FUELCELL ENERGY INC
Form 10-K
January 16, 2007

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

FORM 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: **October 31, 2006**

OR

o 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 Number)
3 Great Pasture Road **Danbury, Connecticut**	**06813**
(Address of principal executive offices)	(Zip Code)

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

N/A
(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act.
None.

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.0001 Par Value

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K o

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

Large Accelerated Filer o Accelerated Filer x Non-accelerated Filer o

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

The aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant known to us as of April 28, 2006 was approximately $587.5 million, which is based on the closing price of $13.13 on April 28, 2006. On January 10, 2007 there were 53,169,234 shares of common stock of the registrant issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE Certain information contained in the registrant's definitive proxy statement relating to its forthcoming 2007 Annual Meeting of Shareholders to be filed not later than 120 days after the end of registrant's fiscal year ended October 31, 2006 is incorporated by reference in Part III of this Annual Report on Form 10-K.

FUELCELL ENERGY, INC.

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Forward-looking Statement Disclaimer

When used in this Report, the words “expects”, “anticipates”, “estimates”, “should”, “will”, “could”, “would”, “may”, and simi expressions are intended to identify forward-looking statements. Such statements relate to the development and commercialization schedule for our fuel cell technology and products, future funding under government research and development contracts, the expected cost competitiveness of our technology, and the timing and availability of products under development. These and other forward looking statements contained in this Report are subject to risks and uncertainties, known and unknown, that could cause actual results to differ materially from those forward-looking statements, including, without limitation, general risks associated with product development and introduction, changes in the utility regulatory environment, potential volatility of energy prices, government appropriations, the ability of the government to terminate its development contracts at any time, rapid technological change, and competition, as well as other risks contained under Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Future Results” of this Report. We cannot assure you that we will be able to meet any of our development or commercialization schedules, that the government will appropriate the funds anticipated by us under our government contracts, that the government will not exercise its right to terminate any or all of our government contracts, that any of our products or technology, once developed, will be commercially successful, or that we will be able to achieve any other result anticipated in any other forward-looking statement contained herein. The forward-looking statements contained herein speak only as of the date of this Report. Except for ongoing obligations to disclose material information under the federal securities laws, we expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any such statement to reflect any change in our expectations or any change in events, conditions or circumstances on which any such statement is based.

Background

Information contained in this Report concerning the electric power supply industry and the distributed generation market, our general expectations concerning this industry and this market, and our position within this industry are based on market research, industry publications, other publicly available information and on assumptions made by us based on this information and our knowledge of this industry and this market, which we believe to be reasonable. Although we believe that the market research, industry publications and other publicly available information are reliable, including the sources that we cite in this Report, they have not been independently verified by us and, accordingly, we cannot assure you that such information is accurate in all material respects. Our estimates, particularly as they relate to our general expectations concerning the electric power supply industry and the distributed generation market, involve risks and uncertainties and are subject to change based on various factors, including those discussed under “Factors That May Affect Future Results” in Item 7 of this Report.

We define distributed generation as small (typically 50 megawatts or less) electric generation plants (combustion-based such as engines and turbines as well as non-combustion-based such as fuel cells) located at or near the end use customer. This is contrasted with central generation that we define as large power plants (typically hundreds of megawatts to 1,000 megawatts or larger) that deliver electricity to end users through a comprehensive transmission and distribution system.

As used in this Report, all degrees refer to Fahrenheit (“F”) and kilowatt and megawatt numbers designate nominal or rated capacity of the referenced power plant. As used in this Annual Report, “efficiency” or “electrical efficiency” means the ratio of the electrical energy (“AC”) generated in the conversion of a fuel to the total energy contained in the fuel. Lower heating value, the standard for power plant generation assumes the water in the product is in vapor form; as opposed to higher heating value, which assumes the water in the product is in the liquid form, net of parasitic load; “overall energy efficiency” refers to efficiency based on the electrical output plus useful heat output of the power plant; “kilowatt” (“kW”) means 1,000 watts; “megawatt” (“MW”) means 1,000,000 watts; “kilowatt hour” (“kWh”) is equal to 1kW power supplied to or taken from an electric circuit steadily for one hour, and “Btu” is equal to one million British Thermal Unit (the amount of heat necessary to raise one pount of pure water from 59^{o}F to 60^{o}F at a specified constant

pressure).

All dollar amounts are in U.S. dollars unless otherwise noted.

Additional technical terms and definitions:

Alternating Current ("AC") — Electric current where the magnitude and direction of the current varies cyclically, as opposed to ***Direct Current ("DC")***, where the direction of the current stays constant. The usual waveform in an AC power circuit is a sine wave, as this results in the most efficient transmission of energy. AC refers to the form in which energy is delivered to businesses and residences.

Anaerobic Digester Gas - Fuel gas produced in biomass digesters employing bacterial and controlled oxygen environment from municipal, industrial or commercial water treatment facilities.

Anode -An active fuel cell component functioning as a negative electrode, where oxidation of fuel occurs. Also referred to as "fuel electrode."

Availability - -An industry standard (IEEE (The Institute of Electrical and Electronics Engineers) 762, "Definitions for Use in Reporting Electric Generating Unit Reliability, Availability and Productivity") used to compute total operating period hours less the amount of time a power plant is not producing electricity due to planned or unplanned maintenance. "Availability percentage" is calculated as total operating hours since commercial acceptance date (mutually agreed upon time period when our DFC power plants have operated at a specific output level for a specified period of time) less hours not producing electricity due to planned and unplanned maintenance divided by total period hours. Grid disturbances, force majeure events and site specific issues such as a lack of available fuel supply or customer infrastructure repair do not penalize the calculation of availability according to this standard.

Cathode - An active fuel cell component functioning as a positive (electrically) electrode, where reduction of oxidant occurs. Also referred to as "oxidant electrode."

Co-generation Configuration - A power plant configuration featuring simultaneous onsite generation of electricity and recovery of waste heat to produce process steam or hot water, or to use heat for space heating.

Humid Flue Gas - Exhaust gas from fuel cell and other power plants or a furnace. The gas typically contains humidity (moisture).

Metallic Bipolar Plates - The conductive plates used in a fuel cell stack to provide electrical continuity from active components of one cell to those in an adjacent cell. The plates also provide isolation of fuel and air fed to the fuel cell.

Microturbine - A gas turbine with typical power output ranges of 30 kW to 350 kW. Microturbines are characterized by low-pressure ratios (less than 5) and high-speed alternators.

Nitrogen Oxides ("NOX") — Generic term for a group of highly reactive gases, all of which contain nitrogen and oxygen in varying amounts. Many of the NOX are colorless and odorless. However, one common pollutant, ***Nitrogen Dioxide ("NO2"),*** along with particles in the air, can often be seen as a reddish-brown layer over many urban areas. NOX form when fuel is burned at high temperatures, as in a combustion process. The primary manmade sources of NOX are motor vehicles, electric utilities, and other industrial, commercial and residential sources that burn fuels.

Reforming - Catalytic conversion of hydrocarbon fuel (such as pipeline natural gas or digester gas) to hydrogen-rich gas. The hydrogen-rich gas serves as a fuel for the electrochemical reaction.

Renewable Portfolio Standards ("RPS") - States seeking to secure cleaner energy sources are setting standards that require utilities provide a certain amount of their electricity from renewable sources such as solar, wind or other biomass-fueled technologies, including fuel cells. These standards are referred to as Renewable Portfolio Standards. There are currently 23 states and the District of Columbia with RPS programs that mandate a certain percentage of their electricity be generated from renewable resources. Fuel cells using biomass fuels qualify as renewable power generation technology in all of these states, and certain states (Connecticut, Hawaii, Maine, New York and Pennsylvania) specify that fuel cells operating on natural gas are eligible under these standards.

Sulfur Oxide ("SOX") - Sulfur oxide refers to any one of the following: sulfur monoxide, sulfur dioxide ("SO2") and sulfur trioxide. SO2 is a byproduct of various industrial processes. Coal and petroleum contain sulfur compounds, and generate SO2 when burned.

Synthesis Gas - A gas mixture of hydrogen and carbon monoxide generally derived from gasification of coal or other biomass. It can serve as a fuel for the fuel cell after any required fuel clean up.

Item 1. BUSINESS

OVERVIEW

FuelCell Energy is a world leader in the development and manufacture of fuel cell power plants for ultra-clean, efficient and reliable electric power generation. Our products are designed to meet the 24/7 baseload power needs of commercial, industrial, government and utility customers. To date our products have generated over 150 million kilowatt hours of electricity and we have units operating at over 50 locations around the world.

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

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

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

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

Typical customers for our products include manufacturers, mission critical institutions such as correction facilities and government installations, hotels and customers who can use waste or byproducts of their operations for fuel such as breweries, food processors and waste water treatment facilities. With increasing demand for renewable and ultraclean power options, and increased volatility and uncertainty in electric markets, our customers gain control of power generation economics, reliability and emissions. Our fuel cells offer flexible siting and easy permitting.

Our DFC power plants are protected by 46 U.S. and 74 international patents and we have also submitted 38 U.S. and 123 international patent applications.

Current Market Dynamics

According to the Energy Information Administration, worldwide electricity demand in 2003 was approximately 15 billion kWh and is expected to more than double by 2030. The market for clean power is strong and growing. Wind and solar installations are expanding rapidly with increasing market demand for renewable and ultraclean power generation. These solutions offer intermittent power generation, in effect, when the wind blows and when the sun is shining. Our ultra-clean products are a 24/7 baseload power solution for this market, a key requirement for commercial, industrial and utility customers.

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

In 2006, customers ordered 5.05 MW and we shipped 6.75 MW of our products. All orders during the year were multi-unit or MW sized products in our target markets. Custmers included wastewater treatment facilities, universities, hotels, industrial operations and natural gas pipeline applications. In addition to expanding our markets, we have taken a number of steps to ensure that we are prepared to address RPS market opportunities. We engineered a lower cost product for multi-megawatt configurations. We also initiated production process improvements to increase the efficiency of our manufacturing and commissioning operations.

Although we made significant progress in 2006 executing our business plan to reduce costs and increase market share, current market dynamics have resulted in a slow developing sales environment. For example, sales in California, Connecticut and Japan have been impacted by volatile fuel prices and lagging electric rates. In California and Connecticut, this situation has recently improved as higher fuel prices are being incorporated into electric rates. Product sales are also impacted by the current regulatory and political environment. Exit fees, standby charges and interconnect fees continue to limit distributed generation, including fuel cells, in many markets.

We expected Connecticut's Project 100 to move forward in early 2006, but it was delayed nearly a year moving through the regulatory cycle. This program is now moving forward and our partners submitted approximately 99 MW of bids in December 2006 in response to the Connecticut Clean Energy Fund Request for Proposals ("RFP"). Site selections are expected to be announced in March 2007.

Positive regulatory actions were enacted in California and by the U.S. government. In California, the legislature recently passed AB32, a sweeping greenhouse gas bill that requires businesses to reduce greenhouse gas emissions 25% by 2020. This, together with existing environmental regulations and incentives as well as the flexibility inherent in siting our products, create a highly favorable market for fuel cells. In December 2006, a bill was approved that extends the Investment Tax Credit through 2008. These credits apply to projects that create electricity from fuel cells, wind, geothermal, solar and biomass, as well as other alternative energy initiatives and enhance the economics of theses projects.

Value Proposition of Our Products

Customers buy our fuel cells for reliability, cost and environmental demands. There are currently strong incentive programs in our target markets including California and the Northeast in the U.S., Korea and Japan in Asia and Germany in Europe that make the cost of clean power solutions including fuel cells, wind and solar competitive. We believe that with the continued cost reduction of our products and with increased volume that our products are expected to be cost competitive on an unsubsidized basis against the grid and other distributed generation products, such as engines.

Value Proposition - On-Site Power. Stationary fuel cell power plants are an economical alternative to utility-provided power and other distributed generation in on-site power applications. Customers can often produce power with our products for less than the local utility price or other competing distributed generation products. Customers gain the added benefits of quiet operations, improved reliability and lower emissions.

Factoring in the value of the heat used for cogeneration, government incentives, and possible offsets due to emissions credits, the net cost to the end user of our products is approximately $0.10 to $0.12/kWh or less, depending on location and application. We believe this is competitive with grid-delivered electricity and other distributed generation products in the regions in which we compete. We believe that tougher emission standards will increase the cost of competing distributed generation products.

Value Proposition - Utility or RPS. States seeking to secure cleaner energy sources are setting standards that require utilities provide a certain amount of their electricity from renewable sources such as solar, wind, biomass-fueled technologies, and fuel cells. There are currently 23 states and the District of Columbia that have instituted Renewable Portfolio Standards legislation. These markets in the U.S. alone represent a potential for an estimated 25,000 MW. Fuel cells using biomass fuels qualify as renewable power generation technology in all of these states, with five states specifying that fuel cells operating on natural gas are eligible for these initiatives.

As more intermittent power generation sources including wind and solar are added to the electric grid, states and utilities are looking to balance this generation with alternative ultraclean products that can provide power 24/7. Stationary fuel cell power plants can provide 24/7 power to meet the needs of utilities trying to implement RPS initiatives. Fuel cell power plants can also provide power to grid-constrained areas incrementally without large transmission and distribution investments.

Business Strategy

Our business strategy is to expand our leadership position in key markets, build multi-megawatt markets and continue to reduce the costs of our products. A product mix weighted more heavily with MW-class products is our fastest path to achieve profitability. In 2007, our focus will be as follows:

Build on our leadership position in vertical and geographic markets -

- *California* – We are the fuel cell market leader in California where high electricity costs and stringent environmental regulations make our products a compelling value proposition for customers. California extended its Self-Generation Incentive Program (SGIP) to 2012. The SGIP provides annual incentives, at least $80 million in 2007, for which our fuel cell products are eligible.

- *Asia* – Japan and Korea continue to be among our best markets due to high electricity cost, environmental regulations and incentives for fuel cells. In 2006, Korea enacted its first-ever subsidies to promote renewable energy technologies as part of a national carbon dioxide reduction effort. Fuel cells are eligible for the recovery of 28 cents per kWh and 50 MW of generation will qualify for these funds which are intended to drive the installation of megawatt-class power plants.

- *Europe* – The European Union and member countries have various initiatives underway to promote clean energy. New and expanding incentives in Germany and elsewhere could encourage more sales in 2007 and we are well positioned to capitalize on this growth.

Build Multi-Megawatt Markets –

RPS Markets – RPS programs mandate a certain percentage of their electricity be generated from renewable and ultra-clean resources. Our multi-MW products in installations from 2 to 50 MWs and our pipelind applications are well suited to operate in these markets. Near term opportunities, which we are pursuing in these markets are:

- *Connecticut* – FuelCell Energy and its partners submitted nearly 99 MW of multi-megawatt bids to the Connecticut Clean Energy Fund (CCEF) in December 2006. CCEF has announced that its project selections will be announced

in March 2007.

· *Natural Gas Pipeline Applications* – FuelCell Energy sold a 1.2 MW fuel cell power plant to Enbridge, Inc. for inclusion in a Direct FuelCell-Energy Recovery Generation™ (DFC-ERG™) system that generates ultra-clean electricity while recovering energy normally lost during natural gas pipeline operations. The DFC-ERG opens major new market opportunities for the Company worldwide - in North America the initial market is estimated to be 200-300 MW. We are working with Enbridge, Inc. to capture opportunities in this market.

Cost Reduction –

· FuelCell Energy will continue its cost out initiatives to deliver the most competitive and environmentally friendly products in the market. Our cost reduction efforts are now in their fourth year and we have reduced product costs by over 70 percent since the program began. As a result, our largest product (the 2.4 MW DFC3000) has a product cost of $3,250/kW, which is close to market clearing prices and could benefit from additional volume that could reduce the cost another 10 to 20 percent in 2007 without further design changes.

· The DFC300MA and DFC1500MA are targeted to achieve 20 percent cost reductions in 2007 through improvements in strategic sourcing, value engineering and operations in 2007.

· We are also working toward additional power output increases and improvements to stack life which are expected to result in lower costs across the entire product line.

At a sustained annual order and production volume of approximately 35 MW to 50 MW, depending on product mix, geographic location and other variables such as fuel prices, we believe we can reach gross margin breakeven. We believe that net income break-even can be achieved at a sustained annual order and volume production of approximately 75-100 MW. Since the cost of our 2.4 MW product is currently at market clearing prices in certain target markets such as Connecticut, profitability could be achieved on lower production volumes if product mix trends more toward MW and multi-MW orders.

PRODUCTS

Direct FuelCell® (DFC®) Power Plants

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

A fuel cell chemically converts a hydrocarbon fuel into electricity without fuel combustion. The primary byproducts of the fuel cell are heat, water and carbon dioxide. There is virtually no SOX or NOX emissions. A fuel cell power plant can be thought of as having two basic segments: the fuel cell stack module, the part that actually produces the electricity, and the balance of plant (“BOP”), which includes various fuel handling and processing equipment, such as pipes and blowers, and electrical interface equipment such as inverters to convert the DC output of the fuel cell to AC.

Conventional fossil fuel based power plants generate electricity by combustion of hydrocarbon fuels, such as coal, oil or natural gas. With reciprocating engines, fuel combustion takes place within the engine that drives a generator that produces electricity. In a gas turbine combined cycle plant, fuels, such as natural gas, are burned in the gas turbine, which drives a generator. The exhaust heat from the gas turbine is used to boil water, which converts to high-pressure steam, which is used to rotate a steam turbine generating additional electricity. The combustion process typically creates emissions of SOX and NOX, carbon monoxide, soot and other air pollutants.

The following table shows industry estimates of the electrical efficiency, operating temperature, expected capacity range and certain other operating characteristics of the principal types of fuel cells being developed for commercial applications:

Fuel Cell Type	**Electrolyte**	**Electrical Efficiency %**	**Operating Temperature ºF**	**Expected Capacity Range**	**By-Product Heat Use**
PEM	Polymer Membrane	30-35	180	5 kW to 250 kW	Warm Water
Phosphoric Acid	Phosphoric Acid	35-40	400	50 kW to 200 kW	Hot Water
Carbonate (Direct FuelCell®)	**Potassium/Lithium Carbonate**	**45-57**	**1200**	**250 kW to 3 MW and larger**	**Hot water or High Pressure Steam**
Solid Oxide (Tubular)	Stabilized Zirconium dioxide Ceramic	45-50	1800	100 kW to 3 MW	Hot water or High Pressure Steam
Solid Oxide (Planar)	Stabilized Zirconium dioxide Ceramic	40-60	1200-1600	3 kW to 1 MW and larger	Hot water or High Pressure Steam

Our carbonate fuel cell, known as the Direct FuelCell, operates at approximately 1200°F. This temperature avoids the use of precious metal electrodes required by lower temperature fuel cells, such as proton exchange membrane (“PEM”) and phosphoric acid, and the more expensive metals and ceramic materials required by higher temperature fuel cells, such as solid oxide. As a result, we are able to use less expensive catalysts and readily available metals in our designs. In addition, our fuel cell produces high quality by-product heat energy (700°F) that can be harnessed for combined heat and power (“CHP”) applications using hot water, steam or chiller water to heat or cool buildings.

Our Direct FuelCell is so named because of its ability to generate electricity directly from a hydrocarbon fuel, such as natural gas or wastewater treatment gas, by reforming the fuel inside the fuel cell to produce hydrogen. We believe that this “one-step” reforming process results in a simpler, more efficient and cost-effective energy conversion system compared with external reforming fuel cells. External reforming fuel cells, such as PEM and phosphoric acid, generally use complex, external fuel processing equipment to convert the fuel into hydrogen. This external equipment increases capital cost and reduces electrical efficiency. Additionally, natural gas and wastewater treatment gas have infrastructures that are already established. Consequently, our DFC products do not need to wait for the development of the hydrogen infrastructure for continued commercialization.

Our Direct FuelCells have been operated using a variety of hydrocarbon fuels, including natural gas, methanol, diesel, biogas, coal gas, coal mine methane and propane. Our commercial DFC power plants currently can achieve an electrical efficiency of between 45 percent and 47 percent. Depending on location, application and load size, a co-generation configuration can reach an overall energy efficiency of between 70 percent and 80 percent.

MARKETS

We have established a leading position in the sale of fuel cell power plants and strengthened our position in 2006 by improving our product performance and availability, reducing costs for our MW and sub-MW products, and expanding repeatable markets for our DFC products.

- Our cumulative fleet availability continues to exceed 90 percent. Many of our units are achieving greater than 95 percent availability at customer sites.

- Seven new orders were received totaling 5.05 MW, with six orders of 600 kW or more and 2 orders of at least 1 MW, in key repeatable markets. Our distribution partner, Marubeni, has also committed, by paying a 10 percent deposit, to another 6 MW of fuel cell products.

Certain of our markets and applications are developing at a faster rate as evidenced by the chart below. Through October 31, 2006, we have installed an aggregate of 18.0 MW and have 10.05 MW in backlog. Geographically, our leading markets are California and Japan, which account for 70 percent of our orders to date. Our leading applications are wastewater treatment facilities and hotels.

There has been increasing support for fuel cell technology. Specific examples include the following:

- The first tax incentives for fuel cell power plants at the U.S. federal level were enacted in August 2005 and provide for a 30 percent investment tax credit (“ITC”) up to $1,000/kW of total project costs, as well as 5 year accelerated depreciation. The bill to extend the ITC through 2008 passed in December 2006.

- State level RPS programs are in place in some states which call for renewable and ultra-clean electric power generation. For example, Connecticut is requiring that 100 MW of renewable/ultra-clean power generation be installed by 2008 and a total of approximately 400 MW by 2010. Currently, 23 states and the District of Columbia have RPS laws on their books of which five specifically make fuel cells using natural gas eligible for credits.

- There are also other subsidy programs that benefit fuel cell market penetration in key markets which we compete. Examples include the California Self Generation Incentive Program which provides annual subsidies greater than $80 million for renewable and ultra-clean distributed generation technologies and a Korean Renewable Portfolio Agreement whereby the Korean government and nine state-run utility companies have agreed to invest over 1 trillion won (approximately $1 billion U.S.) in a renewable energy research and development effort.

Distributed Generation Markets

We believe distributed generation can be a more cost-effective solution than traditional grid-delivered electricity and other distributed generation technologies:

- ***Provides better economics.*** Distributed generation avoids transmission and distribution system investment, reduces line losses, can use the heat by-product from onsite power generation and offers the ability to control energy cost economics through fuel flexibility.

- ***Increases reliability by locating power closer to the end user.*** Onsite power generation bypasses the congested transmission and distribution system, increasing electrical reliability.

- ***Eases congestion in the transmission and distribution system.*** Each kW of onsite power generation removes the same amount from the transmission and distribution system, thereby easing congestion that can cause power outages and hastening the grid recovery after electrical infrastructure problems have been resolved.

· ***Eliminates T&D investments and provides greater capacity utilization in less time.*** Distributed generation can be added in increments that more closely match expected demand in a shorter time frame (weeks to months) compared with traditional central power generating plants and transmission and distribution systems (often 36 months or longer) which require more extensive siting and right of way approvals. Siting distributed generation can defer or avoid altogether massive T&D investment such as unpopular above ground high voltage lines or even more expensive underground high voltage lines.

· ***Enhances security.*** By locating smaller, incremental power plants in dispersed locations closer to energy consumers, distributed generation can reduce dependence on a vulnerable centralized electrical infrastructure.

Our DFC power plants specifically provide the following attributes that provide an advantage over other distributed technologies of similar size:

· ***Higher operational efficiency***. Our DFC power plants currently achieve electrical efficiencies of 45 to 47 percent and have the potential to reach an electrical efficiency of 57 percent and an overall energy efficiency of 70 to 80 percent for CHP applications. This is significantly greater than the fuel efficiency of competing fuel cell and combustion-based technologies of similar size and results in a lower cost per kWh over the life of the power plant.

· ***Lower emissions.*** Our DFC power plants have lower emissions of carbon dioxide, and significantly lower emissions of other harmful pollutants, such as NOX, SOX and particulate matter, than conventional combustion-based power plants. They have been designated ultra-clean by the California Air Resources Board ("CARB"), and our DFC products are certified to CARB 2007 emissions standards. Emissions of fuel cell power plants versus traditional combustion-based power plants as compiled by the DOE/National Energy Technology Laboratory and company product specification sheets are as follows:

	Emissions (Lbs. Per MWh)		
	NOX	**SO_2**	**CO_2**
Average U.S. Fossil Fuel Plant	4.200	9.210	2,017
Microturbine (60 kW)	0.490	0.000	1,862
Small Gas Turbine (250 kW)	0.467	0.000	1,244
Fuel Cell, Single Cycle (DFC)	0.016	0.000	967

· ***Utilize multiple fuels.*** Our DFC power plants can use many fuel sources, such as natural gas, industrial and municipal wastewater treatment gas and coal gas (escaping gas from active and abandoned coal mines as well as synthesis gas processed from coal), thereby enhancing independence from imported oil and allowing customers to have fuel flexibility. Our DFC power plants can provide our customers with an option to choose the cheapest alternative.

· ***Provide end users with greater control of their energy costs.*** Due to the high efficiency of our DFC power plants, end users would typically select to have their firm, 24/7 baseload power needs provided by our ultra-clean products. The cost of utility provided power continues to rise and is subject to large, unpredictable increases. Generating on-site power with hedged fuel and known generating costs resulting from the operation of a DFC power plant give customers a predictable component of their operations that can be budgeted, and controlled.

Geographic Markets

We are focused on markets where local business conditions, incentives and regulations make it advantageous for customers to purchase our products.

North America – California

California has maintained a leadership position in environmental policy. Executive Order S-3-05 enacted in 2005 set state reduction levels for greenhouse gasses and the California Air Resources Board Standard for 2007 ("CARB 2007") set limits for other emissions (i.e. NOX, SOX, particulates, etc.). These regulations help promote technologies such as fuel cells for clean distributed power generation. Our DFC power plants meet these strict emissions requirements and have been designated as an ultra-clean distributed generation technology. As a result, customers have access to certain incentive funding for the purchase of our DFC power plants and are exempt from exit fees and stand-by charges. In

addition, end users of fuel cell power plants are eligible to sell back unused power to publicly owned utilities at wholesale or generation-based rates.

The California Self Generation Incentive Program provides annual incentives of at least $80 million for renewable and ultra-clean distributed generation technologies. Our DFC power plants operating on natural gas are eligible for a subsidy of up to $2,500/kW and our DFC power plants operating on biomass renewable fuels, such as anaerobic digester gas from wastewater treatment facilities, are eligible for a subsidy of up to $4,500/kW. This program has been extended through 2012.

North America – U.S. RPS and Northeastern States

States seeking to secure cleaner energy sources are setting standards that require that utilities provide a certain amount of their electricity from renewable sources such as solar, wind or other biomass-fueled technologies, as well as 'ultra-clean' fuel cells. Currently, 23 states and the District of Columbia have RPS laws on their books. Fuel cells using biomass fuels qualify as renewable power generation technology in all of these states, and five states specify fuel cells operating on natural gas as eligible for these initiatives.

Connecticut has enacted legislation requiring the state's utility distribution companies to procure approximately 400 MW of clean energy sources by 2010. In addition, 100 MW of generation from renewable technologies must be in place by 2008 ("Project 100"). Fuel cell power plants principally manufactured in Connecticut have an advantage against other project competition as they are entitled to the available air emissions credits and tax credits attributable to the project and no less than 50 percent of the energy credits in the Class I renewable energy credits attributable to the project. For other Class I renewable energy technologies, these credits are allocated to the utility to be used to reduce costs to ratepayers.

New York has adopted an energy policy requiring up to 3,700 MW of new generation from renewable technology by 2013. New York State issued its first request for proposal ("RFP") under this program in 2004 and is expected to issue additional requests for proposals in 2007 focused on customer sited projects as well as large utility size projects.

