FUELCELL ENERGY INC
Form 10-Q
September 11, 2006

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

Form 10-Q

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

for the quarterly period ended July 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 (Address of Principal Executive Offices)	**06813** (Zip Code)

(203) 825-6000
(Registrant's Telephone Number, including Area Code)

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

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 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

Common Stock, par value $.0001 per share, outstanding at September 6, 2006: 53,129,693

FUELCELL ENERGY, INC.

FORM 10-Q

As of and for the Three and Nine Month Periods Ended July 31, 2006

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

	July 31, 2006 (Unaudited)	[Revised] October 31, 2005
ASSETS		
Current assets :		
Cash and cash equivalents	$ 19,480	$ 22,702
Investments: U.S. treasury securities	82,616	113,330
Accounts receivable, net of allowance for doubtful accounts of $70 and $104, respectively	9,886	10,062
Inventories, net	14,688	12,141
Other current assets	4,096	3,659
Total current assets	130,766	161,894
Property, plant and equipment, net	49,568	46,705
Investments: U.S. treasury securities	31,489	43,928
Equity investments	11,596	12,473
Other assets, net	422	520
Total assets	$ 223,841	$ 265,520
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and other liabilities	$ 398	$ 503
Accounts payable	9,523	6,221
Accrued liabilities	6,787	7,018
Deferred license fee income	112	38
Deferred revenue and customer deposits	11,285	9,366
Total current liabilities	28,105	23,146
Long-term debt and other liabilities	551	904
Total liabilities	28,656	24,050
Redeemable preferred stock ($0.01 par value, liquidation preference of $64,120 and $105,875 at July 31, 2006 and October 31, 2005, respectively)	59,950	98,989
Shareholders' equity:		
Preferred shares of subsidiary (convertible into FuelCell Common Stock)	12,547	11,517
Common stock ($.0001 par value); 150,000,000 shares authorized; 53,108,026 and 48,497,088 shares issued and outstanding at July 31, 2006 and October 31, 2005, respectively.	5	5
Additional paid-in capital	464,864	421,298
Accumulated deficit	(342,181)	(290,339)
Treasury stock, Common at cost (15,583 and 4,279 shares in 2006 and 2005)	(44)	(44)
Deferred compensation	44	44
Total shareholders' equity	135,235	142,481
Total liabilities and shareholders' equity	$ 223,841	$ 265,520

See accompanying notes to consolidated financial statements

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

	Three Months Ended July 31,	
	2006	**2005**
Revenues:		
Product sales and revenues	$ 5,376	$ 4,877
Research and development contracts	3,307	3,865
Total revenues	8,683	8,742
Costs and expenses:		
Cost of product sales and revenues	15,240	13,827
Cost of research and development contracts	2,647	3,665
Administrative and selling expenses	4,320	4,049
Research and development expenses	6,621	5,732
Total costs and expenses	28,828	27,273
Loss from operations	(20,145)	(18,531)
License fee income (expense), net	(7)	69
Interest expense	(22)	(6)
Loss from equity investments	(275)	(510)
Interest and other income, net	1,737	1,976
Loss before provision for income taxes	(18,712)	(17,002)
Provision for income taxes	—	—
Net loss	(18,712)	(17,002)
Preferred stock dividends	(1,082)	(1,576)
Net loss to common shareholders	$ (19,794)	$ (18,578)
Loss per share basic and diluted:		
Net loss per share to common shareholders	$ (0.37)	$ (0.38)
Basic and diluted weighted average shares outstanding	53,116,670	48,275,315

See accompanying notes to consolidated financial statements

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

	Nine Months Ended July 31,	
	2006	**2005**
Revenues:		
Product sales and revenues	$ 14,863	$ 13,257
Research and development contracts	9,298	9,153
Total revenues	24,161	22,410
Costs and expenses:		
Cost of product sales and revenues	40,332	38,138
Cost of research and development contracts	8,283	9,095
Administrative and selling expenses	13,238	10,793
Research and development expenses	17,898	16,244
Total costs and expenses	79,751	74,270
Loss from operations	(55,590)	(51,860)
License fee income, net	45	172
Interest expense	(76)	(79)
Loss from equity investments	(715)	(1,185)
Interest and other income, net	4,491	3,947
Loss before provision for income taxes	(51,845)	(49,005)
Provision for income taxes	—	—
Loss from continuing operations	(51,845)	(49,005)
Discontinued operations, net of tax	—	(1,252)
Net loss	(51,845)	(50,257)
Preferred stock dividends	(8,139)	(4,491)
Net loss to common shareholders	$ (59,984)	$ (54,748)
Loss per share basic and diluted:		
Continuing operations	$ (1.19)	$ (1.11)
Discontinued operations	—	(.03)
Net loss per share to common shareholders	$ (1.19)	$ (1.14)
Basic and diluted weighted average shares outstanding	50,341,771	48,205,160

See accompanying notes to consolidated financial statements

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

	Nine Months Ended July 31,	
	2006	**2005**
Cash flows from operating activities:		
Net loss	$ (51,845)	$ (50,257)
Adjustments to reconcile net loss to net cash used in operating activities, net of effects of acquisition:		
Loss from discontinued operations	—	1,252
Asset impairment	—	994
Share-based compensation	3,211	—
Loss in equity investments	715	1,185
Depreciation and amortization	6,820	5,775
Amortization (accretion) of bond premium (discount)	97	(611)
Provision for doubtful accounts	34	256
(Increase) decrease in operating assets:		
Accounts receivable	317	(5,456)
Inventories	(2,547)	1,352
Other assets	(550)	(923)
Increase (decrease) in operating liabilities:		
Accounts payable	3,289	(2,345)
Accrued liabilities	1,057	(128)
Deferred revenue and customer deposits	1,919	1,514
Deferred license fee income and other	74	76
Net cash used in operating activities	(37,409)	(47,316)
Cash flows from investing activities:		
Capital expenditures	(9,469)	(10,463)
Treasury notes matured	149,900	274,858
Treasury notes purchased	(106,844)	(342,262)
Net cash provided by (used in) investing activities	33,587	(77,867)
Cash flows from financing activities:		
Repayment on long-term debt	(458)	(327)
Net proceeds from issuance of common stock	7,812	—
Net proceeds from issuance of preferred stock	—	99,007
Payment of preferred dividends	(8,129)	(2,997)
Common stock issued for option and stock purchase plans	1,375	555
Net cash provided by financing activities	600	96,238
Net increase (decrease) in cash and cash equivalents	(3,222)	(28,945)
Cash and cash equivalents-beginning of period	22,702	45,759
Cash and cash equivalents-end of period	$ 19,480	$ 16,814

See accompanying notes to consolidated financial statements

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FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2006 and 2005
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

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 are currently in the process of commercializing 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.

