

FUELCELL ENERGY INC

Form 10-Q

September 09, 2010

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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, 2010**  
**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**

**06-0853042**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

**3 Great Pasture Road**  
**Danbury, Connecticut**

**06813**

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(203) 825-6000**

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

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

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

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

Number of shares of common stock, par value \$.0001 per share, outstanding at September 8, 2010: 112,952,359



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**FUELCELL ENERGY, INC.**  
**Consolidated Balance Sheets**  
**(Unaudited)**

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

|   | July 31,<br>2010 | October 31,<br>2009 |
|---|------------------|---------------------|
| <b>ASSETS</b>   |                  |                     |
| Current assets:   |                  |                     |
| Cash and cash equivalents   | \$ 15,728        | \$ 57,823           |
| Investments U.S. treasury securities  | 36,997           | 7,004               |
| Accounts receivable, net  | 13,897           | 22,920              |
| Inventories, net  | 30,574           | 25,433              |
| Other current assets  | 4,700            | 6,499               |
| Total current assets  | 101,896          | 119,679             |
| Property, plant and equipment, net  | 28,832           | 32,394              |
| Investments U.S. treasury securities  | 15,113           |                     |
| Investment in and loans to affiliate  | 10,079           | 10,064              |
| Other assets, net   | 1,311            | 551                 |
| Total assets  | \$ 157,231       | \$ 162,688          |
| <b>LIABILITIES AND EQUITY</b>   |                  |                     |
| Current liabilities:  |                  |                     |
| Current portion of long-term debt and other liabilities   | \$ 980           | \$ 997              |
| Accounts payable  | 8,574            | 8,484               |
| Accounts payable due to affiliate   | 560              | 1,584               |
| Accrued liabilities   | 15,639           | 13,808              |
| Deferred revenue, royalty income and customer deposits  | 22,576           | 17,013              |
| Total current liabilities   | 48,329           | 41,886              |
| Long-term deferred revenue and royalty income   | 8,436            | 10,124              |
| Long-term debt and other liabilities  | 4,132            | 4,410               |
| Total liabilities   | 60,897           | 56,420              |
| Redeemable preferred stock of subsidiary  | 16,246           | 14,976              |
| Redeemable preferred stock (liquidation preference of \$64,020 at July 31, 2010 and \$64,120 at October 31, 2009) | 59,857           | 59,950              |
| Total Equity:   |                  |                     |
| Shareholders' equity  | 11               | 8                   |

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Common stock (\$.0001 par value); 150,000,000 shares authorized;  
112,950,468 and 84,387,741 shares issued and outstanding at July 31, 2010  
and October 31, 2009, respectively

|   |                |                |
|---|----------------|----------------|
| Additional paid-in capital  | 663,979        | 631,296        |
| Accumulated deficit   | (643,500)      | (599,960)      |
| Accumulated other comprehensive income (loss)   | 11             | (2)            |
| Treasury stock, Common, at cost (5,679 shares at July 31, 2010 and<br>October 31, 2009) | (53)           | (53)           |
| Deferred compensation   | 53             | 53             |
| <br>Total shareholders' equity  | <br>20,501     | <br>31,342     |
| Noncontrolling interest in subsidiaries   | (270)          |                |
| <br>Total equity  | <br>20,231     | <br>31,342     |
| <br>Total liabilities and equity  | <br>\$ 157,231 | <br>\$ 162,688 |

See accompanying notes to consolidated financial statements.

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**FUELCELL ENERGY, INC.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

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

|   | <b>Three Months Ended<br/>July 31,</b> |             |
|---|--|-------------|
|   | <b>2010</b>                            | <b>2009</b> |
| Revenues:   |  |             |
| Product sales and revenues                            | \$ 16,218                              | \$ 18,738   |
| Research and development contracts                    | 2,655                                  | 4,279       |
| Total revenues  | 18,873                                 | 23,017      |
| Costs and expenses:                                   |  |             |
| Cost of product sales and revenues                    | 20,050                                 | 26,269      |
| Cost of research and development contracts            | 2,579                                  | 2,978       |
| Administrative and selling expenses                   | 4,185                                  | 4,107       |
| Research and development expenses                     | 4,618                                  | 4,150       |
| Total costs and expenses                              | 31,432                                 | 37,504      |
| Loss from operations                                  | (12,559)                               | (14,487)    |
| Interest expense                                      | (10)                                   | (65)        |
| Loss from equity investment                           | (183)                                  | (15)        |
| Interest and other income, net                        | 296                                    | 185         |
| Loss before redeemable preferred stock of subsidiary  | (12,456)                               | (14,382)    |
| Accretion of redeemable preferred stock of subsidiary | (603)                                  | (533)       |
| Loss before provision for income taxes                | (13,059)                               | (14,915)    |
| Provision for income taxes                            | (55)                                   |             |
| Net loss  | (13,114)                               | (14,915)    |
| Net loss attributable to noncontrolling interest      | 88                                     |             |
| Net loss attributable to FuelCell Energy, Inc.        | (13,026)                               | (14,915)    |
| Preferred stock dividends                             | (799)                                  | (802)       |

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|   |             |             |
|---|-------------|-------------|
| Net loss to common shareholders           | \$ (13,825) | \$ (15,717) |
| Net loss per share to common shareholders |             |             |
| Basic                                     | \$ (0.15)   | \$ (0.21)   |
| Diluted                                   | \$ (0.15)   | \$ (0.21)   |
| Weighted average shares outstanding       |             |             |
| Basic                                     | 93,512,868  | 73,493,470  |
| Diluted                                   | 93,512,868  | 73,493,470  |

See accompanying notes to consolidated financial statements.

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**FUELCELL ENERGY, INC.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

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

|   | <b>Nine Months Ended<br/>July 31,</b> |             |
|---|---------------------------------------|-------------|
|   | <b>2010</b>                           | <b>2009</b> |
| Revenues:   |                                       |             |
| Product sales and revenues                            | \$ 42,033                             | \$ 57,077   |
| Research and development contracts                    | 8,043                                 | 10,527      |
| Total revenues  | 50,076                                | 67,604      |
| Costs and expenses:                                   |                                       |             |
| Cost of product sales and revenues                    | 57,183                                | 83,820      |
| Cost of research and development contracts            | 7,942                                 | 8,053       |
| Administrative and selling expenses                   | 12,888                                | 13,108      |
| Research and development expenses                     | 14,327                                | 14,940      |
| Total costs and expenses                              | 92,340                                | 119,921     |
| Loss from operations                                  | (42,264)                              | (52,317)    |
| Interest expense                                      | (118)                                 | (191)       |
| Loss from equity investment                           | (576)                                 | (577)       |
| Interest and other income, net                        | 979                                   | 730         |
| Loss before redeemable preferred stock of subsidiary  | (41,979)                              | (52,355)    |
| Accretion of redeemable preferred stock of subsidiary | (1,763)                               | (1,559)     |
| Loss before provision for income taxes                | (43,742)                              | (53,914)    |
| Provision for income taxes                            | (68)                                  |             |
| Net loss  | (43,810)                              | (53,914)    |
| Net loss attributable to noncontrolling interest      | 270                                   |             |
| Net loss attributable to FuelCell Energy, Inc.        | (43,540)                              | (53,914)    |
| Preferred stock dividends                             | (2,401)                               | (2,406)     |

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|   |             |             |
|---|-------------|-------------|
| Net loss to common shareholders           | \$ (45,941) | \$ (56,320) |
| Net loss per share to common shareholders |             |             |
| Basic                                     | \$ (0.52)   | \$ (0.80)   |
| Diluted                                   | \$ (0.52)   | \$ (0.80)   |
| Weighted average shares outstanding       |             |             |
| Basic                                     | 87,510,734  | 70,629,631  |
| Diluted                                   | 87,510,734  | 70,629,631  |

See accompanying notes to consolidated financial statements.

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

|   | <b>Nine Months Ended<br/>July 31,</b> |                 |
|---|---------------------------------------|-----------------|
|   | <b>2010</b>                           | <b>2009</b>     |
| <b>Cash flows from operating activities:</b>                                |                                       |                 |
| Net loss  | \$ (43,810)                           | \$ (53,914)     |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                       |                 |
| Share-based compensation  | 2,168                                 | 3,684           |
| Loss from equity investment   | 576                                   | 577             |
| Accretion of redeemable preferred stock of subsidiary                       | 1,763                                 | 1,559           |
| Interest receivable on loan to affiliate                                    | (111)                                 | (107)           |
| Loss on derivatives   | 6                                     | 255             |
| Depreciation  | 5,581                                 | 6,542           |
| Amortization of bond premium  | 74                                    | 788             |
| Provision (recovery) for doubtful accounts                                  | 52                                    | (47)            |
| (Increase) decrease in operating assets:                                    |                                       |                 |
| Accounts receivable   | 8,971                                 | (1,152)         |
| Inventories   | (5,141)                               | (510)           |
| Other assets  | 1,150                                 | 917             |
| Increase (decrease) in operating liabilities:                               |                                       |                 |
| Accounts payable and accounts payable due to affiliate                      | (934)                                 | (6,674)         |
| Accrued liabilities   | 2,680                                 | 2,703           |
| Deferred revenue, royalty income and customer deposits                      | 3,875                                 | (7,351)         |
| <b>Net cash used in operating activities</b>                                | <b>(23,100)</b>                       | <b>(52,730)</b> |
| <b>Cash flows from investing activities:</b>                                |                                       |                 |
| Capital expenditures  | (2,012)                               | (2,066)         |
| Convertible loan to affiliate   | (600)                                 | (600)           |
| Treasury notes matured  | 10,500                                | 28,000          |
| Treasury notes purchased  | (55,680)                              |                 |
| <b>Net cash (used in) provided by investing activities</b>                  | <b>(47,792)</b>                       | <b>25,334</b>   |
| <b>Cash flows from financing activities:</b>                                |                                       |                 |
| Repayment of debt   | (299)                                 | (176)           |
| Proceeds from debt  |                                       | 436             |
| Payment of preferred dividends  | (2,897)                               | (2,829)         |
| Net proceeds from sale of common stock                                      | 32,131                                | 24,612          |
| Common stock issued (repurchased) for stock plans and related expenses      | (151)                                 | 273             |
| <b>Net cash provided by financing activities</b>                            | <b>28,784</b>                         | <b>22,316</b>   |

|  |                  |                  |
|--|------------------|------------------|
| Effects on cash from changes in foreign currency rates       | 13               | (5)              |
| <b>Net decrease in cash and cash equivalents</b>             | (42,095)         | (5,085)          |
| Cash and cash equivalents-beginning of period                | 57,823           | 38,043           |
| <b>Cash and cash equivalents-end of period</b>               | <b>\$ 15,728</b> | <b>\$ 32,958</b> |
| Supplemental cash flow disclosures:                          |                  |                  |
| Cash interest paid   | \$ 118           | \$ 191           |
| Noncash operating activity:                                  |                  |                  |
| Stock issued in settlement of prior year bonus obligation    | \$ 673           | \$ 926           |
| See accompanying notes to consolidated financial statements. |                  |                  |

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**FUELCELL ENERGY, INC.**

Notes to Consolidated Financial Statements

**(Unaudited)**

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

**Note 1. Nature of Business and Summary of Significant Accounting Policies**

FuelCell Energy, Inc. and subsidiaries (the Company, FuelCell, we, us, or our) is a Delaware corporation engaged in the development and manufacture of high temperature fuel cells for clean electric power generation. Our Direct FuelCell power plants produce reliable, secure and environmentally friendly 24/7 base load electricity for commercial, industrial, government and utility customers. We have been commercializing our stationary fuel cells and are beginning the development of planar solid oxide fuel cell and other fuel cell technologies. We expect to incur losses as we continue to participate in government cost share programs, sell certain products at prices lower than current production costs, and invest in cost reduction initiatives.

***Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial information. Accordingly, they do not contain all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements. In the opinion of management, all normal and recurring adjustments necessary to fairly present our financial position as of July 31, 2010 have been included. All intercompany accounts and transactions have been eliminated.

Interim results are not necessarily indicative of the results to be expected for the full year. The information included in this Form 10-Q should be read in conjunction with information included in our Annual Report on Form 10-K for the year ended October 31, 2009 filed with the SEC.

