appropriations and the results of government or agency sponsored reviews and audits of our cost reduction projections and efforts. We can only receive funds under these contracts ultimately made available to us annually by Congress as a result of the appropriations process. Accordingly, we cannot be sure whether we will receive the full amounts awarded under our government research and development or other contracts. Failure to receive the full amounts under any of our government research and development contracts could materially and adversely affect our business prospects, results of operations and financial condition.

***A negative government audit could result in an adverse adjustment of our revenue and costs and could result in civil and criminal penalties***

Government agencies, such as the Defense Contract Audit Agency, routinely audit and investigate government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with

applicable laws, regulations and standards. If the agencies determine through these audits or reviews that we improperly allocated costs to specific contracts, they will not reimburse us for these costs. Therefore, an audit could result in adjustments to our revenue and costs.

Further, although we have internal controls in place to oversee our government contracts, no assurance can be given that these controls 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

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may be subject to civil or criminal penalties and administrative sanctions, payments, fines and suspension or prohibition from doing business with the government, any of which could materially affect our financial condition.

***The U.S. government has certain rights relating to our intellectual property, including restricting or taking title to certain patents.***

Many of our U.S. patents relating to our fuel cell technology are the result of government-funded research and development programs. Two of our patents that were the result of DOE-funded research prior to January 1988 (the date that we qualified as a small business) are owned by the U.S. government and have been licensed to us. This license is revocable only in the limited circumstances where it has been demonstrated that we are not making an effort to commercialize the invention. We own all patents resulting from research funded by our DOE contracts awarded after January 1988 to date, based on our small business status when each contract was awarded. Under current regulations, patents resulting from research funded by government agencies other than the DOE are owned by us, whether or not we are a small business.

Ten U.S. patents that we own have resulted from government-funded research and are subject to the risk of exercise of march-in rights by the government. March-in rights refer to the right of the U.S. government or a government agency to exercise its non-exclusive, royalty-free, irrevocable worldwide license to any technology developed under contracts funded by the government if the contractor fails to continue to develop the technology. These march-in rights permit the U.S. government to take title to these patents and license the patented technology to third parties if the contractor fails to utilize the patents. In addition, our DOE-funded research and development agreements also require us to agree that we will not provide to a foreign entity any fuel cell technology subject to that agreement unless the fuel cell technology will be substantially manufactured in the U.S. Accordingly, we could lose some or all of the value of these patents.

***A failure to qualify as a small business could adversely affect our rights to own future patents under DOE-funded contracts.***

Qualifying as a small business under DOE contracts allows us to own the patents that we develop under DOE contracts. A small business under applicable government regulations generally consists of no more than 500 employees. If we continue to grow, we will no longer qualify as a small business and no longer own future patents we develop under future contracts, grants or cooperative agreements funded by the DOE based on such certification, unless we obtain a patent waiver from the DOE. Should we not obtain a patent waiver and outright ownership, we would nevertheless retain exclusive rights to any such patents, so long as we continue to commercialize the technology covered by the patents. As a result of our acquisition of Global Thermoelectric Inc., the number of our employees increased and therefore, we temporarily did not qualify as a small business. Following the sale of Global Thermoelectric Inc. and its TEG product line on May 27, 2004, we again qualified as a small business; however, we cannot assure you that we will continue to qualify as a small business in the future.

***Our future success and growth is dependent on our distribution strategy.***

We cannot assure you that we will enter into distributor relationships that are consistent with, or sufficient to support, our commercialization plans or our growth strategy or that these relationships will be on terms favorable to us. Even if we enter into these types of relationships, we cannot assure you that the distributors with which we form relationships will focus adequate resources on selling our products or will be successful in selling them. Some of these distributor arrangements have or will require that we grant exclusive distribution rights to companies in defined territories. These exclusive arrangements could result in us being unable to enter into other arrangements at a time when the distributor with which we formed a relationship is not successful in selling our products or has reduced its commitment to marketing our products. In addition, certain distributor arrangements include, and some future distributor

arrangements may also include, the issuance of equity and warrants to purchase our equity, which may have an adverse effect on our stock price. To the extent we enter into distributor relationships, the failure of these distributors in assisting us with the

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marketing and distribution of our products may adversely affect our results of operations and financial condition.