North America – Canada

Canada has ratified the Kyoto Protocol and is also focused on reducing emissions such as NOX and SOX in selected regions. Our distribution partner, Enbridge Inc., is currently seeking to have our products included in a portfolio to replace more than 500 MW of coal power to help meet the Canadian Government's Kyoto Protocol carbon dioxide and other emissions reduction commitments. These projects would compete with other low impact generation technologies (like solar and some wind) for funding through the country's Cdn.$250 million Sustainable Development Technology Corporation Program and other similar Federal and Provincial programs. In addition, we are jointly developing with Enbridge the DFC ERG product, a specifically designed product for natural gas pipeline applications, with a market potential of over 40 MW in the greater Toronto area and over 200 MW in the Northeast U.S. and California.

Asia – Japan

The key drivers for clean distributed power generation in Japan are high electricity prices, the lack of significant domestic natural energy sources, and the adoption of the Kyoto Protocol. In response, Japanese companies are maximizing the energy efficiency of their operations and reducing the emissions of greenhouse gases. Additionally, government regulations require the use of biomass fuels from wastewater treatment facilities. The high efficiency of our products can provide lower energy costs and reduced carbon dioxide emissions, and the fuel flexibility of our products allows operation using biomass fuel. These factors create several market opportunities in Japan.

Japan has instituted a number of incentive programs. The recently introduced Biomass Nippon program administered by the Ministry of Agriculture, Forestry, and Fisheries provides 33 percent incentive funding for local governments or private companies installing power generation facilities. The Ministry of Land, Infrastructure and Transport ("MLIT") provides 55 percent subsidies to local governments who install equipment to generate power at wastewater treatment facilities. A national RPS program for the power generation sector was adopted in 2004 with initial targets of approximately 3,500 MW by 2010. Our DFC products qualify under these programs.

Working with our distribution partner, Marubeni Corporation, we have installed or in backlog 7.25 MW for the Japanese market. Applications include wastewater treatment and manufacturing for several well known companies such as Sharp Electronics, Seiko Epson and Kirin Brewery. As grid electricity continues to be costly in Japan, and our product costs continue to decline, we expect Japan to be a strong market for our fuel cells.

Asia – Korea

In 2004, the Korean government identified fuel cells as one of the 10 economic growth engines for the Korean economy. POSCO, our distribution partner, was selected to develop and commercialize large stationary fuel cell power plants. The Korean government's goal is to install 300 stationary fuel cell power plants, sized 250 kW to 1 MW, by 2012, and has designated $1.6 billion to support this effort.

The Korean government and nine state-run utility companies have agreed to invest over 1 trillion won (approximately $1 billion U.S.) in a renewable energy research and development effort designated as the Renewable Portfolio Agreement ("RPA"). Korea's Ministry of Commerce, Industry and Energy has stated that the RPA signed seeks to generate enough new power from renewable sources to replace approximately 1.6 million barrels of crude oil. During 2006, Korea followed up these initiatives by instituting a $0.28/kWh incentive to encourage end-users to use power from renewable sources.

POSCO and the Korea South-East Power Company ("KOSEP") have announced an alliance to market and develop fuel cell power plants based on our DFC products as a means to fulfill the RPA requirements As part of this alliance agreement, KOSEP has recently installed one of our DFC300MA units at its plant in Bundang, Gyeonggi province. Currently, we have three units operating in Korea at Chosun University, Tancheon Sewage Treatment Plant and at POSCO's Research Institute of Science and Technology (RIST) in Pohang, POSCO itself, representing 1 MW of installations in Korea. We believe that our partnership with POSCO combined with the $0.28/kWh incentive makes this Korea an excellent market for our fuel cells.

Europe

The European Union ("EU") imports 50 percent of its energy and projects that 65 percent of its total energy requirements will be imported by 2030. Interest in nuclear power, which currently accounts for 13 percent of generating capacity, has declined amid safety concerns in recent years, with several EU counties recently announcing a phase-out of their nuclear programs. The emphasis remains on reducing carbon dioxide emissions and grid-connected CHP projects are encouraged. Under the Kyoto Protocol, the EU is obligated to reduce its greenhouse gas emissions by 8 percent from 1990 levels by 2008 to 2012. In a report dated January 10, 2007, the Commission of the European Communities recommended reducing greenhouse gas emissions by 20 to 30 percent of 1990 levels by 2020. The report cited three reasons: (1) energy production accounts for 80 percent of all greenhouse gas emissions in Europe, (2) such a reduction will limit Europe's exposure to volatile energy prices, and (3) this plan could lead to more innovative power generation technology and more jobs.

MTU CFC Solutions GmbH, our partner, has exclusive distribution rights for our DFC products in Europe. Their strategy is to seed the market with sub-MW units, and lobby the EU and German government for increased subsidies to further market penetration, and then expand production as costs approach market clearing prices. Several subsidy

programs have been implemented. In January 2005, the EU instituted the EU Emissions Trading Scheme (ETS), under which approximately 12,000 large industrial plants in the EU have been able to buy and sell permits to release carbon dioxide into the atmosphere. The ETS enables companies exceeding individual carbon dioxide emissions targets to buy allowances from greener ones. In Germany, a CHP Law was enacted in 2002 that provides a €0.0511/kWh subsidy payable for 10 years for grid-connected CHP power plants, up to 2 MW. MTU CFC believes that these subsidies along with others that are being contemplated will help to increase sales in the European market.

Applications

Within these geographic markets, we are targeting applications that we believe have the best potential for repeatable business for our products:

- ***Wastewater treatment plants***. For wastewater treatment applications, the methane generated from the anaerobic gas digestion process is used as fuel for the DFC power plant, which generates the electricity to operate the wastewater treatment equipment at the facility or for the grid. Through December 31, 2006, we have installed or have in backlog a total of 5.85 megawatts. Representative installations include:

  - *City of Tulare, California (digester gas, 750 kW)*
  - *Sierra Nevada Brewing Company, California (Natural / digester gas, 1 MW)*
  - *LA County Sanitation Palmdale Waste Water Treatment Plant (digester gas, 250 kW)*
  - *Kirin Brewery, Japan (Natural gas/ propane, 250 kW).*

- ***Hotels***. Hotels, with their stable baseload heat and power demand profile, are ideal applications for our DFC power plants. A 300-room suburban hotel typically has a baseload power requirement of 250 kW. Through December 31, 2006, we have installed or have in backlog 3.50 MW. Representative installations include:

  - *Sheraton San Diego Hotel & Marina, California (1.5 MW).*
  - *Westin San Francisco Airport, California (500 kW).*
  - *Sheraton New York Hotel and Towers, New York (250 kW).*

- ***Industrial – Manufacturing***. Manufacturing companies are also a great application for our combined heat and power fuel cell systems. Through December 31, 2006, we have installed or have in backlog 4.0 MW. Representative installations include:

  - *Gills Onions, California (500 kW)*
  - *NGK, Korea (Ceramics kiln, 250 kW).*

- ***Institutional – Universities***. Universities are excellent combined heat and power applications as many have their own independent grid. In the U.S., there are over 1,000 universities with an average generating capacity of approximately 7 MW. Through December 31, 2006, we have installed or have in backlog 2.5 MW. Representative installations include:

  - *California State University, Northridge (1 MW)*
  - *State University of New York - Environmental Science and Forestry, New York (250 kW)*
  - *Pohang University, Korea (250 kW).*

- ***Institutional – Hospitals***. Hospitals are an excellent combined heat and power application, with a critical need for reliable, baseload heat and power for 24/7 operation and the grid for backup. A 300-bed hospital has a typical baseload power requirement of 2 MW. Through December 31, 2006, we have installed or have

in backlog 1.25 MW. Representative installations include (all 250 kW):

· *Chosen University Hospital, Korea*

- *Gruendstadt Clinic, Germany*

- *Bad Berka Hospital, Germany*.

- ***Mission-Critical - Telecommunications/Government.*** Reliability is a key driver for applications at government facilities and telecommunications/data centers. Through December 31, 2006, we have installed or have in backlog 4.5 MW. Representative installations include:

  - *San Francisco Post Office, California (Post Office, 250 kW)*

  - *NTT Sendai, Japan (Telecommunications, 250 kW)*

  - *Santa Rita Correctional Facility, California (Prison, 1 MW).*

- ***Grid Support***. Through December 31, 2006, we have installed or have in backlog 1.75 MW. Representative installations include (all 250 kW):

  - *Los Angeles Headquarters of Water and Power, California*

  - *Salt River Project, Arizona*

  - *RWE Energy Park, Germany*

- ***Natural Gas Pipeline.*** The DFC-ERG power plant is an ultra-clean combined cycle generation system that incorporates our Direct FuelCell power plant and an unfired expansion gas turbine for natural gas pipeline letdown stations. These are stations in the gas distribution system where gas pressure is reduced from the transmission pressure (>500 psi) to local distribution pressures (typically 30 – 60 psi). This pressure reduction is usually done through a pressure letdown valve, and because the gas is cooled by the pressure reduction, it often needs to be heated by combustion-based boilers to prevent freezing. The DFC-ERG combines an expansion turbine and a DFC fuel cell in an integrated system. The expansion turbine replaces the let-down valve, producing power in the process. The combustion boiler is replaced by waste heat recovered from the DFC, which makes additional power. The high efficiency of the DFC combined with the power recovered from the let-down turbine and the fuel saved by heat recovery result in a system efficiency of approximately 60 percent. Enbridge, Inc. has estimated the North American market for the DFC-ERG to be between 200 and 300 MW.

  - *Enbridge, Inc. has ordered a 1.2MW plant from us which will be used in a DFC-ERG configuration.*

Strategic Alliances and Market Development Agreements

Our original equipment manufacturer (“OEM”) and energy service company (“ESCO”) partners have extensive experience in designing, manufacturing, distributing selling and servicing energy products worldwide. We believe our strength in the development of fuel cell products coupled with their understanding of sophisticated commercial and industrial customers, products and services will enhance the sales, service and product development of our product.

OEM Partners

MTU CFC Solutions GmbH (“MTU CFC”), headquartered in Ottobrunn, Germany, has been a co-developer of our DFC technology since 1989. Our sub-MW power plant is a collaborative effort using our DFC technology and the Hot Module® BOP designed by MTU CFC. As an OEM developer of stationary fuel cell power plants, MTU CFC assembles and stacks the DFC components that we sell to them and then adds their mechanical and electrical balance

of plants for ultimate sale to their customers. In 2006, EQT (a Sweden-based private equity firm), acquired MTU CFC's parent company, MTU Friedrichshafen GmbH, from DaimlerChrysler. There are currently sub-MW fuel cell power plant installations at eleven locations in Europe. The parent company of MTU CFC (MTU Friedrichshafen GmbH) owns approximately 2.7 million shares of our common stock and is represented on our Board of Directors.

Marubeni Corporation. We have installed or have in backlog 8.25 MW in Japan and we currently have a commitment from Marubeni for an additional 6 MW. In 2006, units were installed at Tokyo Gas' new research and development center at Tsurumi, Tokyo, where it is undergoing evaluation and demonstration prior to potentially being offered by Tokyo Gas to its customers via their industrial gas sales division. Four DFC300MA units, totaling 1 MW in output, were also installed at Sharp Ltd.'s "super-green" factory in Kameyama Prefecture, where Sharp manufactures LCD screens for its flat-panel television displays. Notably, the 1 MW fuel cell installation provides base load power to the facility, while 5 MW of Sharp's own photovoltaic (PV) modules provide peaking power. This is an example of the way in which DFC systems can combine with solar power to provide a total solution for ultra-clean renewable power for environmentally leading companies.

In 2006, world-leading ceramics manufacturer NGK Inc. installed one of our DFC300MA systems at its headquarters building and main factory in Nagoya, where NGK manufactures catalytic converters for Toyota Corp. and others. In 2007, the DFC300MA will be integrated with the company's ceramics kiln in a proprietary configuration to boost the overall energy efficiency of the plant. Other installations in Japan include the Tokyo Super Eco Town Project and Kyoto Eco Energy Project, both of which convert food wastes into useful energy; the Kirin Brewery near Tokyo; the City of Fukuoka municipal wastewater treatment facility; Japex's Katakai natural gas gathering station located in the Niigata Prefecture; and two units to Epson's Quartz Device Division in the City of Ina, Nagano Prefecture, Japan.

Marubeni invested $10 million in us in 2001 through the purchase of approximately 268,000 shares of our common stock. In 2004, we issued warrants to purchase 1,000,000 shares of our common stock to Marubeni in conjunction with a revised distribution agreement. As part of these warrant agreements, the warrants vest in separate tranches once Marubeni has ordered totals of between 5 MW and 45 MW of our products. As of October 31, 2006, 800,000 of these warrants had expired. The exercise price of the remaining 200,000 outstanding warrants (which are not vested) is $18.73 per share and the warrants will expire April 2007, if not earned and exercised sooner.

POSCO. In Since November 2004, we and Marubeni Corp. signed an agreement with POSCO to distribute and package DFC power plants in Korea. POSCO has purchased four 250 kW DFC300MA power plants through Marubeni, which are located at the Research Institute of Science and Technology (RIST) in Pohang University, Chosun University Hospital, and Tancheon Wastewater Treatment Facility in Seoul, and at the KOSEP power generating station at Bundang. POSCO has extensive experience in power plant project development, building over 2,400 megawatts of power plants, equivalent to 3.7 percent of Korea's national capacity, for its various facilities. POSCO is a world leader in the materials industry and is one of the world's largest producers of steel.

Caterpillar, Inc. DFC units have been shipped to several commercial customers of Caterpillar including: a municipal wastewater treatment application for the Sanitation Districts of Los Angeles County in Palmdale, California; and the State University of New York College of Environmental Science and Forestry. Caterpillar is currently offering our DFC products to its customers and has stated it intends to offer its own branded fuel cell power plant based on our technology.

Enbridge Inc. Enbridge, a leader in energy transportation and distribution in North America and internationally, expanded our market development agreement to include current DFC product distribution in the US as well as Canada, and to include the new DFC-ERG™ product in North America. In 2005, we issued warrants to Enbridge to purchase up to 1,000,000 shares of our common stock in conjunction with an amended distribution agreement. The warrants vest on a graduated scale based on the total number of megawatts contained in product orders and the timing of when such orders are generated by Enbridge. In October 2006, Enbridge placed an order for the first DFG ERG™, which resulted in vesting of 30,000 warrants with an exercise price of $9.89. The expiration date of these vested warrants is October 31, 2008. The exercise prices of the remaining non-vested 970,000 warrants range from $9.89 to $11.87 per share and the expiration dates range from June 30, 2008 to June 30, 2010, if not earned and exercised sooner.

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Energy Service Company Distribution Partners

We have five Energy Service Company distribution partners:

Alliance Power, Inc. Alliance Power is a developer of distributed generation facilities ranging in size from 1 MW to 49 MW. Alliance has been focusing its efforts in California on customers requiring DFC power plants for baseload combined heat and power applications from 500 kW to 1.5 MW. In 2006, Alliance Power secured orders totaling 3.85 MW, including projects for California State University, Northridge, Gills Onions, the City of Tulare and a California resort.

Chevron Energy Solutions. We entered into an agreement with Chevron Energy Solutions ("Chevron"), a subsidiary of ChevronTexaco, in December 2001, to jointly market and sell DFC power plants, with initial projects targeted for the northeastern U.S. and California. Chevron has sold and installed a 1 MW DFC1500MA power plant in California to Alameda County for the Santa Rita Correctional Facility and a DFC300MA power plant for the U.S. Postal Service's San Francisco Processing and Distribution Center.

Linde Group We entered into a non exclusive agreement with The Linde Group, a worldwide market leader in industrial gases and engineering, to sell and market Direct FuelCell(R) (DFC(R)) power plants worldwide except where FuelCell Energy already has granted exclusive distribution agreements. Linde will focus initially on DFC opportunities in North America that fit into its overall strategy of developing sustainable energy solutions and providing low-carbon distributed generation solutions to industrial, commercial and governmental customers, with longer term plans to leverage this relationship into other geographies where Linde has market leadership.

LOGANEnergy Corp. We entered into an agreement with LOGANEnergy Corp. ("LOGAN") in July 2004 to jointly market and sell DFC power plants. In 2005, we received two orders from LOGAN totaling 750 kW for government training facilities in California - 500 kW for a U.S. Marine Base at Camp Pendleton and the U.S. Marine Corps Air Ground Center at Twentynine Palms.

PPL Energy Plus. PPL Energy Plus ("PPL"), a subsidiary of PPL Corporation, has purchased and installed DFC power plants at three Starwood Resorts properties (Sheraton Edison and Sheraton Parsippany in New Jersey and Sheraton New York Towers in Manhattan); one unit at Ocean County College in New Jersey; and one unit at a Pepperidge Farm Bakery in Bloomfield, Conn.

Customer Partners

We have partnered directly with certain customers who have installed our products. These customer partners have the option to negotiate arrangements for the sale, distribution and service of our DFC power plants upon completion of the project.

Our longest standing customer partner relationship is with the Los Angeles Department of Water and Power ("LADWP"), the largest municipal utility in the U.S. with 640,000 water customers and 1.4 million electric customers. LADWP participated with us on our 2 MW Santa Clara Demonstration Project in 1996-1997 and currently has three DFC 300A power plant installations (grid-connected units at its Main Street facility, headquarters building, and a wastewater treatment plant installation at Terminal Island).

Competition

We compete on the basis of our products' reliability, fuel efficiency, environmental considerations and cost. We believe that our DFC carbonate fuel cell offers competitive and environmental advantages over most other fuel cell designs and other combustion-based technologies for stationary baseload power generation.

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

There are other potential carbonate fuel cell competitors internationally. In Asia, Ishikawajima Harima Heavy Industries is active in developing carbonate fuel cells. In Europe, a company in Italy, Ansaldo Fuel Cells, is actively engaged in carbonate fuel cell development and is a potential competitor. MTU CFC and its partners have been the most active in Europe.

Other than fuel cell developers, we must also compete with such companies as Caterpillar, Cummins Inc., and Detroit Diesel Corporation (a subsidiary of DaimlerChrysler AG), which manufacture more mature combustion-based equipment, including various engines and turbines, and have more established manufacturing, distribution, operating and cost features. Significant competition may also come from gas turbine companies like General Electric, Ingersoll-Rand Company Limited, Solar Turbines Incorporated and Kawasaki, which have recently made progress in improving fuel efficiency and reducing pollution in large-size combined cycle natural gas fueled generators. These companies have made efforts to extend these advantages to smaller sizes. We believe, however, that these smaller gas turbines will not be able to match our fuel efficiency or favorable environmental characteristics.

POWER PURCHASE AGREEMENTS

Power purchase agreements (PPAs) are a common arrangement in the energy industry, whereby a customer purchases energy from an owner and operator of the power generation equipment. A number of our partners enter into PPAs with end use customers, such as Marubeni in Japan and PPL in the U.S., where they purchase DFC power plants from us, own and operate the units, and recognize revenue as energy is sold to the end user.

We have seeded the market with a number of Company funded PPAs to penetrate key target markets and develop operational and transactional experience. To date, we have funded the development and construction of certain fuel cell power plants sited near customers in California, and own and operate 3 MW of assets through PPA entities in which we have an 80% ownership interest. As we enter in to multi-MW projects in the RPS markets and with the

benefit of the federal investment tax credit and accelerated depreciation in the Energy Policy Act of 2005 we believe future PPAs will attract third party financing.

MANUFACTURING AND COST REDUCTION

We have established a 65,000 square foot manufacturing facility in Torrington, Connecticut where we produce our repeating fuel cell components: the anode and cathode electrodes, metallic bipolar plates and the electrolyte matrix. These stack components are combined and assembled into modules that are currently delivered to our test and conditioning facilities in Danbury, Connecticut. Sub-MW modules are combined and tested with the balance of plant to complete our power plants at the customer site. Our MW modules for the DFC1500MA and DFC3000 are tested and conditioned in Danbury and then shipped to the customer site for final testing with an assembled balance of plant.

Our manufacturing, testing and conditioning facilities have equipment in place for a production capacity of 50 MW per year. We believe manufacturing capacity can be increased to 125 - 150 MW within our existing Torrington facility through the addition of parallel production lines and additional machinery. We also have additional land surrounding our Torrington facility, on which we could expand to 400 MW of annual production of our repeating fuel cell components. Expansion of our manufacturing facilities beyond 50 MW would also require new facilities for the fuel cell stack and module assembly, test and conditioning which could be deployed regionally. These regional assembly, test and conditioning facilities are expected to provide additional cost savings as they will reduce shipping costs, enhance delivery times and improve customer service. Our current production volume is 10 MW which will be adjusted depending on customer demand and the emergence of the RPS market.

Our 2 MW Santa Clara ‘proof-of-concept’ project in 1996-1997 cost more than $20,000/kW to produce. In 2003, we shipped our first commercial product, a DFC300 to the Kirin Brewery which cost more than $10,000/kW. At that time, we implemented our commercial cost-out program hiring additional engineers who focused on reducing the total life cycle costs of our power plants. Since 2003, they have made significant progress primarily through value engineering our products and increasing the power output by 20%. Our current manufactured cost of approximately $3,250 /kW on our multi-MW power plant, $4,300/kW on our MW plant and $4,800/kW for the sub-MW product. Reducing product cost is essential for us to further penetrate the market for our high temperature fuel cell products. Cost reductions will lessen and/or eliminate the need for incentive funding programs that are currently available to allow our product pricing to compete with grid-delivered power and other distributed generation technologies, and are critical to us attaining profitability.

In 2006, we primarily focused our cost saving efforts on our multi-MW product, the DFC3000. Significant savings came from “value engineering” – developing lower-cost designs for various elements of the power plant – and improving the efficiency of the Company’s manufacturing, testing and commissioning processes. The cost reduction also resulted from the 20 percent increase in power output in our DFC products announced in August 2006. By improving thermal management of electrochemical activity within the stack, the Company increased the power output from each cell, which produces more electricity from the same basic power plant components.

FuelCell Energy will continue to emphasize its cost out initiatives to deliver the most cost efficient and environmentally friendly power generation solutions and meet the needs of the emerging RPS markets. In 2007, the DFC300MA and DFC1500MA are targeted to achieve another 20 percent cost reduction through improvements in strategic sourcing, value engineering and operations. Increased production volume could also reduce that cost another 10 to 20 percent.

SERVICE AND CUSTOMER SATISFACTION

Our service organization offers comprehensive service and maintenance programs including total fleet management, refurbishment and recycling services, and complete product support including spare parts inventory. We are offering service agreements at various levels for one to 13 years, with flexible renewal options.

FuelCell Energy has invested in a Service Group organization that offers a complete service portfolio for FuelCell Energy's DFC product line. The Service Group's primary task is to maintain a high level of service for our end user customers during the warranty period of the original DFC equipment. In providing the wide range of services required to support the fleet during the warranty period, the Service Group has developed infrastructure that can be easily extended to capture revenue as the units in the field enter the period past the warranty period. In 2006, we achieved revenues of $1.7 million in long-term service agreements and revenue is expected to grow in the years to come.

In providing the range of services required to support the fleet during the warranty and service agreement period, the service organization has developed infrastructure to support its efforts which includes a 24/7 Call Center and a web-based information system network that allows fingertip access to plant performance data. We have also established regional parts warehouses including rotable pool of spare stacks, fully equipped regional field service teams, a stack repair/refurbishment center, testing and conditioning facilities. All personnel complete an operator and maintenance technician training program and work very closely with the engineering and technology support organizations to service our products in the field. This infrastructure has enabled us do diagnosis issues quickly and maintain strong customer satisfaction.

In 2006, we improved the availability of our fleet meeting our customers' expectation for product performance and availability. We have over 50 units installed at customer sites throughout the U.S., Asia and Europe. Through December 31, 2006, we have generated more than 150 million kWhs at customer sites worldwide, with a cumulative fleet availability of over 90 percent.

In 2006, a customer satisfaction survey polling customers that own and operate our DFC units in the U.S. and Japan, solicited feedback on all aspects of our products and services. The Service organization received high ratings from our customers. The customers polled were extremely pleased with the aftermarket and service support that they were receiving and believed that the service provided held exceptional value.

GOVERNMENT RESEARCH AND DEVELOPMENT CONTRACTS

The goal of our research and development efforts is to improve our core DFC products and expand our technology portfolio in complementary high temperature fuel cell systems, such as SOFC. In addition, we are also conducting limited development work on advanced applications for other fuel cell technologies, such as PEM. A significant portion of our research and development has been funded by government contracts and is classified as cost of research and development contracts in our consolidated financial statements. For the fiscal years ended 2006, 2005 and 2004, total research and development expenses, including amounts received from the DOE, other government departments and agencies and our customers, and amounts that have been self-funded, were $22.0 million, $35.0 million and $44.9 million, respectively.

Government Research & Development Contracts

Since 1975, we have worked on the development of our DFC technology with various U.S. government departments and agencies, including the DOE, the Navy, the Coast Guard, the Department of Defense, the Environmental Protection Agency, the Defense Advance Research Projects Agency and the National Aeronautics and Space Administration. Government funding, principally from the DOE, provided approximately 35 percent, 43 percent and 60 percent of our revenue for the fiscal years ended 2006, 2005 and 2004, respectively. From the inception of our carbonate fuel cell development program in the mid-1970s to date, more than $536 million has been invested to

support the development of our DFC technology. This includes approximately $355 million from government agencies, with the balance provided by private entities, utility organizations and licensees.

Significant programs we are currently working on include:

Carbonate Fuel Cell Programs

Direct FuelCell/Turbine. The DOE's Office of Fossil Energy established its Vision 21 Program in 1999 with the objective of developing a "21st Century Energy Plant" that can generate electricity, heat, clean fuels, chemicals and hydrogen from a variety of feedstocks such as fossil fuels and biomass with high efficiency and low environmental impact. The Company was awarded a $19.4 million cost-shared contract to develop a fuel cell / turbine hybrid power plant under this program.

In 2005, we completed the fabrication of an alpha sub-MW power plant by the intregration of a 250kW DFC stack module with a Capstone C60 microturbine. The microturbine supplements the power produced by the fuel cell, increasing the system electrical efficiency. The unit was installed and grid-connected at the Billings Clinic in Billings, Montana and started generating power in April 2006. During approximately 8,000 hours of operation, the unit achieved a record-breaking electrical efficiency of 56 percent, surpassing all distributed generation technologies in this size range. Emissions testing of the DFC/T system demonstrated compliance with the stringent California Air Resources Board's CARB '07 standards.

Subsequent to the success of the DFC/T field demonstration and following the Company's shift to MW scale products, we have initiated the design of a MW-scale hybrid DFC/T.

Dual Fuel Testing at CTC. The ability to operate highly efficient, pollution-free, distributed-generation power plants interchangeably on either natural gas or HD-5 grade propane is of interest to the U.S. Army and other applications as a way to maintain secure power for critical power operations. Propane, a readily available and transportable fuel that can easily be stored on-site, can also be used as a primary fuel to islands, remote sites, national parks, data centers, military bases, hotels, and hospitals. In response to the interest for a fuel flexible power plant, Concurrent Technologies Corporation (CTC), under contract to the U.S. Army Engineering, Research and Development Center's Construction Engineering Research Laboratory (ERDC-CERL), subcontracted with FuelCell Energy (Sept. 2005) to test a DFC300MA power plant on propane at their Johnstown, Pennsylvania location. The purpose of the demonstration was to operate our DFC300MA power plant on HD-5 grade propane as well as natural gas and to switch rapidly between these fuels. This system was designed to enable the generation of ultra-clean baseload electricity even in situations when fuel supplies are threatened due to natural disaster, terrorism or repair outages.