Basis of Presentation - Interim Consolidated financial statements

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"), for interim financial information, and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not contain all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary to present fairly our financial position as of July 31, 2006 have been included. The balance sheet as of October 31, 2005 has been derived from the audited financial statements at that date. The consolidated balance sheet as of October 31, 2005 has been revised to reclassify the 5% Series B Cumulative Convertible Perpetual Preferred Stock ("Series B Preferred Stock") out of the general heading of shareholders' equity and into temporary equity.

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

The results of operations and cash flows for the three and nine months ended July 31, 2006 are not necessarily indicative of the results to be expected for the full year. The reader should supplement the information in this document with prior disclosures in our 2005 Annual Report on Form 10-K.

Consolidation

The consolidated financial statements include our accounts and those of our subsidiaries, including our Canadian subsidiary, FuelCell Energy, Ltd., and a subsidiary formed in April 2006, Bridgeport Fuel Cell Park, LLC, for the purpose of developing a 10 MW fuelcell park to be located in Bridgeport. 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.

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Notes to Consolidated Financial Statements
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Foreign Currency

Our Canadian subsidiary, FuelCell Energy, Ltd., is financially and operationally integrated and therefore the temporal method of translation of foreign currencies is followed. The functional currency is U.S. dollars. We recognized foreign currency losses of approximately ($0.04) million and ($0.01) million for the three and nine months ended July 31, 2006, respectively. A foreign currency gain of approximately $0.01 million and a foreign currency loss of approximately ($0.05) million were recognized in the three and nine months ended July 31, 2005, respectively. These amounts have been classified in interest and other income on our consolidated statements of operations.

Comprehensive Loss

Comprehensive losses were $18.7 million and $51.8 million for the three and nine months ended July 31, 2006, respectively. Comprehensive losses were $17.0 million and $50.5 million for the three and nine months ended July 31, 2005, respectively. Comprehensive loss for the nine months ended July 31, 2005 included an adjustment to retained earnings totaling approximately $0.2 million as a result from switching from the cost to equity method of accounting for our investment in Versa. Refer also to Note 3 - Equity Investments.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 123 (revised 2004) (“SFAS No. 123R”), “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, utilizing the modified prospective method. Share-based compensation of $1.1 million and $3.2 million was recognized in the consolidated statements of operations for the three and nine months ended July 31, 2006, respectively. Refer to Note 7 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. FIN 47 is effective for fiscal years ending after December 15, 2005, or no later than our fiscal fourth quarter of 2006. We have not yet determined the impact of adopting this statement on our consolidated financial statements.

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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 a 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 situation.

Reclassification of Series B Cumulative Convertible Perpetual Preferred Stock

On November 11, 2004, the Company 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, the Company closed on the sale of 100,000 shares and 5,875 shares, respectively, of Series B Preferred Stock to the Initial Purchasers. The carrying value of the Series B Preferred Stock as of October 31, 2005 represents the net proceeds to us of approximately $99.0 million and the carrying value as of July 31, 2006 of approximately $60.0 million represents the net proceeds to us related to the remaining shares of Series B Preferred Stock outstanding after converting 41,755 of these shares into common stock during the nine months ended July 31, 2006.

Redemption by holders of the Series B Preferred Stock can only occur upon a fundamental change. Upon a fundamental change as set forth in the Certificate of Designation for the Series B Preferred Stock and subject to certain exceptions, holders of the Series B Preferred Stock may require the Company 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. 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.

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.

Refer to Note 8 of Notes to Consolidated Financial Statements for additional information.

Note 2. Discontinued Operations

During fiscal 2004, we acquired, Global Thermoelectric Inc. (Global) and subsequently divested its generator product line through the sale of Global on May 28, 2004. As a result, historical results were reclassified as discontinued operations. During the nine months ended July 31, 2005, we exited certain facilities related to this business 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 total loss from discontinued operations of approximately $1.3 million. There were no discontinued operations during the three or nine months ended July 31, 2006.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
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Note 3. Equity Investments

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 $11.6 million and $12.3 million as of July 31, 2006 and October 31, 2005, respectively. Our current ownership interest is 39 percent and we account for Versa under the equity method of accounting.

Note 4. 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 July 31, 2006 and October 31, 2005:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
At July 31, 2006				
U.S. government obligations	$ 114,105	$ 135	$ (571)	$ 113,669
At October 31, 2005				
U.S. government obligations	$ 157,258	$ —	$ (606)	$ 156,652

Reported as:

	July 31, 2006	October 31, 2005
Short-term investments	$ 82,616	$ 113,330
Long-term investments	31,489	43,928
Total	$ 114,105	$ 157,258

As of July 31, 2006, short-term investment securities have maturity dates ranging from August 15, 2006 to July 31, 2007, and estimated yields ranging from 3.32 percent to 5.02 percent. Long-term investment securities have maturity dates ranging from August 15, 2007 to March 31, 2008, and estimated yields ranging from 3.72 percent to 5.16 percent. Our weighted average yield on our short and long-term investments was 4.36 percent as of July 31, 2006.

FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2006 and 2005
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Note 5. Inventories

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

	July 31, 2006	October 31, 2005
Raw materials	$ 5,598	$ 4,772
Work-in-process	9,090	7,369
Total	$ 14,688	$ 12,141

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

Note 6. Property, Plant and Equipment

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

	July 31, 2006	October 31, 2005	Estimated Useful Life
Land	$ 524	$ 524	—
Building and improvements	5,989	5,978	10-30 years
Machinery, equipment and software	50,863	49,435	3-8 years
Furniture and fixtures	2,454	2,354	6-10 years
Equipment leased to others	2,063	2,063	3 years
Power plants for use under power purchase agreements	18,504	15,331	10 years
Construction in progress[(1)]	7,271	2,764	
	$ 87,668	$ 78,449	
Less, accumulated depreciation and amortization	(38,100)	(31,744)	
Total	$ 49,568	$ 46,705	

(1) Included in construction in progress are costs of approximately $5.0 million and $1.5 million at July 31, 2006 and October 31, 2005, respectively, to build power plants, which will service power purchase agreement contracts.

Depreciation expense was approximately $6.6 million and $5.6 million for the nine months ended July 31, 2006 and 2005, respectively.

There were no asset impairment charges during the nine months ended July 31, 2006. During the nine months ended July 31, 2005, we recorded a fixed asset impairment charge, related to an obsolete catalyst extruding system totaling $1.0 million, against cost of product sales. This was related to a planned change in manufacturing processes that is expected to improve product performance and reduce costs in future periods. In addition, during the nine months ended July 31, 2005, we recorded a fixed asset impairment charge to discontinued operations totaling $0.9 million related to excess facilities in Calgary, Alberta, Canada.

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FUELCELL ENERGY, INC.
Notes to Consolidated Financial Statements
As of and for the three and nine months ended July 31, 2006 and 2005
(Unaudited)
(Tabular amounts in thousands, except share and per share amounts)

Note 7. Share-Based Compensation

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

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 was $1.1 million and $3.2 million for the three and nine months ended July 31, 2006, respectively. For the three months ended July 31, 2006, share-based compensation expense included $0.2 million in cost of product sales and revenues, $0.05 million in cost of research and development contracts, $0.7 million in general and administrative expense and $0.2 million in research and development expenses. For the nine months ended July 31, 2006, share-based compensation expense included $0.5 million in cost of product sales and revenues, $0.1 million in cost of research and development contracts, $2.1 million in general and administrative expense and $0.5 million in research and development expenses. There was no share-based compensation expense recognized in the consolidated statement of operations for the three or nine months ended July 31, 2005.

The following table illustrates the effect on net loss and net loss per basic and diluted share for the three and nine months ended July 31, 2005 as if we had applied the fair value method to our share-based compensation:

	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2005
Net loss to common shareholders, as reported	$ (18,578)	$ (54,748)
Add: Share-based employee compensation expense included in reported net loss	—	—
Less: Total share-based employee compensation expense determined under the fair value method for all awards	(2,074)	(5,463)
Pro forma net loss to common shareholders	$ (20,652)	$ (60,211)
Loss per basic and diluted common share to common shareholders, as reported	$ (0.38)	$ (1.14)
Pro forma loss per basic and diluted common share to common shareholders	$ (0.43)	$ (1.25)

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 July 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 July 31, 2006 and 2005.

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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 the three and nine months ended July 31, 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 the three and nine months ended July 31, 2005 is based on the historical volatility of the Company's stock. We use historical data to estimate the expected term of options granted.

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	**2005**	**2006**	**2005**
Expected life (in years)	6.27	6.25	6.31	6.25
Risk-free interest rate	4.91%	3.86%	4.57%	4.04%
Volatility	58.1%	72.04%	56.6%	73.19%
Dividend yield	—	—	—	—

The following table summarizes the Plans' stock option activity for the nine months ended July 31, 2006:

	Number of options	**Weighted average option price**
Outstanding at October 31, 2005	5,886,336	$ 10.26
Granted	1,078,858	10.05
Exercised	(276,978)	4.42
Forfeited/Cancelled	(147,737)	16.35
Outstanding at July 31, 2006	6,540,479	$ 10.33

The weighted average grant-date fair value per share for options granted during the three and nine months ended July 31, 2006 was $5.47 and $5.92, respectively, and was $6.24 and $6.03, respectively, for the three and nine months ended July 31, 2005. The total intrinsic value of options outstanding and options exercisable at July 31, 2006 was $13.2 million and $12.6 million, respectively. The total intrinsic value of options exercised during the three and nine months ended July 31, 2006 was $0.2 million and $2.1 million, respectively, and was $0.1 million and $0.4 million for the three and nine months ended July 31, 2005, respectively.

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The following table summarizes information about stock options outstanding and exercisable at July 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
$0.28 - $5.10	1,592,300	1.32	1.67	1,591,800	1.66
$5.11 - $9.92	1,704,505	7.83	7.92	654,814	7.16
$9.93 - $14.74	2,070,056	7.43	12.41	1,078,632	13.41
$14.75 - $19.56	658,618	4.39	17.59	649,368	17.61
$19.57 - $24.39	246,000	4.71	23.01	246,000	23.01
$24.40 - $29.21	27,000	4.49	26.15	27,000	26.15
$29.22 - $34.03	178,000	4.38	29.91	178,000	29.91
$34.04 - $48.49	64,000	4.20	38.50	64,000	38.50
	6,540,479	5.51	10.33	4,489,614	10.55

As of July 31, 2006, total compensation cost related to nonvested stock options not yet recognized was $11.1 million, which is expected to be recognized over the next 1.5 years on a weighted-average basis.

During the first nine months of 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). These shares were fully vested at the date of grant. No shares of common stock were issued to directors during the nine months ended July 31, 2005.

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 July 30, 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.

Activity in the ESPP for the nine months ended July 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 July 31, 2006	355,587

The weighted-average grant date fair value of shares under the ESPP during the three and nine months ended July 31, 2006 was $4.07 and $3.27, respectively.