***Use of Estimates***

The preparation of financial statements and related disclosures requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, revenue recognition, contract loss reserves, excess, slow-moving and obsolete inventories, product warranty costs, reserves on long-term service agreements, share-based compensation expense, allowance for doubtful accounts, depreciation and amortization, long-lived asset impairments and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

***Revenue Recognition***

We earn revenue from (i) the sale and installation of fuel cell power plants, modules and component parts to customers (i.e. product sales), (ii) providing services under long-term service agreements (LTSA), (iii) the sale of electricity under power purchase agreements (PPA), (iv) incentive revenue from the sale of electricity under PPAs, (v) site engineering and construction services and (vi) customer-sponsored research and development projects. Our revenue is primarily generated from customers located throughout the U.S. and Asia and from agencies of the U.S. government. Revenue from customer-sponsored research and development projects is recorded as research and development contracts revenue and all other revenues are recorded as product sales and revenues in the consolidated statements of operations.

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Notes to Consolidated Financial Statements

**(Unaudited)**

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

Revenue from sales of our DFC power plants and modules are recognized under the percentage of completion method of accounting. Revenues are recognized proportionally as costs are incurred and assigned to a customer contract by comparing total expected costs for each contract to the total contract value. Prior to fiscal 2010, we did not provide for a contract loss reserve on product sales contracts as products were in their early stages of development and market acceptance, and the total costs to produce, install and commission these units could not be reasonably estimated. As a result of a consistent production rate over the past two fiscal years and installation and commissioning experience for our major product lines, management now believes that it has sufficient product cost history to reasonably estimate the total costs of our fuel cell product sales contracts. Accordingly, effective November 1, 2009, a contract loss reserve on product sales contracts is recognized at the time we become aware that estimated total costs are expected to exceed the contract sales price. We have reviewed open contracts and recorded an estimated loss of \$0.5 million for the nine months ended July 31, 2010. Actual results could vary from initial estimates and reserve estimates will be updated as we gain further manufacturing and operating experience. For component and spare parts sales, revenue is recognized upon shipment under the terms of the customer contract.

Revenue earned by performing routine monitoring and maintenance under LTSA s is recognized ratably over the term of the contract. Costs for performing routine and unplanned maintenance are recognized as incurred. For service contracts which include a minimum operating output over the course of the contract, a portion of the contract revenue is deferred until such time as it is earned through power plant performance.

Revenue from the sale of electricity is recognized as electricity is provided to the customer. Incentive revenue is recognized ratably over the term of the PPA. Site engineering and construction services revenue is recognized as costs are incurred.

Revenue from research and development contracts is recognized proportionally as costs are incurred and compared to the estimated total research and development costs for each contract. Revenue 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, and on certain contracts we are reimbursed only a portion of the costs incurred. 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.

***Warranty and Service Expense Recognition***

We warranty our products for a specific period of time against manufacturing or performance defects. Our warranty is limited to a term generally 15 months after shipment or 12 months after installation of our products. We reserve for estimated future warranty costs based on historical experience. Given our limited operating experience, particularly for newer product designs, actual results could vary from initial estimates. Estimates used to record warranty reserves are updated as we gain further operating experience.

In addition to the standard product warranty, we have entered into LTSA contracts with certain customers to provide monitoring, maintenance and repair services for fuel cell power plants ranging from one to 13 years. Our standard service agreement term is five years. Under the terms of our LTSA, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may replace the customer s fuel cell stack with a new or used unit. Our contractual liability under LTSA s is limited to the amount of service fees payable under the contract. This can often times be less than the cost of a new stack replacement. In order to continue to meet customer expectations on early product designs, we have often incurred costs in excess of our contractual liabilities.

LTSA s for power plants that have our five-year stack design are not expected to require a stack change to continue to meet minimum operating levels during the initial five-year term of the contract, although we have limited operating experience with these products. Stack replacements for new agreements which include the five-year stack design are expected to only be required upon renewal of the service agreement. We expect the replacement of older stacks

produced prior to the five-year stack design will continue over the next several years, and as a result, we may incur losses in order to fulfill the requirements of LTSA s. Reserve estimates for future costs associated with maintaining legacy service agreements will be determined by a number of factors including the estimated life of the stack, used replacement stacks available, our limit of liability on service agreements and future operating plans for the power plant.

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**(Unaudited)**

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

As our fuel cell products have been in their early stages of commercialization and market acceptance, we historically had not provided for a pricing reserve if the agreement was sold below our standard pricing. As a result of our experience with these contracts and production rates of stacks and related costing, effective February 1, 2010, the method of estimating LTSA contract losses has been revised resulting in a \$0.5 million benefit to the consolidated statement of operations in the second fiscal quarter of 2010. As of July 31, 2010, our reserve on LTSA contracts totaled \$5.5 million compared to \$6.0 million as of October 31, 2009. Deferred LTSA revenue as of July 31, 2010 totaled \$3.1 million compared to \$2.5 million as of October 31, 2009. We estimate that reserves and deferred revenues exceed our minimum contractual liabilities under our current contracts, however, LTSA pricing reserves and revenue deferrals are based upon estimates of future costs, which given our products' early stage of commercialization could be materially different from actual expenses. Net loss on service agreements were \$3.0 million and \$3.6 million for the quarters ended July 31, 2010 and 2009, respectively.

***Inventories and Advance Payments to Vendors***

Inventories consist principally of raw materials and work-in-process and are stated at the lower of cost or market. In certain circumstances, we will make advance payments to vendors for future inventory deliveries. These advance payments (net of related reserves) are recorded as other current assets on the consolidated balance sheets.

Prior to November 1, 2009, we provided for a lower of cost or market ( LCM ) reserve to the cost basis of inventory at the time of purchase. During the second half of 2009, we began production of our newest megawatt-class power plants and modules. The manufactured cost per kilowatt of these products is lower than previous models due to a 17 percent power increase and lower component and raw materials cost and are expected to be gross margin positive on a unit by unit basis. As a result, beginning in fiscal 2010, we revised our method of estimating contract losses and no longer provide for an LCM reserve on new inventory purchased. As inventory is utilized in finished products and sold, the Company expects the LCM reserve to continue to decline.

***Concentrations***

We contract with a small number of customers for the sale of products and for research and development contracts. Significant revenues from individual customers for the three and nine months ended July 31, 2010 and 2009 included POSCO Power ( POSCO ), which is a related party and owns approximately 10 percent of the outstanding common shares of the Company, the U.S. government (primarily the Department of Energy) and Pacific Gas and Electric Company.

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## Notes to Consolidated Financial Statements

**(Unaudited)**

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

The percent of consolidated revenues from each customer is presented below.

|                                  | <b>Three Months Ended<br/>July 31,</b> |             | <b>Nine Months Ended<br/>July 31,</b> |             |
|----------------------------------|--|-------------|---------------------------------------|-------------|
|                                  | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                           | <b>2009</b> |
| POSCO                            | 46%                                    | 74%         | 57%                                   | 68%         |
| Pacific Gas and Electric Company | 29%                                    |             | 11%                                   |             |
| U.S. Government                  | 14%                                    | 19%         | 16%                                   | 16%         |
| Combined                         | 89%                                    | 93%         | 84%                                   | 84%         |

There can be no assurance that we will continue to achieve historical levels of sales of our products to our largest customers. Even though our customer base is expected to increase and our revenue streams to diversify, a substantial portion of net revenues could continue to depend on sales to a limited number of customers. Our agreements with these customers may be cancelled if we fail to meet certain product specifications or materially breach the agreement, and our customers may seek to renegotiate the terms of current agreements or renewals. The loss of, or reduction in sales to, one or more of our larger customers, could have a material adverse affect on our business, financial condition and results of operations.

***Subsequent Events***

We have evaluated subsequent events and transactions for potential recognition or disclosure in our financial statements prior to the issuance of the financial statements.

***Comprehensive Loss***

Comprehensive loss for the periods presented was as follows:

|  | <b>Three Months Ended<br/>July 31,</b> |             | <b>Nine Months Ended<br/>July 31,</b> |             |
|--|--|-------------|---------------------------------------|-------------|
|  | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                           | <b>2009</b> |
| Net loss attributable to FuelCell        | \$ (13,026)                            | \$ (14,915) | \$ (43,540)                           | \$ (53,914) |
| Foreign currency translation adjustments |  | (1)         | 13                                    | (5)         |
| Comprehensive loss                       | \$ (13,026)                            | \$ (14,916) | \$ (43,527)                           | \$ (53,919) |

***Liquidity***

Our future liquidity will be dependent on obtaining the order volumes and cost reductions necessary to achieve profitable operations. We may also raise capital through debt or equity offerings; however, there can be no assurance that we will be able to obtain additional capital in the future. The timing and size of any financing will depend on multiple factors including market conditions, future order flow and the need to adjust production capacity. If we are unable to raise additional capital, our growth potential may be adversely affected and we may have to modify our plans.

***Recently Adopted Accounting Guidance***

In February 2010, the Financial Accounting Standards Board ( FASB ) issued amended guidance relating to the disclosure of subsequent events. Under previous guidance, SEC registrants were required to evaluate subsequent events through the date the financial statements were issued, or available for issuance, and disclose in its public filings the date through which subsequent events were evaluated. Under the amended guidance, SEC registrants are required

to evaluate subsequent events through the date the financial statements are issued (rather than the date the financial statements are available for issuance), but are no longer required to disclose in its public filings the date through which subsequent events were evaluated. The amended guidance is effective immediately and has been adopted and reflected in our financial statements.

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**FUELCELL ENERGY, INC.**

Notes to Consolidated Financial Statements

**(Unaudited)**

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

In April 2008, the FASB issued accounting guidance that amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. In developing assumptions about renewal or extension options used to determine the useful life of an intangible asset, a company needs to consider its own historical experience adjusted for company-specific factors. In the absence of that experience, the company shall consider the assumptions that market participants would use about renewal or extension options. The new guidance was effective for the first quarter of fiscal 2010. We currently do not have any intangible assets recorded in our consolidated balance sheets; therefore, the impact of this guidance on our consolidated financial statements will be determined when and if we acquire definite-lived intangible assets.

In December 2007, the FASB issued revised accounting guidance for business combinations that requires an acquirer to measure the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. The guidance also requires that certain other assets and liabilities related to the acquisition, such as contingencies and research and development, be recorded at fair value. The new guidance was effective for the first quarter of fiscal 2010. The potential impact of this revised guidance on our consolidated financial statements will be based upon future business combinations, if any.

In December 2007, the FASB issued new guidance that requires noncontrolling interests (formerly minority interests) in a subsidiary be reported as equity in the consolidated financial statements. Consolidated net income should include the net income for both the parent and the noncontrolling interest with disclosure of both amounts in the consolidated statements of operations. The calculation of earnings per share would continue to be based on income amounts attributable to the parent. This guidance became effective in the first quarter of fiscal 2010 and changed the accounting for and reporting of noncontrolling interests in our subsidiaries.

Our consolidated financial statements include the accounts and operations of Alliance Monterrey, LLC; Alliance Chico, LLC; Alliance Star Energy, LLC; and Alliance TST Energy, LLC (collectively, the Alliance Entities). Each of the Alliance Entities is a joint venture with Alliance Power, Inc. (Alliance) established to construct fuel cell power plants and sell power under power purchase agreements. We have an 80 percent interest in each entity and accordingly, the financial results of the Alliance Entities are consolidated with our financial results.

Each of the Alliance Entities has a capital deficit as they have historically operated at a loss. Under previous accounting guidance, we absorbed the noncontrolling interest's share of these losses because the noncontrolling interest was under no obligation to repay these losses. If the Alliance Entities generated future earnings, we would be credited to the extent of the noncontrolling interest's losses previously absorbed. Additionally, the consolidated balance sheets did not reflect the noncontrolling interest's share of the capital deficit of the Alliance Entities. Under the new accounting guidance, the noncontrolling interest's share of the losses is reflected in the consolidated statements of operations and its share of the capital deficit of the Alliance Entities is reflected as equity in the consolidated balance sheets.

The prior period financial statements have not been adjusted as our noncontrolling interests holders have always been in a deficit position. The proforma impact on the total equity section of our consolidated balance sheet as of October 31, 2009 had this guidance been required for that period would have been a \$1.9 million reduction in accumulated deficit in total shareholders' equity and an increase in the deficit position for noncontrolling interest in subsidiaries. Had this guidance been required for the prior year periods, net loss attributable to common shareholders would have been \$15.6 million and \$56.0 million for the three and nine months ended July 31, 2009, respectively, and basic and diluted net loss per share attributable to common shareholders would have been \$(0.21) and \$(0.79) for three and nine months ended July 31, 2009, respectively.



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**FUELCELL ENERGY, INC.**

Notes to Consolidated Financial Statements

**(Unaudited)**

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

***Recent Accounting Guidance Not Yet Effective***

In April 2010, the FASB provided guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon the achievement of milestone events. An entity may only recognize consideration that is contingent upon the achievement of a milestone in its entirety in the period the milestone is achieved only if the milestone meets certain criteria. This guidance is effective prospectively for milestones achieved in fiscal years beginning on or after June 15, 2010. While we are still analyzing the potential impact of this guidance, we believe that our current practices are consistent with the guidance and, accordingly, we do not expect the adoption of this guidance will have a material impact on our financial statements.