This DFC300MA fuel cell power plant operated on HD-5 propane for eight months in 2006. During this demonstration period the power plant accumulated over 5,000 hours of operation on propane and natural gas generating more than 700 MW hours (MWh) of electricity.

Co-production of Hydrogen and Electricity using DFC Power Plants

Our high temperature DFC power plants produce hydrogen internally from hydrocarbon fuels, and then convert it to electricity. These DFC products are capable of co-production of electricity and hydrogen at potentially attractive costs. This value-added proposition is quite attractive for industrial users of hydrogen in the near term. It also provides a technology bridge to the hydrogen infrastructure being developed by DOE for our nation's energy independence. A recent DOE-sponsored study performed by Air Products and Chemicals, Inc. (APCI), showed that a sub-MW DFC power plant installed at a hydrogen refueling station for fuel cell vehicles can handle a fleet of approximately 200 cars while providing enough electricity to power a community of 200 homes.

During 2005, we were selected by Air Products to develop and demonstrate the Next Generation Hydrogen Energy station. The $10 million cost-shared project, co-sponsored by DOE, APCI and FCE, will integrate our ultra-clean DFC power plant and Air Products' advanced gas separation technology to co-produce hydrogen and electricity at a vehicle refueling station from one single system ("DFC-H_2"). The sub-MW system will be designed to operate on pipeline natural gas and other renewable fuels such as waste-derived biogas. Air Products estimates that the DFC-H_2 system has the potential to be highly efficient and cost competitive with other conventional technologies. Several locations in California are being evaluated for the demonstration of the DFC-H_2 system, presently scheduled to be on-stream in late 2007.

We are also engaged in technology development of an electrochemical hydrogen separator (EHS). Under sponsorship of Connecticut Clean Energy Fund, a subscale EHS stack was designed, built and delivered to University of Connecticut for demonstration in February 2006. The EHS stack has accumulated over six months of stable operation on a variety of test conditions. During 2006, we were selected by U.S. Department of Defense to scale-up its solid-state electrochemical hydrogen separator (EHS) technology to co-produce high purity hydrogen from its DFC power plants. The EHS technology is highly modular, "truly green" and promises over 50 percent reduction in the separation cost. EHS has no moving parts, which leads to enhanced reliability and higher levels of safety needed for the hydrogen infrastructure. The technology scale-up during 2007 will focus on laboratory validation tests of large-area EHS stacks, followed by a sub-megawatt system demonstration in 2008.

DFC Marine/Diesel. We are continuing development of marine applications for our DFC technology under contracts to the U.S. Navy. The marine power plants are required to operate on liquid fuel including diesel. We have a multi-year contract with the Office of Naval Research to develop a 500 kW first generation power plant for demonstration at the Naval Sea Systems Command facility in Philadelphia. We have constructed and verified operation of the balance of plant (BOP) process equipment for the marine DFC power plant. The BOP has been integrated with our commercial DFC module, and the complete power plant is undergoing initial performance testing in Danbury, Connecticut. Following completion of additional testing, the plant is expected to be delivered to Philadelphia during the second quarter of 2007. This $25.4 million cost-shared project commenced in 2000 and is a continuation of an earlier $4.6 million contract that completed the conceptual design and testing of the critical components for the marine fuel cell power module.

We expect that successful demonstration of this project can lead to additional diesel fuel cell power plant applications for commercial ships and remote site power generation.

Solid Oxide Fuel Cell Programs

SECA Program

In September 2006, we completed all the technical requirements for the DOE's Solid State Energy Conversion Alliance ("SECA") Phase I, 3-10 kW solid oxide fuel cell ("SOFC") cost reduction program and entered into a new SECA Phase I program for development of a multi-megawatt SOFC power plant operating on coal syngas (the Large Scale Hybrid Program).

Program technical highlights included demonstration testing of a 3 kW SOFC system for over 2,100 hours that successfully met or exceeded all DOE performance metrics for power output, efficiency and degradation (life). This system was subsequently shipped to the DOE National Energy Technology Laboratory ("NETL") at Morgantown, West Virginia where the unit operated for approximately 1,500 hours confirming the operational results. A factory cost estimate was conducted based on the 3 kW SOFC system design and bill-of-materials which verified that the system cost estimate is less than the DOE SECA program specified phase I program metric of $800/kW.

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Large Scale Hybrid

In February 2006, we were selected by the DOE as a prime contractor for a Phase I award to develop a coal-based, multi-megawatt solid oxide fuel cell-based hybrid system. The contract was finalized in September 2006. The program's overall objective is to develop SOFC technology, fueled by coal synthesis gas (coal gas) that will be used in highly-efficient central generation power plant facilities. The advanced fuel cell-hybrid system will have an overall efficiency of at least 50 percent in converting energy contained in coal to grid electrical power. In contrast, today's average U.S. coal-based power plant has an electrical efficiency of approximately 35 percent. In addition, the envisioned SOFC-hybrid system is expected to separate 90 percent or more of the system's carbon dioxide emissions for capture and environmentally safe disposal while being cost competitive with other baseload power generating technologies.

The first phase of this three phase program will focus on SOFC cell and stack technology scale-up, as well as baseline and proof-of-concept system engineering design and analysis. The project will culminate in phase three with the fabrication and operation of a multi-MW proof-of-concept SOFC-hybrid power plant at FutureGen, a planned DOE demonstration of advanced power systems that emit near-zero emissions, doubling today's electric generating efficiency, co-produce hydrogen, and sequester carbon dioxide or at another suitable location using coal-derived synthesis gas as the fuel. Phase I of the program is a two-year, $36.2 million cost-shared program. If selected for subsequent phases, total project funding of approximately $180 million is anticipated.

We are the prime contractor on this program and other team members include: Versa Power Systems, Inc., Gas Technology Institute ("GTI"), Nexant, Inc., WorleyParsons Group Inc., and SatCon Technology Corporation.

GOVERNMENT REGULATION

We presently are, and our fuel cell power plants will be, subject to various federal, state and local laws and regulations relating to, among other things, land use, safe working conditions, handling and disposal of hazardous and potentially hazardous substances and emissions of pollutants into the atmosphere. Emissions of SOX and NOX from our fuel cell power plants are much lower than conventional combustion-based generating stations, and are well within existing and proposed regulatory limits. The primary emissions from our DFC power plants, assuming no cogeneration application, is humid flue gas that is discharged at a temperature of approximately 700-800° F, water that is discharged at a temperature of approximately 10-20° F above ambient air temperatures and carbon dioxide. In light of the high temperature of the gas emissions, we are required by regulatory authorities to site or configure our power plants in a way that will allow the gas to be vented at acceptable and safe distances. The discharge of water from our power plants requires permits that depend on whether the water is permitted to be discharged into a storm drain or into the local wastewater system. Lastly, as with any use of hydrocarbon fuel, the discharge of particulates must meet emissions standards. While our products have very low carbon monoxide emissions, there could be additional permitting requirements in smog non-attainment areas with respect to carbon monoxide if a number of our units are aggregated together.

We are also subject to federal, state, provincial or local regulation with respect to, among other things, emissions and siting. In addition, utility companies and several states have created and adopted or are in the process of creating interconnection regulations covering both technical and financial requirements for interconnection to utility grids.

PROPRIETARY RIGHTS AND LICENSED TECHNOLOGY

To compete in the marketplace, align effectively with business partners and protect our proprietary rights, we rely primarily on a combination of trade secrets, patents, confidentiality procedures and agreements and patent assignment agreements. In this regard, we have 46 current U.S. patents and 74 international patents covering our fuel cell technology (in certain cases covering the same technology in multiple jurisdictions). All of the 46 U.S. patents relate to our Direct FuelCell technology. We also have submitted 38 U.S. and 123 international patent applications.

The patents we have obtained will expire between 2008 and 2024, and the current average remaining life of our patents is approximately 11.4 years. In 2006, three new U.S patents were issued. In fiscal 2006, six U.S. patents expired. The expiration of these patents has no material impact on our current or anticipated operations. We also have approximately 30 invention disclosures in process with our patent counsel that may result in additional patent applications.

Many of our U.S. patents are the result of government-funded research and development programs, including the DOE cooperative agreement. Three of our patents, which resulted from government-funded research before January 1988 (when we qualified as a “small business”), are owned by the U.S. government and have been licensed to us.

U.S. patents that we own that resulted from government-funded research are subject to the government exercising “march-in” rights. We believe, however, that the likelihood of the U.S. government exercising these rights is remote and would only occur if we ceased our commercialization efforts and there was a compelling national need to use the patents.

We have also entered into certain license agreements through which we have obtained the rights to use technology developed under joint projects. Through these agreements we must make certain royalty payments on the sales of products that contain the licensed technology, subject to certain milestones and limitations.

We have two agreements with MTU CFC; a Cell License Agreement and a Balance of Plant License Agreement. Under our current Cell License Agreement, which has been extended through December 2009, we license our DFC technology to MTU CFC for use exclusively in Europe and the Middle East and non-exclusively in Africa and South America. We also sell our DFC components and stacks to MTU CFC under this agreement. Under the Cell License Agreement, MTU CFC also granted us an exclusive, royalty-free license to use any of their existing improvements to our Direct FuelCell that MTU CFC developed as of December 1999 under a previous license agreement. In addition, MTU CFC has agreed to negotiate a license grant of any separate carbonate fuel cell know-how it develops during the term of the current Cell License once it is ready for commercialization. Under our Balance of Plant Cross Licensing and Cross-Selling Agreement, we may sell to MTU CFC our MW-class modules and MTU CFC may sell their sub-MW class modules to us. The Balance of Plant License continues through July 2008 and may be extended for up to three additional 5-year terms, at the option of either MTU CFC or us.

REVENUE AND BACKLOG

Our consolidated revenues for the years ended October 31, 2006, 2005 and 2004 were $33.3 million, $30.4 million and $31.4 million, respectively. These consolidated revenues included product sales and revenues of $21.5 million, $17.4 million and $12.6 million, respectively, and revenues from research and development contracts of $11.8 million, $13.0 million and $18.8 million, respectively. Consolidated revenues for the years ended October 31, 2006, 2005 and 2004 in the U.S. were $27.5 million, $22.2 million and $23.4 million, respectively, and consolidated revenues from foreign locations were $5.8 million, $8.2 million and $8.0 million, respectively, based on customer order location.

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Our backlog as of October 31, 2006 was approximately $58.0 million compared with backlog of approximately $42.2 million as of October 31, 2005. Backlog refers to the aggregate revenues remaining to be earned at a specified date under contracts we hold.

- Product order backlog was approximately $18.1 million and $20.3 million as of October 31, 2006 and 2005, respectively, representing 8.05 MW as of October 31, 2006 and 8.25 MW as of October 31, 2005. Product orders represent approximately 50 percent of our total funded backlog as of October 31, 2006. Backlog for long-term service agreements was approximately $9.8 million and $6.1 million as of October 31, 2006 and 2005, respectively. Although backlog reflects business that is considered firm, cancellations or scope adjustments may occur and will be reflected in our backlog when known.

- For research and development contracts, we include the total contract value including any unfunded portion of the total contract value in backlog. Research and development contract backlog was approximately $30.1 million and $15.8 million as of October 31, 2006 and 2005, respectively. The unfunded portion of our research and development contracts amounted to approximately $21.6 million and $3.9 million as of October 31, 2006 and 2005, respectively. Due to the long-term nature of these contracts, fluctuations from year to year are not an indication of any future trend.

As of October 31, 2006 and 2005, we had contracts for power plants totaling 4 MW under power purchase agreements ranging from 5 - 10 years. Revenue under these agreements is recognized as electricity is produced. This revenue is not included in backlog.

EMPLOYEES

As of October 31, 2006 we had 384 full-time employees, of whom 110 were located at the Torrington, Connecticut manufacturing plant, and 274 were located at the Danbury, Connecticut facility or various field offices.

AVAILABLE INFORMATION

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

Item 1A. RISK FACTORS

You should carefully consider the following risk factors before making an investment decision. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially and adversely affected. In such cases, the trading price of our common stock could decline, and you may lose all or part of your investment.

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

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

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

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

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

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

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

Under the terms of our power purchase agreements, customers agree to purchase power from our fuel cell power plants at negotiated rates, generally for periods of five to ten years. Electricity rates are generally a function of the customer's current and future electricity pricing available from the grid. Revenues are earned and collected under these PPAs as power is produced. As owner of the power plants in these PPA entities, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel, generally natural gas, to run the power plants. Should electricity rates decrease or operating costs increase from our original estimates, our results of operations could be negatively impacted. We have qualified for incentive funding for these projects in California under the states' Self Generation Incentive Funding Program and from other government programs. Funds are payable upon commercial installation and demonstration of the plant and may require return of the funds for failure of certain performance requirements. Revenue related to these incentive

funds is recognized ratably over the performance period. We are not required to produce minimum amounts of power under our PPA agreements and we have the right to terminate PPA agreements by giving written notice to the customer, subject to certain exit costs.

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

We extend product warranties which could affect our operating results.

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

We currently face and will continue to face significant competition.

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

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

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

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

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

Our largest two institutional shareholders each own more than 5%, but less than 10%, of our outstanding common stock. MTU Friedrichshafen GmbH owns approximately 5% of our outstanding common stock. James D. Gerson beneficially owns approximately 2% of our outstanding common stock. Loeb Investors Co. LXXV and Warren Bagatelle (a managing director of an affiliate of Loeb Investors Co. LXXV) collectively beneficially own approximately 2% of our outstanding common stock. These ownership levels could make it difficult for a third party to acquire our common stock or have input into the decisions made by our board of directors, which include Michael Bode (Chief Executive Officer of MTU CFC Solutions GmbH), James D. Gerson, Warren Bagatelle and Thomas L. Kempner (Chairman and Chief Executive Officer of an affiliate of Loeb Investors Co. LXXV). MTU CFC is also a

licensee of our technology and a purchaser of our Direct FuelCell products. Therefore, it may be in MTU CFC's interest to possess substantial influence over matters concerning our overall strategy and technological and commercial development.

MTU CFC may develop competing technologies.

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

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

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

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

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

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

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

Our plans are dependent upon market acceptance of, as well as enhancements to, those products. Fuel cell systems represent an emerging market, and we cannot be sure that potential customers will accept fuel cells as a replacement for traditional power sources. As is typical in a rapidly evolving industry, demand and market acceptance for recently introduced products and services are subject to a high level of uncertainty and risk. Since the distributed generation market is still evolving, it is difficult to predict with certainty the size of the market and its growth rate. The development of a market for our Direct FuelCell products may be affected by many factors that are out of our control, including:

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

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

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

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

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

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

contracts could materially and adversely affect our business prospects, results of operations and financial condition.

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

Government agencies, such as the Defense Contract Audit Agency, routinely audit and investigate government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. If the agencies determine through these audits or reviews that we improperly allocated costs to specific contracts, they will not reimburse us for these costs. Therefore, an audit could result in adjustments to our revenue and costs.

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

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

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

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

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

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

qualify as a “small business” in the future.

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

We cannot assure you that we will enter into distributor relationships that are consistent with, or sufficient to support, our commercialization plans or our growth strategy or that these relationships will be on terms favorable to us. Even if we enter into these types of relationships, we cannot assure you that the distributors with which we form relationships will focus adequate resources on selling our products or will be successful in selling them. Some of these distributor arrangements have or will require that we grant exclusive distribution rights to companies in defined territories. These exclusive arrangements could result in us being unable to enter into other arrangements at a time when the distributor with which we form a relationship is not successful in selling our products or has reduced its commitment to marketing our products. In addition, certain distributor arrangements include, and some future distributor arrangements may also include, the issuance of equity and warrants to purchase our equity, which may have an adverse effect on our stock price. To the extent we enter into distributor relationships, the failure of these distributors in assisting us with the marketing and distribution of our products may adversely affect our results of operations and financial condition.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

management and technical personnel. Our inability to attract and retain additional qualified management and technical personnel, or the departure of key employees, could materially and adversely affect our development and commercialization plans and, therefore, our business, prospects, results of operations and financial condition.

Our management may be unable to manage rapid growth effectively.

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

We may be affected by environmental and other governmental regulation.

We are subject to federal, state, provincial or local regulation with respect to, among other things, emissions and siting. Assuming no co-generation applications are used in conjunction with our Direct FuelCell plants, they will discharge humid flue gas at temperatures of up to 800º F, water at temperatures of approximately 10-20 º F above surrounding air temperatures and carbon dioxide.

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

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

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

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

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

Our business exposes us to the risk of harmful substances escaping into the environment, resulting in personal injury or loss of life, damage to or destruction of property, and natural resource damage. Depending on the nature of the claim, our current insurance policies may not adequately reimburse us for costs incurred in settling environmental damage claims, and in some instances, we may not be reimbursed at all. Our business is subject to numerous federal, state and local laws and regulations that govern environmental protection and human health and safety. We believe that our businesses are operating in compliance in all material respects with applicable environmental laws, however these laws and regulations have changed frequently in the past and it is reasonable to expect additional and more stringent changes in the future.

Our operations may not comply with future laws and regulations and we may be required to make significant unanticipated capital and operating expenditures. If we fail to comply with applicable environmental laws and regulations, governmental authorities may seek to impose fines and penalties on us or to revoke or deny the issuance or renewal of operating permits and private parties may seek damages from us. Under those circumstances, we might be required to curtail or cease operations, conduct site remediation or other corrective action, or pay substantial damage claims.

We may be required to conduct environmental remediation activities, which could be expensive.

We are subject to a number of environmental laws and regulations, including those concerning the handling, treatment, storage and disposal of hazardous materials. These environmental laws generally impose liability on present and former owners and operators, transporters and generators for remediation of contaminated properties. We believe that our businesses are operating in compliance in all material respects with applicable environmental laws, many of which provide for substantial penalties for violations. We cannot assure you that future changes in such laws, interpretations of existing regulations or the discovery of currently unknown problems or conditions will not require substantial additional expenditures. Any noncompliance with these laws and regulations could subject us to material administrative, civil or criminal penalties or other liabilities. In addition, we may be required to incur substantial costs to comply with current or future environmental and safety laws and regulations.

Our products use inherently dangerous, flammable fuels, operate at high temperatures and use corrosive carbonate material, each of which could subject our business to product liability claims.

Our business exposes us to potential product liability claims that are inherent in products that use hydrogen. Our products utilize fuels such as natural gas and convert these fuels internally to hydrogen that is used by our products to generate electricity. The fuels we use are combustible and may be toxic. In addition, our Direct FuelCell products operate at high temperatures and our Direct FuelCell products use corrosive carbonate material, which could expose us to potential liability claims. Although we have comprehensive safety, maintenance and training programs in place, we cannot guarantee there will not be accidents. Any accidents involving our products or other hydrogen-using products could materially impede widespread market acceptance and demand for our Direct FuelCell products. In addition, we might be held responsible for damages beyond the scope of our insurance coverage. We also cannot predict whether we will be able to maintain our insurance coverage on acceptable terms.

We are subject to risks inherent in international operations.

Since we market our Direct FuelCell products both inside and outside the U.S. and Canada, our success depends, in part, on our ability to secure international customers and our ability to manufacture products that meet foreign regulatory and commercial requirements in target markets. We have limited experience developing and manufacturing our products to comply with the commercial and legal requirements of international markets. In addition, we are subject to tariff regulations and requirements for export licenses, particularly with respect to the export of some of our technologies. We face numerous challenges in our international expansion, including unexpected changes in regulatory requirements, fluctuations in currency exchange rates, longer accounts receivable requirements and collections, difficulties in managing international operations, potentially adverse tax consequences, restrictions on repatriation of earnings and the burdens of complying with a wide variety of international laws. Any of these factors could adversely affect our operations and revenues.

Our stock price has been and could remain volatile.

The market price for our common stock has been and may continue to be volatile and subject to extreme price and volume fluctuations in response to market and other factors, including the following, some of which are beyond our control:

- failure to meet our product development and commercialization milestones;
- variations in our quarterly operating results from the expectations of securities analysts or investors;
- downward revisions in securities analysts' estimates or changes in general market conditions;
- announcements of technological innovations or new products or services by us or our competitors;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- additions or departures of key personnel;
- investor perception of our industry or our prospects;
- insider selling or buying;
- demand for our common stock; and
- general technological or economic trends.

In the past, following periods of volatility in the market price of their stock, many companies have been the subjects of securities class action litigation. If we became involved in securities class action litigation in the future, it could result in substantial costs and diversion of management's attention and resources and could harm our stock price, business, prospects, results of operations and financial condition.

Provisions of Delaware and Connecticut law and of our charter and by-laws may make a takeover more difficult.

Provisions in our certificate of incorporation and by-laws and in Delaware and Connecticut corporate law may make it difficult and expensive for a third party to pursue a tender offer, change in control or takeover attempt that is opposed

by our management and board of directors. Public stockholders who might desire to participate in such a transaction may not have an opportunity to do so. These anti-takeover provisions could substantially impede the ability of public stockholders to benefit from a change in control or change in our management and board of directors.

We depend on relationships with strategic partners, and the terms and enforceability of many of these relationships are not certain.

We have entered into relationships with strategic partners for design, product development and distribution of our existing products, and products under development, some of which may not have been documented by a definitive agreement. The terms and conditions of many of these agreements allow for termination by the partners. Termination of any of these agreements could adversely affect our ability to design, develop and distribute these products to the marketplace. We cannot assure you that we will be able to successfully negotiate and execute definitive agreements with any of these partners, and failure to do so may effectively terminate the relevant relationship.

Future sales of substantial amounts of our common stock could affect the market price of our common stock.

Future sales of substantial amounts of our common stock, or securities convertible or exchangeable into shares of our common stock, into the public market, including shares of our common stock issued upon exercise of options and warrants, or perceptions that those sales could occur, could adversely affect the prevailing market price of our common stock and our ability to raise capital in the future.

The rights of the Series 1 preferred shares and Series B preferred shares could negatively impact our company.

The terms of the Series 1 preferred shares issued by FuelCell Energy, Ltd., our wholly-owned, indirect subsidiary, provide rights to the holder, Enbridge Inc. (“Enbridge”), including dividend and conversion rights among others that could negatively impact us. For example, the terms of the Series 1 preferred shares provide that the holders are entitled to receive cumulative dividends for each calendar quarter for so long as such shares are outstanding. Assuming the exchange rate for Canadian dollars is Cdn.$1.1758 to U.S.$1.00 (exchange rate on January 10, 2007) at the time of the applicable dividend payment date, we are required to pay a preferred dividend of approximately $265,776 per calendar quarter, subject to reduction in accordance with the terms of the Series 1 preferred shares. The terms of the Series 1 preferred shares also require that the holder be paid any accrued and unpaid dividends on December 31, 2010. To the extent that there is a significant amount of accrued dividends that is unpaid as of December 31, 2010 and we do not have sufficient working capital at that time to pay the accrued dividends, our financial condition could be adversely affected. We have guaranteed these dividend obligations, including paying a minimum of Cdn.$500,000 in cash annually to Enbridge for so long as Enbridge holds the Series 1 preferred shares. We have also guaranteed the liquidation obligations of FuelCell Energy, Ltd. under the Series 1 preferred shares.

We are also required to issue common stock to the holder of the Series 1 preferred shares if and when the holder exercises its conversion rights. The number of shares of common stock that we may issue upon conversion could be significant and dilutive to our existing stockholders. For example, assuming the holder of the Series 1 preferred shares exercises its conversion rights after July 31, 2020 and assuming our common stock price is U.S.$6.22 (our common stock closing price on January 10, 2007) and the exchange rate for Canadian dollars is Cdn.$1.1758 to U.S.$1.00 (exchange rate on January 10, 2007) at the time of conversion, we would be required to issue approximately 3,598,260 shares of our common stock.

The terms of the Series B Preferred Shares also provide rights to their holders that could negatively impact us. Holders of the Series B Preferred Shares are entitled to receive cumulative dividends at the rate of $50 per share per year, payable either in cash or in shares of our common stock. To the extent the dividend is paid in shares, additional issuances could be dilutive to our existing stockholders and the sale of those shares could have a negative impact on the price of our common stock. A share of our Series B preferred stock may be converted at any time, at the option of the holder, into 85.1064 shares of our common stock (which is equivalent to an initial conversion price of $11.75 per share) plus cash in lieu of fractional shares. Furthermore, the conversion rate applicable to the Series B Preferred Stock is subject to adjustment upon the occurrence of certain events.

Item 2. PROPERTIES

Our headquarters are located in Danbury, Connecticut. The following is a summary of our offices and locations:

Location	Business Use	Square Footage	Lease Expiration Dates
Danbury, Connecticut	Corporation Headquarters, Research and Development, Sales, Marketing, Purchasing and Administration	72,000	Company owned
Torrington, Connecticut	Manufacturing	65,000	December 2010 (1)
Danbury, Connecticut	Manufacturing and Operations	38,000	October 2009

(1) We have an option to extend the lease for an additional five years.

Item 3. LEGAL PROCEEDINGS

On November 14, 2005, Zoot Properties, LLC and Zoot Enterprises, Inc. (“Zoot”) commenced an action in the U.S. District Court for the District of Montana, Butte Division against the Company and one of its distribution partners, PPL Energy Services Holding, LLC. The lawsuit alleges that the plaintiffs purchased fuel cells from PPL that were manufactured by the Company, and that these fuel cells have failed to perform as represented and warranted. Zoot is seeking rescission of the contract with PPL, totaling approximately $2.5 million. Zoot may also be seeking damages for breach of contract and under tort arising out of the alleged misrepresentation. The Company intends to vigorously defend the action. The Company is unable to predict at this time the ultimate outcome of this lawsuit and therefore no loss contingency has been included in the consolidated financial statements.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

FUELCELL COMMON STOCK

Our common stock has been publicly traded since June 25, 1992. From September 21, 1994 through February 25, 1997, it was quoted on the NASDAQ National Market, and from February 26, 1997 through June 6, 2000 it was traded on the American Stock Exchange.

Our common stock has traded under the symbol "FCEL" on the Nasdaq Stock Market since June 7, 2000. The following table sets forth the high and low sale prices for our common stock for the fiscal periods indicated as reported by the Nasdaq Stock Market during the indicated quarters.

	Common Stock Price	
	High	Low
Year Ended October 31, 2004		
First Quarter	$ 17.79	$ 10.75
Second Quarter	$ 20.30	$ 11.54
Third Quarter	$ 17.59	$ 8.30
Fourth Quarter	$ 13.36	$ 7.16
Year Ended October 31, 2005		
First Quarter	$ 13.45	$ 7.98
Second Quarter	$ 12.06	$ 7.71
Third Quarter	$ 10.94	$ 7.05
Fourth Quarter	$ 12.25	$ 8.25
Year Ended October 31, 2006		
First Quarter	$ 10.90	$ 7.90
Second Quarter	$ 15.00	$ 9.22
Third Quarter	$ 13.97	$ 8.29
Fourth Quarter	$ 9.90	$ 6.59

On January 10, 2007, the closing price of our common stock on the Nasdaq Stock Market was $6.22 per share. As of January 10, 2007, there were 736 holders of record of our common stock.

We have never paid a cash dividend on our common stock and do not anticipate paying any cash dividends on common stock in the foreseeable future. In addition, the terms of our Series B preferred shares prohibit the payment of dividends on our common stock unless all dividends on the Series B preferred stock have been paid in full.