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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:

	Three months ended July 31, 2006	Nine months ended July 31, 2006
Expected life (in years)	.5	.5
Risk-free interest rate	5.0%	4.6%
Volatility	51.0%	50.2%
Dividend yield	—	—

Incentive Compensation

Stock may be issued to employees as part of the annual incentive bonus. During the nine months ended July 31, 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).

Note 8. Shareholders' Equity

Changes in shareholders' equity were as follows for the nine months ended July 31, 2006:

Balance at October 31, 2005 (revised)	**$**	**142,481**
Increase in additional paid-in-capital for conversion of Series B redeemable preferred stock		39,039
Sale of common stock		7,803
Increase in additional paid-in-capital for 2006 share-based compensation		3,211
Increase in additional paid-in-capital for stock issued under employee benefit plans		2,231
Accretion of fair value discount of preferred stock		1,030
Reduction of additional paid in capital for accretion of discount		(1,030)
Series B preferred dividends		(7,309)
Series 1 preferred dividends		(380)
Net loss		(51,845)
Balance at July 31, 2006	**$**	**135,235**

Sale of Common Stock

During the nine months ended July 31, 2006, we sold 661,000 shares of our common stock. Total net proceeds to us from the sale of these securities was approximately $7.8 million and was used to pay the conversion premium on the converted shares of our Series B Preferred Stock, discussed below, and to pay dividends on our Series B 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 July 31, 2006 and October 31, 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, 2005 represents the net proceeds to us of approximately $99.0 million. The carrying value of approximately $60.0 million represents the net proceeds to us related to number of shares of Series B Preferred Stock outstanding as of July 31, 2006.

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During the nine months ended July 31, 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 and was accounted for as a dividend in the Consolidated Statements of Operations.

Shares of our Series B Preferred Stock will not be redeemable by us, except in the case of a fundamental change (as set forth below) 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. The conversion price of the Series B Preferred Stock is subject to adjustment in certain circumstances as set forth in the Company’s Certificate of Designation for the Series B Preferred Stock to prevent dilution of the interests of the holders of the Series B Preferred Stock. 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.

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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.

Series 1 Preferred Shares

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 equivalent Series 1 Preferred shares issued by FuelCell Energy, Ltd. The Series 1 Preferred shares are convertible at the option of the holder into a certain number of FuelCell Energy, Inc. common shares based on the date of conversion.

As of November 3, 2003, the acquisition date of Global, the fair value of the Series 1 Preferred shares was determined to be $9.1 million. This valuation was performed 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. In discounting future cash flows, a discount rate of 13 percent was used which is a rate comparable to yield indexes of technology high yield bonds trading as of the valuation date. In addition to the discount rate, as these securities are not publicly traded, the valuation assumed an additional marketability discount of 15 percent. 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 July 31, 2006, the Series 1 Preferred shares had an accreted value of $12.5 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. 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.

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.

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.

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Warrants

We issued warrants to purchase shares of our common stock to Marubeni Corp. and Enbridge Inc. as part of their distribution agreements. The warrants for each distributor vest in separate tranches if certain order levels are received by specified dates. As of July 31, 2006, Marubeni held 400,000 unvested warrants and Enbridge held 1,000,000 unvested warrants.

Note 9. 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.

Enterprise-wide Information

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

	Three months ended July 31,		Nine months ended July 31,	
Revenues:	**2006**	**2005**	**2006**	**2005**
United States	$ 6,606	$ 6,291	$ 18,686	$ 15,625
Japan	*	1,912	*	4,796
Germany	1,215	*	4,084	*

Information about Major Customers

We contract with a small number of customers for the sales of our products or research and development contracts. Those customers that accounted for greater than ten percent of our total revenues during the three and nine months ended July 31, 2006 and 2005 are as follows:

	Three months ended July 31,		Nine months ended July 31,	
	2006	**2005**	**2006**	**2005**
U.S. Government (1)	37%	43%	37%	39%
Marubeni Corporation	*%	22%	*%	21%
MTU CFC Solutions, GmbH	14%	*%	17%	*%
Logan Energy	11%	*%	11%	*%
Alliance Power, Inc.	18%	*%	*%	*%

* 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.

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Note 10. Earnings Per Share

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

	Three months ended July 31,		Nine months ended July 31,	
	2006	**2005**	**2006**	**2005**
Weighted average basic common shares	53,116,670	48,275,315	50,341,771	48,205,160
Effect of dilutive securities[1]	—	—	—	—
Weighted average basic common shares adjusted for diluted calculations	53,116,670	48,275,315	50,341,771	48,205,160

(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 July 31, 2006 and 2005 totaled 2.8 million and 3.2 million, respectively. Future potentially dilutive stock options that were not in-the-money at July 31, 2006 and 2005 totaled 3.7 million and 2.6 million, respectively. We also have issued warrants, which vest and expire over time. These warrants, if dilutive, would be excluded from the calculation of EPS since their vesting is contingent upon certain future performance requirements that are not yet probable.

Note 11. Supplemental Cash Flow Information

The following represents supplemental cash flow information:

	Nine Months Ended July 31,	
	2006	**2005**
Cash paid during the period for:		
Interest	$ 75	$ 78
Taxes	$ 282	$ 276
Supplemental disclosure of non-cash investing and financing activities:		
Assets and liabilities, net, invested in Versa Power Systems, Inc.	$ —	$ 12,132

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

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is provided as a supplement to the accompanying consolidated 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. This section provides a general description of our business and where investors can find additional information.

Recent developments. This section provides a brief overview of any significant events occurring subsequent to the close of the reporting period.

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

Results of operations. This section provides an analysis of our results of operations for the three and nine months ended July 31, 2006 and 2005, respectively. In addition, a brief description is provided for 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 discusses any new accounting pronouncements that had an impact on our consolidated financial statements during the reporting period.

CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

The following discussion should be read in conjunction with the accompanying Unaudited Consolidated Financial Statements and Notes thereto included within this report, and our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended October 31, 2005. In addition to historical information, this Form 10-Q and the following discussion contain forward-looking statements. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. Factors that could cause such a difference include, without limitation, general risks associated with product development, manufacturing, changes in the utility regulatory environment, potential volatility of energy prices, rapid technological change, ability to reach product cost objectives, and competition, as well as other risks set forth in our filings with the Securities and Exchange Commission including those set forth under the caption "Risk Factors" in our Annual Report on Form 10-K filed for the fiscal year ended October 31, 2005.

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 clean, efficient and reliable electric power generation. We have been developing fuel cell technology since our founding in 1969. We are currently commercializing our core carbonate fuel cell products (Direct FuelCell® or DFC® power plants"), offering stationary applications for commercial and industrial customers and continuing to

develop our next generation of carbonate fuel cell products. In addition, we are developing another high temperature fuel cell system, planar solid oxide fuel cell ("SOFC") technology, as a prime contractor in the U.S. Department of Energy's ("DOE") Solid State Energy Conversion Alliance ("SECA") Program and through our ownership interest in Versa Power Systems, Inc. ("Versa").

Our proprietary carbonate DFC power plants electrochemically produce electricity directly from readily available hydrocarbon fuels, such as natural gas and biomass fuels. We believe our products offer significant advantages compared to other power generation technologies. The primary benefits to our customers include:

- High fuel efficiency;
- Ultra-clean emissions;
- High reliability;
- Firm, 24/7 base load power; and,
- The ability to site units locally and provide heat for cogeneration applications.

Other customer benefits of our DFC power plants include:

- Quiet operation;
- Flexible siting and permitting capabilities;
- Potentially lower operating, maintenance and generation costs than alternative distributed power generation technologies and the grid; and,
- The ability to provide end users with greater control of their energy source costs and reliability.

The demand for reliable, clean and economical power is increasing worldwide. Volatile fuel and energy prices, the ratification of the Kyoto Protocol by over 140 countries in 2005 and other strict emissions guidelines mandating clean electric power generation are placing greater emphasis on high efficiency distributed generation products that are ultra-clean. Electric generation without combustion (ultra-clean) significantly reduces harmful pollutants such as NOX, SOX and particulates. Higher efficiency results in lower emissions of carbon dioxide, a major contributor of harmful greenhouse gases. Higher efficiency also results in less fuel per kWh of electricity and Btu of heat produced, thereby reducing operating costs.

Our core products, the DFC300MA, DFC1500MA and DFC3000, are currently rated in capacity at 300 kW, 1.2 MW and 2.4 MW, respectively. Our products are designed to meet the base load power requirements of a wide range of commercial and industrial 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. Ideally, our DFC power plants are part of a total onsite power generation solution for commercial and industrial customers, with our high efficiency products providing the base load power. Grid-delivered electricity or less efficient combustion-based equipment can provide peaking and load following energy needs. Through July 31, 2006, over 124 million kWhs of electricity have been generated from power plants incorporating our DFC technology at over 50 customer sites worldwide.

While our products compete essentially on price with gas engines, turbines and the grid, we believe that the attributes of our DFC products enhance our value proposition. For example, in some regions with strict air emissions controls, the ‘ultra-clean’ designation of our DFC power plants enables our products to be sited where combustion-based technologies cannot. As an ultra-clean technology, our products benefit from: (1) preferential rate treatment, such as the elimination of exit fees and standby charges for onsite electric generation; (2) a streamlined installation process with exemptions from air pollution control or air quality district permitting requirements; and (3) qualification for government-sponsored incentive programs for clean, high efficiency and firm 24/7 power generation.

While we believe that we are making significant progress, we continue to face obstacles that can lengthen the sales cycle. Recently, sales have been impacted by volatile fuel prices and lagging electric rates. We can face regulatory uncertainty for distributed generation, long capital appropriation cycles, interconnect issues, disparate recognition of the locational value and environmental benefits of distributed generation, standby power costs and stranded asset exit fees. In addition, due to the early commercialization stage of our DFC power plants and our low volume of sales, our

product pricing is generally higher than competing products that are more mature. These factors can slow and constrict our sales cycle and delay our growth. Our sales for the last two years have been approximately 6 MW of power plants per year. In 2006, we have increased our production rate to 9 MW of power plants per year.

We are currently selling our products to customers in high cost electricity markets. We believe that market clearing prices in California and the Northeast are between $2,000 and $3,000 per kW and up to $4,000/kW in Asia and for mission-critical applications that demand higher reliability. The manufactured cost of our standard sub-MW product design at the end of 2005 was approximately $4,600 per kW (reduced from approximately $6,200/kW at the end of 2004) and our 1 MW product was approximately $4,300/kW. Our cost reduction plans and increased volume will bring us closer to market clearing prices through process improvements, value engineering, supplier/purchasing opportunities, and product output and efficiency improvements.

We recently announced an advanced cell stack design that boosts the power output of our DFC power plants by 20 percent. The enhancement is being incorporated across our entire line of power plants, increasing power output to 2.4 megawatts, 1.2 megawatts and 300 kilowatts. This increase in power output is a major milestone toward achieving the Company’s cost target for the multi-megawatt power plant. In addition, the Company has completed most of the component sourcing for this product line and remains on track to produce a DFC3000 power plant with a cost between $3,200/kW and $3,500/kW, and below $3,000/kW with increased volume.

RECENT DEVELOPMENTS

Change in Executive Management

On January 12, 2006, we announced that R. Daniel Brdar was promoted to President and Chief Executive Officer. Jerry D. Leitman retained the position of Chairman of the Board in the Company's planned management succession.

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 will be 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 will focus 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 $0.09 per basic and diluted share during the nine months ended July 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 661,000 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 $7.8 million and was used to pay the $4.3 million conversion premium on the converted shares of our Series B Preferred Stock and 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 $1.1 million and $3.2 million was recognized in the consolidated statement of operations for the three and nine months ended July 31, 2006, respectively. Refer to Note 7 of the consolidated financial statements for additional information.