In March 2010, the FASB issued guidance clarifying that embedded credit-derivative features related only to the transfer of credit risk in the form of subordination of one financial instrument to another are not subject to potential bifurcation and separate accounting. Other embedded credit-derivative features are required to be analyzed to determine whether they must be accounted for separately. The guidance is effective at the beginning of a company's first fiscal quarter beginning after June 15, 2010 and may be early adopted in a company's first fiscal quarter beginning after March 5, 2010 (the issuance date of the guidance). We currently do not enter into contracts containing embedded credit-derivative features related only to the transfer of credit risk in the form of subordination of one financial instrument to another; and therefore, do not expect the adoption of this guidance will have a material impact on our financial statements or disclosures.

In January 2010, the FASB issued guidance that requires new disclosures for fair value measurements and provides clarification for existing disclosure requirements. This amended guidance requires disclosures about inputs and valuation techniques used to measure fair value as well as disclosures about significant transfers in and out of Level 1 and Level 2 fair value measurements and disclosures about the purchase, sale, issuance and settlement activity of Level 3 fair value measurements. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for disclosures about the purchase, sale, issuance and settlement activity of Level 3 fair value measurements, which is effective for fiscal years beginning after December 15, 2010. The Company was not impacted by the disclosures effective for interim periods beginning after December 15, 2009 and we do not expect the remaining disclosures required after December 15, 2010 upon adoption of this guidance will have a material impact on our financial statements or disclosures.

In December 2009, the FASB issued revised guidance related to the consolidation of variable interest entities (VIE). The revised guidance requires reporting entities to evaluate former qualified special purpose entities for consolidation, changes the approach to determining a VIE's primary beneficiary from a quantitative assessment to a qualitative assessment designed to identify a controlling financial interest, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a VIE. It also clarifies, but does not significantly change, the characteristics that identify a VIE. The guidance is effective as of the beginning of a company's first fiscal year beginning after November 15, 2009 (November 1, 2010 for the Company), and for subsequent interim and annual reporting periods. We are evaluating the impact of adopting this guidance.

In October 2009, the FASB issued guidance updating accounting standards for revenue recognition for multiple-deliverable arrangements. The stated objective of the update was to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services separately rather than as a combined unit. The guidance provides amended methodologies for separating consideration in multiple-deliverable arrangements and expands disclosure requirements. The guidance will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 (November 1, 2010 for the Company), with early adoption permitted. We are evaluating the impact of adopting this guidance.



**Table of Contents****FUELCELL ENERGY, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

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

In June 2009, the FASB issued accounting guidance which requires a company to perform ongoing reassessment of whether it is the primary beneficiary of a variable interest entity ( VIE ). Specifically, the guidance modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The guidance clarifies that the determination of whether a company is required to consolidate a VIE is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the VIE that most significantly impact the VIE's economic performance. The guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a VIE and enhanced disclosures of the company's involvement in VIEs and any significant changes in risk exposure due to that involvement. The guidance will be effective for the first quarter of fiscal 2011. We are evaluating the impact of adopting this guidance.

***Health Care Reform Acts***

In March 2010, the President of the United States signed the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (collectively the 2010 Acts ). The 2010 Acts will have a substantial impact on health care providers, insurers, employers and individuals. The 2010 Acts will impact employers and businesses differently depending on the size of the organization and the specific impacts on a company's employees. Certain provisions of the 2010 Acts will become effective with our next open enrollment period (November 1, 2010) while other provisions of the 2010 Acts will be effective in future years. The 2010 Acts could require, among other things, changes to our current employee benefit plans, our information technology infrastructure, and in our administrative and accounting processes. The ultimate extent and cost of these changes cannot be determined at this time and are being evaluated and updated as related regulations and interpretations of the 2010 Acts become available.

**Note 2. Investments**

We classify our investments as held-to-maturity and record them at amortized cost. These investments consist entirely of U.S. treasury securities. The following table summarizes the amortized cost basis and fair value (based on quoted market prices) at July 31, 2010 and October 31, 2009:

|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>unrealized<br/>gains</b> | <b>Gross<br/>unrealized<br/>(losses)</b> | <b>Fair Value</b> |
|---|---------------------------|---------------------------------------|--|-------------------|
| <b><i>U.S. Government Obligations</i></b> |                           |                                       |  |                   |
| As of July 31, 2010                       | \$ 52,110                 | \$ 56                                 | \$ (1)                                   | \$ 52,165         |
| As of October 31, 2009                    | \$ 7,004                  | \$ 40                                 | \$                                       | \$ 7,044          |

The following table summarizes the contractual maturities of investments at amortized cost and fair value as of July 31, 2010:

|                     | <b>Amortized<br/>Cost</b> | <b>Fair Value</b> | <b>Weighted<br/>average<br/>yield<br/>to maturity</b> |
|---------------------|---------------------------|-------------------|---|
| Due within one year | \$ 36,997                 | \$ 36,997         | 0.2%  |
| Due after one year  | 15,113                    | 15,168            | 1.2%  |
| Total investments   | \$ 52,110                 | \$ 52,165         | 0.5%  |



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## Notes to Consolidated Financial Statements

**(Unaudited)**

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

**Note 3. Accounts Receivable**

Accounts receivable at July 31, 2010 and October 31, 2009 consisted of the following:

|                            | <b>July 31,<br/>2010</b> | <b>October 31,<br/>2009</b> |
|----------------------------|--------------------------|-----------------------------|
| U.S. Government:           |                          |                             |
| Amount billed              | \$ 1,013                 | \$ 574                      |
| Unbilled recoverable costs | 650                      | 776                         |
|                            | 1,663                    | 1,350                       |
| Commercial Customers:      |                          |                             |
| Amount billed              | 4,849                    | 5,439                       |
| Unbilled recoverable costs | 7,385                    | 16,131                      |
|                            | 12,234                   | 21,570                      |
|                            | \$ 13,897                | \$ 22,920                   |

We bill customers for power plant and module sales based on certain milestones being reached. We bill the U.S. government for research and development contracts based on actual costs incurred, typically in the month subsequent to incurring costs. Unbilled recoverable costs relate to revenue recognized on customer contracts that have not been billed. Accounts receivable are presented net of an allowance for doubtful accounts of \$0.07 million and \$0.02 million at July 31, 2010 and October 31, 2009, respectively.

**Note 4. Inventories**

Inventories are stated at the lower of cost or market price. The components of inventory at July 31, 2010 and October 31, 2009 consisted of the following:

|  | <b>July 31,<br/>2010</b> | <b>October 31,<br/>2009</b> |
|--|--------------------------|-----------------------------|
| Raw materials  | \$ 14,833                | \$ 14,583                   |
| Work-in-process  | 22,478                   | 19,790                      |
| Gross inventory  | 37,311                   | 34,373                      |
| Less amount to reduce certain inventories to lower of cost or market | (6,737)                  | (8,940)                     |
| Net inventory  | \$ 30,574                | \$ 25,433                   |

**Table of Contents****FUELCELL ENERGY, INC.**

## Notes to Consolidated Financial Statements

**(Unaudited)**

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

**Note 5. Property, Plant and Equipment**

Property, plant and equipment are stated at cost, less accumulated depreciation provided on the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized on the straight-line method over the shorter of the estimated useful lives of the assets or the term of the lease. Property, plant and equipment at July 31, 2010 and October 31, 2009 consisted of the following:

|   | <b>July 31,<br/>2010</b> | <b>October 31,<br/>2009</b> | <b>Estimated<br/>Useful<br/>Life</b> |
|---|--------------------------|-----------------------------|--------------------------------------|
| Land  | \$ 524                   | \$ 524                      |                                      |
| Building and improvements                       | 7,000                    | 6,851                       | 10-26 years                          |
| Machinery, equipment and software               | 64,973                   | 59,860                      | 3-15 years                           |
| Furniture and fixtures                          | 2,635                    | 2,604                       | 10 years                             |
| Power plants for use under PPAs                 | 17,743                   | 17,743                      | 10 years                             |
| Construction in progress <sup>(1)</sup>         | 3,435                    | 6,710                       |                                      |
|   | 96,310                   | 94,292                      |                                      |
| Less, accumulated depreciation and amortization | (67,478)                 | (61,898)                    |                                      |
| Property, plant and equipment, net              | \$ 28,832                | \$ 32,394                   |                                      |

(1) Included in construction in progress are costs of \$0.9 million and \$0.8 million at July 31, 2010 and October 31, 2009, respectively, to build power plants that will service power purchase agreement contracts.

Depreciation expense was \$5.6 million and \$6.5 million, for the nine months ended July 31, 2010 and 2009, respectively.

**Note 6. Investment in and Loans to Affiliate**

Versa Power Systems, Inc. ( Versa ) is one of our sub-contractors under the Department of Energy's large-scale hybrid project to develop a coal-based, multi-megawatt solid oxide fuel cell-based ( SOFC ) system. Versa is a private

company founded in 2001 that has been developing advanced SOFC systems for various stationary and mobile applications.

During the second quarter of fiscal 2010, we invested \$0.6 million in Versa in the form of a convertible note and received warrants for the right to purchase 861 shares of common stock with an exercise price of \$139 per share. As of July 31, 2010, we own 77,140 shares of Versa common stock, representing 39 percent of Versa's outstanding common shares. In addition, we have convertible loans receivable from Versa of \$3.2 million and hold warrants for the right to purchase a total of 3,969 shares of Versa common stock at a weighted average price of \$161 per share. Should the convertible notes and warrants be converted, our total ownership interest in Versa would increase to 45 percent.

We account for Versa under the equity method of accounting and recognize our share of the losses as loss from equity investments on the consolidated statements of operations. We recorded losses from Versa of \$0.2 million and \$0.6 million during the three and nine months ended July 31, 2010, respectively, and \$0.02 million and \$0.6 million during the three and nine months ended July 31, 2009, respectively. Our total investment in and loans to Versa was \$10.1 million as of July 31, 2010 and October 31, 2009.

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## Notes to Consolidated Financial Statements

**(Unaudited)**

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

**Note 7. Accrued Liabilities**

Accrued liabilities at July 31, 2010 and October 31, 2009 consisted of the following:

|   | <b>July 31,<br/>2010</b> | <b>October 31,<br/>2009</b> |
|---|--------------------------|-----------------------------|
| Accrued payroll and employee benefits               | \$ 2,746                 | \$ 3,258                    |
| Accrued contract and operating costs <sup>(1)</sup> | 4,970                    | 3,190                       |
| Reserve for product warranty costs <sup>(2)</sup>   | 501                      | 500                         |
| Reserve for long-term service agreement costs       | 5,515                    | 5,950                       |
| Accrued taxes and other                             | 1,907                    | 910                         |
| <b>Total</b>  | <b>\$ 15,639</b>         | <b>\$ 13,808</b>            |

(1) Includes \$2.3 million and \$2.2 million at July 31, 2010 and October 31, 2009, respectively, potentially owed to customers related to contract performance. In June 2010 the Company entered into an agreement with Marubeni Corporation to return certain advance contract payments, resolve claims for services and repurchase surplus inventory items previously sold to Marubeni

Corporation.  
The agreement calls for payments of approximately \$1.9 million to Marubeni Corporation between June and December 2010 and a payment of \$1.0 million upon title transfer of surplus inventory to FuelCell. As of July 31, 2010, \$2.5 million was recorded in accrued expenses related to this agreement. The Company does not expect to incur a charge to the consolidated statement of operations as a result of this agreement and may record a gain in the range of \$0.3 million to \$1.3 million depending on the valuation of inventory recovered. Terms of the agreement are expected to be completed in December of 2010.

- (2) Activity in the reserve for product warranty costs

during the nine months ended July 31, 2010 included additions for specific known warranty issues totaling \$1.5 million, other additions for estimates of potential future warranty obligations of \$1.0 million on contracts in the warranty period and reserve reductions related to actual warranty spend and reversals to income of \$2.5 million as contracts progress through the warranty period or are beyond the warranty period.

#### **Note 8. Debt**

At July 31, 2010 and October 31, 2009, debt consisted of the following:

|  | <b>July 31,<br/>2010</b> | <b>October 31,<br/>2009</b> |
|--|--------------------------|-----------------------------|
| Connecticut Development Authority Note | \$ 3,874                 | \$ 4,000                    |
| Connecticut Clean Energy Fund Note     | 694                      | 650                         |
| Capitalized lease obligations          | 170                      | 321                         |
| <br>Total debt                         | <br>4,738                | <br>4,971                   |
| Less current portion                   | (980)                    | (997)                       |
| <br>Long-term debt                     | <br>\$ 3,758             | <br>\$ 3,974                |

The Connecticut Development Authority note bears interest at 5 percent and the loan is collateralized by the assets procured under this loan as well as \$4.0 million of additional machinery and equipment. Interest and principal payments are required through May 2018.