SERIES 1 PREFERRED SHARES

On August 4, 2003, we entered into a combination agreement with Global Thermoelectric Inc. ("Global") to combine Global with us in a share-for-share exchange pursuant to a Plan of Arrangement subject to approval by the Court of Queen's Bench of Alberta, Canada. On October 31, 2003, our shareholders and the shareholders of Global approved the combination. On October 31, 2003, the Court of Queen's Bench of Alberta issued an order approving the

combination. On November 3, 2003, the combination transaction was consummated. In the aggregate, we issued approximately 8.2 million shares of our common stock and exchangeable shares in the acquisition. Following our acquisition of Global, Global's Series 2 preferred shares remained outstanding in Global. At the time of the sale of our thermoelectric generator business, the holder of the Series 2 preferred shares exchanged them for Series 1 Class A cumulative redeemable exchangeable preferred shares (which were referred to as the Series 1 preferred shares) issued by FuelCell Energy, Ltd., one of our indirect, wholly-owned subsidiaries. We have guaranteed the obligations of FuelCell Energy, Ltd. under the Series 1 preferred shares.

The Series 1 preferred shares may be converted into shares of our common stock at the following conversion prices:

- Cdn.$120.22 per share of our common stock until July 31, 2010;
- Cdn.$129.46 per share of our common stock after July 31, 2010 until July 31, 2015;
- Cdn.$138.71 per share of our common stock after July 31, 2015 until July 31, 2020; and
- at any time after July 31, 2020, the price equal to 95% of the then current market price (converted to Cdn.$ at the time of such calculation) of shares of our common stock at the time of conversion.

The foregoing conversion prices are subject to adjustment for certain subsequent events. As illustrated below, the number of shares of our common stock issuable upon conversion of the Series 1 preferred shares after July 31, 2020 may be significantly greater than the number of shares issuable prior to that time.

The following examples illustrate the number of shares of our common stock that we will be required to issue to the holder(s) of the Series 1 preferred shares if and when the holder(s) exercise their conversion rights pursuant to the terms of the Series 1 preferred shares. The following examples are based upon Cdn.$25.0 million of Series 1 preferred shares outstanding (which is the amount currently outstanding) and assume that all accrued dividends on the Series 1 preferred shares have been paid through the time of the conversion and, in the case of conversions occurring after July 31, 2020, that the exchange rate for Canadian dollars is Cdn.$1.1758 to U.S.$1.00 (exchange rate on January 10, 2007) at the time of the conversion:

- if the Series 1 preferred shares convert prior to July 31, 2010, we would be required to issue approximately 207,952 shares of our common stock;
- if the Series 1 preferred shares convert after July 31, 2010, but prior to July 31, 2015, we would be required to issue approximately 193,110 shares of our common stock;
- if the Series 1 preferred shares convert after July 31, 2015, but prior to July 31, 2020, we would be required to issue approximately 180,232 shares of our common stock; and
- if the Series 1 preferred shares convert any time after July 31, 2020, assuming our common stock price is U.S. $6.22 (our common stock closing price on January 10, 2007) at the time of conversion, we would be required to issue approximately 3,598,260 shares of our common stock.

Subject to the Business Corporations Act (Alberta), the holder of the Series 1 preferred shares is not entitled to receive notice of or to attend or vote at any meeting of the FuelCell Energy, Ltd. Common shareholders. At present, we own all of the FuelCell Energy, Ltd. common stock.

Quarterly dividends of Cdn.$312,500 accrue on the Series 1 preferred shares (subject to possible reduction pursuant to the terms of the Series 1 preferred shares on account of increases in the price of our common stock). We have agreed to pay a minimum of Cdn.$500,000 in cash or common stock annually to Enbridge, the sole current holder of the Series 1 preferred shares, as long as Enbridge holds the shares. Interest accrues on cumulative unpaid dividends at a 2.45% quarterly rate, compounded quarterly, until payment thereof. All cumulative unpaid dividends must be paid by December 31, 2010. Subsequent to 2010, FuelCell Energy, Ltd. would be required to pay annual dividend amounts totaling Cdn.$1.25 million so long as the Series 1 Preferred shares remain outstanding. Cumulative unpaid dividends of $5.3 million on the Series 1 preferred shares were outstanding as of October 31, 2006. We have guaranteed the dividend obligations of FuelCell Energy, Ltd. to the Series 1 preferred shareholders.

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Subject to the Business Corporations Act (Alberta), we may redeem the Series 1 preferred shares, in whole or part, at any time, if on the day that the notice of redemption is first given, the volume-weighted average price at which our common stock is traded on the applicable stock exchange during the 20 consecutive trading days ending on a date not earlier than the fifth preceding day on which the notice of redemption is given was not less than a 20% premium to the current conversion price on payment of Cdn.$25.00 per Series 1 Preferred Share to be redeemed, together with an amount equal to all accrued and unpaid dividends to the date fixed for redemption. On or after July 31, 2010, the Series 1 preferred shares are redeemable by us at any time on payment of Cdn.$25.00 per Series 1 preferred share to be redeemed together with an amount equal to all accrued and unpaid dividends to the date fixed for redemption. Holders of the Series 1 preferred shares do not have any mandatory or conditional redemption rights. There are currently 1,000,000 Series 1 preferred shares outstanding.

In the event of the liquidation, dissolution or winding up of FuelCell Energy, Ltd., whether voluntary or involuntary, or any other distribution of its assets among its shareholders for the purpose of winding up its affairs, the holder of the Series 1 preferred shares will be entitled to receive the amount paid on such Series 1 preferred shares (currently Cdn.$25.0 million) together with an amount equal to all accrued and unpaid dividends thereon, before any amount will be paid or any of FuelCell Energy, Ltd.’s property or assets will be distributed to the holders of FuelCell Energy, Ltd.’s common stock. After payment to the holder of the Series 1 preferred shares of the amounts payable to them, the holder of the Series 1 preferred shares will not be entitled to share in any other distribution of FuelCell Energy, Ltd.’s property or assets. We have guaranteed the liquidation obligations of FuelCell Energy, Ltd. under the Series 1 preferred shares.

SERIES B PREFERRED SHARES

On November 11, 2004, we entered into a purchase agreement with Citigroup Global Markets Inc., RBC Capital Markets Corporation, Adams Harkness, Inc., and Lazard Freres & Co., LLC (the “Initial Purchasers”) for the private placement under Rule 144A of up to 135,000 shares of our 5% Series B Cumulative Convertible Perpetual Preferred Stock (Liquidation Preference $1,000) (“Series B Preferred Stock”). On November 17, 2004 and January 25, 2005, we closed on the sale of 100,000 shares and 5,875 shares, respectively, of Series B Preferred Stock to the Initial Purchasers.

At October 31, 2006 and 2005, there were 200,000 authorized of which 64,120 and 105,875 shares were issued and outstanding, respectively. The carrying value of the Series B Preferred Stock as of October 31, 2006 and 2005 represents the net proceeds to us of approximately $60.0 million and $99.0 million, respectively. During fiscal 2006, we converted 41,755 shares of Series B Preferred Stock (the "Shares") into 3,553,615 shares of our common stock. The conversion occurred pursuant to the terms of the Certificate of Designation for the Series B Preferred Stock, whereby upon conversion, the holders received 85.1064 shares of our common stock per share of Series B Preferred Stock. In addition, pursuant to this conversion, we paid a conversion premium of $4.3 million.

The following is a summary of certain provisions of our Series B Preferred Stock. The resale of the shares of our Series B Preferred Stock and the resale of the shares of our common stock issuable upon conversion of the shares of our Series B Preferred Stock are covered by a registration rights agreement.

Ranking

Shares of our Series B Preferred Stock rank with respect to dividend rights and rights upon our liquidation, winding up or dissolution:

- senior to shares of our common stock;
- junior to our debt obligations; and
- effectively junior to our subsidiaries' (i) existing and future liabilities and (ii) capital stock held by others.

Dividends

The Series B Preferred Stock pays cumulative annual dividends of $50 per share which are payable quarterly in arrears on February 15, May 15, August 15 and November 15, which commenced on February 15, 2005, when, as and if declared by the board of directors. Dividends will be paid on the basis of a 360-day year consisting of twelve 30-day months. Dividends on the shares of our Series B Preferred Stock will accumulate and be cumulative from the date of original issuance. Accumulated dividends on the shares of our Series B preferred stock will not bear any interest.

The dividend rate on the Series B Preferred Stock is subject to upward adjustment as set forth in the certificate of designation of the Series B Preferred Stock if we fail to pay, or to set apart funds to pay, dividends on the shares of our Series B Preferred Stock for any quarterly dividend period. The dividend rate on the Series B Preferred Stock is also subject to upward adjustment as set forth in the registration rights agreement entered into with the Initial Purchasers if we fail to satisfy our registration obligations with respect to the Series B Preferred Shares (or the underlying common shares) set forth in the registration rights agreement.

No dividends or other distributions may be paid or set apart for payment upon our common shares (other than a dividend payable solely in shares of a like or junior ranking) unless all accumulated and unpaid dividends have been paid or funds or shares of common stock therefore have been set apart on our Series B Preferred Stock.

We may pay dividends on the Series B Preferred Stock:

- in cash; or
- at the option of the holder, in shares of our common stock, which will be registered pursuant to a registration statement to allow for the immediate sale of these common shares in the public market.

Liquidation

The Series B Preferred Stock has a liquidation preference of $1,000 per share. Upon any voluntary or involuntary liquidation, dissolution or winding up of our company resulting in a distribution of assets to the holders of any class or series of our capital stock, each holder of shares of our Series B preferred stock will be entitled to payment out of our assets available for distribution of an amount equal to the liquidation preference per share of Series B Preferred Stock held by that holder, plus all accumulated and unpaid dividends on those shares to the date of that liquidation, dissolution, or winding up, before any distribution is made on any junior shares, including shares of our common stock, but after any distributions on any of our indebtedness or senior shares (if any). After payment in full of the liquidation preference and all accumulated and unpaid dividends to which holders of shares of our Series B preferred stock are entitled, holders of shares of our Series B preferred stock will not be entitled to any further participation in any distribution of our assets.

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Conversion

A share of our Series B Preferred Stock may be converted at any time, at the option of the holder, into 85.1064 shares of our common stock (which is equivalent to an initial conversion price of $11.75 per share) plus cash in lieu of fractional shares. The conversion rate is subject to adjustment upon the occurrence of certain events, as described below, but will not be adjusted for accumulated and unpaid dividends. Upon conversion, holders of Series B preferred stock will not receive a cash payment for any accumulated dividends. Instead accumulated dividends, if any, will be cancelled.

On or after November 20, 2009 we may, at our option, cause shares of our Series B Preferred Stock to be automatically converted into that number of shares of our common stock that are issuable at the then prevailing conversion rate. We may exercise our conversion right only if the closing price of our common stock exceeds 150% of the then prevailing conversion price for 20 trading days during any consecutive 30 trading day period, as described in the certificate of designation for the Series B preferred stock.

If holders of shares of our Series B Preferred Stock elect to convert their shares in connection with certain fundamental changes (as described below and in the certificate of designation), we will in certain circumstances discussed below increase the conversion rate by a number of additional shares of common stock upon conversion or, in lieu thereof, we may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that shares of our Series B preferred stock are converted into shares of the acquiring or surviving company, in each case as described in the certificate of designation.

The adjustment of the conversion price of the Series B Preferred Stock is to prevent dilution of the interests of the holders of the Series B Preferred Shares, including on account of the following:

- Issuances of common stock as a dividend or distribution to holders of our common stock;

- Common stock share splits or share combinations;

- Issuances to holders of our common stock of any rights, warrants or options to purchase our common stock for a period of less than 60 days; and

- Distributions of assets, evidences of indebtedness or other property to holders of our common stock.

Shares of our Series B Preferred Stock will not be redeemable by us, except in the case of a fundamental change (as described below and in the certificate of designation) whereby holders may require us to purchase all or part of their shares at a redemption price equal to 100% of the liquidation preference of the shares of Series B Preferred Stock to be repurchased, plus accrued and unpaid dividends, if any. We may, at our option, elect to pay the redemption price in cash or, in shares of our common stock valued at a discount of 5% from the market price of shares of our common stock, or any combination thereof. Notwithstanding the foregoing, we may only pay such redemption price in shares of our common stock that are registered under the Securities Act of 1933 and eligible for immediate sale in the public market by non-affiliates of the Company.

Redemption by holders of the Series B Preferred Stock can only occur upon a fundamental change, which the Company does not consider to be probable at this time. Accordingly, future adjustments of the redemption price will only be made if and when a fundamental change is considered probable.

A “fundamental change” will be deemed to have occurred if any of the following occurs:

(1) any "person" or "group" is or becomes the beneficial owner, directly or indirectly, of 50% or more of the total voting power of all classes of our capital stock then outstanding and normally entitled to vote in the election of directors;

(2) during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors (together with any new directors whose election by our Board of Directors or whose nomination for election by our shareholders was approved by a vote of two-thirds of our directors then still in office who were either directors at the beginning of such period or whose election of nomination for election was previously so approved) cease for any reason to constitute a majority of our directors then in office;

(3) the termination of trading of our common stock on the Nasdaq Stock Market and such shares are not approved for trading or quoted on any other U.S. securities exchange; or

(4) we consolidate with or merge with or into another person or another person merges with or into us or the sale, assignment, transfer, lease, conveyance or other disposition of all or substantially all of our assets and certain of our subsidiaries, taken as a whole, to another person and, in the case of any such merger or consolidation, our securities that are outstanding immediately prior to such transaction and which represent 100% of the aggregate voting power of our voting stock are changed into or exchanged for cash, securities or property, unless pursuant to the transaction such securities are changed into securities of the surviving person that represent, immediately after such transaction, at least a majority of the aggregate voting power of the voting stock of the surviving person.

Notwithstanding the foregoing, holders of shares of Series B Preferred Stock will not have the right to require us to repurchase their shares if either:

- the last reported sale price of shares of our common stock for any five trading days within the 10 consecutive trading days ending immediately before the later of the fundamental change or its announcement equaled or exceeded 105% of the conversion price of the shares of Series B Preferred Stock immediately before the fundamental change or announcement;

- at least 90% of the consideration, excluding cash payments for fractional shares and in respect of dissenters' appraisal rights, in the transaction constituting the fundamental change consists of shares of capital stock traded on a U.S. national securities exchange or which will be so traded or quoted when issued or exchanged in connection with a fundamental change and as a result of the transaction, shares of Series B Preferred Stock become convertible into such publicly traded securities; or

- in the case of number 4 above of a fundamental change event, the transaction is effected solely to change our jurisdiction of incorporation.

Voting

Holders of shares of our Series B Preferred Stock have no voting rights unless (1) dividends on any shares of our Series B Preferred Stock or any other class or series of stock ranking on a parity with the shares of our Series B Preferred Stock with respect to the payment of dividends shall be in arrears for dividend periods, whether or not consecutive, containing in the aggregate a number of days equivalent to six calendar quarters or (2) we fail to pay the repurchase price, plus accrued and unpaid dividends, if any, on the fundamental change repurchase date for shares of our Series B Preferred Stock following a fundamental change (as described in the certificate of designation for the Series B Preferred Stock). In each such case, the holders of shares of our Series B Preferred Stock (voting separately

as a class with all other series of other Preferred Stock on parity with our Series B Preferred Stock upon which like voting rights have been conferred and are exercisable, if any) will be entitled to vote for the election of two directors in addition to those directors on the board of directors at such time at the next annual meeting of shareholders and each subsequent meeting until the repurchase price or all dividends accumulated on the shares of our Series B Preferred Stock have been fully paid or set aside for payment. The term of office of all directors elected by the holders of shares of our Series B Preferred Stock will terminate immediately upon the termination of the right of holders of shares of our Series B Preferred Stock to vote for directors.

So long as any shares of our Series B Preferred Stock remain outstanding, we will not, without the consent of the holders of at least two-thirds of the shares of our Series B Preferred Stock outstanding at the time (voting separately as a class with all other series of Preferred Stock, if any, on parity with our Series B Preferred Stock upon which like voting rights have been conferred and are exercisable) issue or increase the authorized amount of any class or series of shares ranking senior to the outstanding shares of our Series B Preferred Stock as to dividends or upon liquidation. In addition, we will not, subject to certain conditions, amend, alter or repeal provisions of our certificate of incorporation, including the certificate of designation relating to our Series B Preferred Stock, whether by merger, consolidation or otherwise, so as to adversely amend, alter or affect any power, preference or special right of the outstanding shares of our Series B Preferred Stock or the holders thereof without the affirmative vote of not less than two-thirds of the issued and outstanding shares of our Series B Preferred Stock.

UNREGISTERED SECURITIES

The following unregistered securities were issued during the period of November 1, 2004 through January 11, 2007:

Shares Issued

As discussed above, on November 17, 2004 and January 25, 2005, we sold 100,000 shares and 5,875 shares, respectively, of Series B Preferred Stock, which were not registered upon issuance to the initial purchasers. During fiscal 2006, we converted 41,755 shares of Series B Preferred Stock (the "Shares") into 3,553,615 shares of our common stock and at October 31, 2006, there were 64,120 shares of Series B Preferred Stock outstanding.

Warrants Issued

On April 6, 2004, we issued warrants to purchase 1,000,000 shares of our common stock to Marubeni Corporation (Marubeni) in conjunction with a revised distribution agreement. Pursuant to the terms of this agreement, Marubeni placed orders for 4 megawatts of DFC power plants, and committed to creating a sub-distributor network and to provide additional support for our products. All previously issued warrants to Marubeni were cancelled. As part of these warrant agreements, the warrants vest in separate tranches once Marubeni has ordered totals of between 5 MW and 45 MW of our products. As of October 31, 2006, 800,000 of these warrants had expired. The exercise price of the remaining 200,000 warrants (which are not vested) is $18.73 per share and the warrants will expire April 2007, if not earned and exercised sooner.

On July 7, 2005, we issued warrants to purchase up to an aggregate of 1,000,000 shares of our common stock to Enbridge Inc. (Enbridge) in conjunction with an amended distribution agreement. All previously issued warrants to Enbridge were cancelled. The warrants vest on a graduated scale based on the total number of megawatts contained in product orders and the timing of when such orders are generated by Enbridge. In October 2006, Enbridge placed a qualifying order resulting in vesting of 30,000 warrants with an exercise price of $9.89. The expiration date of these vested warrants is October 31, 2008. The exercise prices of the remaining 970,000 warrants not vested range from $9.89 to $11.87 per share and the expiration dates range from June 30, 2008 to June 30, 2010, if not earned and exercised sooner.

Item 6. SELECTED FINANCIAL DATA

The selected consolidated financial data presented below as of the end of each of the years in the five-year period ended October 31, 2006 have been derived from our audited consolidated financial statements together with the notes thereto included elsewhere in this Report (the "Financial Statements"). The data set forth below is qualified by reference to, and should be read in conjunction with, the Financial Statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Report.

(Amounts presented in thousands, except for per share amounts)

Consolidated Statement of Operations Data:

	Year Ended October 31,				
	2006	**2005**	**2004**	**2003**	**2002**
Revenues:					
Product sales and revenue	$ 21,514	$ 17,398	$ 12,636	$ 16,081	$ 7,656
Research and development contracts	11,774	12,972	18,750	17,709	33,575
Total revenues	33,288	30,370	31,386	33,790	41,231
Costs and expenses:					
Cost of product sales and revenues	61,526	52,067	39,961	50,391	32,129
Cost of research and development contracts	10,330	13,183	27,290	35,827	45,664
Administrative and selling expenses	17,759	14,154	14,901	12,631	10,451
Research and development expenses	24,714	21,840	26,677	8,509	6,806
Purchased in-process research and development	—	—	12,200	—	—
Total costs and expenses	114,329	101,244	121,029	107,358	95,050
Loss from operations	(81,041)	(70,874)	(89,643)	(73,568)	(53,819)
License fee income, net	42	70	19	270	270
Interest expense	(103)	(103)	(137)	(128)	(160)
Loss from equity investments	(828)	(1,553)	—	—	—
Loss on derivatives	(233)	—	—	—	—
Interest and other income, net	5,951	5,526	2,472	6,012	4,876
Redeemable minority interest	107	—	—	—	—
Provision for taxes	—	—	—	—	(7)
Loss from continuing operations	(76,105)	(66,934)	(87,289)	(67,414)	(48,840)
Discontinued operations, net of tax	—	(1,252)	846	—	—
Net loss	(76,105)	(68,186)	(86,443)	(67,414)	(48,840)
Preferred stock dividends	(8,117)	(6,077)	(964)	—	—
Net loss to common shareholders	$ (84,222)	$ (74,263)	$ (87,407)	$ (67,414)	$ (48,840)
Basic and diluted loss per share:					
Continuing operations	$ (1.65)	$ (1.51)	$ (1.84)	$ (1.71)	$ (1.25)
Discontinued operations	—	(.03)	0.01	—	—
Net loss to common shareholders	$ (1.65)	$ (1.54)	$ (1.83)	$ (1.71)	$ (1.25)
Basic and diluted weighted average shares Outstanding	51,047	48,261	47,875	39,342	39,135

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Consolidated Balance Sheet Data:

	As of October 31,				
	2006	**2005**	**2004**	**2003**	**2002**
Cash, cash equivalents and short term investments (U.S. treasury securities)	$ 107,533	$ 136,032	$ 152,395	$ 134,750	$ 205,996
Working capital	105,868	140,736	156,798	143,998	218,423
Total current assets	133,709	161,894	178,866	160,792	234,739
Long-term investments (U.S. treasury securities)	13,054	43,928	—	18,690	14,542
Total assets	206,652	265,520	236,510	223,363	289,803
Total current liabilities	27,841	21,158	22,070	16,794	16,316
Total non-current liabilities	7,401	2,892	1,476	1,484	1,785
Redeemable minority interest	10,665	11,517	10,259	—	—
Redeemable preferred stock	59,950	98,989	—	—	—
Total shareholders' equity	100,795	130,964	202,705	205,085	271,702
Book value per share(1)	$ 1.90	$ 2.70	$ 4.21	$ 5.20	$ 6.93

(1) Calculated as total shareholders' equity divided by common shares issued and outstanding as of the balance sheet date.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

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

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

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

Results of operations. This section provides an analysis of our results of operations for the years ended October 31, 2006, 2005 and 2004. In addition, a description is provided of transactions and events that impact the comparability of the results being analyzed.

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

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

Factors that may affect future results. In this section, we detail risk factors that affect our quarterly and annual results, but which are difficult to predict.

CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

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

OVERVIEW AND RECENT DEVELOPMENTS

Overview

FuelCell Energy, Inc. (the "Company", "we", "us" or "our") is a world leader in the development and manufacture of fuel cell power plants for ultra-clean, efficient and reliable electric power generation. Our products are designed to meet the 24/7 baseload power needs of commercial, industrial, government and utility customers. To date our products have generated over 150 million kilowatt hours of electricity and we have units operating at over 50 locations around the world.

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

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

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

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

Typical customers for our products include manufacturers, mission critical institutions such as correction facilities and government installations, hotels and customers who can use waste or byproducts of their operatons for fuel such as breweries, food processors and waste water treatment facilities. With increasing demand for renewable and ultraclean power options, and increased volatility and uncertainty in electric markets, our customers gain control of power generation economics, reliability and emissions. Our fuel cells offer flexible siting and easy permitting.

Through December 31, 2006, our cumulative fleet availability was greater than 90 percent. Our DFC power plants are protected by 46 U.S. and 74 international patents and we have also submitted 38 U.S. and 123 international patent applications.

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

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Recent Developments

Change in Executive Management

On January 12, 2006, FuelCell Energy, Inc. announced that R. Daniel Brdar was promoted to President and Chief Executive Officer. Effective January 12, 2007, R. Daniel Brdar was appointed Chairman of the Board. Jerry D. Leitman resigned as Chairman of the Board and as a member of the Company's Board.

On February 15, 2006, Dr. Hans Maru retired as Chief Technology Officer, but will remain as a consultant to the Company. The Chief Technology Officer responsibilities have been assumed by executives within the Company.

On April 17, 2006, Bruce Ludemann was named Senior Vice President of Sales and Marketing for the Company and has been focusing on MW and multi-MW sales opportunities and developing repeatable customers in the Company's key global markets.

Conversion of Series B Cumulative Convertible Preferred Stock

We have completed transactions with certain holders of the Company's Series B Cumulative Convertible Preferred Stock to convert an aggregate of 41,755 shares of Series B Preferred Stock into approximately 3.6 million shares of common stock. Pursuant to the conversion of the preferred shares, we have paid the holders a per share conversion premium of approximately $4.3 million or an average of $103.02 per share of Series B Preferred Stock. This conversion resulted in a charge to preferred stock dividends on the consolidated statement of operations of $4.3 million or $0.08 per basic and diluted share for the fiscal year ended October 31, 2006. As a result of this conversion, quarterly dividend obligations have been reduced by approximately $0.5 million or $0.01 per basic and diluted share, which began in the third quarter of fiscal 2006.

Common Stock Offering

During fiscal 2006, we sold 681,000 shares of our common stock on the open market pursuant to a S-3 registration statement filed in June 2005. Total net proceeds to us from the sale of these securities was approximately $8.0 million and was used to pay the $4.3 million conversion premium on the converted shares of our Series B Preferred Stock and to make dividend payments on our Series B Preferred Stock.

2006 Equity Incentive Plan

In February 2006, the Board adopted the Company's 2006 Equity Incentive Plan (the "2006 Plan"). This plan was approved by shareholders at the Company's March 2006 Annual Meeting. The purpose of the 2006 Plan is to attract and retain key employees, directors, advisors and consultants to provide an incentive for them to assist the Company to achieve long-range performance goals and to enable them to participate in the long-term growth of the Company. There are a total of 2,500,000 shares of Common Stock available for issuance under the 2006 Plan, subject to adjustment for any stock dividend, recapitalization, stock split, stock combination or certain other corporate reorganizations.

Adoption of Statement of Financial Accounting Standard No. 123R, "Share-Based Payments"

On November 1, 2005, we adopted Statement of Financial Accounting Standard No. 123R, "Share-Based Payments" (SFAS 123R), which revised SFAS No. 123, "Accounting for Stock-Based Compensation". This statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such

transactions be recognized in the consolidated statement of operations. Share-based compensation of $4.4 million was recognized in the consolidated statement of operations for the fiscal year ended October 31, 2006. Refer to Note 14 of the consolidated financial statements for additional information.

Change in Accounting for Series 1 Preferred Shares and Derivative Liability

In the fourth quarter of 2006, the Company recorded a cumulative net charge of $0.1 million to the consolidated statement of operations to correct an accounting error related to the Series 1 Preferred shares of FuelCell Energy, Ltd (a wholly-owned subsidiary of the Company). This net charge was recorded in the consolidated statement of operations as a loss on derivatives of $0.2 million and a gain related to redeemable minority interest of $0.1 million. Prior to this change in accounting, the Series 1 Preferred shares were reported in shareholders' equity as Preferred shares of subsidiary. We have concluded that these shares should be accounted for as a redeemable minority interest in FuelCell Energy, Ltd. As a result, we have reclassified the Preferred shares of subsidiary totaling $10.7 million and $11.5 million as of October 31, 2006 and 2005, respectively to Redeemable minority interest on the consolidated balance sheets. Additionally, in the consolidated balance sheet as of October 31, 2005, we have reclassified to accumulated deficit the accretion of the fair value discount on the Series 1 Preferred shares and dividends paid on these shares, which had previously been reported in additional paid-in-capital. No revisions have been made to the historical consolidated statements of operations.

As part of this accounting change, we determined that the Series 1 Preferred shares include embedded derivatives (the conversion feature of the security and its variable dividend obligation) which require bifurcation from the host contract and separate accounting in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities.* This derivative liability is classified as a component of Long-term debt and other liabilities on the Consolidated Balance Sheets. Refer to Note 12 of Notes to Consolidated Financial Statements for additional information.