Available Information

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

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

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

While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress has authorized the funds. As of July 31, 2006, research and development sales backlog totaled $9.8 million, of which 73 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 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 recognized ratably over the contract term. Revenue from electricity sales under power purchase agreements are recognized as power is produced. Revenue from incentive funding is 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 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. Fair value is determined through market sources, option pricing models and management estimates.

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 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 July 31, 2006 and October 31, 2005, the LCM adjustment to the cost basis of inventory and advance payments to vendors was approximately $11.2 million and $8.0 million, respectively, which equates to a reduction of approximately 42 and 39 percent, respectively, of the gross value of inventory and advance payments to vendors. The increase in reserve percentage relates to the current mix of inventory on hand. 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.

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, margins and cost ratios compared to prior periods and internal forecasts, costs of our products and results of our "cost-out" initiatives, and operating cash use. These are discussed throughout the 'Results of Operations' and 'Liquidity and Capital Resources' sections.

Comparison of Three Months ended July 31, 2006 and July 31, 2005

Revenues and costs of revenues

The following tables summarize the components of our revenues and cost of revenues for the three months ended July 31, 2006 and 2005 (dollar amounts in thousands), respectively:

	Three Months Ended July 31, 2006		Three Months Ended July 31, 2005		Percentage Increase in Revenues
	Revenues	Percent of Revenues	Revenues	Percent of Revenues	
Revenues:					
Product sales and revenues	$ 5,376	62%	$ 4,877	56%	10%
Research and development contracts	3,307	38%	3,865	44%	(14)%
Total	$ 8,683	100%	$ 8,742	100%	(1)%

	Three Months Ended July 31, 2006		Three Months Ended July 31, 2005		Percentage Increase 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	$ 15,240	85%	$ 13,827	79%	10%
Research and development contracts	2,647	15%	3,665	21%	(28)%
Total	$ 17,887	100%	$ 17,492	100%	2%

Total revenues of $8.7 million for the three months ended July 31, 2006 decreased by $0.1 million, or 1 percent from the same period last year. Components of revenues and costs of revenues are as follows:

Product sales and revenues

Product sales and revenue increased $0.5 million to $5.4 million or 10% for the three months ended July 31, 2006, compared to $4.9 million for the same period in 2005. Revenue during the quarter included approximately $4.7 million of product and stack components and approximately $0.7 million of revenue on power purchase and service agreements. The increase in product sales and revenues is primarily due to a 1 MW order received during the second fiscal quarter and the timing of customer delivery requirements on existing backlog.

At July 31, 2006, product sales backlog totaled approximately $20.0 million, compared to $23.3 million as of July 31, 2005. Included in these figures are $6.5 million and $5.7 million, respectively, related to long-term service agreements. Product backlog does not include power purchase or incentive funding agreements.

Cost of product sales and revenues increased to $15.2 million during the three months ended July 31, 2006, compared to $13.8 million during the same period of the prior year. The ratio of product cost to sales was 2.8-to-1 during both the three months ended July 31, 2006 and 2005.
Cost of product sales, and the related ratio of product costs to sales are impacted by changes in inventory levels as cost of sales includes lower of cost or market adjustments. Thus, while margins related to sales of power plants improved in the quarter over the prior year, the timing and increase of inventory receipts impacted cost of sales and the related cost ratio in the quarter. In addition, after market costs increased in the current year quarter due to an expanding power plant 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 $0.5 million to $3.3 million for the three months ended July 31, 2006, compared to $3.9 million for the same period in 2005. Research and development contract revenue for the three months ended July 31, 2006 was primarily related to solid oxide fuel cell (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.

Cost of research and development contracts decreased $1.0 million to $2.6 million during the three months ended July 31, 2006, compared to $3.7 million for the same period in 2005. The ratio of research and development cost to revenue improved to .80-to-1 from .95-to-1 over the same quarter a year ago due to the current mix of cost share contracts.

As of July 31, 2006, research and development sales backlog totaled approximately $9.8 million of which Congress has authorized funding of $7.2 million, compared to $19.2 million ($15.1 million funded) as of July 31, 2005. The Company is in final contract negotiations on two previously announced contracts from the DOE and the U.S. Navy that will add approximately $21.5 million to backlog.

Administrative and selling expenses

Administrative and selling expenses increased $0.3 million to $4.3 million during the three months ended July 31, 2006, compared to $4.0 million in the same period of the prior year. This increase is primarily due to share-based compensation of approximately $0.7 million resulting from the adoption of SFAS 123R, partially offset by lower consulting fees and a decrease in bad debt expense.

Research and development expenses

Research and development expenses increased to $6.6 million during the three months ended July 31, 2006, compared to $5.7 million recorded in the same period of the prior year. The increase in the quarter is due primarily to higher labor costs for engineers and contractors focused on achieving megawatt-class cost reductions. Increased research and development spending also related to advanced cell stack design that boosts the power output of our power plants and our efforts to extend stack life from the current three years to five years and longer.

Loss from operations

Loss from operations for the three months ended July 31, 2006 totaled $20.1 million and is approximately $1.6 million higher than the $18.5 million loss recorded in the comparable period last year. Of this increase, $1.1 million is attributable to share-based compensation expense resulting from the adoption of SFAS 123R. The remainder of the increase is primarily due to higher commercial cost of sales due to increased inventory and increased research and development spending related primarily to our MW-class products. The increase in loss from operations was partially offset by improved margins related to sales of power plants as a result of our cost-reduction efforts and a higher margin on research and development contracts.

Loss from equity investments

Our investment in Versa totaled approximately $11.6 million and $12.3 million as of July 31, 2006 and October 31, 2005, respectively. Our current ownership interest is 39% and we account for Versa under the equity method of accounting. Our share of equity losses for the three months ended July 31, 2006 and 2005 were $0.3 million and $0.5 million, respectively.