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

The Connecticut Clean Energy Fund note is an agreement between Bridgeport Fuel Cell Park, LLC ( BFCP ), a wholly owned subsidiary, and the Connecticut Clean Energy Fund, the proceeds of which were designated for pre-development expenses associated with the development, construction and operation of a fuel cell generation facility in Bridgeport, Connecticut (the Project ). Interest accrues monthly at an annual rate of 8.75 percent. Repayment of principal and any accrued and unpaid interest is required on the earliest occurrence of any of the following events: (a) twelve months after the commencement date of the commercial operation of the Project, (b) the date of closing of permanent institutional financing of the Project, (c) the date of any sale of the Project and (d) the date upon which certain change in control events occur related to BFCP. The note is secured by assets of BFCP. The note is classified as currently payable as the timing of events that would result in repayment are not determinable.

We have leased technology and other equipment. Lease payment terms are generally thirty-six months from the date of acceptance for leased equipment.

**Note 9. Share-Based Compensation Plans**

We have shareholder approved equity incentive plans and a shareholder approved Section 423 Stock Purchase Plan (the ESPP ). Under the equity incentive plans, the board is authorized to grant incentive stock options, nonqualified stock options, restricted stock awards ( RSA ) and stock appreciation rights ( SARs ) to our officers, key employees and non-employee directors. We account for stock awards to employees and non-employee directors under the fair value method. We determine the fair value of stock options at the grant date using the Black-Scholes valuation model. The model requires us to make estimates and assumptions regarding the expected life of the award, the risk-free interest rate, the expected volatility of our common stock price and the expected dividend yield. The fair value of restricted stock awards is based on the common stock price on the date of grant. The fair value of stock awards is amortized to expense over the vesting period, generally four years.

Share-based compensation reflected in the consolidated statements of operations for the three and nine months ended July 31, 2010 and 2009 was as follows:

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>July 31,</b>           |             | <b>July 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| Cost of product sales and revenues         | \$ 191                    | \$ 263      | \$ 583                   | \$ 777      |
| Cost of research and development contracts | 53                        | 43          | 130                      | 145         |
| General and administrative expense         | 408                       | 642         | 974                      | 2,137       |
| Research and development expense           | 139                       | 182         | 480                      | 607         |
| Total share-based compensation             | \$ 791                    | \$ 1,130    | \$ 2,167                 | \$ 3,666    |

Activity under our equity incentive plans for the nine months ended July 31, 2010 was as follows:

|                                 | <b>Stock Options</b> |                   | <b>Restricted Stock Awards</b> |                   |
|---------------------------------|----------------------|-------------------|--------------------------------|-------------------|
|                                 | <b>Number of</b>     | <b>Weighted</b>   | <b>Number of</b>               | <b>Weighted</b>   |
|                                 | <b>options</b>       | <b>average</b>    | <b>RSAs</b>                    | <b>average</b>    |
|                                 |                      | <b>price (\$)</b> |                                | <b>price (\$)</b> |
| Outstanding at October 31, 2009 | 5,740,705            | 10.86             | 593,262                        | 2.88              |
| Granted                         | 171,139              | 2.89              | 749,849                        | 2.70              |
| Exercised / Vested              |                      |                   | (135,417)                      | 2.85              |
| Cancelled                       | (673,743)            | 11.69             | (21,372)                       | 2.85              |

|                              |           |       |           |      |
|------------------------------|-----------|-------|-----------|------|
| Outstanding at July 31, 2010 | 5,238,101 | 10.56 | 1,186,322 | 2.77 |
|------------------------------|-----------|-------|-----------|------|

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**(Unaudited)**

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

Activity under our ESPP for the nine months ended July 31, 2010 was as follows:

|                             | <b>Number of<br/>Shares</b> |
|-----------------------------|-----------------------------|
| Balance at October 31, 2009 | 207,207                     |
| Issued @ \$2.70             | (39,858)                    |
| Issued @ \$2.34             | (39,646)                    |
| Balance at July 31, 2010    | 127,703                     |

**Note 10. Conversion of Preferred Stock**

During the nine months ended July 31, 2010, 100 shares of Series B redeemable preferred stock, with a book value of \$0.1 million net of original issuance costs, were converted into 8,510 shares of common stock.

**Note 11. Equity**

Changes in total equity for the nine months ended July 31, 2010 was as follows:

|  | <b>Total<br/>Shareholders<br/>Equity</b> | <b>Noncontrolling<br/>interest</b> | <b>Total<br/>Equity</b> |
|--|--|------------------------------------|-------------------------|
| Balance at October 31, 2009  | \$ 31,342                                | \$                                 | \$ 31,342               |
| Share-based compensation   | 2,168                                    |                                    | 2,168                   |
| Sale of common stock   | 32,104                                   |                                    | 32,104                  |
| Stock issued under benefit plans   | 722                                      |                                    | 722                     |
| Preferred dividends Series B   | (2,401)                                  |                                    | (2,401)                 |
| Conversion of Series B preferred stock to common stock, net of original issuance costs | 93                                       |                                    | 93                      |
| Effect of foreign currency translation   | 13                                       |                                    | 13                      |
| Net loss   | (43,540)                                 | (270)                              | (43,810)                |
| Balance at July 31, 2010   | \$ 20,501                                | \$ (270)                           | \$ 20,231               |

During the third quarter, the Company sold 27,600,000 shares of its common stock at \$1.25 per share in a public offering that generated net cash proceeds of approximately \$32.1 million. The Company intends to use the net proceeds from this offering for product development, project financing, expansion of manufacturing capacity and general corporate purposes.

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## Notes to Consolidated Financial Statements

**(Unaudited)**

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

**Note 12. Net Loss Per Share**

The calculation of basic and diluted net loss per share was as follows:

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>July 31,</b>           |             | <b>July 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| Numerator  |                           |             |                          |             |
| Net loss   | \$ (13,114)               | \$ (14,915) | \$ (43,810)              | \$ (53,914) |
| Net loss attributable to noncontrolling interest | 88                        |             | 270                      |             |
| Preferred stock dividend                         | (799)                     | (802)       | (2,401)                  | (2,406)     |
| Net loss to common shareholders                  | \$ (13,825)               | \$ (15,717) | \$ (45,941)              | \$ (56,320) |
| Denominator                                      |                           |             |                          |             |
| Weighted average basic common shares             | 93,512,868                | 73,493,470  | 87,510,734               | 70,629,631  |
| Effect of dilutive securities <sup>(1)</sup>     |                           |             |                          |             |
| Weighted average diluted common shares           | 93,512,868                | 73,493,470  | 87,510,734               | 70,629,631  |
| Basic loss per share                             | \$ (0.15)                 | \$ (0.21)   | \$ (0.52)                | \$ (0.80)   |
| Diluted loss per share <sup>(1)</sup>            | \$ (0.15)                 | \$ (0.21)   | \$ (0.52)                | \$ (0.80)   |

(1) Diluted loss per share was computed without consideration to potentially dilutive instruments as their inclusion would have been antidilutive. Potentially dilutive instruments include stock options, warrants and convertible

preferred stock.  
At July 31, 2010  
and 2009, there  
were options to  
purchase  
5.2 million and  
5.8 million  
shares of  
common stock,  
respectively.  
There were no  
outstanding  
warrants as of  
July 31, 2010  
and 0.5 million  
outstanding  
warrants at  
July 31, 2009.  
Refer to our  
Annual Report  
on Form 10-K  
for the year  
ended  
October 31,  
2009 for  
information on  
our convertible  
preferred stock.

**Note 13. Commitments and Contingencies**

We have pledged approximately \$9.0 million of our cash and cash equivalents as collateral and letters of credit for certain banking requirements and contracts. As of July 31, 2010, outstanding letters of credit totaled \$7.3 million. These expire on various dates through May 2012.

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**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 following discussion should be read in conjunction with information included in our Annual Report on Form 10-K for the year ended October 31, 2009 filed with the Securities and Exchange Commission ( SEC ). Unless otherwise indicated, the terms Company , FuelCell Energy , we , us , and our refer to FuelCell Energy Inc. and its subsidiaries. All tabular dollar amounts are in thousands. 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.*** This section provides a general description of our business.

***Results of operations.*** This section provides an analysis of our results of operations for the three and nine months ended July 31, 2010 and 2009. 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.

***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.

***Recent accounting guidance.*** This section summarizes recently issued accounting guidance and its potential impact on our financial statements and disclosures.

**CAUTION CONCERNING FORWARD-LOOKING STATEMENTS**

In addition to historical information, this MD&A contains 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 regulatory environment, customer strategies, potential volatility of energy prices, rapid technological change, competition, and the ability to achieve our sales plans and cost reduction targets, as well as other risks set forth under Part II. Item 1A Risk Factors in this report.

**OVERVIEW**

We are a world leader in the development and production of stationary fuel cells for commercial, industrial, government, and utility customers. Our ultra-clean and high efficiency power plants are generating power at over 50 locations worldwide. Our products have generated over 550 million kilowatt hours ( kWh ) of power using a variety of fuels including renewable wastewater gas, food and beverage waste, natural gas and other hydrocarbon fuels. Our power plants offer higher-efficiency stationary power generation for customers. In addition to our commercial products, we continue to develop our carbonate fuel cells, planar solid oxide fuel cell technology and other fuel cell technologies with our own and government research and development funds.

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Our proprietary carbonate power plants electrochemically (without combustion) produce electricity directly from readily available hydrocarbon fuels such as natural gas and biogas. Customers buy fuel cells to reduce cost and pollution, and improve power reliability. Electric generation without combustion significantly reduces harmful pollutants such as Nitrogen Oxide and particulates. Higher fuel efficiency results in lower emissions of carbon dioxide ( CO<sub>2</sub> ), a major greenhouse gas, and also results in less fuel needed per kWh of electricity generated and Btu of heat produced. Greater efficiency reduces customers' exposure to volatile fuel costs and minimizes operating costs. Our fuel cells operate 24/7 providing reliable power to both on-site customers and for grid-support applications. Compared to other power generation technologies, our products offer significant advantages including:

- Near-zero toxic emissions;
- High fuel efficiency;
- Ability to site units locally as distributed power generation;
- Potentially lower cost power generation;
- Byproduct heat ideal for cogeneration applications;
- Reliable, 24/7 base load power;
- Quiet operation; and
- Fuel flexibility.

Typical customers for our products include manufacturers, mission critical institutions such as correction facilities and government installations, hotels, natural gas letdown stations and customers who can use renewable gas for fuel such as breweries, food processors and wastewater treatment facilities. Our megawatt-class products are also used to supplement the grid for utility customers. With increasing demand for renewable and ultra-clean power options and increased volatility in electric markets, our customers gain control of power generation economics, reliability, and emissions.

**Table of Contents****RESULTS OF OPERATIONS**

Management evaluates the results of operations and cash flows using a variety of key performance indicators including 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, 2010 and July 31, 2009****Revenues and Costs of revenues**

Our revenues and cost of revenues for the three months ended July 31, 2010 and 2009 were as follows:

|   | <b>Three Months Ended<br/>July 31,</b> |             | <b>Change</b> |          |
|---|--|-------------|---------------|----------|
|   | <b>2010</b>                            | <b>2009</b> | <b>\$</b>     | <b>%</b> |
| <b>Revenues:</b>  |  |             |               |          |
| Product sales and revenues <sup>(1)</sup>                 | \$ 16,218                              | \$ 18,738   | \$ (2,520)    | (13)     |
| Research and development contracts                        | 2,655                                  | 4,279       | (1,624)       | (38)     |
| Total   | \$ 18,873                              | \$ 23,017   | \$ (4,144)    | (18)     |
| <b>Cost of revenues:</b>                                  |  |             |               |          |
| Product sales and revenues <sup>(2)</sup>                 | \$ 20,050                              | \$ 26,269   | \$ (6,219)    | (24)     |
| Research and development contracts                        | 2,579                                  | 2,978       | (399)         | (13)     |
| Total   | \$ 22,629                              | \$ 29,247   | \$ (6,618)    | (23)     |
| <b>Gross Margin:</b>                                      |  |             |               |          |
| Product sales and revenues                                | \$ (3,832)                             | \$ (7,531)  | \$ 3,699      | 49       |
| Research and development contracts                        | 76                                     | 1,301       | (1,225)       | (94)     |
| Total   | \$ (3,756)                             | \$ (6,230)  | \$ 2,474      | 40       |
| <b>Product Sales Cost-to-revenue ratio <sup>(3)</sup></b> | 1.24                                   | 1.40        |               |          |

<sup>(1)</sup> Product sales and revenues consist primarily of revenue from power plant products, long-term service agreements and power purchase agreements.