Reclassification of Series B Cumulative Convertible Perpetual Preferred Stock

EITF Topic D-98, "Classification and Measurement of Redeemable Securities", requires that if registered securities are required to be issued, that maintaining registration may be outside of the Company's control. Accordingly, we have reclassified the Series B Preferred stock into a temporary equity classification (outside of the general heading of shareholders' equity) as of October 31, 2005 because we are unable to ensure that registered shares of our common stock will be available to pay the redemption price. Notwithstanding the foregoing, it is the Company's intent to convert or pay any potential redemption price on the Series B Preferred stock through the issuance of our common stock, if possible.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

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

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

While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress has authorized the funds. As of October 31, 2006, research and development sales backlog totaled $30.1 million, of which 28 percent is funded. Should funding be temporarily delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

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

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

Warrant Value Recognition

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

Inventories

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

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

As of October 31, 2006 and October 31, 2005, the LCM adjustment to the cost basis of inventory and advance payments to vendors was approximately $11.3 million and $8.0 million, respectively, which equates to a reduction of approximately 43 and 39 percent, respectively, of the gross inventory value. As of October 31, 2006, our gross inventory and advances to vendors' balances increased from the October 31, 2005 balances which resulted in higher gross reserve balances. As inventory levels increase or decrease, appropriate adjustments to the cost basis are made.

Internal Research and Development Expenses

We conduct internally funded research and development activities to improve current or anticipated product performance and reduce product life-cycle costs. These costs are classified as research and development expenses on our consolidated statements of operations.

Share-Based Compensation

On November 1, 2005, we adopted Statement of Financial Accounting Standard No. 123R, "Share-Based Payments" (SFAS 123R). Share-based payment transactions with employees, which primarily consist of stock options, and third parties requires the application of a fair value methodology that involves various assumptions. The fair value of our options awarded to employees is estimated on the date of grant using the Black-Scholes option valuation model that uses the following assumptions: expected life of the option, risk-free interest rate, expected volatility of our common stock price and expected dividend yield. We estimate the expected life of the options using historical data and the volatility of our common stock is estimated based on a combination of the historical volatility and the implied volatility from traded options. Share-based compensation of $4.4 million was recognized in the consolidated statement of operations for the fiscal year ended October 31, 2006. Refer to Note 14 of the consolidated financial statements for additional information.

RESULTS OF OPERATIONS

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

Comparison of the Years Ended October 31, 2006 and October 31, 2005

Revenues and costs of revenues

The following tables summarize our revenue mix for the years ended October 31, 2006 and 2005 (dollar amounts in thousands), respectively:

	Year Ended October 31, 2006		Year Ended October 31, 2005		Percentage Increase / (Decrease) in Revenues
	Revenues	Percent of Revenues	Product Revenues	Percent of Revenues	
Revenues:					
Product sales and revenues	$ 21,514	65%	$ 17,398	57%	24%
Research and development contracts	11,774	35%	12,972	43%	(9)%
Total	$ 33,288	100%	$ 30,370	100%	10%

	Year Ended October 31, 2006		Year Ended October 31, 2005		Percentage Increase / (Decrease) in Costs of Revenues
	Costs of Revenues	Percent of Costs of Revenues	Costs of Revenues	Percent of Costs of Revenues	
Cost of revenues:					
Product sales and revenues	$ 61,526	86%	$ 52,067	80%	18%
Research and development contracts	10,330	14%	13,183	20%	(22%)
Total	$ 71,856	100%	$ 65,250	100%	10%

Total revenues for the year ended October 31, 2006 increased by $2.9 million, or 10 percent, to $33.3 million from $30.4 million during the same period last year. Components of revenues and costs of revenues are as follows:

Product sales and revenues

Product sales and revenue increased $4.1 million to $21.5 million for fiscal 2006, compared to $17.4 million for fiscal 2005. Product sales and revenue for 2006 included approximately $13.0 million of power plant sales, $5.0 million related to service agreements and component sales and approximately $3.5 million of revenue related to power purchase agreements. The increase in product sales and revenues is primarily due to increased market share in the California market as well as to the timing of customer delivery requirements on new and existing backlog, an increase in both electricity and grant incentive revenues on power purchase agreements as more units are operating in the field and higher revenues on service agreements and stack components also due to a larger operating fleet of units compared to the prior year.

Cost of product sales and revenues increased to $61.5 million during fiscal 2006, compared to $52.1 million during fiscal 2005. Included in cost of sales during 2006 was a non-cash fixed asset impairment charge of $0.6 million related to the pending sale as of October 31, 2006 of a power plant operating under a power purchase agreement. This sale

was completed in December 2006. Included in cost of sales during 2005 was a non-cash fixed asset impairment charge totaling $1.0 million. This was related to a planned change in manufacturing processes expected to increase electrical output for improved product performance and reduced cost in future periods.

The ratio of product cost to sales improved to 2.9-to-1 during fiscal 2006 from 3.0-to-1 during fiscal 2005. The improvement in the cost ratio primarily reflects a decrease in the average cost of our DFC power plants, offset by short-term pressure on selling prices in California due to higher natural gas pricing, delays in the Connecticut Renewable Portfolio Standards program and higher after-market costs on a larger installed fleet.

Our products do not ship on an even production schedule. The shipment date to customers depends on a number of factors that are outside of our control, including siting requirements, timing of construction and permits. We do not have the sales or order history to quantify trends as of yet.

We expect to continue to sell our DFC products at prices lower than our production costs until such time as we are able to reduce product costs through our engineering and manufacturing efforts and production volumes increase.

Research and development contracts

Research and development revenue decreased $1.2 million to $11.8 million for fiscal 2006, compared to $13.0 million for fiscal 2005. Cost of research and development contracts decreased to $10.3 million during fiscal 2006, compared to $13.2 million for fiscal 2005.

Research and development contract revenue and costs were primarily related to SOFC development under the DOE's Solid State Energy Conversion Alliance Program, the Ship Service Fuel Cell contract with the U.S. Navy and the combined cycle Direct FuelCell/Turbine® development under DOE's Vision 21 program. The ratio of research and development cost to revenue improved to 0.9-to-1 from 1.0-to-1 over the same period a year ago due to the current mix of cost share contracts.

Administrative and selling expenses

Administrative and selling expenses increased by $3.6 million to $17.8 million during fiscal 2006, compared to $14.2 million in fiscal 2005. This increase is primarily due to share-based compensation of approximately $2.6 million resulting from the adoption of SFAS 123R, higher salaries as a result of increased headcount and higher professional costs resulting from commercial market development and increased proposal activity for research and development and commercial contracts.

Research and development expenses

Research and development expenses increased to $24.7 million during fiscal 2006, compared to $21.8 million recorded in fiscal 2005. The increase is due to development costs for sub-MW and MW cost reduction, including recent achievements in advanced cell stack design that increases the power output of our power plants by 20 percent, costs related to our efforts to extend stack life from the current three years to five years and longer and $0.8 million of share-based compensation resulting from the adoption of SFAS 123R.

Loss from operations

The net result of our revenues and costs was a loss from operations for fiscal 2006 totaling $81.0 million. This operating loss is approximately 14 percent higher than the $70.9 million loss recorded in fiscal 2005. Operating loss was higher primarily from increased product losses on higher revenue, an increase in administrative and selling expenses and research and development expenses as discussed above.

Other factors impacting the operating loss included development of our distribution network, increases in depreciation on new production equipment, business insurance premiums, information systems and infrastructure development. We expect to incur operating losses in future reporting periods as we continue to participate in government cost share programs, sell products at prices lower than our current production costs, and invest in our "cost out" initiatives.

Loss from equity investments

Our investment in Versa totaled approximately $11.5 million and $12.3 million as of October 31, 2006 and 2005, respectively. Our current ownership interest is 39% and we account for our investment in Versa under the equity method of accounting. Our share of equity losses for fiscal 2006 and 2005 were $0.9 million and $1.6 million, respectively.

In April 2006, we entered into an agreement to sell our equity investment in Everplore Technology (Xiamen) Co. and recognized a gain of approximately $37 thousand, which offset losses from equity investments.

Interest and other income, net

Interest and other income, net, was $6.0 million for fiscal 2006, compared to $5.5 million for fiscal 2005. Interest and other income increased due to higher average yields on invested balances, partially offset by lower state research and development tax credits, which totaled $0.2 million and $0.5 million for 2006 and 2005, respectively.

Discontinued operations, net of tax

There were no discontinued operations in fiscal 2006. During fiscal 2005, we exited certain facilities in Canada and as a result recorded fixed asset impairment charges totaling approximately $0.9 million and approximately $0.4 million of exit costs related to these facilities. This resulted in total loss from discontinued operations of approximately $1.3 million.

Provision for income taxes

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

Comparison of the Years Ended October 31, 2005 and October 31, 2004

Revenues and costs of revenues

The following tables summarize our revenue and cost mix for the years ended October 31, 2005 and 2004 respectively (dollar amounts in thousands):

	Year Ended October 31, 2005		Year Ended October 31, 2004		Percentage Increase / (Decrease) in Revenues
	Revenues	Percent of Revenues	Product Revenues	Percent of Revenues	
Revenues:					
Product sales and revenues	$ 17,398	57%	$ 12,636	40%	38%
Research and development contracts	12,972	43%	18,750	60%	(31)%
Total	$ 30,370	100%	$ 31,386	100%	(3%)

	Year Ended October 31, 2005		Year Ended October 31, 2004		Percentage Increase / (Decrease) in Costs of Revenues
	Costs of Revenues	Percent of Costs of Revenues	Costs of Revenues	Percent of Costs of Revenues	
Cost of revenues:					
Product sales and revenues	$ 52,067	80%	$ 39,961	59%	30%
Research and development contracts	13,183	20%	27,290	41%	(52%)
Total	$ 65,250	100%	$ 67,251	100%	(3%)

Total revenues for the year ended October 31, 2005 decreased by $1.0 million, or 3 percent, to $30.4 million from $31.4 million during the same period last year. The components of our revenues and cost of revenues are further described as follows:

Product sales and revenues and product costs

Product sales were $17.4 million for fiscal 2005, compared to $12.6 million in fiscal 2004. The increase in product sales and revenues is primarily due to increased manufacturing of power plants for the County of Alameda (Santa Rita Jail), Logan Energy, MTU CFC and recognition of electricity and grant revenue related to power purchase agreements. Product sales backlog totaled approximately $26.4 million as of both October 31, 2005 and 2004. Included in these figures are $6.1 million and $1.6 million for 2005 and 2004, respectively, related to long-term service agreements. Product backlog does not include power purchase or incentive funding agreements.

Product costs were higher with increased revenue to $52.1 million for the year ended October 31, 2005, compared to $40.0 million in the same period of a year ago. Included in cost of sales during 2005 was a non-cash fixed asset impairment charge totaling $1.0 million. This was related to a planned change in manufacturing processes expected to increase electrical output for improved product performance and reduced costs in future periods. The ratio of costs to revenue decreased to approximately 3.0-to-1 in 2005 from approximately 3.2-to-1 in 2004. This ratio is inclusive of any LCM adjustments in cost of sales related to power plants for power purchase agreements. Costs related to power purchase agreements were $10.3 million and $3.1 million for the fiscal years ended October 31, 2005 and 2004, respectively. Excluding the non-cash fixed asset impairment charge and power purchase agreement costs, our cost ratios would have been approximately 2.4-to-1 and approximately 2.7-to-1 for the fiscal years ended October 31, 2005

and 2004, respectively. The ratio of costs to product sales improved from the same period of a year ago as we recognized savings from our cost-out program. The cost ratios included above that exclude certain non-cash items are not considered generally accepted accounting principles ("GAAP") financial measures and should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP. We have used non-GAAP pro forma financial measures in analyzing financial results because they provide meaningful information regarding our operational performance and facilitate management's internal comparisons to our historical operating results and comparisons to competitors' operating results.

Our products do not ship on an even production schedule. The shipment date to customers depends on a number of factors that are outside of our control, including siting requirements, timing of construction and permits. We do not have the sales or order history to quantify sufficient trends as of yet.

Research and development contracts

Revenue from research and development contracts will vary from year to year depending on government funding levels, new contracts and work on existing contracts. Revenue from research and development contracts decreased 31 percent during fiscal 2005 to $13.0 million from $18.8 million in fiscal 2004. Revenues decreased with the completion of the DOE's Product Design Improvement program ("PDI") program and the Bath Iron Works contract. Revenues were also lower on the DOE's Clean Coal contract and other U.S. Navy contracts compared to the prior year. These decreases were partially offset by an increase in revenue related to the DOE's SECA program.

The cost of research and development contract revenue declined by $14.1 million for fiscal 2005, compared to fiscal 2004, due to reduced costs on the Clean Coal contract, the PDI program, U.S. Navy contracts and King County contracts. The ratio of research and development cost to revenue was approximately 1.0-to-1 in 2005, compared to approximately 1.5-to-1 in 2004 due to the substantial completion of the Clean Coal and King County contracts, which had significant cost share commitments. The Clean Coal DFC3000 power plant was not operated at the Indiana site due to fuel supply issues and was removed upon receiving approval from the DOE.

Administrative and selling expenses

Administrative and selling expenses decreased by $0.7 million or 5 percent, to $14.2 million in fiscal 2005, compared to $14.9 million in fiscal 2004. This decrease is primarily the result of the disposition of Canadian operations with costs totaling $1.2 million in 2004, partially offset by higher sales and proposal costs for multi-megawatt projects of approximately $0.2 million and higher administrative costs related to Sarbanes-Oxley Act compliance totaling approximately $0.4 million.

Research and development expenses

Research and development expenses decreased to $21.8 million during fiscal 2005, compared to $26.7 million for fiscal 2004. This decrease is the result of the disposition of Canadian operations with costs totaling approximately $9.1 million, partially offset by increased internal research and development related to support of our DFC 300 products and our cost-out program totaling approximately $5.4 million.

Purchased in-process research and development

The $12.2 million in-process research and development ("IPR&D") charge relates to SOFC technology acquired in the Global transaction. In 1997, Global began developing SOFC technology, which is still in development. The $12.2 million allocated to IPR&D was determined using two established valuation techniques. An average of the cost valuation and market valuation approaches were used to determine the IPR&D amount. The amounts estimated in this valuation were calculated using a risk-adjusted discount rate of 30 percent. As the acquired technology has not yet reached technological feasibility and no alternative future uses existed, it was expensed upon acquisition in accordance with Statement of Financial Accounting Standards ("SFAS") No. 2, "Accounting for Research and Development Costs."

The IPR&D acquired was related to one project, the development of a solid oxide fuel cell. Prior to the transaction date, Global spent approximately five years developing this technology. In 2003, we received notice of an award to participate in the DOE's ten-year SECA program to develop low cost solid oxide fuel cells for residential, commercial, and light industrial applications. The SECA program is a cost-share program totaling approximately $139 million which has three phases. This technology was subsequently sold to our partner in the SECA program, Versa, along with fixed assets in exchange for Versa stock. We currently estimate that it will take approximately five to ten years to complete the development.

Loss from operations

The loss from operations for the year ended October 31, 2005 totaled $70.9 million compared to the loss of $89.6 million recorded in 2004. This decrease of approximately 21 percent is due primarily to the acquisition related charge of purchased in-process research and development in the prior year totaling $12.2 million, lower cost ratios for both research and development contracts and product sales and the disposition of our Canadian operations. We expect to incur operating losses in future reporting periods as we continue to participate in government cost share programs, sell products at prices lower than our current production costs, and invest in our cost-out initiatives.

Loss from equity investments

Our investment in Versa totaled approximately $12.3 million and $2.0 million as of October 31, 2005 and 2004, respectively. We began accounting for this investment under the equity method of accounting as of November 1, 2004, at which time our ownership had increased from 16 percent to 42 percent. As a result of additional capital contributions by other shareholders during 2005, our ownership interest decreased to 41 percent as of October 31, 2005. Our share of equity losses for fiscal 2005 totaled approximately $1.6 million.

Interest and other income, net

Interest and other income, net, increased by $3.1 million when comparing the fiscal year ended October 31, 2005 to the prior year. The increase is due to higher yields on higher investment balances and state research and development tax credits totaling $0.5 million.

Provision for income taxes

We believe, that due to our efforts to commercialize our DFC technology, we will continue to incur losses. Based on projections for future taxable income over the period in which the deferred tax assets are realizable, management believes that significant uncertainty exists surrounding the recoverability of the deferred tax assets. Therefore, no tax benefit has been recognized related to current year losses and other deferred tax assets. We pay franchise and capital taxes in certain states, which are classified as a component of administrative and selling expenses.

Discontinued operations, net of tax

During the fiscal year ended October 31, 2005, we exited certain facilities in Canada and as a result recorded fixed asset impairment charges totaling approximately $0.9 million and exit costs of approximately $0.4 million. During the fiscal year ended October 31, 2004, we acquired Global and subsequently divested its generator business unit through the sale of Global on May 28, 2004. As a result, historical results were reclassified as discontinued operations. Income, net of taxes, related to the generator business totaled approximately $0.8 million for fiscal 2004.

LIQUIDITY AND CAPITAL RESOURCES

We had approximately $120.6 million of cash, cash equivalents and investments as of October 31, 2006, compared to $180.0 million as of October 31, 2005. Net cash and investments used during fiscal 2006 was $59.4 million. Cash and investments used during fiscal 2006 include dividend payments on our preferred stock of $8.9 million (includes $4.3 million related to the conversion of 41,755 shares of Series B Preferred Stock), offset by proceeds from the issuance of common stock of $8.0 million, proceeds from common stock issued for option and stock purchase plans of $1.4 million and receipt of incentive funding related to our power purchase agreements of $6.6 million.

Cash Inflows and Outflows

Cash and cash equivalents as of October 31, 2006 totaled $26.2 million, reflecting an increase of $3.5 million from the balance reported as of October 31, 2005. The key components of our cash inflows and outflows from continuing operations were as follows:

Operating Activities: During fiscal 2006, we used $48.4 million in cash for operating activities, compared to operating cash usage of $56.0 million during fiscal 2005. Cash used in operating activities during fiscal 2006 consists of a net loss for the period of approximately $76.1 million, offset by non-cash adjustments totaling $15.4 million, including $4.4 million of share-based compensation and depreciation and amortization expense of $9.6 million.

In addition, cash provided by working capital totaled approximately $12.3 million, including lower accounts receivable of $0.8 million due to the timing of production and shipping milestones, higher deferred revenue of approximately $5.6 million primarily related to incentive funds received for PPAs, higher accounts payable and accrued liabilities of $7.0 million due to increased production. These amounts were partially offset by an increase in inventories of approximately $2.0 million, due to higher production levels.

Investing Activities: During fiscal 2006, net cash provided by investing activities totaled $51.8 million, compared with net cash used of approximately $63.9 million in fiscal 2005. Capital expenditures totaled $11.3 million for 2006. This included approximately $7.3 million for equipment being built for power purchase agreements. During fiscal 2006, approximately $202.8 million of investments in U.S. Treasury Securities matured and new treasury purchases totaled $139.7 million.

Financing Activities: During fiscal 2006, net cash provided by financing activities was approximately $0.2 million, compared to $96.8 million in fiscal 2005. Fiscal 2005 included $99.0 million of net proceeds from the sale of the Series B Preferred stock. For fiscal 2006, cash provided by financing activities related to net proceeds from the sale of common stock of approximately $8.0 million and proceeds from employee stock option exercises of approximately $1.4 million. This was offset by the payment of dividends on our Series 1 and Series B Preferred Stock of approximately $8.9 million, including $4.3 million related to the conversion of 41,755 shares of Series B Preferred Stock.

Sources and Uses of Cash and Investments

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

Future involvement in research and development contracts

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

Implementing cost reduction efforts on our fuel cell products

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

Our 2 MW Santa Clara 'proof-of-concept' project in 1996-1997 cost more than $20,000/kW to produce. In 2003, we shipped our first commercial product, a DFC300 to the Kirin Brewery which cost more than $10,000/kW. At that time, we implemented our commercial cost-out program hiring additional engineers who focused on reducing the total life cycle costs of our power plants. Since 2003, they have made significant progress primarily through value engineering our products and increasing the power output by 20%. Our current manufactured cost is approximately $3,250 /kW on our multi-MW power plant, $4,300/kW on our MW plant and $4,800/kW for the sub-MW product. As these products are produced in 2007, we expect to realize these manufactured costs in our financial statements.

In 2006, we primarily focused our cost saving efforts on our multi-MW product, the DFC3000. Significant savings came from "value engineering" -- developing lower-cost designs for various elements of the power plant -- and improving the efficiency of the Company's manufacturing, testing and commissioning processes. The cost reduction also resulted from the 20 percent increase in power output in our DFC products announced in August 2006. By improving thermal management of electrochemical activity within the stack, the Company increased the power output from each cell, which produces more electricity from the same basic power plant components.

FuelCell Energy will continue to emphasize its cost out initiatives to deliver the most cost efficient and environmentally friendly power generation solutions and meet the needs of the emerging RPS markets. In 2007, the DFC300MA and DFC1500MA are targeted to achieve another 20 percent cost reduction through improvements in strategic sourcing, value engineering and operations. Increased production volume could also reduce that cost another 10 to 20 percent.

Increasing annual order volume

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

We currently have 8.05 MW in backlog and we have limited visibility into future order volume. In Connecticut, we have partnered with multiple developers to submit 98.6 MW of proposals for large-scale multi-MW projects to be submitted in round two under Connecticut's RPS Program, Project 100. California is a leading market for renewable/ultraclean products, approximately 30 percent of our installed capacity is in California and the state has made available approximately $80 million of funding in 2007.

With our currently achieved and projected annual cost reduction targets, we believe we can reach gross margin break-even on product sales at a sustained annual order and production volume of approximately 35 MW to 50 MW, depending on product mix, geographic location and other variables such as fuel prices. We believe that Company net income break-even can be achieved at a sustained annual order and volume production of approximately 75-100 MW assuming a mix of sub-MW and MW sales. If this mix trends more toward MW and multi-MW orders, we believe that the gross margin and net income break-even volumes can be lower.

Our fiscal 2005 production volume was approximately 6 MW and our 2006 volume was approximately 9 MW. Our current production volume is 10MW. Depending on customer demand and emergence of the RPS market, our production rates will be adjusted accordingly.

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

Commitments and Significant Contractual Obligations

A summary of our significant future commitments and contractual obligations as of October 31, 2006 and the related payments by fiscal year is summarized as follows (in thousands):

		Payments Due by Period			
Contractual Obligation:	**Total**	**Less than 1 Year**	**1 - 3 Years**	**3 - 5 Years**	**More than 5 Years**
Capital and Operating lease commitments [1]	$ 2,920	$ 776	$ 1,546	$ 598	$ —
Term loans (principal and interest)	751	441	309	1	—
Purchase commitments[2]	29,113	27,690	1,328	19	76
Series I Preferred dividends payable [3]	20,009	379	758	10,349	8,523
Series B Preferred dividends payable [4]	10,464	3,206	6,412	846	—
Totals	$ 63,257	$ 32,492	$ 10,353	$ 11,813	$ 8,599

(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) Quarterly dividends of Cdn.$312,500 accrue on the Series 1 preferred shares (subject to possible reduction pursuant to the terms of the Series 1 preferred shares on account of increases in the price of our common stock). We have agreed to pay a minimum of Cdn.$500,000 in cash or common stock annually to Enbridge, Inc., the holder of the Series 1 preferred shares, so long as Enbridge holds the shares. Interest accrues on cumulative unpaid dividends at a 2.45 percent quarterly rate, compounded quarterly, until payment thereof. Cumulative unpaid dividends and interest at October 31, 2006 were approximately $5.3 million. For the purposes of this disclosure, we have assumed that the minimum dividend payments would be made through 2010. In 2010, we would be required to pay any unpaid and accrued dividends. Subsequent to 2010, we would be required to pay annual dividend amounts totaling Cdn.$1.25 million. We have the option of paying these dividends in stock or cash.

(4) Dividends on Series B Preferred Stock accrue at an annual rate of 5% paid quarterly. The obligations schedule assumes we will pay preferred dividends on these shares through November 20, 2009, at which time the preferred shares may be subject to mandatory conversion at the option of the Company.

On June 29, 2000, we entered into a loan agreement, secured by machinery and equipment, and have borrowed an aggregate of $2.2 million under the agreement. The loan is payable over eight years, with payments of interest only for the first six months and then repaid in monthly installments with interest computed annually based on the ten-year

U.S. Treasury note plus 2.5 percent. Our current interest rates at October 31, 2006 is 7.6 percent and the outstanding principal balance on this loan is approximately $0.7 million

Approximately $0.8 million of our cash and cash equivalents have been pledged as collateral for certain banking relationships in which we participate.

Research and Development Cost-Share Contracts

We have contracted with various government agencies as either a prime contractor or sub-contractor on cost-share contracts and agreements. Cost-share terms require that participating contractors share the total cost of the project based on an agreed upon ratio with the government agency. As of October 31, 2006, our research and development sales backlog totaled $30.1 million. As this backlog is funded in future periods, we will incur additional research and development cost-share related to this backlog totaling approximately $17.9 million for which we would not be reimbursed by the government.

Product Sales Contracts

Our fuel cell power plant products are in the initial stages of development and market acceptance. As such, costs to manufacture and install our products exceed current market prices. As of October 31, 2006, we had product sales backlog of approximately $18.1 million. We do not expect sales from this backlog to be profitable.

Long-term Service Agreements

We have contracted with certain customers to provide service for fuel cell power plants ranging from one to thirteen years. Under the provisions of these contracts, we provide services to maintain, monitor and repair customer power plants. In some contracts we provide for replacement of fuel cell stacks. 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. As of October 31, 2006, we had a service agreement sales backlog of approximately $9.8 million.

Power Purchase Agreements

Power purchase agreements (PPAs) are a common arrangement in the energy industry, whereby a customer purchases energy from an owner and operator of the power generation equipment. A number of our partners enter into PPAs with end use customers, such as Marubeni in Japan and PPL in the U.S., where they purchase DFC power plants from us, own and operate the units, and recognize revenue as energy is sold to the end user.

We have seeded the market with a number of Company funded PPAs to penetrate key target markets and develop operational and transactional experience. With the added benefit of the federal investment tax credit and accelerated depreciation in the Energy Policy Act of 2005, we believe this experience may enable us to attract third party financing for existing and future projects, including multi-MW projects. To date, we have funded the development and construction of certain fuel cell power plants sited near customers in California, and own and operate assets through PPA entities that we maintain an 80% ownership interest with Alliance Power, Inc. owning the remaining 20%.

We have qualified for incentive funding for these projects in California under the state’s Self Generation Incentive Funding Program and from other government programs. Funds are payable upon commercial installation and demonstration of the plant and may require return of the funds for failure of certain performance requirements. Revenue related to these incentive funds is recognized ratably over the performance period. As of October 31, 2006 we had deferred revenue totaling $9.5 million on the consolidated balance sheet related to incentive funding received on PPAs.

Under the terms of our PPAs, customers agree to purchase power from our fuel cell power plants at negotiated rates, generally for periods of five to ten years. Electricity rates are generally a function of the customer’s current and future electricity pricing available from the grid. Revenues are earned and collected under these PPAs as power is produced. As owner of the power plants in these PPA entities, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel, generally natural gas, to run the power plants. The assets, including fuel cell power plants in these PPA entities, are carried at fair value on the consolidated balance sheets based on our estimates of future revenues and expenses. Should actual results differ from our estimates, our results of operations could be negatively impacted. We are not required to produce minimum amounts of power under our PPAs and we have the right to terminate PPAs by giving written notice to the customer, subject to certain exit costs.