We cannot be sure that CFC Solutions GmbH will continue to, or original equipment manufacturers ( OEMs ) will, manufacture or package products using our Direct FuelCell® components. In this area, our success will largely depend upon our ability to make our products compatible with the power plant products of OEMs and the ability of these OEMs to sell their products containing our products. In addition, some OEMs may need to redesign or modify their existing power plant products to fully incorporate our products. Accordingly, any integration, design, manufacturing or marketing problems encountered by CFC or other OEMs could adversely affect the market for our Direct FuelCell® products and, therefore, our business, prospects, results of operations and financial condition.

***We depend on third party suppliers for the development and supply of key components for Direct FuelCell® products.***

We purchase several key components of our Direct FuelCell® products from other companies and rely on third-party suppliers for the balance-of-plant components in our Direct FuelCell® products. There are a limited number of suppliers for some of the key components of Direct FuelCell® products. A supplier's failure to develop and supply components in a timely manner or to supply components that meet our quality, quantity or cost requirements or technical specifications or our inability to obtain alternative sources of these components on a timely basis or on terms acceptable to us could harm our ability to manufacture our Direct FuelCell® products. In addition, to the extent the processes that our suppliers use to manufacture components are proprietary, we may be unable to obtain comparable components from alternative suppliers.

We do not know when or whether we will secure long-term supply relationships with any of our suppliers or whether such relationships will be on terms that will allow us to achieve our objectives. Our business, prospects, results of operations and financial condition could be harmed if we fail to secure long-term relationships with entities that will supply the required components for our Direct FuelCell® products.

***We depend on our intellectual property, and our failure to protect that intellectual property could adversely affect our future growth and success.***

Failure to protect our existing intellectual property rights may result in the loss of our exclusivity or the right to use our technologies. If we do not adequately ensure our freedom to use certain technology, we may have to pay others for rights to use their intellectual property, pay damages for infringement or misappropriation or be enjoined from using such intellectual property. We rely on patent, trade secret, trademark and copyright law to protect our intellectual property. The patents that we have obtained will expire between 2008 and 2024 and the average remaining life of our U.S. patents is approximately 11.4 years.

Some of our intellectual property is not covered by any patent or patent application and includes trade secrets and other know-how that is not patentable, particularly as it relates to our manufacturing processes and engineering design. In addition, some of our intellectual property includes technologies and processes that may be similar to the patented technologies and processes of third parties. If we are found to be infringing third-party patents, we do not know whether we will be able to obtain licenses to use such patents on acceptable terms, if at all. Our patent position is subject to complex factual and legal issues that may give rise to uncertainty as to the validity, scope and enforceability of a particular patent. Accordingly, we cannot assure you that:

any of the U.S., Canadian or other foreign patents owned by us or other patents that third parties license to us will not be invalidated, circumvented, challenged, rendered unenforceable or licensed to others; or,

any of our pending or future patent applications will be issued with the breadth of claim coverage sought by us, if issued at all.

In addition, effective patent, trademark, copyright and trade secret protection may be unavailable, limited or not applied for in certain foreign countries.

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We also seek to protect our proprietary intellectual property, including intellectual property that may not be patented or patentable, in part by confidentiality agreements and, if applicable, inventors' rights agreements with our subcontractors, vendors, suppliers, consultants, strategic partners and employees. We cannot assure you that these agreements will not be breached, that we will have adequate remedies for any breach or that such persons or institutions will not assert rights to intellectual property arising out of these relationships. Certain of our intellectual property has been licensed to us on a non-exclusive basis from third parties that may also license such intellectual property to others, including our competitors. If our licensors are found to be infringing third-party patents, we do not know whether we will be able to obtain licenses to use the intellectual property licensed to us on acceptable terms, if at all.

If necessary or desirable, we may seek extensions of existing licenses or further licenses under the patents or other intellectual property rights of others. However, we can give no assurances that we will obtain such extensions or further licenses or that the terms of any offered licenses will be acceptable to us. The failure to obtain a license from a third party for intellectual property that we use at present could cause us to incur substantial liabilities, and to suspend the manufacture or shipment of products or our use of processes requiring the use of that intellectual property.