- (2) Cost of product sales and revenues includes costs to manufacture and ship power plants and power plant components, site engineering and construction costs where we are responsible for power plant system installation, scrap, non-recurring engineering costs, warranty expense, liquidated damages, costs of monitoring and maintenance services under long-term service agreements (including stack replacement costs), operating costs for power purchase agreements, inventory reserves and over capacity costs.
- (3) Cost-to-revenue ratio is calculated as cost of product sales and revenues divided by product sales and revenues.

Total revenues for the three months ended July 31, 2010 decreased \$4.1 million, or 18 percent to \$18.9 million from \$23.0 million during the same period last year. Total cost of revenues for the three months ended July 31, 2010 decreased \$6.6 million, or 23 percent to \$22.6 million from \$29.2 million during the same period last year.

We contract with a small number of customers for the sale of products and for research and development contracts. Significant revenues from individual customers for the three and nine months ended July 31, 2010 and 2009 included POSCO Power ( POSCO ), which is a related party and owns approximately 10 percent of the outstanding common shares of the Company, the U.S. government (primarily the Department of Energy) and Pacific Gas and Electric Company. On a combined basis, these customers accounted for 89 percent and 93 percent of consolidated revenues for the three months ended July 31, 2010 and 2009, respectively. POSCO accounted for 46 percent and 74 percent of consolidated revenues, Pacific Gas and Electric Company accounted for 29 percent and 0 percent, and the U.S. government accounted for 14 percent and 19 percent of consolidated revenues for the three months ended July 31, 2010 and 2009, respectively.

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There can be no assurance that we will continue to achieve historical levels of sales of our products to our largest customers. Even though our customer base is expected to increase and our revenue streams to diversify, a substantial portion of net revenues could continue to depend on sales to a limited number of customers. Our agreements with these customers may be cancelled if we fail to meet certain product specifications or materially breach the agreement, and our customers may seek to renegotiate the terms of current agreements or renewals. The loss of, or reduction in sales to, one or more of our larger customers, could have a material adverse affect on our business, financial condition and results of operations.

### *Product sales and revenues*

Product sales and revenues for the three months ended July 31, 2010 totaled \$16.2 million compared to \$18.7 million which is a \$2.5 million, or 13 percent decline compared to the third quarter of 2009. Compared to the prior year quarter, revenues are lower as the U.S. market has been in an economic downturn. However, revenues increased by \$3.2 million or 25 percent from \$13.0 million reported in the second quarter. Order activity in the U.S. increased in the third quarter with 3.4 MW of new orders resulting in increased revenue over the second quarter. Partially offsetting the year over year decline was higher revenue due to an increased number of long-term service agreements ( LTSA's ) resulting from sales of service agreements on power plant installations in South Korea. Total product sales and service backlog as of July 31, 2010, was \$79.8 million including \$24.6 million related to LTSA's. This compares to \$104.8 million as of July 31, 2009 including \$25.5 million related to LTSA's.

Cost of product sales and revenues decreased \$6.2 million, or 24 percent in the third quarter 2010 to \$20.1 million compared to \$26.3 million for the third quarter 2009. This decrease is primarily due to the shift in sales from complete power plants to fuel cell stack modules for POSCO, production of lower cost multi-megawatt products and a lower manufacturing run-rate than the prior year quarter.

Net loss on service agreements were \$3.0 million and \$3.6 million for the quarters ended July 31, 2010 and 2009, respectively. Revenue earned by performing routine monitoring and maintenance under LTSA's is recognized ratably over the term of the contract. Costs for performing maintenance are recognized as incurred. Costs in excess of revenues are largely driven by stack replacements, unplanned maintenance and repairs, excess capacity and increases in estimated contract loss reserves. Should our power plants fail to meet minimum operating levels, we may be required to replace the fuel cell stack with a new or used stack. Our contractual liability under LTSA's is limited to the amount of service fees payable under the contract, which can often times be less than the cost of a new stack replacement. However, in order to continue to meet customer expectations on early product designs, we often incur costs in excess of our contractual liabilities. Excluding these net service agreement costs, the cost-to-revenue ratio would have been 1.06-to-1 for the third quarter of 2010 compared to 1.22-to-1 for the third quarter of 2009.

Power plants with our five-year stack design are not expected to require a stack change to continue to meet minimum operating levels during the initial five-year term of the LTSA, however the Company will continue to monitor performance and life of these stacks based on actual performance at customer sites. Stack replacements for these agreements are expected to only be required upon renewal of the LTSA. Accordingly, five-year LTSA's with our five-year stack design have not required a contract loss reserve. We expect the replacement of older stacks produced prior to the five-year stack design to continue over the next several years, and as a result, we may continue to incur additional losses in order to maintain power plants to the extent costs exceed our contract loss reserves on these legacy service agreements. Future costs for maintaining legacy service agreements will be determined by a number of factors including the estimated life of the stack, used replacement stacks available, our limit of liability on service agreements and future operating plans for the power plant.

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Gross margins for product sales and revenues improved over the prior year quarter by \$3.7 million, driven primarily by sales of lower cost megawatt class modules compared to products produced in the same period in the prior year. The product cost-to-revenue ratio was 1.24-to-1.00 in the third quarter of 2010 compared to 1.40-to-1.00 in the third quarter of 2009.

### *Research and development contracts*

Research and development contract revenue in the third quarter 2010 was \$2.7 million, compared to \$4.3 million in the third quarter 2009. Cost of research and development contracts decreased \$0.4 million to \$2.6 million in the third quarter 2010 compared to \$3.0 million in the third quarter 2009. The reduction in contract revenue year-over-year reflects decreased activity under the solid oxide fuel cell development contract with the U.S. Department of Energy (DOE).

Research and development contract backlog as of July 31, 2010 was \$7.4 million, of which Congress has authorized funding of \$5.1 million compared to \$15.3 million and \$3.5 million funded as of July 31, 2009. The Company is currently proposing on the third phase of the solid oxide fuel cell development contract with a decision from the DOE anticipated by the end of 2010. Should government funding be delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

### **Administrative and selling expenses**

Administrative and selling expenses for the three months ended July 31, 2010 increased \$0.1 million to \$4.2 million compared to \$4.1 million in the prior year period on increased sales and marketing activities. This increase reflects increased sales and market development activities.

### **Research and development expenses**

Research and development expenses for the three months ended July 31, 2010 were \$4.6 million, compared to \$4.2 million in the prior year period on increased product development.

### **Loss from operations**

Loss from operations for the three months ended July 31, 2010 improved by \$1.9 million and totaled \$12.6 million compared to a loss from operations of \$14.5 million for the three months ended July 31, 2009. The improvement in net loss from operations was primarily due to improved product margins which reduced loss by \$3.7 million. This improvement was partially off-set by lower research and development contract margins of \$1.2 million on timing of contract activity and higher selling general and administrative and research and development costs of \$0.5 million.

### **Loss from equity investment**

Our share of equity losses in Versa was \$0.2 million for the three months ended July 31, 2010 compared to \$0.02 million for the same period in 2009.

### **Interest and other income, net**

Interest and other income, net, was \$0.3 million for the three months ended July 31, 2010 compared to \$0.2 million for the same period in 2009. This increase is due to license fee income on the POSCO technology transfer agreements.

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**Accretion of Preferred Stock of Subsidiary**

The Series 1 Preferred Shares issued by our subsidiary, FuelCell Energy, Ltd., were originally recorded at a substantial discount to par value ( fair value discount ). On a quarterly basis, the carrying value of the Series 1 Preferred Shares is increased to reflect the passage of time with a corresponding non-cash charge (accretion). The accretion of the fair value discount was \$0.6 million and \$0.5 million for the three months ended July 31, 2010 and 2009, respectively.

**Provision for income taxes**

We have not paid federal or state income taxes in several years due to our history of net operating losses. Additionally, no tax benefit has been recognized for these net operating losses or other deferred tax assets since management cannot reasonably estimate when the Company will generate taxable income.

The Company incurred foreign income tax expense (approximately \$0.1 million for the three months ended July 31, 2010) related to royalty income from POSCO.

**Net loss attributable to noncontrolling interest**

The net loss attributed to the noncontrolling interest for the three months ended July 31, 2010 was \$0.1 million. During the year, we adopted new guidance on the accounting for noncontrolling interest (formerly minority interest ). See Note 1 to the Consolidated Financial Statements for further details.

**Preferred Stock dividends**

Dividends paid on the Series B Preferred Stock were \$0.8 million in each of the quarters ended July 31, 2010 and 2009.

**Net loss to common shareholders and loss per common share**

Net loss to common shareholders represents the net loss for the period less the net loss attributable to noncontrolling interest plus the preferred stock dividends on the Series B Preferred Stock. For the three months ended July 31, 2010 and 2009, net loss to common shareholders was \$13.8 million and \$15.7 million, respectively and loss per common share was \$(0.15) and \$(0.21), respectively.

**Table of Contents****Comparison of Nine Months Ended July 31, 2010 and July 31, 2009****Revenues and Costs of revenues**

Our revenues and cost of revenues for the nine months ended July 31, 2010 and 2009 were as follows:

|  | <b>Nine Months Ended<br/>July 31,</b> |             | <b>Change</b> |          |
|--|---------------------------------------|-------------|---------------|----------|
|  | <b>2010</b>                           | <b>2009</b> | <b>\$</b>     | <b>%</b> |
| <b>Revenues:</b>                           |                                       |             |               |          |
| Product sales and revenues                 | \$ 42,033                             | \$ 57,077   | \$ (15,044)   | (26)     |
| Research and development contracts         | 8,043                                 | 10,527      | (2,484)       | (24)     |
| Total                                      | \$ 50,076                             | \$ 67,604   | \$ (17,528)   | (26)     |
| <b>Cost of revenues:</b>                   |                                       |             |               |          |
| Product sales and revenues                 | \$ 57,183                             | \$ 83,820   | \$ (26,637)   | (32)     |
| Research and development contracts         | 7,942                                 | 8,053       | (111)         | (1)      |
| Total                                      | \$ 65,125                             | \$ 91,873   | \$ (26,748)   | (29)     |
| <b>Gross Margin:</b>                       |                                       |             |               |          |
| Product sales and revenues                 | \$ (15,150)                           | \$ (26,743) | \$ 11,593     | (43)     |
| Research and development contracts         | 101                                   | 2,474       | (2,373)       | (96)     |
| Total                                      | \$ (15,049)                           | \$ (24,269) | \$ 9,220      | (38)     |
| <b>Product Sales Cost-to-revenue ratio</b> | 1.36                                  | 1.47        |               |          |

Total revenues for the nine months ended July 31, 2010 decreased \$17.5 million, or 26 percent to \$50.1 million from \$67.6 million during the same period last year. Total cost of revenues for the nine months ended July 31, 2010 decreased \$26.7 million, or 29 percent to \$65.1 million from \$91.9 million during the same period last year.

We contract with a small number of customers for the sale of products and for research and development contracts. Significant revenues from individual customers for the nine months ended July 31, 2010 and 2009 included POSCO, the U.S. government and Pacific Gas and Electric Company. On a combined basis, these customers accounted for 84 percent in each of the nine months ended July 31, 2010 and 2009 of consolidated revenues. POSCO accounted for 57 percent and 68 percent, Pacific Gas and Electric Company accounted for 11 percent and 0 percent and the U.S. government accounted for 16 percent of consolidated revenues for each of the nine months ended July 31, 2010 and 2009, respectively.

*Product sales and revenues*

Product sales and revenues declined \$15.0 million, or 26 percent in the first nine months of 2010 to \$42.0 million compared to \$57.1 million in the first nine months of 2009. A change in product sales mix from complete power plants to stack modules to POSCO compared to the prior year quarter resulted in lower overall product revenue. Partially offsetting this decline was higher revenue from long-term service agreements ( LTSAs ) due to sales of service agreements on power plant installations in South Korea.

Cost of product sales and revenues decreased \$26.6 million, or 32 percent in the nine months ended July 31, 2010 to \$57.2 million compared to \$83.8 million for the nine months ended July 31, 2009. This decrease is also due to the shift in sales from complete power plants to fuel cell stack modules for POSCO, as well as production of lower cost

multi-megawatt products.