As of October 31, 2006, we had 3.5 MW of power plants in operation under PPAs ranging from 5 - 10 years. Another 0.5 MW was placed in operation during November 2006 and in December 2006, we sold a 1 MW power plant that was operating as a PPA to the Sierra Nevada Brewing Company and entered into a 5-year long-term service and planned maintenance agreement.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R (revised 2004), "Share-Based Payment", which revised SFAS No. 123, "Accounting for Stock-Based Compensation". This statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the consolidated statement of operations. The Company adopted this statement as of November 1, 2005 as required. Refer to Note 14 of Notes to Consolidated Financial Statements for additional information.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs," which amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal". In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company adopted the provisions of this accounting standard on November 1, 2005, as required, and there was not a material impact to the Company's consolidated financial statements.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143" ("FIN 47"). FIN 47 requires the recognition of a liability for the fair value of a legally-required conditional asset retirement obligation when incurred, if the liability's fair value can be reasonably estimated. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company adopted the provisions of this accounting standard in the fourth quarter of fiscal 2006, as required, and there was no impact to the Company's consolidated financial statements as of October 31, 2006.

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

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Exposure

Our exposures to market risk for changes in interest rates relate primarily to our investment portfolio and long term debt obligations. Our investment portfolio includes both short-term U.S. Treasury instruments with maturities averaging three months or less, as well as U.S. Treasury notes with fixed interest rates with maturities of up to twenty months. Cash is invested overnight with high credit quality financial institutions. Based on our overall interest exposure at October 31, 2006, including all interest rate sensitive instruments, a near-term change in interest rate movements of 1 percent would affect our results of operations by approximately $0.2 million annually.

Foreign Currency Exchange Risk

With our Canadian business entity, FuelCell Energy, Ltd., we are subject to foreign exchange risk, although we have taken steps to mitigate those risks where possible. As of October 31, 2006, approximately $0.8 million (less than one percent) of our total cash, cash equivalents and investments was in currencies other than U.S. dollars. The functional currency of FuelCell Energy, Ltd. is the U.S. dollar.

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. Consequently, isolating the effect of changes in currency does not incorporate these other important economic factors.

Derivative Fair Value Exposure

As discussed in more detail within Note 13 of Notes to Consolidated Financial Statements, we have determined that our Series 1 Preferred shares include embedded derivatives that require bifurcation from the host contract and separate accounting in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the embedded derivatives requiring bifurcation from the host contract are the conversion feature of the security and the variable dividend obligation. The aggregate fair value of these derivatives included within Long-term debt and other liabilities on our Consolidated Balance Sheet as of October 31, 2006 was $0.2 million. The fair value of these derivatives is 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 will result in fluctuations in the derivative value and will impact the consolidated statement of operations. For example, a 25% increase from the closing price of our common stock at October 31, 2006 would result in an increase in the fair value of these derivatives and a charge to the consolidated statement of operations of approximately $0.1 million, assuming all other assumptions remain the same.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to the Consolidated Financial Statements **Page**

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FuelCell Energy, Inc.:

We have audited the accompanying balance sheets of FuelCell Energy, Inc. as of October 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended October 31, 2006. We also have audited management's assessment, included in the accompanying Management’s Annual Report on Internal Control Over Financial Reporting, that FuelCell Energy, Inc. and subsidiaries maintained effective internal control over financial reporting as of October 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). FuelCell Energy, Inc.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FuelCell Energy, Inc. as of October 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the three-year period ended October 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, management's assessment that FuelCell Energy, Inc. maintained effective internal control over financial reporting as of October 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations

of the Treadway Commission (COSO). Furthermore, in our opinion, FuelCell Energy, Inc. maintained, in all material respects, effective internal control over financial reporting as of October 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As discussed in Notes 1 and 14 to the consolidated financial statements, the Company changed its method of accounting for share-based payments as of November 1, 2005.

/s/ KPMG LLP

January 12, 2007
Hartford, Connecticut

FUELCELL ENERGY, INC.
Consolidated Balance Sheets
(Dollars in thousands, except share and per share amounts)

	October 31, 2006	October 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 26,247	$ 22,702
Investments: U.S. treasury securities	81,286	113,330
Accounts receivable, net of allowance for doubtful accounts of $43 and $104, respectively	9,402	10,062
Inventories, net	14,121	12,141
Other current assets	2,653	3,659
Total current assets	133,709	161,894
Property, plant and equipment, net	48,136	46,705
Investments: U.S. treasury securities	13,054	43,928
Equity investments	11,483	12,473
Other assets, net	270	520
Total assets	$ 206,652	$ 265,520
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and other liabilities	$ 653	$ 503
Accounts payable	12,508	6,221
Accrued liabilities	6,418	7,018
Deferred license fee income	38	38
Deferred revenue and customer deposits	8,224	7,378
Total current liabilities	27,841	21,158
Long-term deferred revenue	6,723	1,988
Long-term debt and other liabilities	678	904
Total liabilities	35,242	24,050
Redeemable minority interest	10,665	11,517
Redeemable preferred stock ($0.01 par value, liquidation preference of $64,120 and $105,875 at October 31, 2006 and 2005, respectively.)	59,950	98,989
Shareholders' equity:		
Common stock ($.0001 par value); 150,000,000 shares authorized at October 31, 2006 and October 31, 2005; 53,130,901 and 48,497,088 shares issued and outstanding at October 31, 2006 and October 31, 2005, respectively.	5	5
Additional paid-in capital	470,045	424,472
Accumulated deficit	(369,255)	(293,513)
Treasury stock, Common, at cost (15,583 shares in 2006 and 4,279 shares in 2005)	(158)	(44)
Deferred compensation	158	44
Total shareholders' equity	100,795	130,964
Total liabilities and shareholders' equity	$ 206,652	$ 265,520

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Operations
For the years ended October 31, 2006, 2005, and 2004
(Dollars in thousands, except share and per share amounts)

	Years Ended October 31,		
	2006	**2005**	**2004**
Revenues:			
Product sales and revenues	$ 21,514	$ 17,398	$ 12,636
Research and development contracts	11,774	12,972	18,750
Total revenues	33,288	30,370	31,386
Costs and expenses:			
Cost of product sales and revenues	61,526	52,067	39,961
Cost of research and development contracts	10,330	13,183	27,290
Administrative and selling expenses	17,759	14,154	14,901
Research and development expenses	24,714	21,840	26,677
Purchased in-process research and development	—	—	12,200
Total costs and expenses	114,329	101,244	121,029
Loss from operations	(81,041)	(70,874)	(89,643)
License fee income, net	42	70	19
Interest expense	(103)	(103)	(137)
Loss from equity investments	(828)	(1,553)	—
Loss on derivatives	(233)	—	—
Interest and other income, net	5,951	5,526	2,472
Loss before redeemable minority interest	(76,212)	(66,934)	(87,289)
Redeemable minority interest	107	—	—
Loss before provision for income taxes	(76,105)	(66,934)	(87,289)
Provision for income taxes	—	—	—
Loss from continuing operations	(76,105)	(66,934)	(87,289)
Discontinued operations, net of tax	—	(1,252)	846
Net loss	(76,105)	(68,186)	(86,443)
Preferred stock dividends	(8,117)	(6,077)	(964)
Net loss to common shareholders	$ (84,222)	$ (74,263)	$ (87,407)
Loss per share basic and diluted:			
Continuing operations	$ (1.65)	(1.51)	$ (1.84)
Discontinued operations	—	(0.03)	0.01
Net loss to common shareholders	$ (1.65)	$ (1.54)	$ (1.83)
Basic and diluted weighted average shares outstanding	51,046,843	48,261,387	47,875,342

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Changes in Shareholders' Equity
For the years ended October 31, 2006, 2005, and 2004
(Dollars in thousands, except share and per share amounts)

	Shares Of Common Stock	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Treasury stock	Deferred Compensation	Total Shareholders' Equity
Balance at October 31, 2003	**39,423,133**	**$ 4**	**$ 340,559**	**$ (135,478)**	**$ —**	**$ —**	**$ 205,085**
Issuance of common stock and assumption of stock options related to acquisition, net	8,159,657	1	81,811	—	—	—	81,812
Reclassification of accretion of fair value discount and dividends paid for Series 1 Preferred stock (Note 1)	—	—	—	(1,537)	—	—	(1,537)
FuelCell Energy, Inc. warrants earned	—	—	534	—	—	—	534
Issuance of common stock under benefit plans	34,106	—	279	—	—	—	279
Stock options exercised	515,798	—	2,975	—	—	—	2,975
Net loss	—	—	—	(86,443)	—	—	(86,443)
Balance at October 31, 2004	**48,132,694**	**5**	**426,158**	**(223,458)**	—	—	**202,705**
Sale of common stock	185,200	—	1,959	—	—	—	1,959
Reclassification of accretion of fair value discount and dividends paid for Series 1 Preferred stock (Note 1)	—	—	—	(1,637)	—	—	(1,637)
Preferred dividends - Series B	—	—	(5,004)	—	—	—	(5,004)
Equity method losses in Versa Power Systems, Inc.	—	—	—	(232)	—	—	(232)
Increase in additional paid-in-capital for stock and options issued under benefit plans	183,473	—	1,359	—	—	—	1,359
Deferred compensation	(4,279)	—	—	—	(44)	44	—
Net loss	—	—	—	(68,186)	—	—	(68,186)
Balance at October 31, 2005	**48,497,088**	**$ 5**	**$ 424,472**	**$ (293,513)**	**$ (44)**	**$ 44**	**$ 130,964**

FUELCELL ENERGY, INC.
Consolidated Statements of Changes in Shareholders' Equity (continued)
For the years ended October 31, 2006, 2005, and 2004
(Dollars in thousands, except share and per share amounts

	Shares Of Common Stock	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Treasury stock	Deferred Compensation	Total Shareholders' Equity
Sale of common stock	681,000	$ —	$ 7,993	$ —	$ —	$ —	$ 7,993
Impact of change in accounting for Series 1 Preferred stock (Note 1)	—	—	—	363	—	—	363
Share-based compensation	—	—	4,369	—	—	—	4,369
Issuance of warrants under distributor agreement	—	—	34	—	—	—	34
Increase in additional paid-in-capital for stock and options issued under benefit plans	410,502	—	2,250	—	—	—	2,250
Conversion of Series B Preferred stock to common stock	3,553,615	—	39,039	—	—	—	39,039
Preferred dividends - Series B	—	—	(8,112)	—	—	—	(8,112)
Deferred compensation	(11,304)	—	—	—	(114)	114	—
Net loss	—	—	—	(76,105)	—	—	(76,105)
Balance at October 31, 2006	**53,130,901**	**$ 5**	**$ 470,045**	**$ (369,255)**	$ (158)	$ 158	**$ 100,795**

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Cash Flows
For the years ended October 31, 2006, 2005, and 2004
(Dollars in thousands, except share and per share amounts)

	Years Ended October 31,		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net loss	$ (76,105)	$ (68,186)	$ (86,443)
Adjustments to reconcile net loss to net cash used in operating activities, net of effects of acquisitions:			
(Income) loss from discontinued operations	—	1,252	(846)
Asset impairment	583	994	—
Stock-based compensation	4,369	236	—
Loss in equity investments	828	1,553	—
Redeemable minority interest	(107)	—	—
Loss on derivatives	233	—	—
Depreciation and amortization	9,558	8,119	7,918
Amortization (accretion) of bond premium (discount)	(167)	(809)	501
Purchased in-process research and development	—	—	12,200
Provision for doubtful accounts	(62)	71	(32)
(Increase) decrease in operating assets:			
Accounts receivable	897	(2,534)	(2,619)
Inventories	(1,980)	2,480	1,333
Other assets	1,001	725	2,436
Increase (decrease) in operating liabilities:			
Accounts payable	6,274	(3,305)	1,388
Accrued liabilities	688	777	(2,762)
Deferred revenue and customer deposits	5,581	2,653	2,315
Net cash used in operating activities	**(48,409)**	**(55,974)**	**(64,611)**
Cash flows from investing activities:			
Capital expenditures	(11,287)	(14,072)	(7,921)
Cash acquired from acquisition of Global Thermoelectric, Inc., net of transaction costs	—	—	53,004
Sale of Global Thermoelectric, Inc., net of transaction costs	—	—	15,913
Treasury notes matured	202,761	382,608	101,546
Treasury notes purchased	(139,676)	(432,424)	(96,433)
Net cash (used in) provided by investing activities	**51,798**	**(63,888)**	**66,109**
Cash flows from financing activities:			
Repayment on long-term debt	(310)	(456)	(160)
Net proceeds from sale of common stock	7,993	1,992	—
Net proceeds from sale of preferred stock	—	99,007	—
Payment of preferred dividends	(8,931)	(4,354)	(378)
Common stock issued for option and stock purchase plans	1,404	616	3,240
Net cash provided by financing activities	**156**	**96,805**	**2,702**

Net cash provided by discontinued operations	**—**	**—**	**559**
Net (decrease) increase in cash and cash equivalents	**3,545**	**(23,057)**	**4,759**
Cash and cash equivalents-beginning of year	22,702	45,759	41,000
Cash and cash equivalents-end of year	**$ 26,247**	**$ 22,702**	**$ 45,759**

See accompanying notes to the consolidated financial statements.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
For the years ended October 31, 2006, 2005, and 2004
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Note 1. Summary of Significant Accounting Policies

Nature of Business

FuelCell Energy, Inc. is engaged in the development and manufacture of high temperature fuel cells for clean electric power generation. Our Direct FuelCell ® ("DFC") power plants produce reliable, secure and environmentally friendly 24/7 base load electricity for commercial and industrial, government and other customers. We have commercialized our DFC carbonate products and are beginning the development of planar solid oxide fuel cell technology. We expect to incur losses as we continue to participate in government cost share programs, sell products at prices lower than our current production costs, and invest in our cost-out initiatives.

The consolidated financial statements include our accounts and those of our subsidiaries, including our Canadian subsidiary, FuelCell Energy, Ltd., and a subsidiary formed in April 2006, Bridgeport Fuel Cell Park, LLC, for the purpose of developing a 10 MW fuelcell park to be located in Bridgeport, Connecticut. Alliance Monterrey, LLC; Alliance Chico, LLC; Alliance Star Energy, LLC; and Alliance TST Energy, LLC are joint ventures with Alliance Power, Inc. to construct fuel cell power plants and sell power under power purchase agreements to the following customers: the City of Santa Barbara, the Sierra Nevada Brewering Co., the Sheraton San Diego Hotel & Marina, the Westin San Francisco Airport Hotel and TST Inc., respectively. The financial results of the joint ventures are consolidated with those of the Company, which owns 80 percent of each entity. Cumulative minority interest in these Alliance entities is not material to the consolidated financial statements. Intercompany accounts and transactions have been eliminated.

Certain reclassifications have been made to our prior year amounts to conform to the 2006 presentation.

Cash and Cash Equivalents

Cash equivalents consist primarily of investments in money market funds and U.S. Treasury securities with original maturities averaging three months or less at date of acquisition. We place our temporary cash investments with high credit quality financial institutions. Approximately $0.8 million of our cash and cash equivalents have been pledged as collateral for certain banking relationships in which we participate.

Investments

Investments consist of U.S. Treasury securities with original maturities of greater than three months at the date of acquisition. The notes are classified as held to maturity since we have the ability and intention to hold them until maturity. The notes are being carried at amortized cost, which is par value, plus or minus unamortized premium or discount. Such notes are classified as current assets when remaining maturities are one year or less, and as non-current assets when remaining maturities are greater than one year.

Inventories

Inventories consist principally of raw materials and work-in-process and are stated at the lower of cost or market.

Raw materials consist mainly of various nickel powders and steels, and various other components used in producing cell stacks. Work-in-process inventory is comprised of material, labor, and overhead costs incurred by us to build fuel cell stacks, which are subcomponents of power generation systems, which have not yet been dedicated to a particular research and development contract, field trial, or commercial customer, (collectively the “end users”), and which are estimated to be fully recovered from the end users. In instances where costs incurred exceed anticipated recovery, those excess costs are charged to cost of product sales and revenues as incurred.

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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.

When property is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations for the period.

Intellectual Property

Intellectual property, including internally generated patents and know-how, is carried at no value.

Impairment of Long Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. If events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable, we compare the carrying amount of the assets to future undiscounted net cash flows, excluding interest costs, expected to be generated by the assets and their ultimate disposition. If the sum of the undiscounted cash flows is less than the carrying value, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less costs to sell.

Revenue Recognition

Our revenue is primarily generated from customers located throughout the U.S., Europe and Asia and from agencies of the U.S. government. We generally require a down payment with the acceptance of a purchase order from a customer.

We contract with our customers to perform research and development or manufacture and install fuel cell components and power plants under long-term contracts. We recognize revenue on a method similar to the percentage-of-completion method. Revenues on fuel cell research and development contracts are recognized proportionally as costs are incurred and compared to the estimated total research and development costs for each contract. In many cases, we are reimbursed only a portion of the costs incurred or to be incurred on the contract. Revenues from government funded research, development and demonstration programs are generally multi-year, cost reimbursement and/or cost shared type contracts or cooperative agreements. We are reimbursed for reasonable and allocable costs up to the reimbursement limits set by the contract or cooperative agreement.

While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress has authorized the funds. As of October 31, 2006, research and development sales backlog totaled $30.1 million, of which 28 percent is funded. Should funding be temporarily delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

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FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
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Product sales and revenues include revenues from product sales, service contracts, revenue from the sale of electricity under power purchase agreements and grant revenue. Revenues from fuel cell product sales are recognized proportionally as costs are incurred and assigned to a customer contract by comparing the estimated total manufacture and installation costs for each contract to the total contract value. Revenues from service contracts are generally recognized ratably over the contract. For service contracts that include a fuel cell stack replacement, a portion of the total contract value is recognized as revenue at the time of the stack replacement and the remainder of the contract value is recognized ratably over the contract. Revenues from the sale of electricity are recognized as electricity is generated and provided to the customer. Incentive funding revenue is recognized ratably over the term of the power purchase agreement.

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

License Fee Income / Expense Recognition

License fee income arises from an agreement with MTU CFC Solutions GmbH (“MTU CFC”), our European partner, in which we granted MTU CFC an exclusive license to use our Direct FuelCell patent rights and know-how in Europe and the Middle East, and a non-exclusive license in South America and Africa, subject to certain rights of others and us, in each case for a royalty. Amounts received are deferred and recognized ratably over the term of the agreement. We recognized approximately $0.3 million of license fee income during each of the fiscal years ended October 31, 2006, 2005, and 2004.

License fee expense arises from royalty agreements with MTU CFC, pursuant to which we have agreed to pay royalties based upon certain milestones or events relating to the sale of carbonate fuel cells. We have accrued approximately $0.2 million of royalty expense under these agreements in fiscal 2006 (which was offset against license fee income on the consolidated statements of operations).

Deferred Revenue and Customer Deposits

We bill customers based upon certain milestones being reached. These billings are deferred and recognized as revenue based upon the Revenue Recognition policy summarized above.

Warrant Value Recognition

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

Research and Development

Our cost of research and development contracts reflects costs incurred under specific customer-sponsored research and development contracts. These costs consist of both manufacturing and engineering labor, including applicable overhead expenses, materials to build prototype units, materials for testing, and other costs associated with our research and development contracts.

FUELCELL ENERGY, INC.
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Our research and development expenses reflect costs incurred for internal research and development projects conducted without specific customer-sponsored contracts. These costs consist primarily of labor, overhead, materials to build prototype units, materials for testing, consulting fees and other costs associated with our internal research and development expenses.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded against deferred tax assets if it is unlikely that some or all of the deferred tax assets will be realized.

Use of Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and revenues and expenses during the period reported. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, allowances for uncollectible receivables, excess or slow-moving inventories, obsolete inventories, impairment of assets, product warranty, depreciation and amortization, taxes, 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.

Comprehensive Income (Loss)

Comprehensive income (loss) is the increase or decrease in equity from sources other than owners. Our comprehensive loss equals net loss as reported on our consolidated statement of operations totaling $76.1 million, $68.2 million and $86.4 million for the years ended October 31, 2006, 2005 and 2004, respectively.

Foreign Currency Translation

Our Canadian operations are considered financially and operationally integrated and therefore the temporal method of translation of foreign currencies is followed. Under the temporal method, foreign currency gains or losses are recorded on the statement of operations. The functional currency is U.S. dollars. Monetary items are translated at period end exchange rates; non-monetary items are translated at historical exchange rates; revenue and expense items are translated at average rates of exchange prevailing during the period; and depreciation and amortization are translated at the same exchange rate as the assets to which they relate. Monetary items consist primarily of current assets and current liabilities, such as cash, cash equivalents and investments and accounts payable, which are denominated in non-U.S. currencies. We recognized approximately $10 thousand and $16 thousand in foreign currency losses during fiscal years ended October 31, 2006 and 2005 and $0.5 million in foreign currency gains during the fiscal year ended

October 31, 2004. These amounts have been classified in interest and other income on our consolidated statement of operations.

FUELCELL ENERGY, INC.
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Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R (revised 2004), "Share-Based Payment", which revised SFAS No. 123, "Accounting for Stock-Based Compensation". This statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the consolidated statement of operations. The Company adopted this statement as of November 1, 2005 as required. Refer to Note 14 of Notes to Consolidated Financial Statements for additional information.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs," which amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal". In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company adopted the provisions of this accounting standard on November 1, 2005, as required, and there was not a material impact to the Company's financial statements.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143" ("FIN 47"). FIN 47 requires the recognition of a liability for the fair value of a legally-required conditional asset retirement obligation when incurred, if the liability's fair value can be reasonably estimated. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company adopted the provisions of this accounting standard in the fourth quarter of fiscal 2006, as required, and there was no impact to the Company's financial statements as of October 31, 2006.

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

Change in Accounting for Series 1 Preferred Shares and Derivative Liability

In the fourth quarter of 2006, the Company recorded a cumulative net charge of $0.1 million to the consolidated statement of operations to correct an accounting error related to the Series 1 Preferred shares of FuelCell Energy, Ltd (a wholly-owned subsidiary of the Company). This net charge was recorded in the consolidated statement of operations as a loss on derivatives of $0.2 million and a gain related to redeemable minority interest of $0.1 million. Prior to this change in accounting, the Series 1 Preferred shares were reported in shareholders' equity as Preferred shares of subsidiary. We have concluded that these shares should be accounted for as a redeemable minority interest in FuelCell Energy, Ltd. As a result, we have reclassified the Preferred shares of subsidiary totaling $10.7 million and

$11.5 million as of October 31, 2006 and 2005, respectively to Redeemable minority interest on the consolidated balance sheets. Additionally, in the consolidated balance sheet as of October 31, 2005, we have reclassified to accumulated deficit the accretion of the fair value discount on the Series 1 Preferred shares and dividends paid on these shares, which had previously been reported in additional paid-in-capital. No revisions have been made to the historical consolidated statements of operations.

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As part of this accounting change, we determined that the Series 1 Preferred shares include embedded derivatives (the conversion feature of the security and its variable dividend obligation) which require bifurcation from the host contract and separate accounting in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities.* This derivative liability is classified as a component of Long-term debt and other liabilities on the Consolidated Balance Sheets.

Refer to Note 12 of Notes to Consolidated Financial Statements for additional information.

Reclassification of Series B Cumulative Convertible Perpetual Preferred Stock

EITF Topic D-98, "Classification and Measurement of Redeemable Securities", requires that if registered securities are required to be issued, that maintaining registration may be outside of the Company's control. Accordingly, we have reclassified the Series B Preferred stock into a temporary equity classification (outside of the general heading of shareholders' equity) as of October 31, 2005 because we are unable to ensure that registered share of our common stock will be available to pay the redemption price. Notwithstanding the foregoing, it is the Company's intent to convert or pay any potential redemption price on the Series B Preferred stock through the issuance of our common stock, if possible.

Note 2. Business Acquisition and Sale Transactions

During fiscal 2004, we acquired, Global Thermoelectric Inc. ("Global") and subsequently divested its business units through the sale of Global on May 28, 2004 and the combination of our Canadian solid oxide fuel cell ("SOFC") operations with Versa, which was agreed to in October 2004 and closed in November 2004.

Acquisition of Global Thermoelectric Inc.

On November 3, 2003, we completed our acquisition of Global, a leading developer of SOFC technology, headquartered in Calgary, Canada. We believe this acquisition strengthened our capabilities for the U.S. DOE's research programs related to SOFC technology.

As consideration in this acquisition, we issued approximately 8.2 million shares of common stock (or equivalents) valued at approximately $80.8 million. We also assumed the Global stock option plan valued at approximately $1.0 million, preferred shares with a fair value at the time of acquisition of approximately $9.1 million, and incurred transaction costs of approximately $3.9 million. The total purchase price was calculated at approximately $94.8 million. Pursuant to the terms of the Global acquisition agreement, there was a collar set in determining the exchange ratio. Specifically, if FuelCell's stock price closed at a 20 day "daily volume-weighted-average trading price":

- greater than $9.74, the exchange ratio would be 0.279 shares of FuelCell Energy common stock for each share of Global common stock;

- less than $7.96, the exchange ratio would be 0.342 shares of FuelCell Energy common stock for each share of Global common stock; and

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between $7.96 and $9.74, the Global common shareholders would receive approximately $2.72 of FuelCell Energy common stock (or exchangeable shares) for each Global share held.

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The measurement date was determined in accordance with EITF Issue No. 99-12 - "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination". EITF 99-12 states that the measurement date is the date at "which the number of acquirer shares and the amount of consideration become fixed and determinable without subsequent revision." In this transaction, the measurement date on which the shares to be issued became fixed and determinable was September 11, 2003 and the common stock valuation price was $9.91. Given this valuation price and according to the terms of the combination agreement, the exchange ratio was 0.279.

In accordance with SFAS 141, "Business Combinations", we allocated the purchase price to the tangible assets, liabilities and intangible assets acquired, as well as in-process research and development based on their estimated fair values. The excess purchase price over the fair value was recorded as goodwill. The initial purchase price allocation was subsequently adjusted due to the sale of Global and the TEG product line. Assets and liabilities of the TEG product line were classified as held for sale as of the acquisition date.

The adjusted purchase price allocation is as follows:

	Purchase Price Allocation
Cash and investments	$ 55,781
Property and equipment	11,193
Other assets	641
Accounts payable and accrued liabilities	(5,185)
Accrued restructuring costs	(1,261)
Long term debt and other liabilities	(353)
Purchased in-process research and development	12,200
Assets held for sale[(1)]	19,107
Liabilities held for sale	(2,061)
Goodwill	4,760
Investment in Global	$ 94,822

(1) Assets held for sale includes goodwill totaling approximately $10.5 million. The amount of goodwill allocated as held for sale was determined to be the cash price paid by the acquiring company (net of selling costs) less the net fair value of the assets and liabilities sold.

Purchased in-process research and development

In 1997, Global began developing SOFC technology, which is a ceramic planar (flat, square or rectangular) cell, with a solid electrolyte that is anode supported (the thickest component to which all other materials are subsequently mounted) and conducts oxygen ions. Global has developed a proprietary microstructure that gives its fuel cells very high power densities (the amount of power measured in watts per square centimeter of surface area).

The $12.2 million allocated to in-process research and development ("IPR&D") was determined using two established valuation techniques. The cost approach valuation method was used because the SOFC technology is early in its

development cycle and reliable forecasts of future benefit do not exist. The market approach method was used to estimate the implied value of the SOFC technology by estimating the fair value of the generator product line, adding net cash assumed in the acquisition, and then subtracting this total amount from the cash and stock consideration paid. An average of these two valuation techniques was used to determine the IPR&D amount. The amounts estimated in this valuation were calculated using a risk-adjusted discount rate of 30 percent. As the acquired technology has not yet reached technological feasibility and no alternative future uses exist, it was expensed upon acquisition in accordance with SFAS No. 2, “Accounting for Research and Development Costs.”

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The IPR&D acquired was related to one project, the development of a solid oxide fuel cell. Prior to the transaction date, Global spent approximately five years developing this technology. In 2003, we received notice of an award to participate in the DOE's ten-year SECA program to develop low cost solid oxide fuel cells for residential, commercial, and light industrial applications. The SECA program is a cost-share program totaling approximately $139 million to be conducted over three phases. We currently estimate that it will take between five and ten years to complete the development.