Interest and other income, net

Interest and other income, net, was $1.7 million for the three months ended July 31, 2006, compared to $2.0 million for the same period in 2005. Interest and other income decreased due to lower invested balances and lower state research and development tax credits totaling $0.2 million and $0.5 million for the three months ended July 31, 2006 and 2005, respectively. The decrease in interest income was partially offset by higher average yields on invested balances.

Provision for income taxes

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

Comparison of Nine Months ended July 31, 2006 and July 31, 2005

Revenues and costs of revenues

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

	Nine Months Ended July 31, 2006		Nine Months Ended July 31, 2005		Percentage
	Revenues	Percent of Revenues	Revenues	Percent of Revenues	Increase in Revenues
Revenues:					
Product sales and revenues	$ 14,863	62%	$ 13,257	59%	12%
Research and development contracts	9,298	38%	9,153	41%	2%
Total	$ 24,161	100%	$ 22,410	100%	8%

	Nine Months Ended July 31, 2006		Nine Months Ended July 31, 2005		Percentage
	Costs of Revenues	Percent of Costs of Revenues	Costs of Revenues	Percent of Costs of Revenues	Increase in Costs of Revenues
Cost of revenues:					
Product sales and revenues	$ 40,332	83%	$ 38,138	81%	6%
Research and development contracts	8,283	17%	9,095	19%	(9)%
Total	$ 48,615	100%	$ 47,233	100%	3%

Total revenues for the nine months ended July 31, 2006 increased by $1.8 million, or 8 percent, to $24.2 million from $22.4 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 $1.6 million to $14.9 million for the nine months ended July 31, 2006, compared to $13.3 million for the same period in 2005. Revenue for the nine-month period included approximately $11.9 million of product and stack components and approximately $3.0 million of revenue on power purchase and service agreements. The increase in product sales and revenues is primarily due to the timing of customer delivery requirements on new and existing backlog, higher revenues on stack components and increased revenue on power purchase and service agreements over the prior year period.

Cost of product sales and revenues increased to $40.3 million during the nine months ended July 31, 2006, compared to $38.1 million during the same period of the prior year. Included in cost of sales during the nine months ended July 31, 2005 was a non-cash fixed asset impairment charge totaling $0.9 million. This was related to a planned change in manufacturing processes expected to increase electrical output (“uprate”) for improved product performance and reduced cost in future periods.

The ratio of product cost to sales improved to 2.7-to-1 during the nine months ended July 31, 2006 from 2.9-to-1 during the nine months ended July 31, 2005. This ratio is inclusive of any lower of cost or market adjustments in cost of sales related to power plants for power purchase agreements, which were $5.8 million and $7.4 million for the nine months ended July 31, 2006 and 2005, respectively. Product cost ratios related to sales of power plants have improved over the prior year as a result of our cost-reduction efforts and lower power purchase agreement costs. Cost of sales and the related cost ratio is impacted by changes in inventory mix as gross inventory increased in the year to

date period as well as by higher aftermarket costs for a larger fleet of power plants.

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 $0.1 million to $9.3 million for the nine months ended July 31, 2006, compared to $9.2 million for the same period in 2005. Cost of research and development contracts decreased to $8.3 million during the nine months ended July 31, 2006, compared to $9.1 million for the same period in 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 $2.4 million to $13.2 million during the nine months ended July 31, 2006, compared to $10.8 million in the same period of the prior year. This increase is primarily due to share-based compensation of approximately $2.1 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 R&D and commercial contracts.

Research and development expenses

Research and development expenses increased to $17.9 million during the nine months ended July 31, 2006 compared to $16.2 million recorded in the same period of the prior year. The increase in the quarter is due to development costs for sub and megawatt cost reduction, including recent achievements in advanced cell stack design that boosts the power output of our power plants by 20 percent, and costs related to our efforts to extend stack life from the current three years to five years and longer.

Loss from operations

The net result of our revenues and costs was a loss from operations for the nine months ended July 31, 2006 totaling $55.6 million. This operating loss is approximately 7 percent higher than the $51.9 million loss recorded in the comparable period last year. Operating loss was higher primarily as a result of the increases in administrative and selling expenses and research and development expenses as discussed above. The cost-to-sales ratio (gross margin) for both commercial product sales and revenues and government research and development contracts improved in the nine-month period.

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 $11.6 million and $12.3 million as of July 31, 2006 and as of October 31, 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 the nine months ended July 31, 2006 and 2005 were $0.7 million and $1.2 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 $4.5 million for the nine months ended July 31, 2006, compared to $3.9 million for the same period in 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 the nine months ended July 31, 2006 and 2005, respectively.

Discontinued operations, net of tax

There were no discontinued operations in fiscal 2006. During the nine months ended July 31, 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.

LIQUIDITY AND CAPITAL RESOURCES

We had approximately $133.6 million of cash, cash equivalents and investments as of July 31, 2006, compared to $180.0 million as of October 31, 2005. Net cash and investments used during the nine months ended July 31, 2006 was $46.4 million. Cash and investments used during the nine months ended July 31, 2006 include dividend payments on our preferred stock of $8.1 million (includes $4.3 million related to the conversion of 41,755 shares of Series B Preferred Stock), proceeds from the issuance of common stock of $7.8 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 $3.0 million.

Cash Inflows and Outflows

Cash and cash equivalents as of July 31, 2006 totaled $19.5 million, reflecting a decrease of $3.2 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 the nine months ended July 31, 2006, we used $37.4 million in cash for operating activities, compared to operating cash usage of $47.3 million during the comparable period of the prior year. Cash used in operating activities during the nine months ended July 31, 2006 consists of a net loss for the period of approximately $51.8 million, offset by non-cash adjustments totaling $10.9 million, including $3.2 million of share-based compensation and depreciation and amortization expense of $6.8 million.