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Gross margins for product sales and revenues improved by \$11.6 million over the prior period primarily due to a change in the sales mix towards lower cost MW class products. The up-rated 1.4 MW fuel cell stacks now in production are generating higher revenue with no commensurate increase in production costs. This improvement was partially offset by charges for warranty and commissioning primarily in the first and second quarters of fiscal 2010. The product cost-to-revenue ratio was 1.36-to-1.00 compared to 1.47-to-1.00 for the same period one year ago. The cost ratio improved on sales of lower cost products and was negatively impacted by warranty and commissioning costs, and lower sales compared to the prior period.

### *Research and development contracts*

Research and development contract revenue decreased \$2.5 million to \$8.0 million in the nine months ended July 31, 2010 compared to \$10.5 million for the nine months ended July 31, 2009. Cost of research and development contracts decreased \$0.1 million to \$7.9 million in the nine months ended July 31, 2010 compared to \$8.0 million in the nine months ended July 31, 2009. The decline in revenue was primarily due to completion of the Vision 21 and Ship Service fuel cell contracts with the U.S. Department of Energy ( DOE ) and U.S. Navy, respectively. The decrease in cost of research and development contracts resulted from the impact of different cost-shares on our contracts and different levels of activity between our contracts for these periods.

### **Administrative and selling expenses**

Administrative and selling expenses for the nine months ended July 31, 2010 decreased slightly to \$12.9 million compared to \$13.1 million in the prior year period.

### **Research and development expenses**

Research and development expenses for the nine months ended July 31, 2010 decreased \$0.6 million to \$14.3 million compared to the prior year period as a result of planned expense reduction actions taken in February 2009 and increased support by the Company's engineers on non-research and development activities.

### **Loss from operations**

Loss from operations for the nine months ended July 31, 2010 totaled \$42.3 million compared to a loss from operations of \$52.3 million for the nine months ended July 31, 2009. The improvement in net loss from operations was due to the \$9.2 million net improvement in gross margin on product sales and research and development contracts, and lower administrative and selling expenses and research and development expenses.

### **Loss from equity investment**

Our share of equity losses in Versa was \$0.6 million in each of the nine month periods ended July 31, 2010 and 2009.

### **Interest and other income, net**

Interest and other income, net, was \$1.0 million for the nine months ended July 31, 2010 compared to \$0.7 million for the same period in 2009. This increase is due to license fee income on the POSCO technology transfer agreements.

### **Accretion of Preferred Stock of Subsidiary**

The accretion of the fair value discount on the Series 1 Preferred Shares was \$1.8 million and \$1.6 million for the nine months ended July 31, 2010 and 2009, respectively.

### **Provision for income taxes**

We have not paid federal or state income taxes in several years due to our history of net operating losses. Additionally, no tax benefit has been recognized for these net operating losses or other deferred tax assets since management cannot reasonably estimate when the Company will generate taxable income.

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The Company incurred foreign income tax expense (approximately \$0.1 million for the nine months ended July 31, 2010) related to royalty income from POSCO.

### **Net loss attributable to noncontrolling interest**

The net loss attributed to the noncontrolling interest for the nine months ended July 31, 2010 was \$0.3 million. During the year, we adopted new guidance on the accounting for noncontrolling interest (formerly minority interest). See Note 1 to the Consolidated Financial Statements for further details.

### **Preferred Stock dividends**

Dividends paid on the Series B Preferred Stock were \$2.4 million in each of the nine month periods ended July 31, 2010 and 2009.

### **Net loss to common shareholders and loss per common share**

For the nine months ended July 31, 2010 and 2009, net loss to common shareholders was \$45.9 million and \$56.3 million, respectively and loss per common share was \$(0.52) and \$(0.80), respectively.

## **LIQUIDITY AND CAPITAL RESOURCES**

We have historically sold our fuel cell products below cost while the market develops, manufacturing output expands and product costs are reduced. We have been engaged in a formal commercial cost-out program since 2003 to reduce the total life cycle costs of our power plants and have made significant progress primarily through value engineering our products, manufacturing process improvements, higher production levels, technology improvements and global sourcing. During fiscal 2009, we began production of our newest megawatt-class power plants. These power plants incorporate new fuel cell stacks with outputs of 350 kilowatts (kW) compared to 300 kW previously, along with lower component and raw material costs. As a result, units produced with 350 kW stacks are expected to result in gross margin improvement.

Our future liquidity will be dependent on obtaining the order volumes and cost reductions necessary to achieve profitable operations. We may also raise capital through debt or equity offerings; however, there can be no assurance that we will be able to obtain additional capital in the future. The timing and size of any financing will depend on multiple factors including market conditions, future order flow and the need to adjust production capacity. If we are unable to raise additional capital, our growth potential may be adversely affected and we may have to modify our plans.

We believe we can reach net income breakeven at a sustained annual order and production volume of approximately 75 MW to 125 MW. The low end for this range would require sustained annual production primarily of our DFC1500 and DFC3000 power plants. The higher end of this range assumes a broader mix of our products including modules, components and our DFC1500 and DFC300 power plants. Actual results will depend on product mix, volume, future service costs, and market pricing.

During the third quarter, our manufacturing run-rate was an annualized 22 MW, compared to 30 MW in fiscal 2009 to match production with customer delivery requirements on remaining backlog. Our product backlog as of July 31, 2010 was approximately 28 MW compared to approximately 44 MW as of October 31, 2009.

Our overall manufacturing process (module manufacturing, final assembly, testing and conditioning) has a production capacity of 70 MW per year for our current product design. To increase capacity to beyond 70 MW to 140 MW, the Company would invest approximately \$35 – \$45 million. Timing of this investment will be dictated by the level of product backlog and customer lead-time requirements.

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### **Cash Flows**

Cash, cash equivalents, and investments in U.S. treasuries totaled \$67.8 million as of July 31, 2010 compared to \$64.8 million as of October 31, 2009.

In July 2010 we completed an underwritten public offering of 27,600,000 shares of common stock at a price to the public of \$1.25 per share. Net proceeds to the Company from the offering, after deducting the underwriters' discounts and commissions and offering expenses, were approximately \$32.1 million. Excluding this offering and a prior year stock offering which totaled \$22.5 million, our net cash use for the nine months ended July 31, 2010 totaled \$29.1 million compared to \$56.4 million in the same 2009 period. Cash use improved over the prior year period on increased customer milestone payments and lower overall product and operating costs.

Cash and cash equivalents as of July 31, 2010 was \$15.7 million compared to \$57.8 million as of October 31, 2009. Investments in U.S. Treasuries totaled \$52.1 million as of July 31, 2010 compared to \$7.0 million as of October 31, 2009. Our cash use is impacted by numerous factors including the timing of new orders and customer milestone payments, changes in working capital, capital spending and the factory production rate. Our future liquidity will be dependent on obtaining the order volumes and cost reductions necessary to achieve profitable operations. We may also raise capital through debt or equity offerings; however, there can be no assurance that we will be able to obtain additional capital in the future. The timing and size of any financing will depend on multiple factors including market conditions, future order flow and the need to adjust production capacity. If we are unable to raise additional capital, our growth potential may be adversely affected and we may have to modify our plans. The key components of our cash inflows and outflows were as follows:

**Operating Activities** Cash used for operating activities was \$23.1 million during the first nine months of 2010 compared to \$52.7 million used during the first nine months of 2009. The improvement over the prior year period was driven primarily by a lower net loss and reduced net working capital usage.

Components of the \$23.1 million of cash used in operating activities were a net loss of \$43.8 million off-set by non-cash items including depreciation, stock based compensation and certain other items of \$10.1 million and a working capital benefit of \$10.6 million. Working capital improved through decreased accounts receivable of \$9.0 million, increased deferred revenue of \$3.9 million due to milestone payments primarily related to our POSCO product and sales contracts. Also benefiting working capital was a \$1.1 million reduction of other assets on lower vendor advances and higher accounts payable and accrued expenses of \$1.7 million. These working capital improvements were partially offset by higher inventory of \$5.1 million related to product in inventory not yet applied to customer contracts.

**Investing Activities** Cash used in investing activities was \$47.8 million during the first nine months of 2010 compared to net cash provided by investing activities of \$25.3 million during the first nine months of 2009. The decrease was due to the net purchase of U.S. treasuries during 2010 of \$55.7 million, capital expenditures of \$2.0 million and a \$0.6 million convertible loan made to our affiliate Versa Power Systems. These changes were partially offset by \$10.5 million from the maturity of U.S. treasuries in the period.

**Financing Activities** Cash provided by financing activities was \$28.8 million during the first nine months of 2010 compared to \$22.3 million in the first nine months of 2009. Cash provided by financing activities consisted primarily of \$32.1 million from the sale and issuance of common stock partially offset by the payment of preferred stock dividends of \$2.8 million, debt repayment of \$0.3 million and restricted stock transactions of \$0.2 million.

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### **Sources and Uses of Cash and Investments**

We continue to invest in new product and market development and, as such, we are not currently generating positive cash flow from our operations. Our operations are funded primarily through cash generated from product sales and research and development contracts, license fee income and sales of equity and debt securities. In order to produce positive cash flow from operations, we need to be successful at increasing annual order volume and implementing our cost reduction efforts as well as continuing involvement in research and development contracts. The status of these activities is described below.

#### *Increasing annual order volume*

We need to increase annual order volume to achieve profitability. Increased production volumes lower costs by leveraging supplier/purchasing opportunities, creating opportunities for incorporating manufacturing process improvements, and spreading fixed costs over more units. Our overall manufacturing process has a current production capacity of 70 MW per year. Updates on our key markets are as follows:

*South Korea:* The South Korean Government passed a Renewable Portfolio Standard (RPS) beginning in 2012 that mandates 350 MW of renewable energy per year through 2016, and 700 MW per year through 2022. Fuel cells operating on natural gas and biogas fully qualify under the mandates of the program. To meet this demand, POSCO Power is currently constructing a fuel cell stack module assembly plant with annual capacity of 100 MW. During the third quarter, the Company entered into a contract to procure and sell fuel cell stack module assembly and conditioning equipment to POSCO Power for use at their new plant. The localization strategy to sell fuel cell components to POSCO Power for stacking, assembling and conditioning fuel cell modules in South Korea allows FuelCell Energy to leverage its manufacturing capacity, reduce costs, and ensure that products meet the needs of individual markets.

*California:* The State and its Public Utilities Commission (CPUC) are driving clean energy deployment to reduce greenhouse gases and pollution while encouraging the utilization of distributed generation. Distributed generation improves reliability by generating power at the point of use and relieves congestion of the electrical grid. Recent orders in the utility and renewable biogas markets are in response to these needs.

In April, the CPUC approved four DFC1500 fuel cell projects totaling 5.6 MW at four different universities, consistent with their goal of increasing distributed generation capacity. Following this approval, Pacific Gas and Electric, one of the largest utilities in the United States, ordered two 1.4 MW DFC1500 fuel cell power plants during the third quarter for installation at two university campuses in California. The power plants provide ultra-clean, efficient power to the electrical grid and byproduct heat to the universities. The quiet operation and near zero emissions of NO<sub>x</sub>, SO<sub>x</sub> and particulate matter allows siting of the fuel cell power plants in a university setting. This is the first multiple megawatt order by a U.S. utility and follows the South Korean fuel cell market, which has adopted the utility ownership model.

Converting the waste problems of food and beverage processors, wastewater treatment plants and agricultural operations into biogas is a large and growing market. Once biogas is created, DFC<sup>®</sup> fuel cells are the most efficient process available to generate ultra-clean power from this renewable fuel source. In a pioneering use of a 1.4 MW DFC1500 fuel cell power plant, a chicken farm in California will convert animal waste into renewable biogas using an anaerobic digester. This is an economically attractive method for solving animal waste disposal issues as it efficiently generates reliable power from a renewable resource while emitting virtually no pollutants such as NO<sub>x</sub>, SO<sub>x</sub> or particulate matter.

A cost effective solution that provides reliable on-site power while complying with stringent clean air regulations drove the purchase by Eastern Municipal Water District in Riverside County, California for two additional 0.3 MW DFC300 fuel cell power plants. This repeat customer wants to utilize the biogas created by the wastewater treatment process to produce renewable power at the point of use for a new treatment plant.

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*Connecticut:* The Company announced the sale of a 0.3 MW DFC300 fuel cell power plant that will be installed at a frozen food processor to support their around-the-clock refrigeration and cold storage needs. The high efficiency of the power plant will result in lower fuel and electrical costs while on-site power generation enhances reliability, power quality and energy security.