Sale of Global Thermoelectric Inc.

On May 28, 2004, we completed the sale of Global, and its thermoelectric generator ("TEG") product line, for proceeds of approximately U.S. $15.9 million. Our SOFC technology development group, including intellectual property, employees, and manufacturing, research and development facilities, was consolidated into a new Canadian subsidiary, FuelCell Energy, Ltd. (formerly FCE Canada Inc.). Assets and liabilities relating to the SOFC business and the majority of Global's cash was transferred to FuelCell Energy, Ltd. and FuelCell Energy, Inc. prior to the sale. In addition, the Global Series 2 Preferred Shares were cancelled, and replaced with substantially equivalent Series 1 Preferred Shares issued by FuelCell Energy, Ltd.

The following table represents the results of this discontinued operation, net of related income taxes:

	Year Ended October 31, 2005[1]	Year Ended October 31, 2004
Product sales and revenues	$ —	$ 13,079
Cost of product sales	—	9,853
Asset impairments and facility exit costs	1,252	—
Operating expenses	—	2,217
Operating income (loss)	(1,252)	1,009
Provision (benefit) for income taxes	—	163
Discontinued operations, net of tax	$ (1,252)	$ 846

(1) During fiscal 2005, we exited certain facilities in Canada and as a result recorded fixed asset impairment charges totaling approximately $0.9 million. In addition, we incurred approximately $0.4 million of exit costs related to these facilities, which resulted in a total loss from discontinued operations of approximately $1.3 million.

There were no discontinued operations during the fiscal period ended October 31, 2006.

Sale of Solid Oxide Fuel Cell Assets

On November 1, 2004, we transferred substantially all of our Canadian solid oxide fuel cell ("SOFC") assets and operations (including manufacturing and test equipment, intellectual property and personnel) to Versa. In exchange, we received 5,714 shares of Versa common stock, increasing our ownership position in Versa to 7,714 shares. No cash was exchanged in the transaction. The consideration received by us in the transaction was determined based upon arms-length negotiations of the parties. Our investment in Versa totaled approximately $11.5 million and $12.3 million as of October 31, 2006 and 2005, respectively.

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Note 3. Investments

Our short and long term investments are in U.S. treasury securities, which are held to maturity. The following table summarizes the amortized cost basis and fair value at October 31, 2006 and 2005:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (losses)	Fair Value
At October 31, 2006				
U.S. government obligations	$ 94,340	$ 24	$ (345)	$ 94,019
At October 31, 2005				
U.S. government obligations	$ 157,258	$ —	$ (606)	$ 156,652

Reported as:

	2006	2005
Short-term investments	$ 81,286	$ 113,330
Long-term investments	13,054	43,928
Total	$ 94,340	$ 157,258

As of October 31, 2006, short-term investment securities have maturity dates ranging from November 15, 2006 to September 30, 2007, and estimated yields ranging from 3.40 percent to 5.10 percent. Long-term investment securities have maturity dates ranging from December 31, 2007 to March 31, 2008, and estimated yields ranging from 4.36 percent to 5.16 percent. Our weighted average yield on our short and long-term investments was 4.42% as of October 31, 2006.

Note 4. Inventories

The components of inventory at October 31, 2006 and October 31, 2005 consisted of the following:

	2006	2005
Raw materials	$ 5,571	$ 4,772
Work-in-process	8,550	7,369
Total	$ 14,121	$ 12,141

Our inventories are stated at the lower of recoverable cost or market price. We provide for a lower of cost or market adjustment against gross inventory values. Our lower of cost or market adjustment, reducing gross inventory values to the reported amounts, was approximately $10.8 million and $7.8 million at October 31, 2006 and 2005, respectively.

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Note 5. Accounts Receivable

Accounts receivable at October 31, 2006 and 2005 consisted of the following:

	2006	2005
U.S. Government:		
Amount billed	$ 28	$ 302
Unbilled recoverable costs	674	1,234
Retainage	—	10
	702	1,546
Commercial Customers:		
Amount billed	3,447	4,178
Unbilled recoverable costs	5,253	4,338
	8,700	8,516
	$ 9,402	$ 10,062

Retainage represents amounts billed but not paid by customers pursuant to retainage provisions in the contracts that will be due upon completion of the contracts and acceptance by the customer and that may be collected over more than one year. Unbilled recoverable costs represent amounts of revenue recognized on costs incurred on contracts in progress that are generally billed within the next 30 days.

The allowance for doubtful accounts was $0.04 million and $0.1 million at October 31, 2006 and 2005, respectively. Fiscal 2006 activity within the allowance for doubtful accounts included decreases totaling $0.4 million, partially offset by increases totaling $0.3 million.

Note 6. Property, Plant and Equipment

Property, plant and equipment at October 31, 2006 and 2005 consisted of the following:

	2006	2005	Estimated Useful Life
Land	$ 524	$ 524	—
Building and improvements	5,996	6,012	10-30 years
Machinery, equipment and software	50,645	49,435	3-8 years
Furniture and fixtures	2,456	2,320	6-10 years
Equipment leased to others	2,063	2,063	3 years
Power plants for use under power purchase agreements	20,576	15,331	10 years
Construction in progress[1]	6,316	2,764	
	88,576	78,449	
Less, accumulated depreciation and amortization	(40,440)	(31,744)	
Total	$ 48,136	$ 46,705	

(1)

Included in construction in progress are costs of approximately $3.0 million and $1.5 million at October 31, 2006 and 2005, respectively, to build power plants, which will service power purchase agreement contracts.

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During fiscal 2006, the Company recorded a charge of $0.5 million related to the impairment of an asset being used to produce electricity under a power purchase agreement. This charge is included in cost of product sales and revenue on the consolidated statement of operations and the fair value of the asset was based on an estimate of future cash flows directly associated with the use and eventual disposition of the asset. As of October 31, 2006, the Company expected the power plant to be sold, however certain modifications were still in process to allow for the power plant to run on digester gas. The sale of this power plant was completed in December 2006.

Depreciation expense was $9.2 million, $7.8 million and $6.5 million for the years ended October 31, 2006, 2005 and 2004, respectively.

Note 7. Other Assets

The components of other current assets at October 31, 2006 and October 31, 2005 consisted of the following:

	2006	2005
Advance payments to vendors [1]	$ 765	$ 591
Interest receivable	789	1,483
Prepaid expenses and other	1,099	1,585
Total	$ 2,653	$ 3,659

(1) Advance payments to vendors related to inventory purchases. We provide for a lower of cost or market adjustment against these advance payments. This adjustment totaled approximately $0.5 million and $0.2 million at October 31, 2006 and 2005, respectively.

Other long-term assets at October 31, 2006 and 2005 consisted of the following:

	2006	2005
Power plant license [1]	$ —	$ 241
Deposits and other	270	279
Total	$ 270	$ 520

(1) Power plant licenses were amortized over 10 years on a straight-line basis and were fully amortized as of October 31, 2006.

Note 8. Equity investments

Our investment in Versa totaled approximately $11.5 million and $12.3 million as of October 31, 2006 and as of October 31, 2005, respectively. We began accounting for this investment under the equity method as of November 1, 2004, at which time our ownership increased from 16 percent to 42 percent. As of October 31, 2006, our ownership interest was 39 percent due to additional capital contributions received by Versa from other owners and our equity in the net assets of Versa totaled approximately $3.5 million.

With the change from the cost to the equity method of accounting, we recorded an adjustment of $0.2 million in 2005 to accumulated deficit to account for our share of the historical losses in this entity assuming we had always been under the equity method. Our share of equity losses for fiscal 2006 and 2005 were $0.9 million and $1.6 million, respectively.

In April 2006, we entered into an agreement to sell our equity investment in Everplore Technology (Xiamen) Co. and recognized a gain of approximately $37 thousand, which offset losses from equity investments.

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Note 9. Accrued Liabilities

Accrued liabilities at October 31, 2006 and 2005 consisted of the following:

	2006	2005
Accrued payroll and employee benefits	$ 3,631	$ 3,370
Accrued contract and operating costs	2,510	2,945
Accrued taxes and other	277	703
Total	$ 6,418	$ 7,018

Note 10. Debt

At October 31, 2006 and 2005, debt consisted of the following:

	2006	2005
Notes payable	$ 955	$ 1,104
Less - current portion	(653)	(364)
Long-term debt	$ 302	$ 740

On June 29, 2000, we entered into a loan agreement, secured by machinery and equipment, and have borrowed an aggregate of $2.2 million under the agreement. The loan is payable over eight years, with payments of interest only for the first six months and then repaid in monthly installments with interest computed annually based on the ten-year U.S. Treasury note plus 2.5 percent. Our current interest rates at October 31, 2006 and October 31, 2005 were 7.6 percent and 6.5 percent, respectively.

Aggregate annual principal payments under the loan agreements for the years subsequent to October 31, 2006 are as follows:

2007	$ 653
2008	286
2009	15
2010	1
	$ 955

Note 11. Shareholders' Equity

Options and Stock Purchase Plan

At October 31, 2006, 9,042,905 shares of common stock have been reserved for issuance pursuant to our equity incentive plans and our Section 423 Stock Purchase Plan. Refer to Note - 14 for additional disclosure related to these plans.

Common Stock Offering

During fiscal 2006, we sold 681,000 shares of our common stock. Total net proceeds to us from the sale of these securities was approximately $8.0 million.

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Warrants

On April 6, 2004, we issued warrants to purchase 1,000,000 shares of our common stock to Marubeni Corporation (Marubeni) in conjunction with a revised distribution agreement. Pursuant to the terms of this agreement, Marubeni placed orders for 4 megawatts of DFC power plants, and committed to creating a sub-distributor network and to provide additional support for our products. All previously issued warrants to Marubeni were cancelled. As part of these warrant agreements, the warrants vest in separate tranches once Marubeni has ordered totals of between 5 MW and 45 MW of our products. As of October 31, 2006, 800,000 of these warrants had expired. The exercise price of the remaining 200,000 warrants (which are unvested) is $18.73 per share and the warrants will expire April 2007, if not exercised sooner.

On July 7, 2005, we issued warrants to purchase up to an aggregate of 1,000,000 shares of our common stock to Enbridge Inc. (Enbridge) in conjunction with an amended distribution agreement. All previously issued warrants to Enbridge were cancelled. The warrants vest on a graduated scale based on the total number of megawatts contained in product orders and the timing of when such orders are generated by Enbridge. In October 2006, Enbridge placed a qualifying order resulting in vesting of 30,000 warrants with an exercise price of $9.89. The expiration date of these vested warrants is October 31, 2008. The exercise prices of the remaining 970,000 unvested warrants range from $9.89 to $11.87 per share and the expiration dates range from June 30, 2008 to June 30, 2010.

Investments by Strategic Partners

Two of our key business partners are shareholders of FuelCell Energy; MTU Friedrichshafen GmbH and Marubeni. These business partners have less than a 10 percent ownership interest in the Company and do not exercise management control over the business.

Note 12. Preferred Stock

Redeemable Series B Preferred Shares

On November 11, 2004, we entered into a purchase agreement with Citigroup Global Markets Inc., RBC Capital Markets Corporation, Adams Harkness, Inc., and Lazard Freres & Co., LLC (the “Initial Purchasers”) for the private placement under Rule 144A of up to 135,000 shares of our 5% Series B Cumulative Convertible Perpetual Preferred Stock (Liquidation Preference $1,000). On November 17, 2004 and January 25, 2005, we closed on the sale of 100,000 shares and 5,875 shares, respectively, of Series B Preferred Stock to the Initial Purchasers.

At October 31, 2006 and 2005, there were 200,000 authorized and there were 64,120 and 105,875 shares issued and outstanding, respectively. The carrying value of the Series B Preferred Stock as of October 31, 2006 and 2005 represents the net proceeds to us of approximately $60.0 million and $99.0 million, respectively. During fiscal 2006, we converted 41,755 shares of Series B Preferred Stock (the "Shares") into 3,553,615 shares of our common stock. The conversion occurred pursuant to the terms of the Certificate of Designation for the Series B Preferred Stock, whereby upon conversion, the holders received 85.1064 shares of our common stock per share of Series B Preferred Stock. In addition, pursuant to the conversion of the Shares, we paid the holders of the Shares a per Share conversion premium ("Conversion Premium"). The aggregate Conversion Premium was $4.3 million, which has been recorded as a dividend.

The following is a summary of certain provisions of our Series B preferred stock. The shares of our Series B preferred stock and the shares of our common stock issuable upon conversion of the shares of our Series B preferred stock are covered by a registration rights agreement.

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Ranking

Shares of our Series B preferred stock rank with respect to dividend rights and rights upon our liquidation, winding up or dissolution:

- senior to shares of our common stock;
- junior to our debt obligations; and
- effectively junior to our subsidiaries' (i) existing and future liabilities and (ii) capital stock held by others.

Dividends

The Series B preferred stock pays cumulative annual dividends of $50 per share which are payable quarterly in arrears on February 15, May 15, August 15 and November 15, which commenced on February 15, 2005, when, as and if declared by the board of directors. Dividends will be paid on the basis of a 360-day year consisting of twelve 30-day months. Dividends on the shares of our Series B preferred stock will accumulate and be cumulative from the date of original issuance. Accumulated dividends on the shares of our Series B preferred stock will not bear any interest.

The dividend rate on the Series B preferred stock is subject to upward adjustment as set forth in the certificate of designation of the Series B preferred stock if we fail to pay, or to set apart funds to pay, dividends on the shares of our Series B preferred stock for any quarterly dividend period. The dividend rate on the Series B preferred stock is also subject to upward adjustment as set forth in the registration rights agreement entered into with the Initial Purchasers if we fail to satisfy our registration obligations with respect to the Series B preferred shares (or the underlying common shares) set forth in the registration rights agreement.

No dividends or other distributions may be paid or set apart for payment upon our common shares (other than a dividend payable solely in shares of a like or junior ranking) unless all accumulated and unpaid dividends have been paid or funds or shares of common stock therefore have been set apart on our Series B preferred stock.

We may pay dividends on the Series B preferred stock:

- in cash; or
- at the option of the holder, in shares of our common stock, which will be registered pursuant to a registration statement to allow for the immediate sale of these common shares in the public market.

Liquidation

The Series B preferred stock has a liquidation preference of $1,000 per share. Upon any voluntary or involuntary liquidation, dissolution or winding up of our company resulting in a distribution of assets to the holders of any class or series of our capital stock, each holder of shares of our Series B preferred stock will be entitled to payment out of our assets available for distribution of an amount equal to the liquidation preference per share of Series B preferred stock held by that holder, plus all accumulated and unpaid dividends on those shares to the date of that liquidation,

dissolution, or winding up, before any distribution is made on any junior shares, including shares of our common stock, but after any distributions on any of our indebtedness or senior shares (if any). After payment in full of the liquidation preference and all accumulated and unpaid dividends to which holders of shares of our Series B preferred stock are entitled, holders of shares of our Series B preferred stock will not be entitled to any further participation in any distribution of our assets.

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Conversion

A share of our Series B preferred stock may be converted at any time, at the option of the holder, into 85.1064 shares of our common stock (which is equivalent to an initial conversion price of $11.75 per share) plus cash in lieu of fractional shares. The conversion rate is subject to adjustment upon the occurrence of certain events, as described below, but will not be adjusted for accumulated and unpaid dividends. Upon conversion, holders of Series B preferred stock will not receive a cash payment for any accumulated dividends. Instead accumulated dividends, if any, will be cancelled.

On or after November 20, 2009 we may, at our option, cause shares of our Series B preferred stock to be automatically converted into that number of shares of our common stock that are issuable at the then prevailing conversion rate. We may exercise our conversion right only if the closing price of our common stock exceeds 150% of the then prevailing conversion price for 20 trading days during any consecutive 30 trading day period, as described in the certificate of designation for the Series B preferred stock.

If holders of shares of our Series B preferred stock elect to convert their shares in connection with certain fundamental changes (as described below and in the certificate of designation), we will in certain circumstances discussed below increase the conversion rate by a number of additional shares of common stock upon conversion or, in lieu thereof, we may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that shares of our Series B preferred stock are converted into shares of the acquiring or surviving company, in each case as described in the certificate of designation.

The adjustment of the conversion price of the Series B preferred stock is to prevent dilution of the interests of the holders of the Series B preferred shares, including on account of the following:

- Issuances of common stock as a dividend or distribution to holders of our common stock;
- Common stock share splits or share combinations;
- Issuances to holders of our common stock of any rights, warrants or options to purchase our common stock for a period of less than 60 days; and
- Distributions of assets, evidences of indebtedness or other property to holders of our common stock.

Shares of our Series B Preferred Stock will not be redeemable by us, except in the case of a fundamental change (as described below and in the certificate of designation) whereby holders may require us to purchase all or part of their shares at a redemption price equal to 100% of the liquidation preference of the shares of Series B Preferred Stock to be repurchased, plus accrued and unpaid dividends, if any. We may, at our option, elect to pay the redemption price in cash or, in shares of our common stock valued at a discount of 5% from the market price of shares of our common stock, or any combination thereof. Notwithstanding the foregoing, we may only pay such redemption price in shares of our common stock that are registered under the Securities Act of 1933 and eligible for immediate sale in the public market by non-affiliates of the Company.

Redemption by holders of the Series B Preferred Stock can only occur upon a fundamental change, which the Company does not consider to be probable at this time. Accordingly, future adjustments of the redemption price will only be made if and when a fundamental change is considered probable.

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A “fundamental change” will be deemed to have occurred if any of the following occurs:

(1) any "person" or "group" is or becomes the beneficial owner, directly or indirectly, of 50% or more of the total voting power of all classes of our capital stock then outstanding and normally entitled to vote in the election of directors;

(2) during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors (together with any new directors whose election by our Board of Directors or whose nomination for election by our shareholders was approved by a vote of two-thirds of our directors then still in office who were either directors at the beginning of such period or whose election of nomination for election was previously so approved) cease for any reason to constitute a majority of our directors then in office;

(3) the termination of trading of our common stock on the Nasdaq Stock Market and such shares are not approved for trading or quoted on any other U.S. securities exchange; or

(4) we consolidate with or merge with or into another person or another person merges with or into us or the sale, assignment, transfer, lease, conveyance or other disposition of all or substantially all of our assets and certain of our subsidiaries, taken as a whole, to another person and, in the case of any such merger or consolidation, Our securities that are outstanding immediately prior to such transaction and which represent 100% of the aggregate voting power of our voting stock are changed into or exchanged for cash, securities or property, unless pursuant to the transaction such securities are changed into securities of the surviving person that represent, immediately after such transaction, at least a majority of the aggregate voting power of the voting stock of the surviving person.

Notwithstanding the foregoing, holders of shares of Series B Preferred Stock will not have the right to require us to repurchase their shares if either:

- the last reported sale price of shares of our common stock for any five trading days within the 10 consecutive trading days ending immediately before the later of the fundamental change or its announcement equaled or exceeded 105% of the conversion price of the shares of Series B Preferred Stock immediately before the fundamental change or announcement;

- at least 90% of the consideration, excluding cash payments for fractional shares and in respect of dissenters' appraisal rights, in the transaction constituting the fundamental change consists of shares of capital stock traded on a U.S. national securities exchange or which will be so traded or quoted when issued or exchanged in connection with a fundamental change and as a result of the transaction, shares of Series B Preferred Stock become convertible into such publicly traded securities; or

- in the case of number 4 above of a fundamental change event, the transaction is effected solely to change our jurisdiction of incorporation.

Voting

Holders of shares of our Series B preferred stock have no voting rights unless (1) dividends on any shares of our Series B preferred stock or any other class or series of stock ranking on a parity with the shares of our Series B

preferred stock with respect to the payment of dividends shall be in arrears for dividend periods, whether or not consecutive, containing in the aggregate a number of days equivalent to six calendar quarters or (2) we fail to pay the repurchase price, plus accrued and unpaid dividends, if any, on the fundamental change repurchase date for shares of our Series B preferred stock following a fundamental change (as described in the certificate of designation for the Series B preferred stock). In each such case, the holders of shares of our Series B preferred stock (voting separately as a class with all other series of other preferred stock on parity with our Series B preferred stock upon which like voting rights have been conferred and are exercisable, if any) will be entitled to vote for the election of two directors in addition to those directors on the board of directors at such time at the next annual meeting of shareholders and each subsequent meeting until the repurchase price or all dividends accumulated on the shares of our Series B preferred stock have been fully paid or set aside for payment. The term of office of all directors elected by the holders of shares of our Series B preferred stock will terminate immediately upon the termination of the right of holders of shares of our Series B preferred stock to vote for directors.

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So long as any shares of our Series B preferred stock remain outstanding, we will not, without the consent of the holders of at least two-thirds of the shares of our Series B preferred stock outstanding at the time (voting separately as a class with all other series of preferred stock, if any, on parity with our Series B preferred stock upon which like voting rights have been conferred and are exercisable) issue or increase the authorized amount of any class or series of shares ranking senior to the outstanding shares of our Series B preferred stock as to dividends or upon liquidation. In addition, we will not, subject to certain conditions, amend, alter or repeal provisions of our certificate of incorporation, including the certificate of designation relating to our Series B preferred stock, whether by merger, consolidation or otherwise, so as to adversely amend, alter or affect any power, preference or special right of the outstanding shares of our Series B preferred stock or the holders thereof without the affirmative vote of not less than two-thirds of the issued and outstanding shares of our Series B preferred stock.

Series 1 Preferred Shares - Redeemable minority interest

In conjunction with our acquisition of Global, we assumed the preferred share obligation comprised of 1,000,000 Series 2 non-voting Preferred Shares. With the sale of the Global entity in May of 2004, the Global Series 2 Preferred Shares were cancelled, and replaced with substantially equivalent Series 1 Preferred Shares (Preferred Shares) issued by FuelCell Energy, Ltd. As discussed in more detail within Note 1, the consolidated financial statements included herein reflect the correction of an accounting error for the Series 1 Preferred shares, which are now accounted for as a redeemable minority interest in FuelCell Energy, Ltd. Prior to this accounting change, the Series 1 Preferred shares were accounted for in shareholders' equity. Additionally, we determined that the Series 1 Preferred shares include embedded derivatives that require bifurcation from the host contract and separate accounting in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* because they are not clearly and closely related to the characteristics of the Series 1 Preferred shares. Specifically, the embedded derivatives requiring bifurcation from the host contract are the conversion feature of the security and the variable dividend obligation. The derivatives embedded within the Series 1 Preferred shares are discussed in more detail below.

As of November 3, 2003, the acquisition date of Global, the fair value of the Series 1 Preferred shares was determined using the income approach to estimate the fair value of the securities based on expected future economic benefits. In applying this method, cash flows are estimated for the life of the securities and then discounted to present value to arrive at an indication of fair value. Amounts projected and then discounted included future dividend payments and conversion of the securities in 2020. Implicit in this valuation are certain assumptions regarding timing and payment of dividends and the ultimate conversion of the securities. Because the Series 1 Preferred shares were issued as a replacement of the Series 2 Preferred shares with equivalent terms and dividend requirements, the Company determined that the fair value of the Series 1 Preferred shares determined on the acquisition date of Global was equivalent to the Series 2 Preferred shares. The fair value of the Series 1 Preferred shares is adjusted quarterly to reflect dividend payments and accretion of the fair value discount. As of October 31, 2006, the Series 1 Preferred shares had an accreted value of $10.7 million.

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The significant terms of the Series 1 Preferred stock include the following:

Voting Rights - The holders of the Series 1 Preferred shares are not entitled to any voting rights or to receive notice of or to attend any meeting of the shareholders of FuelCell Energy, Ltd., but shall be entitled to receive notice of meetings of shareholders of FuelCell Energy, Ltd. called for the purpose of authorizing the dissolution or sale of its assets or a substantial part thereof.

Dividends - Quarterly dividends of Cdn.$312,500 accrue on the Series 1 Preferred shares (subject to possible reduction pursuant to the terms of the Series 1 Preferred shares on account of increases in the price of our common stock). We have agreed to pay a minimum of Cdn.$500,000 in cash or common stock annually to Enbridge, Inc. ("Enbridge"), the sole current holder of the Series 1 Preferred shares, as long as Enbridge holds these shares. Interest accrues on cumulative unpaid dividends at a 2.45% quarterly rate, compounded quarterly, until payment thereof. All cumulative unpaid dividends must be paid by December 31, 2010. Cumulative unpaid dividends and interest at October 31, 2006 were approximately $5.3 million. Subsequent to 2010, FuelCell Energy, Ltd. would be required to pay annual dividend amounts totaling Cdn.$1.25 million so long as the Series 1 Preferred shares remain outstanding. The Company has guaranteed the dividend obligations to the Series 1 Preferred shareholders. During the year ended October 31, 2006, we paid cash dividends totaling Cdn. $500,000 to Enbridge.

Dividend and accrued interest payments can be made in cash or common stock, at the option of FuelCell Energy, Ltd., and such shares issuable may be unregistered. If the Company elects to make such payments using shares of common stock, the number of common shares is determined by dividing the cash dividend obligation by 95% of the volume weighted average price in U.S. dollars at which the common shares have been traded on NASDAQ during the 20 consecutive trading days preceding the end of the calendar quarter for which such dividend in common shares is to be paid converted into Canadian dollars using the Bank of Canada's noon rate of exchange on the day of determination.

Redemption - FuelCell Energy, Ltd., at its option, may redeem the whole or any part of the Series 1 Preferred shares if the trading price of our common stock for a calculated period is not less than 120% of the current conversion price and any accrued and unpaid dividends. On and after July 31, 2010, the Series 1 Preferred shares are redeemable by FuelCell Energy, Ltd. for Cdn.$25 per share and any accrued and unpaid dividends. Holders of the Series 1 Preferred shares do not have any mandatory or conditional redemption rights.

Liquidation or Dissolution - In the event of the liquidation or dissolution of the Company, the holder of Series 1 Preferred shares will be entitled to receive a priority of Cdn.$25,000,000 and any accrued and unpaid dividends. These liquidation obligations have been guaranteed by the Company.

Conversion - A holder of Series 1 Preferred shares has the right to convert such shares into fully paid and non-assessable common stock of the Company at the following conversion prices:

- Cdn$120.22 per share of our common stock until July 31, 2010;
- Cdn$129.46 per share of our common stock after July 31, 2010 until July 31, 2015;
- Cdn$138.71 per share of our common stock after July 31, 2015 until July 31, 2020; and

· at any time after July 31, 2020, at a price equal to 95% of the then current market price (in Cdn.$) of shares of our common stock at the time of conversion.

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Conditions resulting in adjustments to conversion rate - The conversion rate set forth above shall be adjusted if we: (i) split our shares of common stock; (ii) pay a stock dividend; (iii) issue rights, options or other convertible securities to our common stockholders enabling them to acquire our common stock at a price less than 95% of the then-current price; or (iii) fix a record date to distribute to our common stockholders shares of any class of securities, indebtedness or assets.

Derivative liability related to Series 1 Preferred Shares

In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the conversion feature and variable dividend contained in the terms governing the Series 1 Preferred shares are not clearly and closely related to the characteristics of the Series 1 Preferred shares. Accordingly, these features qualified as embedded derivative instruments and, because they do not qualify for any scope exception within SFAS No. 133, they are required to be accounted for separately and recorded as derivative financial instruments.