While we are not currently engaged in any material intellectual property litigation, we could become subject to lawsuits in which it is alleged that we have infringed the intellectual property rights of others or commence lawsuits against others who we believe are infringing upon our rights. Our involvement in intellectual property litigation could result in significant expense to us, adversely affecting the development of sales of the challenged product or intellectual property and diverting the efforts of our technical and management personnel, whether or not that litigation is resolved in our favor.

***Our future success will depend on our ability to attract and retain qualified management and technical personnel.***

Our future success is substantially dependent on the continued services and on the performance of our executive officers and other key management, engineering, scientific, manufacturing and operating personnel, particularly R. Daniel Brdar, our Chief Executive Officer. The loss of the services of any executive officer, including Mr. Brdar, or other key management, engineering, scientific, manufacturing and operating personnel, could materially adversely affect our business. Our ability to achieve our development and commercialization plans will also depend on our ability to attract and retain additional qualified management and technical personnel. Recruiting personnel for the fuel cell industry is competitive. We do not know whether we will be able to attract or retain additional qualified management and technical personnel. Our inability to attract and retain additional qualified management and technical personnel, or the departure of key employees, could materially and adversely affect our development and commercialization plans and, therefore, our business, prospects, results of operations and financial condition.

***Our management may be unable to manage rapid growth effectively.***

We may rapidly expand our manufacturing capabilities, accelerate the commercialization of our products and enter a period of rapid growth, which will place a significant strain on our senior management team and our financial and other resources. Any expansion may expose us to increased competition, greater overhead, marketing and support costs and other risks associated with the commercialization of a new product. Our ability to manage rapid growth effectively will require us to continue to improve our operations, to improve our financial and management information systems and to train, motivate and manage our employees. Difficulties in effectively managing the budgeting, forecasting and other process control issues presented by such a rapid expansion could harm our business, prospects, results of operations and financial condition.

***We may be affected by environmental and other governmental regulation.***

We are subject to federal, state, provincial or local regulation with respect to, among other things, emissions and siting. Assuming no co-generation applications are used in conjunction with our Direct

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FuelCell® plants, they will discharge humid flue gas at temperatures of up to 800° F, water at temperatures of approximately 10-20° F above surrounding air temperatures and carbon dioxide.

In addition, it is possible that industry-specific laws and regulations will be adopted covering matters such as transmission scheduling, distribution and the characteristics and quality of our products, including installation and servicing. These regulations could limit the growth in the use of carbonate fuel cell products, decrease the acceptance of fuel cells as a commercial product and increase our costs and, therefore, the price of our Direct FuelCell® products. Accordingly, compliance with existing or future laws and regulations could have a material adverse effect on our business, prospects, results of operations and financial condition.

***Utility companies could impose customer fees or interconnection requirements on our customers that could make our products less desirable.***

Utility companies commonly charge fees to larger, industrial customers for disconnecting from the electric grid or for having the capacity to use power from the electric grid for back up purposes. These fees could increase the cost to our customers of using our Direct FuelCell® products and could make our products less desirable, thereby harming our business, prospects, results of operations and financial condition.

Several states have created and adopted or are in the process of creating their own interconnection regulations covering both technical and financial requirements for interconnection to utility grids. Depending on the complexities of the requirements, installation of our systems may become burdened with additional costs that might have a negative impact on our ability to sell systems. The Institute of Electrical and Electronics Engineers has been working to create an interconnection standard addressing the technical requirements for distributed generation to interconnect to utility grids. Many parties are hopeful that this standard will be adopted nationally to help reduce the barriers to deployment of distributed generation such as fuel cells; however this standard may not be adopted nationally thereby limiting the commercial prospects and profitability of our fuel cell systems.

***We could be liable for environmental damages resulting from our research, development or manufacturing operations.***

Our business exposes us to the risk of harmful substances escaping into the environment, resulting in personal injury or loss of life, damage to or destruction of property, and natural resource damage. Depending on the nature of the claim, our current insurance policies may not adequately reimburse us for costs incurred in settling environmental damage claims, and in some instances, we may not be reimbursed at all. Our business is subject