The need for ultra-clean and reliable distributed generation by the U.S. Department of Defense drove an order for two 0.3 MW DFC300 power plants. The high efficiency fuel cells will be installed at U.S. Navy Submarine Base New London where they will be configured to utilize the byproduct heat for boiling water, reducing fuel costs for the Base. This order represents the fifth U.S. military base that will have a DFC® fuel cell power plant.

The Company is working through phase II of the U.S. Department of Energy loan guarantee application process for 27.3 MW of the 43.5 MW of fuel cell projects selected by the Connecticut Department of Utility Control (CDUC). If approved, the Company will then negotiate term sheets for funding. Concurrent with this process, the Company is in active discussions with private financing sources.

*Cost reduction efforts*

Product cost reductions are essential for us to more fully penetrate the market for our fuel cell products and attain profitability. Cost reductions will also reduce or eliminate the need for incentive funding programs which currently allow us to price our products to compete with grid-delivered power and other distributed generation technologies. Product cost reductions come from several areas including:

- engineering improvements;
- technology advances;
- supply chain management;
- production volume; and
- manufacturing process improvements.

We continually strive to reduce product costs and increase power output of our products. As previously mentioned, we began production of our newest megawatt-class power plants during fiscal 2009, which incorporate higher output stacks and lower component and raw material costs. Also in 2009, we introduced a five-year fuel cell stack which is expected to reduce our long-term service costs.

*Continued involvement in research and development contracts*

Our research and development contracts are generally multi-year, cost reimbursement contracts. The majority of these are U.S. government contracts that are dependent upon the 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, and to obtain these contracts, we must continue to prove the benefits of our technologies and be successful in our competitive bidding. Our most significant programs are:

*Solid Oxide Fuel Cell Development:* The Company has partnered with Versa Power Systems Inc., for the development of a Large Scale Coal-Based Solid Oxide Fuel Cell under the U.S. Department of Energy Solid State Energy Conversion Alliance (SECA) Program. The FuelCell Energy/Versa team remains on track to meet cost and performance objectives for a minimum 25 kW fuel cell stack in Phase II of the program and is currently testing a stack tower with capacity greater than 25 kW. The full scale advanced fuel cell system to be demonstrated in Phase III is expected to incorporate an SOFC module with an output of at least 250 kW to efficiently convert the energy contained in coal to ultra-clean grid electrical power.

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*Advanced Hydrogen Programs:* The Company is collaborating with Air Products and Chemicals (NYSE: APD) to demonstrate a renewable hydrogen refueling station in California. Both the fuel cell power plant and the hydrogen refueling station are being installed at a wastewater treatment plant, which is located next to a major freeway in downtown Los Angeles. The fuel cell will operate on renewable bio-gas from the wastewater treatment process and will generate three value streams, including 1) hydrogen for vehicle refueling; 2) ultra-clean electricity; and 3) usable heat. The fuel cell power plant has been installed and is expected to be operational on natural gas by the fourth quarter of 2010 and operational on bio-gas by early 2011.

*Other Government Research:* During the third quarter of 2010, the Company was selected for five different projects by the U.S. Department of Energy (DOE) with awards totaling in excess of \$5 million. These projects are currently under negotiation with the DOE.

**Commitments and Significant Contractual Obligations**

A summary of our significant future commitments and contractual obligations as of July 31, 2010 and the related payments by fiscal year are as follows:

|  | Total            | Payments Due by Period |                 |                  |                         |
|--|------------------|------------------------|-----------------|------------------|-------------------------|
|  |                  | Less<br>than<br>1 Year | 1 3<br>Years    | 3 5<br>Years     | More<br>than<br>5 Years |
| Capital and operating lease commitments <sup>(1)</sup> | \$ 3,975         | \$ 1,076               | \$ 1,493        | \$ 1,257         | \$ 149                  |
| Term loans (principal and interest)                    | 5,778            | 1,029                  | 730             | 730              | 3,289                   |
| Purchase commitments <sup>(2)</sup>                    | 38,710           | 30,459                 | 2,197           | 6,054            |                         |
| Series 1 Preferred dividends payable <sup>(3)</sup>    | 23,916           | 12,408                 | 2,423           | 2,423            | 6,662                   |
| Series B Preferred dividends payable <sup>(4)</sup>    |                  |                        |                 |                  |                         |
| <b>Totals</b>  | <b>\$ 72,379</b> | <b>\$ 44,972</b>       | <b>\$ 6,843</b> | <b>\$ 10,464</b> | <b>\$ 10,100</b>        |

(1) Future minimum lease payments on capital and operating leases.

(2) Purchase commitments with suppliers for materials, supplies and services incurred in the normal course of business.

(3) Annual dividends of Cdn.\$1.25 million accrue on the Series 1 Preferred Stock. We have

agreed to pay a minimum of Cdn.\$500,000 in cash or common stock annually through December 31, 2010. Interest accrues on unpaid dividends at an annual rate of 9 percent. Cumulative unpaid dividends and accrued interest on July 31, 2010 was \$11.6 million using a July 31, 2010 exchange rate of Cdn.\$1.03 All cumulative unpaid dividends and accrued interest must be paid by December 31, 2010 at which time the required annual dividend payment increases to Cdn.\$1.25 million. We have the option of paying these amounts in stock or cash.

- (4) We are currently paying \$3.2 million in annual dividends on our Series B Preferred Stock. We may, at our option, convert these shares into that number of shares of our common stock that are issuable at the then prevailing conversion rate if the closing price of our common stock exceeds

150 percent of the then prevailing conversion price (\$11.75) for 20 trading days during any consecutive 30 trading day period. The \$3.2 million annual dividend payment has not been included as we cannot reasonably determine when and if we will be able to convert the Series B Preferred Stock into shares of our common stock.

In April 2008, we entered into a 10-year loan agreement with the Connecticut Development Authority allowing for a maximum amount borrowed of \$4.0 million. At July 31, 2010, principal of \$3.9 million was outstanding on this loan. The stated interest rate is 5 percent and the loan is collateralized by the assets procured under this loan as well as \$4.0 million of additional machinery and equipment. Interest and principal payments are required through May 2018. Bridgeport FuelCell Park, LLC ( BFCP ), one of our wholly-owned subsidiaries, has an outstanding loan with the Connecticut Clean Energy Fund, secured by assets of BFCP. Interest accrues monthly at an annual rate of 8.75 percent and repayment of principal and accrued interest is not required until the occurrence of certain events. As of July 31, 2010, no repayments of principal and interest have been made and we cannot reasonably determine when such repayments will begin. The outstanding balance on this loan, including accrued interest, is \$0.7 million as of July 31, 2010.

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We have pledged approximately \$9.0 million of our cash and cash equivalents as collateral and letters of credit for certain banking requirements and contracts. As of July 31, 2010, outstanding letters of credit totaled \$7.3 million. These expire on various dates through May 2012.

We have identified uncertain tax positions aggregating \$15.7 million and reduced our net operating loss carryforwards by this amount. Because of the level of net operating losses and valuation allowances, unrecognized tax benefits, even if not resolved in our favor, would not result in any cash payment or obligation and therefore have not been included in the contractual obligation table above.

In June 2010 the Company entered into an agreement with Marubeni Corporation to return certain advance contract payments, resolve claims for services and repurchase surplus inventory items previously sold to Marubeni Corporation. The agreement calls for payments of approximately \$1.9 million to Marubeni Corporation between June and December 2010 and a payment of \$1.0 million upon title transfer of surplus inventory to FuelCell. Payments due under this agreement are recorded under accrued expenses. The Company does not expect to incur a charge to the consolidated statement of operations as a result of this agreement and may record a gain in the range of \$0.3 million to \$1.3 million depending on the valuation of inventory recovered. Terms of the agreement are expected to be completed in December of 2010.

In addition to the commitments listed in the table above, we have the following outstanding obligations:

### *Power purchase agreements*

In California, we have 3 MW of power plant installations under power purchase agreements ranging in duration from five to ten years. As owner of the power plants, 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 to run the power plants.

We qualified for incentive funding for these projects under California's SGIP 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 during the period specified by the government program. Revenue related to these incentive funds is recognized ratably over the performance period. As of July 31, 2010, we had deferred incentive funding revenue totaling \$1.4 million.

### *Service and warranty agreements*

We warranty our products for a specific period of time against manufacturing or performance defects. Our standard warranty period is generally 15 months after shipment or 12 months after installation of the product. In addition to the standard product warranty, we have contracted with certain customers to provide services to ensure the power plants meet minimum operating levels for terms ranging from one to 13 years. Our standard LTSA term is five years. Pricing for service contracts is based upon estimates of future costs, which given our products' early stage of development, could be materially different from actual expenses. Also see Critical Accounting Policies and Estimates for additional details.

### *Research and development cost-share contracts*

We have contracted with various government agencies to conduct research and development as either a prime contractor or sub-contractor under multi-year, cost-reimbursement and/or cost-share type contracts or cooperative agreements. Cost-share terms require that participating contractors share the total cost of the project based on an agreed upon ratio. In many cases, we are reimbursed only a portion of the costs incurred or to be incurred on the contract. 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 authorizes the funds. As of July 31, 2010, research and development sales backlog totaled \$7.4 million, of which \$5.1 million is funded. Should funding be delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

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### *Health Care Reform Acts*

In March 2010, the President of the United States signed the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (collectively the 2010 Acts ). The 2010 Acts will have a substantial impact on health care providers, insurers, employers and individuals. The 2010 Acts will impact employers and businesses differently depending on the size of the organization and the specific impacts on a company's employees. Certain provisions of the 2010 Acts will become effective with our next open enrollment period (November 1, 2010) while other provisions of the 2010 Acts will be effective in future years. The 2010 Acts could require, among other things, changes to our current employee benefit plans, our information technology infrastructure, and in our administrative and accounting processes. The ultimate extent and cost of these changes cannot be determined at this time and are being evaluated and updated as related regulations and interpretations of the 2010 Acts become available.

### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of financial statements and related disclosures requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, revenue recognition, contract loss reserves, excess, slow-moving and obsolete inventories, product warranty costs, reserves on long-term service agreements, share-based compensation expense, allowance for doubtful accounts, depreciation and amortization, impairment of long-lived assets and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

Our critical accounting policies are those that are both most important to our financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Refer to Critical Accounting Policies and Estimates in our Annual Report on Form 10-K for the fiscal year ended October 31, 2009 for detailed information regarding our accounting policies and estimates that we consider critical in preparing our consolidated financial statements. The critical accounting policies below represent those policies that management has updated during the year.

#### ***Revenue Recognition***

We earn revenue from (i) the sale and installation of fuel cell power plants, modules and component parts to customers (i.e. product sales), (ii) providing services under long-term service agreements, (iii) the sale of electricity under power purchase agreements ( PPA ), (iv) incentive revenue from the sale of electricity under PPAs, (v) site engineering and construction services and (vi) customer-sponsored research and development projects. Our revenue is primarily generated from customers located throughout the U.S. and Asia and from agencies of the U.S. government. Revenue from customer-sponsored research and development projects is recorded as research and development contracts revenue and all other revenues are recorded as product sales and revenues in the consolidated statements of operations.

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Revenue from sales of our power plants and modules are recognized under the percentage of completion method of accounting. Revenues are recognized proportionally as costs are incurred and assigned to a customer contract by comparing total expected costs for each contract to the total contract value. Prior to fiscal 2010, we did not provide for a contract loss reserve on product sales contracts as products were in their early stages of development and market acceptance, and the total costs to produce, install and commission these units could not be reasonably estimated. As a result of a consistent production rate over the past two fiscal years and installation and commissioning experience for our major product lines, management now believes that it has sufficient product cost history to reasonably estimate the total costs of our fuel cell product sales contracts. Accordingly, effective November 1, 2009, a contract loss reserve on product sales contracts is recognized at the time we become aware that estimated total costs are expected to exceed the contract sales price. We have reviewed open contracts and recorded an estimated loss of \$0.5 million for the nine months ended July 31, 2010. Actual results could vary from initial estimates and reserve estimates will be updated as we gain further manufacturing and operating experience. For component and spare parts sales, revenue is recognized upon shipment under the terms of the customer contract.

Revenue earned by performing routine monitoring and maintenance under LTSAs is recognized ratably over the term of the contract. Costs for performing maintenance are recognized as incurred. For service contracts that include a minimum operating output over the course of the contract, a portion of the contract revenue is deferred until such time as it is earned through power plant performance.

Revenue from the sale of electricity is recognized as electricity is provided to the customer. Incentive revenue is recognized ratably over the term of the PPA. Site engineering and construction services revenue is recognized as costs are incurred.

Revenue from research and development contracts is recognized proportionally as costs are incurred and compared to the estimated total research and development costs for each contract. Revenue from government funded research and development 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, and on certain contracts we are reimbursed only a portion of the costs incurred. 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.