The conversion feature is valued using a lattice model. This is a one-factor model used to project stochastic stock prices, while risk free rates, discount rates and foreign exchange rates are deterministic factors. Based on the pay-off profiles of the Series 1 Preferred security, it is assumed that the Company will exercise the call option to force conversion in 2020. Conversion after 2020 delivers a fixed pay-off to the investor, and is modeled as a fixed payment in 2020. The cumulative dividend is modeled as a quarterly cash dividend component (to satisfy minimum dividend payment requirement), and a one-time cumulative dividend payment in 2010. The cumulative dividend is compounded at a 2.45% quarterly rate. Call option strikes are adjusted for the cumulative dividend and the conversion ratio is adjusted by the accreted notional until 2010.

The variable dividend is valued using a Monte Carlo simulation model. The embedded derivative is defined as the difference between the value of a normal 5% quarterly dividend payment stream, and the value of stock price and foreign exchange rate linked dividend payment stream. Future stock prices and exchange rates are simulated following geometric Brownian motion to determine the stock/FX linked dividend going out to the year 2020, when the preferred security is assumed to be force converted.

The assumptions used in both valuation models discussed above include 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 security is denominated in Canadian dollars, and the closing price of the Company’s common stock to determine the fair value of the derivatives. The aggregate fair value of these derivatives included within Long-term debt and other liabilities on our Consolidated Balance Sheet as of October 31, 2006 was $0.2 million

Note 13. Segment Information and Major Customers

Under SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information,” we use the “management” approach to reporting segments. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of reportable segments. SFAS No. 131 also requires disclosures about products and services, geographic areas, and major customers. Under SFAS No. 131, we have identified one business segment: fuel cell power plant production and research.

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Enterprise-wide Information

Enterprise-wide information provided on geographic revenues is based on the customer's ordering location. The following table presents net revenues by country:

	Years ended October 31,		
	2006	**2005**	**2004**
Revenues:			
U.S.	$ 27,531	$ 22,178	$ 23,355
Germany	4,097	2,648	1,605
Asia	1,660	5,544	6,426
Total	$ 33,288	$ 30,370	$ 31,386

Information about Major Customers

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

	Years ended October 31,		
	2006	**2005**	**2004**
U.S. Government [(1)]	34%	40%	60%
MTU CFC	12%	*%	*%
County of Alameda, CA	*%	10%	*%
Marubeni	*%	18%	20%

* Less than 10 percent of total revenues in period.

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

Note 14. Benefit Plans

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

Employee Savings Plans

The Capital Accumulation Plan (the "Plan") for employees of FuelCell Energy, Inc. was established by us on January 19, 1987 and was last amended in June 2004. A three-member committee administers the Plan. The Plan is a 401(k) plan covering our full time employees who have completed and provides for tax-deferred salary deductions for eligible employees (beginning the first month following an employee's hire date). Employees may choose to make

voluntary contributions of their annual compensation to the Plan, limited to an annual maximum amount as set periodically by the Internal Revenue Service. We provide matching contributions equal to the employee's deferred compensation, up to a maximum of 6 percent of the employee's annual compensation. Participants are required to contribute a minimum of 3 percent in order to be eligible to participate and receive a Company match. Company contributions begin vesting after one year and are fully vested after five years. Under the Plan, there is no option available to the employee to receive or purchase our common stock. Under this plan, we charged to expense $1.3 million, $1.2 million and $1.1 million during the fiscal years ended October 31, 2006, 2005 and 2004, respectively.

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Equity Incentive Plans

The Board adopted the 1988, 1998 and 2006 Equity Incentive Plans (collectively, "the Plans"). Under the terms of the Plans, 12.7 million shares of common stock may be granted as options or stock to our officers, key employees and directors. As of October 31, 2006, 2.2 million shares were available for grant. Pursuant to the Plans, the Board is authorized to grant incentive stock options or nonqualified options and stock appreciation rights to our officers and key employees and may grant nonqualified options and stock appreciation rights to our directors. Stock options and stock appreciation rights have restrictions as to transferability. The option exercise price shall be fixed by the Board but in the case of incentive stock options, shall not be less than 100 percent of the fair market value of the shares subject to the option on the date the option is granted. Stock appreciation rights may be granted in conjunction with options granted under the Plans. Stock options that have been granted are generally exercisable commencing one year after grant at the rate of 25 percent of such shares in each succeeding year and have a ten-year maximum term. There were no stock appreciation rights outstanding at October 31, 2006 or 2005.

On November 1, 2005, we adopted SFAS No. 123R, "Share-Based Payment" utilizing the modified prospective approach. This statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", which we used to account for share-based compensation transactions prior to November 1, 2005. The compensation expense for Share-Based Plans, which is recognized on a straight-line basis over the vesting period of each award, was $4.4 million for the fiscal period ended October 31, 2006. For fiscal 2006, share-based compensation expense included $0.7 million in cost of product sales and revenues, $0.2 million in cost of research and development contracts, $2.7 million in general and administrative expense and $0.8 million in research and development expenses. There was no share-based compensation expense recognized in the consolidated statement of operations for fiscal 2005.

The following table illustrates the effect on net loss and net loss per basic and diluted share for fiscal 2005 and 2004 as if we had applied the fair value method to our share-based compensation:

	2005	2004
Net loss to common shareholders, as reported	$ (74,263)	$ (87,407)
Add: Share-based employee compensation expense included in reported net loss	169	—
Less: Total share-based employee compensation expense determined under the fair value method for all awards	(7,425)	(9,690)
Pro forma net loss to common shareholders	$ (81,519)	$ (97,097)
Loss per basic and diluted common share to common shareholders, as reported	$ (1.54)	$ (1.83)
Pro forma loss per basic and diluted common share to common shareholders	$ (1.69)	$ (2.03)

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The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. Expected volatility for fiscal 2006 is based on a combination of the historical volatility of the Company's stock and the implied volatility from traded options. Expected volatility for fiscal 2005 and 2004 is based on the historical volatility of the Company's stock. We use historical data to estimate the expected term of options granted.

	2006	2005	2004
Expected life (in years)	6.3	6.3	7.3
Risk-free interest rate	4.6%	4.0%	4.1%
Volatility	56.6%	73.0%	66.7%
Dividend yield	0%	0%	0%

The following table summarizes the Plans' stock option activity for the year ended October 31, 2006:

	Number of options	Weighted average option price
Outstanding at October 31, 2005	5,887,086	10.26
Granted	1,109,858	9.89
Exercised	(279,853)	4.44
Cancelled	(263,687)	16.54
Outstanding at October 31, 2006	6,453,404	$ 10.33

The weighted average grant-date fair value per share for options granted during the periods ended October 31, 2006, 2005 and 2004 was $5.91, $6.10 and $9.25, respectively. The total intrinsic value of options outstanding and options exercisable at October 31, 2006 was $8.3 million and $8.1 million, respectively. The total intrinsic value of options exercised during the periods ended October 31, 2006, 2005 and 2004 was $2.1 million, $0.4 million and $5.4 million, respectively.

The following table summarizes information about stock options outstanding and exercisable at October 31, 2006:

	Options Outstanding			Options Exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
$0.27 - $5.10	1,591,800	1.07	1.66	1,591,800	1.66
$5.11 - $9.92	1,677,005	7.51	7.93	669,939	7.17
$9.93 - $14.74	2,010,981	6.94	12.41	1,102,519	13.32
$14.75 - $19.56	658,618	2.36	17.59	650,118	17.61
$19.57 - $24.39	246,000	4.46	23.01	246,000	23.01

$24.40 - $29.21	27,000	4.24	26.15	27,000	26.15
$29.22 - $34.03	178,000	4.05	29.91	178,000	29.91
$34.04 - $48.49	64,000	3.95	38.50	64,000	38.50
	6,453,404	4.96	10.33	4,529,376	10.54

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As of October 31, 2006, total compensation cost related to nonvested stock options not yet recognized was $9.4 million, which is expected to be recognized over the next 1.4 years on a weighted-average basis.

During fiscal 2006, we issued 14,480 shares of common stock with a value of $0.1 million to directors as compensation (in lieu of cash). In 2005, we issued 5,826 shares of common stock with a value of $0.1 million to directors as compensation (in lieu of cash). These shares were fully vested at the date of grant.

Employee Stock Purchase Plan

Our shareholders adopted a Section 423 Stock Purchase Plan (the "ESPP") on April 30, 1993, which has been amended from time to time by the Board. The total shares allocated to the ESPP are 900,000. Under the ESPP, eligible employees have the right to subscribe to purchase shares of common stock at the lesser of 85 percent of the high and low market prices on the first day of the purchase period or the last day of the purchase period and such purchased shares have a six month vesting period. As of October 31, 2006, there were 355,587 shares of Common Stock reserved for issuance under the ESPP. These shares may be adjusted for any future stock splits.

ESPP activity for the year ended October 31, 2006 was as follows:

	Number of Shares
Balance at October 31, 2005	396,171
Issued @ $6.76	(20,646)
Issued @ $7.33	(19,938)
Balance at October 31, 2006	355,587

The weighted-average grant date fair value of shares under the ESPP during fiscal 2006 was $3.27.

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

	2006	2005	2004
Expected life (in years)	.5	.5	.5
Risk-free interest rate	4.6%	3.6%	1.3%
Volatility	50.2%	66.9%	64.3%
Dividend yield	0%	0%	0%

Incentive Compensation

Stock may be issued to employees as part of the annual incentive bonus. In 2006 and 2005, we issued shares of common stock totaling 75,585 and 67,456, respectively, with values of $0.7 million and $0.5 million, respectively, as incentive bonus (in lieu of cash).

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Note 15. Income Taxes

The components of loss from continuing operations before income taxes for the fiscal years ended October 31, 2006, 2005 and 2004 are as follows:

	2006	2005	2004
U.S.	(76,098)	(67,017)	(65,740)
Foreign	(7)	83	(21,549)
Loss before income taxes	(76,105)	(66,934)	(87,289)

There was no current or deferred federal income tax expense (benefit) for the years ended October 31, 2006, 2005 and 2004. Franchise tax expense, which is included in administrative and selling expenses, was $0.3 million, $0.4 million and $0.5 million for the years ended October 31, 2006, 2005 and 2004, respectively.

The reconciliation of the federal statutory income tax rate to our effective income tax rate for the years ended October 31, 2006, 2005 and 2004 was as follows:

	2006	2005	2004
Statutory federal income tax rate	(34.0%)	(34.0%)	(34.0%)
Nondeductible expenditures	—	—	—
Other, net	—	—	—
Valuation Allowance	34.0%	34.0%	34.0%
Effective income tax rate	0.0%	0.0%	0.0%

Our federal and state deferred tax assets and liabilities consisted of the following at October 31, 2006 and 2005:

	2006	2005
Deferred tax assets:		
Compensation and benefit accruals	$ 1,890	$ 1,153
Bad debt and other reserves	644	510
Capital loss and tax credit carryforwards	6,188	5,933
Net operating losses	117,855	92,166
Lower of cost or market reserves	4,527	4,114
Gross deferred tax assets	131,104	103,876
Valuation allowance	(128,115)	(100,705)
Deferred tax assets after valuation allowance	2,988	3,171
Deferred tax liability:		
Accumulated depreciation	(2,988)	(3,171)

Gross deferred tax liability	(2,988)	(3,171)
Net deferred tax assets (state and federal)	$ —$	—

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We continually evaluate our deferred tax assets as to whether it is "more likely than not" that the deferred tax assets will be realized. In assessing the realizability of our deferred tax assets, management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies. Based on the projections for future taxable income over the periods in which the deferred tax assets are realizable, management believes that significant uncertainty exists surrounding the recoverability of the deferred tax assets. As a result, we recorded a full valuation allowance against our net deferred tax assets. Approximately $4.6 million of the valuation allowance will reduce additional paid in capital upon subsequent recognition of any related tax benefits.

At October 31, 2006, we had available, for federal and state income tax purposes, net operating loss carryforwards of approximately $307.5 million and $265.9 million, respectively. The Federal net operating loss carryforwards expire in varying amounts from 2020 through 2026 while state net operating loss carryforwards expire in varying amounts from 2006 through 2026.

Certain transactions involving the Company's beneficial ownership occurred in fiscal 2005 and prior years, which could have resulted in a stock ownership change for purposes of Section 382 of the Internal Revenue Code of 1986, as amended. We have determined that there has been no ownership change as of the end of our 2005 fiscal year under Section 382.

Note 16. Earnings Per Share

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

	2006	2005	2004
Weighted average basic common shares	51,046,843	48,261,387	47,875,342
Effect of dilutive securities[1]	—	—	—
Weighted average basic common shares adjusted for diluted calculations	51,046,843	48,261,387	47,875,342

(1) We computed earnings per share without consideration to potentially dilutive instruments due to the fact that losses incurred would make them antidilutive. Future potentially dilutive stock options that were in-the-money at October 31, 2006, 2005 and 2004 totaled 1,913,338, 2,799,861 and 3,645,036, respectively. Future potentially dilutive stock options that were not in-the-money at October 31, 2006, 2005 and 2004 totaled 4,540,066, 3,010,225 and 1,708,755. We also have future potentially dilutive warrants issued, which vest and expire over time. As of October 31, 2006, 30,000 warrants were vested with an exercise price of $9.89. At October 31, 2006, we also had 1,170,000 unvested warrants. Refer to Note 11 for further information on warrants.

Note 17. Commitments and Contingencies

Lease agreements

We lease certain computer and office equipment, the Torrington, CT manufacturing facility and additional manufacturing space in Danbury, CT, under operating leases expiring on various dates through 2011. Rent expense was $1.2 million for both fiscal years ended October 31, 2006 and 2005 and $1.5 million for fiscal 2004.

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Aggregate minimum annual payments under lease agreements for the years subsequent to October 31, 2006 are as follows:

2007	$	776
2008		774
2009		772
2010		513
2011		85
	$	2,920

Service and warranty agreements

Once a fuel cell is installed at a customer site, the Company generally provides a warranty period on certain components. As we have limited operating experience these costs are expensed as incurred. In addition, certain customers have agreed to extended service agreements whereby they will contract with us to provide routine maintenance, minimum operating levels and warranty on certain parts.

Power purchase agreements

Under the terms of our power purchase agreements, customers agree to purchase power from our fuel cell power plants at negotiated rates, generally for periods of five to ten years. Electricity rates are generally a function of the customer's current and future electricity pricing available from the grid. Revenues are earned and collected under these PPA's as power is produced. As owner of the power plants in these PPA entities, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel, generally natural gas, to run the power plants. We believe that the assets, including fuel cell power plants in these PPA entities, are carried at fair value on the consolidated balance sheets based on our estimates of future revenues and expenses. Should actual results differ from our estimates, our results of operations could be negatively impacted. We are not required to produce minimum amounts of power under our PPA agreements and we have the right to terminate PPA agreements by giving written notice to the customer, subject to certain exit costs.

Royalty agreements

We have royalty agreements with MTU CFC, pursuant to which we have agreed to pay royalties based upon certain milestones or events relating to the sale of carbonate fuel cells. We have accrued approximately $0.4 million of royalty expense under these agreements. Through October 31, 2006, we have not paid any royalties. In connection with certain contracts and grants from the DOE, we have agreed to pay the DOE 10 percent of the annual license income received from MTU CFC, up to $0.5 million in total. Through October 31, 2006, we have paid the DOE a total of $0.5 million.

Legal proceedings

On November 14, 2005, Zoot Properties, LLC and Zoot Enterprises, Inc. ("Zoot") commenced an action in the U.S. District Court for the District of Montana, Butte Division against the Company and one of our distribution partners, PPL Energy Services Holding, LLC. The lawsuit alleges that the plaintiffs purchased fuel cells from PPL that were

manufactured by the Company, and that these fuel cells have failed to perform as represented and warranted. Zoot is seeking rescission of the contract with PPL, totaling approximately $2.5 million. Zoot may also be seeking damages for breach of contract and under tort arising out of the alleged misrepresentation. The Company intends to vigorously defend the action. The Company is unable to predict at this time the ultimate outcome of this lawsuit and therefore no loss contingency has been included in the consolidated financial statements.

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Note 18. Supplemental Cash Flow Information

The following represents supplemental cash flow information:

	Year Ended October 31,		
	2006	**2005**	**2004**
Cash paid during the period for:			
Interest	$ 102	$ 100	$ 137
Taxes	$ 365	$ 339	$ 480
Supplemental disclosure of non-cash investing and financing activities:			
Assets and liabilities, net, invested in Versa Power Systems, Inc.	$ —	$ 12,132	$ —
Common stock issued in acquisitions	$ —	$ —	$ 81,825
Capital lease obligations in connection with property and Equipment	$ —	$ —	$ 390
Common stock issued for employee annual incentive bonus	$ 717	$ 506	$ —

Capital lease obligations are grouped with current and long term portion of long-term debt and other liabilities on the consolidated balance sheets.

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Note 19. Quarterly Information (Unaudited)

The following tables contain selected unaudited consolidated statement of operations data for each quarter of fiscal years 2006 and 2005. We believe that the following information reflects all normal recurring adjustments necessary for a fair presentation of the information for the periods presented. The operating results for any quarter are not necessarily indicative of results to be expected for any future period.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Year ended October 31, 2006:					
Revenues	$ 5,944	$ 9,534	$ 8,683	$ 9,127	$ 33,288
Operating loss	(16,437)	(19,008)	(20,145)	(25,451)	(81,041)
Net loss	(15,075)	(18,058)	(18,712)	(24,260)	(76,105)
Preferred stock dividends	(1,595)	(5,462)	(1,082)	(802)*	(8,117)*
Net loss to common shareholders	(16,670)	(23,520)	(19,794)	(25,062)*	(84,222)*
Loss per basic and diluted common share:					
Net loss to common shareholders	$ (0.34)	$ (0.48)	$ (0.37)	$ (0.47)	$ (1.65)
Year ended October 31, 2005:					
Revenues	$ 7,554	$ 6,114	$ 8,742	$ 7,960	$ 30,370
Operating loss	(17,336)	(15,993)	(18,531)	(19,014)	(70,874)
Loss from continuing operations	(16,772)	(15,231)	(17,002)	(17.929)	(66,934)
Discontinued operations, net of tax	(1,252)	—	—	—	(1,252)
Net loss	(18,024)	(15,231)	(17,002)	(17,929)	(68,186)
Preferred stock dividends	(1,342)	(1,573)	(1,576)	(1,586)	(6,077)
Net loss to common shareholders	(19,366)	(16,804)	(18,578)	(19,515)	(74,263)
Loss per basic and diluted common share:					
Continuing operations	$ (0.37)	$ (0.35)	$ (0.38)	$ (0.40)	$ (1.51)
Discontinued operations	(0.03)	—	—	—	(0.03)
Net loss to common shareholders	$ (0.40)	$ (0.35)	$ (0.38)	$ (0.40)	$ (1.54)

* As a result of the correction made in the fourth quarter of 2006 related to a prior period accounting error, which is discussed in Note 1 of Notes to Consolidated Financial Statements, the fourth quarter and full year 2006 presentation of preferred stock dividends and net loss to common shareholders in the consolidated statement of operations does not include dividends earned on the Series 1 Preferred stock. The Company did not revise periods prior to fourth quarter 2006 and therefore, the quarterly information for preferred stock dividends and net loss to common shareholders does not total to the full year 2006.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

Disclosure 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.

Management's annual report on internal control over financial reporting.

We, as members of management of FuelCell Energy, Inc., and its Subsidiaries (the "Company"), are responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America. Internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles of the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Under the supervision and with the participation of management, including our principal executive and financial officers, we assessed the Company's internal control over financial reporting as of October 31, 2006, based on criteria for effective internal control over financial reporting established in *Internal Control — Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, we have concluded that the Company maintained effective internal control over financial reporting as of October 31, 2006 based on the specified criteria.

KPMG LLP, the independent registered public accounting firm that also audited the Company's consolidated financial statements included in this report, audited management's assessment of the effectiveness of internal control over financial reporting and issued their report, which is included herein.

/s/ R. Daniel Brdar

R. Daniel Brdar
Chairman, President and Chief Executive Officer

January 12, 2007

/s/ Joseph G. Mahler

Joseph G. Mahler
Senior Vice President and

Chief Financial Officer
January 12, 2007

Changes in internal control over financial reporting.

During the most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information required under this Item is incorporated by reference to the Company's 2007 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 11. Executive Compensation

Information required under this Item is incorporated by reference to the Company's 2007 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required under this Item is incorporated by reference to the Company's 2007 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 13. Certain Relationships and Related Transactions

Information required under this Item is incorporated by reference to the Company's 2007 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 14. Principal Accounting Fees and Services

Information required under this Item is incorporated by reference to the Company's 2007 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

FINANCIAL STATEMENTS

The financial statements of the Company filed as part of this report on Form 10-K are set forth in the Index to Financial Statements under Part II, Item 8 of this Form 10-K.

FINANCIAL STATEMENT SCHEDULES

Supplemental schedules are not provided because of the absence of conditions under which they are required or because the required information is given in the financial statements or notes thereto.

REPORTS ON FORM 8-K

We filed a Form 8-K dated September 8, 2006 under Items 2.02 and 9.01, in connection with a press release announcing our financial results and accomplishments for the three and nine months ended July 31, 2006.

EXHIBITS

EXHIBITS TO THE 10-K

Exhibit No.	Description
3.1	Certificate of Incorporation of the Registrant, as amended, July 12, 1999 (incorporated by reference to exhibit of the same number contained in the Company's Form 8-K dated September 21, 1999)
3.1.1	Certificate of Amendment of the Certificate of Incorporation of the Registrant, dated October 31, 2003 (incorporated by reference to exhibit of the same number contained in the Company's Form 8-K dated November 4, 2003)
3.2	Restated By-Laws of the Registrant, dated July 13,1999 (incorporated by reference to exhibit of the same number contained in the Company's Form 8-K dated September 21, 1999)
4	Specimen of Common Share Certificate (incorporated by reference to exhibit of the same number contained in the Company's Annual Report on Form 10K/A for fiscal year ended October 31, 1999)
10.6	**License Agreement, dated February 11, 1988, between Electric Power Research Institute and the Company (confidential treatment requested) (incorporated by reference to exhibit of the same number contained in the Company's Registration Statement on Form S-1 (File No. 33-47233) dated April 14, 1992)
10.21	*FuelCell Energy, Inc. 1988 Stock Option Plan (incorporated by reference to exhibit of the same number contained in the Company's Amendment No. 1 to its Registration Statement on Form S-1 (File No. 33-47233) dated June 1, 1992)
10.26	Addendum to License Agreement, dated as of September 29, 1989, between Messerschmitt-Bölkow-Blohm and the Company (incorporated by reference to exhibit of the same number contained in the Company's Amendment No. 3 to its Registration Statement on Form S-1 (File No. 33-47233) dated June 24, 1992)
10.27	Cross-Licensing and Cross-Selling Agreement, as amended December 15, 1999, between the Company and MTU CFC Motoren-Und Turbinen-Union Friedrichshafen GmbH ("MTU CFC") (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended January 31, 2000)
10.31	License Agreement for The Santa Clara Demonstration Project between the Company and the Participants in the Santa Clara Demonstration Project, dated September 16, 1993 (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1993, dated January 18, 1994)

10.32	Security Agreement for the Santa Clara Demonstration Project, dated September 16, 1993 (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1993, dated January 18, 1994)
10.33	Guaranty By FuelCell Energy, Inc., dated September 16, 1993, for the Santa Clara Demonstration Project (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1993, dated January 18, 1994)
10.36	*The FuelCell Energy, Inc. Section 423 Stock Purchase Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1994 dated January 18, 1995)

EXHIBITS TO THE 10-K

Exhibit No.	Description
10.39	**Cooperative Agreement, dated December 20, 1994, between the Company and the United States Department of Energy, Cooperative Agreement #DE-FC21-95MC31184 (confidential treatment requested) (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1994 dated January 18, 1995)
10.40	Loan and Security Agreement between the Company and MetLife Capital Corporation (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1995 dated January 17, 1996)
10.41	*Amendment No. 2 to the FuelCell Energy, Inc. Section 423 Stock Purchase Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended April 30, 1996 dated June 13, 1996)
10.42	*Amendments to the FuelCell Energy, Inc. 1988 Stock Option Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended April 30, 1996 dated June 13, 1996)
10.47	Amendment of Cooperative Agreement dated September 5, 1996 between the Company and the United States Department of Energy, Cooperative Agreement #DE-FC21-95MC31184 (incorporated by reference to exhibit of the same number contained in the Company's 10-K for the fiscal year ended October 31, 1998)
10.48	*Employment Agreement between FuelCell Energy, Inc. and the Chief Financial Officer, Treasurer and Secretary, dated October 5, 1998 (incorporated by reference to exhibit of the same number contained in the Company's 10-K for the fiscal year ended October 31, 1998)
10.49	*Employment Agreement between FuelCell Energy, Inc. and the President and Chief Executive Officer, dated August 1, 1997 (incorporated by reference to exhibit of the same number contained in the Company's 10-K for the fiscal year ended October 31, 1997)
10.50	**Technology Transfer and License Agreement between the Company and the Joint Venture owned jointly by the Xiamen Daily-Used Chemicals Co., Ltd. Of China and Nan Ya Plastics Corporation of Taiwan, dated February 21, 1998 (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended April 30, 1998)
10.54	*The FuelCell Energy, Inc. 1998 Equity Incentive Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 1998)

10.55	Lease agreement, dated March 8, 2000, between the Company and Technology Park Associates, L.L.C. (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended April 30, 2000)
10.56	Security agreement, dated June 30, 2000, between the Company and the Connecticut Development Authority (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 2000)
10.57	Loan agreement, dated June 30, 2000, between the Company and the Connecticut Development Authority (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 2000)

EXHIBITS TO THE 10-K

Exhibit No.	Description
10.58	*Modification, dated June 20, 2002, to the Employment Agreement between FuelCell Energy, Inc. and the President and Chief Executive Officer (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 2002)
10.59	*Modification, dated January 12, 2006, to the Employment Agreement between FuelCell Energy, Inc. and the Jerry D. Leitman (incorporated by reference to exhibit of the same number contained in the Company's 8-K dated January 17, 2006).
10.60	* Employment Agreement, dated January 12, 2006, between R. Daniel Brdar (incorporated by reference to exhibit of the same number contained in the Company's 8-K dated January 17, 2006).
14	Code of Ethics applicable to the Company's principal executive officer, principal financial officer and principal accounting officer. (incorporated by reference to exhibit of the same number contained in the Company's 10-K for the year ended October 31, 2004)
21	Subsidiaries of the Registrant
23.1	Consent of Independent Public Accounting Firm
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

* Management Contract or Compensatory Plan or Arrangement

** Confidential Treatment has been granted for portions of this document

SIGNATURES

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.

FUELCELL ENERGY, INC.

/s/ R. Daniel Brdar

R. Daniel Brdar
Chariman, President and Chief Executive Officer

Dated: January 12, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ R. Daniel Brdar R. Daniel Brdar	Chairman, President, and Chief Executive Officer (Principal Executive Officer)	January 12, 2007
/s/ Joseph G. Mahler Joseph G. Mahler	Senior Vice President, Chief Financial Officer, Corporate Secretary and Treasurer (Principal Accounting and Financial Officer)	January 12, 2007
/s/ Warren D. Bagatelle Warren D. Bagatelle	Director	January 10, 2007
/s/ Michael Bode Michael Bode	Director	January 14, 2007
/s/ James D. Gerson James D. Gerson	Director	January 13, 2007
/s/ Thomas L. Kempner Thomas L. Kempner	Director	January 10, 2007
/s/ William A. Lawson William A. Lawson	Director	January 11, 2007
/s/ Charles J. Murphy Charles J. Murphy	Director	January 12, 2007
George K. Petty	Director	
/s/ John A. Rolls John A. Rolls	Director	January 10, 2007

INDEX OF EXHIBITS

Exhibit 21 Subsidiaries of the registrant

Exhibit 23.1 Consent of Independent Registered Public Accounting Firm

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

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

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

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