***Warranty and Service Expense Recognition***

We warranty our products for a specific period of time against manufacturing or performance defects. Our warranty is limited to a term generally 15 months after shipment or 12 months after installation of our products. We reserve for estimated future warranty costs based on historical experience. Given our limited operating experience, particularly for newer product designs, actual results could vary from initial estimates. Estimates used to record warranty reserves are updated as we gain further operating experience.

In addition to the standard product warranty, we have entered into LTSA contracts with certain customers to provide monitoring, maintenance and repair services for fuel cell power plants ranging from one to 13 years. Our standard service agreement term is five years. Under the terms of our LTSA, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may replace the customer's fuel cell stack with a new or used unit. Our contractual liability under LTSA's is limited to the amount of service fees payable under the contract. This can often times be less than the cost of a new stack replacement. In order to continue to meet customer expectations on early product designs, at our election we have often incurred costs in excess of our contractual liabilities.

Power plants with our five-year stack design are not expected to require a stack change to continue to meet minimum operating levels during the initial five-year term of the LTSA, however the Company will continue to monitor performance and life of these stacks based on actual performance at customer sites. Stack replacements for these agreements are expected to only be required upon renewal of the LTSA. Accordingly, five-year LTSA's with our five-year stack design have not required a contract loss reserve. We expect the replacement of older stacks produced prior to the five-year stack design to continue over the next several years, and as a result, we may continue to incur losses in order to maintain power plants to the extent costs exceed our contract loss reserves on these legacy service agreements. Future costs for maintaining legacy service agreements will be determined by a number of factors

including the estimated life of the stack, used replacement stacks available, our limit of liability on service agreements and future operating plans for the power plant.

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As our fuel cell products have been in their early stages of commercialization and market acceptance, we historically had not provided for a pricing reserve if the agreement was sold below our standard pricing. As a result of our experience with these contracts and production rates of stacks and related costing, effective February 1, 2010, the method of estimating LTSA contract losses has been revised resulting in a \$0.5 million benefit to the consolidated statement of operations in the second fiscal quarter of 2010. As of July 31, 2010, our reserve on LTSA contracts totaled \$5.5 million compared to \$6.0 million as of October 31, 2009. Deferred LTSA revenue as of July 31, 2010 totaled \$3.1 million compared to \$2.5 million as of October 31, 2009. We estimate that reserves and deferred revenues exceed our minimum contractual liabilities under our current contracts, however, LTSA pricing reserves and revenue deferrals are based upon estimates of future costs, which given our products' early stage of commercialization could be materially different from actual expenses. Net loss on service agreements were \$3.0 million and \$3.6 million for the quarters ended July 31, 2010 and 2009, respectively.

***Inventories and Advance Payments to Vendors***

Inventories consist principally of raw materials and work-in-process and are stated at the lower of cost or market. In certain circumstances, we will make advance payments to vendors for future inventory deliveries. These advance payments (net of related reserves) are recorded as other current assets on the consolidated balance sheets.

Prior to November 1, 2009, we provided for a lower of cost or market ( LCM ) reserve to the cost basis of inventory at time of purchase. During the second half of 2009, we began production of our newest megawatt-class power plants and modules. The manufactured cost per kilowatt of these products is lower than previous models due to a 17 percent power increase and lower component and raw materials cost and are expected to be gross margin positive on a unit by unit basis. As a result, beginning in fiscal 2010, we revised our method of estimating contract losses and no longer provide for an LCM reserve on new inventory purchased. As inventory is utilized in finished products and sold, the Company expects the LCM reserve to continue to decline.

**ACCOUNTING GUIDANCE UPDATE*****Recently Adopted Accounting Guidance***

In February 2010, the Financial Accounting Standards Board ( FASB ) issued amended guidance relating to the disclosure of subsequent events. Under previous guidance, SEC registrants were required to evaluate subsequent events through the date the financial statements were issued, or available for issuance, and disclose in its public filings the date through which subsequent events were evaluated. Under the amended guidance, SEC registrants are required to evaluate subsequent events through the date the financial statements are issued (rather than the date the financial statements are available for issuance), but are no longer required to disclose in its public filings the date through which subsequent events were evaluated. The amended guidance is effective immediately and has been adopted and reflected in our financial statements.

In April 2008, the Financial Accounting Standards Board ( FASB ) issued accounting guidance that amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. In developing assumptions about renewal or extension options used to determine the useful life of an intangible asset, a company needs to consider its own historical experience adjusted for company-specific factors. In the absence of that experience, the company shall consider the assumptions that market participants would use about renewal or extension options. The new guidance was effective for the first quarter of fiscal 2010. We currently do not have any intangible assets recorded in our consolidated balance sheets; therefore, the impact of this guidance on our consolidated financial statements will be determined when and if we acquire definite-lived intangible assets.

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In December 2007, the FASB issued new guidance that requires noncontrolling interests (formerly minority interests ) in a subsidiary be reported as equity in the consolidated financial statements. Consolidated net income should include the net income for both the parent and the noncontrolling interest with disclosure of both amounts in the consolidated statements of operations. The calculation of earnings per share would continue to be based on income amounts attributable to the parent. This guidance became effective for the quarter ended January 31, 2010 and changed the accounting for and reporting of noncontrolling interests in our subsidiaries.

In December 2007, the FASB issued revised accounting guidance for business combinations that requires an acquirer to measure the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. The guidance also requires that certain other assets and liabilities related to the acquisition, such as contingencies and research and development, be recorded at fair value. The new guidance was effective for the first quarter of fiscal 2010. The potential impact of this revised guidance on our consolidated financial statements will be based upon future business combinations, if any.

### ***Recent Accounting Guidance Not Yet Effective***

In April 2010, the FASB provided guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon the achievement of milestone events. An entity may only recognize consideration that is contingent upon the achievement of a milestone in its entirety in the period the milestone is achieved only if the milestone meets certain criteria. This guidance is effective prospectively for milestones achieved in fiscal years beginning on or after June 15, 2010. While we are still analyzing the potential impact of this guidance, we believe that our current practices are consistent with the guidance and, accordingly, we do not expect the adoption of this guidance will have a material impact on our financial statements.

In March 2010, the FASB issued guidance clarifying that embedded credit-derivative features related only to the transfer of credit risk in the form of subordination of one financial instrument to another are not subject to potential bifurcation and separate accounting. Other embedded credit-derivative features are required to be analyzed to determine whether they must be accounted for separately. The guidance is effective at the beginning of a company's first fiscal quarter beginning after June 15, 2010 and may be early adopted in a company's first fiscal quarter beginning after March 5, 2010 (the issuance date of the guidance). We currently do not enter into contracts containing embedded credit-derivative features related only to the transfer of credit risk in the form of subordination of one financial instrument to another; and therefore, do not expect the adoption of this guidance will have a material impact on our financial statements or disclosures.

In January 2010, the FASB issued guidance that requires new disclosures for fair value measurements and provides clarification for existing disclosure requirements. This amended guidance require disclosures about inputs and valuation techniques used to measure fair value as well as disclosures about significant transfers in and out of Levels 1 and Levels 2 fair value measurements and disclosures about the purchase, sale, issuance and settlement activity of Level 3 fair value measurements. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for disclosures about the purchase, sale, issuance and settlement activity of Level 3 fair value measurements, which is effective for fiscal years beginning after December 15, 2010. The Company was not impacted by the disclosures effective for interim periods beginning after December 15, 2009 and we do not expect the remaining disclosures required after December 15, 2010 upon adoption of this guidance will have a material impact on our financial statements or disclosures.

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In December 2009, the FASB issued revised guidance related to the consolidation of variable interest entities ( VIE ). The revised guidance requires reporting entities to evaluate former qualified special purpose entities for consolidation, changes the approach to determining a VIE s primary beneficiary from a quantitative assessment to a qualitative assessment designed to identify a controlling financial interest, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a VIE. It also clarifies, but does not significantly change, the characteristics that identify a VIE. The guidance is effective as of the beginning of a company s first fiscal year beginning after November 15, 2009 (November 1, 2010 for the Company), and for subsequent interim and annual reporting periods. We are evaluating the impact of adopting this guidance.

In October 2009, the FASB issued guidance updating accounting standards for revenue recognition for multiple-deliverable arrangements. The stated objective of the update was to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services separately rather than as a combined unit. The guidance provides amended methodologies for separating consideration in multiple-deliverable arrangements and expands disclosure requirements. The guidance will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 (November 1, 2010 for the Company), with early adoption permitted. We are evaluating the impact of adopting this guidance.

In June 2009, the FASB issued accounting guidance which requires a company to perform ongoing reassessment of whether it is the primary beneficiary of a variable interest entity ( VIE ). Specifically, the guidance modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The guidance clarifies that the determination of whether a company is required to consolidate a VIE is based on, among other things, an entity s purpose and design and a company s ability to direct the activities of the VIE that most significantly impact the VIE s economic performance. The guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a VIE and enhanced disclosures of the company s involvement in VIEs and any significant changes in risk exposure due to that involvement. The guidance will be effective for the first quarter of fiscal 2011. We are evaluating the impact of adopting this guidance.

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**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Interest Rate Exposure**

We typically invest in U.S. treasury securities with maturities ranging from less than three months to one year or more. We expect to hold these investments until maturity and accordingly, these investments are carried at cost and not subject to mark-to-market accounting. At July 31, 2010, U.S. treasury investments had a carrying value of \$52.1 million, which approximated fair value. These investments have maturity dates ranging from August 2010 to March 2012 and a weighted average yield to maturity of 0.5%. Cash is invested overnight with high credit quality financial institutions and therefore we are not exposed to market risk from changing interest rates. Based on our overall interest rate exposure at July 31, 2010, including all interest rate sensitive instruments, a change in interest rates of one percent would not have a material impact on our results of operations.

**Foreign Currency Exchange Risk**

As of July 31, 2010, less than one percent of our total cash, cash equivalents and investments were in currencies other than U.S. dollars (primarily Canadian dollars and South Korean Won). We make purchases from certain vendors in currencies other than U.S. dollars. Although we have not experienced significant foreign exchange rate losses to date, we may in the future, especially to the extent that we do not engage in currency hedging activities. The economic impact of currency exchange rate movements on our operating results is complex because such changes are often linked to variability in real growth, inflation, interest rates, governmental actions and other factors. These changes, if material, may cause us to adjust our financing and operating strategies.

**Derivative Fair Value Exposure**

*Series 1 Preferred Stock*

The conversion feature and the variable dividend obligation of our Series 1 Preferred shares are embedded derivatives that require bifurcation from the host contract. The aggregate fair value of these derivatives included within long-term debt and other liabilities as of July 31, 2010 was \$0.5 million. The fair value was based on valuation models using various assumptions including historical stock price volatility, risk-free interest rate and a credit spread based on the yield indexes of technology high yield bonds, foreign exchange volatility as the Series 1 Preferred security is denominated in Canadian dollars, and the closing price of our common stock. Changes in any of these assumptions would change the underlying fair value with a corresponding charge or credit to earnings. However, any changes to these assumptions would not have a material impact on our results of operations.

*Warrants*

We hold warrants for the right to purchase an additional 3,969 shares of Versa's common stock. The fair value of the warrants at July 31, 2010 was \$0.3 million. The fair value was determined based on the Black-Scholes valuation model using historical stock price, volatility (based on a peer group since Versa's common stock is not publicly traded) and risk-free interest rate assumptions. Changes in any of these assumptions would change the fair value of the warrants with a corresponding charge or credit to earnings. However, any changes to these assumptions would not have a material impact on our results of operations.

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**Item 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures, which are designed to provide reasonable assurance that information required to be disclosed in the Company's periodic SEC reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the Company's periodic SEC reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There has been no change in our internal controls over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

We are involved in legal proceedings, claims and litigation arising out of the ordinary conduct of our business. Although we cannot assure the outcome, management presently believes that the result of such legal proceedings, either individually, or in the aggregate, will not have a material adverse effect on our consolidated financial statements, and no material amounts have been accrued in our consolidated financial statements with respect to these matters.

**Item 1A. RISK FACTORS**

There have been no material changes with respect to the risk factors disclosed in our Registration Statement on Form S-3/A filed on September 2, 2010.

**Item 6. EXHIBITS****Exhibit****No.****Description**

|      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on September 9, 2010.

**FUELCELL ENERGY, INC.**  
**(Registrant)**

September 9, 2010

/s/ Joseph G. Mahler

**Date**

**Joseph G. Mahler**  
Senior Vice President, Chief Financial  
Officer, Treasurer and Corporate Secretary  
(Principal Financial Officer and Principal  
Accounting Officer)

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**INDEX OF EXHIBITS**

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