In addition, cash provided by working capital totaled approximately $3.6 million, including lower accounts receivable of $0.3 million due to the timing of production and shipping milestones, higher deferred revenue of approximately $1.9 million primarily related to timing of cash receipts and production on Marubeni contracts as well as receipt of incentive funds for PPAs, and higher accounts payable and accrued liabilities of $4.3 million, partially offset by an increase in inventories of approximately $2.5 million, due to higher production levels.

Investing Activities: During the nine months ended July 31, 2006, net cash provided by investing activities totaled $33.6 million, compared with net cash used of approximately $77.9 million in the comparable period of the prior year. Capital expenditures totaled $9.5 million for the nine months ended July 31, 2006. This included approximately $6.7 million for equipment being built for power purchase agreements in our Alliance entities. During the first nine months of fiscal 2006, approximately $149.9 million of investments in U.S. Treasury Securities matured and new treasury purchases totaled $106.8 million.

Financing Activities: During the nine months ended July 31, 2006, net cash provided by financing activities was approximately $0.6 million, compared to $96.2 million in the comparable period of the prior year. For the first nine months of fiscal 2006, cash provided by financing activities related to net proceeds from the sale of common stock of approximately $7.8 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 $8.1 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. 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.

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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 of our products is key to improving our operating results in future periods. Reducing product cost 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 compete with grid-delivered power and other distributed generation technologies, and are critical to us attaining profitability. Our multi-disciplined cost reduction program focuses on value engineering, manufacturing process improvements, and technology improvements to increase power plant output and efficiency.

With the market demand shifting toward multi-MW projects as a result of emerging renewable portfolio standards programs, our focus in 2006 has been predominantly on cost reduction for the multi-megawatt DFC3000 power plant. We recently announced an advanced cell stack design that boosts the power output of our DFC power plants by 20 percent. The enhancement is being incorporated across our entire line of power plants, increasing power output to 2.4 megawatts, 1.2 megawatts and 300 kilowatts. In addition, the Company has completed most of the component sourcing for this product line and remains on track to produce a DFC3000 power plant with a cost between $3,200/kW and $3,500/kW, and below $3,000/kW with increased volume.

Increasing annual order volume

In addition to the cost reduction initiatives discussed above, we will need to increase annual order volume. We believe that 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 equipment in place to accommodate 50 MW of annual production volume. Higher production volume will require increasing the manufacturing workforce.

We currently have 6 MW in backlog and we have visibility into future order volume. California is a leading market for renewable/ultraclean products, approximately 30 percent of our installed capacity is in California and there are indications of future demand as over 8 MW has been approved for customer funding under the Self Generation Incentive Program. In Connecticut, we are partnering with multiple developers to submit initial proposals, expected to total over 40 MW, for large scale multi-MW projects to be submitted in round two under Connecticut's RPS Program, Project 100. In Asia, we extended the distribution agreement with Marubeni and obtained a commitment to order an additional 6 MW of fuel cell units.

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, then 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 run rate is approximately 9 MW.

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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 July 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]	$ 3,120	$ 785	$ 1,545	$ 790	$ —
Term loans (principal and interest)	862	442	415	5	—
Purchase commitments[2]	33,005	30,124	2,881	—	—
Series I Preferred dividends payable [3]	19,693	379	758	9,798	8,758
Series B Preferred dividends payable [4]	11,266	3,206	6,412	1,648	—
Totals	$ 67,946	$ 34,936	$ 12,011	$ 12,241	$ 8,758

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

(2) Short-term 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, 2005 were approximately $3.5 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. From 2010 through 2020, 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 seven years, with payments of interest only for the first six months and then repaid in monthly installments over the remaining six and one-half years with interest computed annually based on the ten-year U.S. Treasury note plus 2.5 percent. Our current interest rate at July 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 July 31, 2006, our research and development sales backlog totaled $9.8 million. As this backlog is funded in future periods, we will incur additional research and development cost-share related to this backlog totaling approximately $4.7 million for which we would not be reimbursed by the government. In addition, the Company has been awarded, and is in final contract negotiations on two contracts from the DOE and the U.S. Navy that will add approximately $21.5 million to backlog once finalized. We would incur an additional research and development cost-share related to these two contracts of approximately $14.7 million for which we would not be reimbursed.

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 July 31, 2006, we had product sales backlog of approximately $13.5 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 will provide for replacement of fuel cell stacks. 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. As of July 31, 2006, we had a service agreement sales backlog of approximately $6.5 million.

Power Purchase Agreements

Power purchase agreements (PPAs) are a common arrangement in the energy industry, whereby a customer purchases energy per unit delivered 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 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 control along with Alliance Power, Inc.

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 July 31, 2006 we had deferred revenue totaling $6.2 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 July 31, 2006, we had 3 MW of power plants in operation under PPAs ranging from 5 - 10 years, with an additional 1 MW under contract. We expect the remaining 1 MW to be placed in operation prior to October 31, 2006.

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 7 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. FIN 47 is effective for fiscal years ending after December 15, 2005, or no later than our fiscal fourth quarter of 2006. We have not yet determined the impact of adopting this statement on our consolidated financial statements.

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 situation.

Item 3. 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 United States 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 July 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 July 31, 2006, approximately $0.5 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.

We recognized foreign currency losses of approximately ($0.04) million and ($0.01) million for the three and nine months ended July 31, 2006, respectively. A foreign currency gain of approximately $0.01 million and a foreign currency loss of approximately ($0.05) million were recognized in the three and nine months ended July 31, 2005, respectively. This has been recorded as a component of 'Interest and other income' on our consolidated statement of operations. 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 hedging activities. We do not enter into derivative financial instruments. 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.

Item 4. CONTROLS AND PROCEDURES

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

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

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

PART II - OTHER INFORMATION

Item 6. Exhibits

Exhibit No.	Description
31.1	CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	CEO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	CFO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

FUELCELL ENERGY, INC.
(Registrant)

September 11, 2006	/s/ Joseph G. Mahler
Date	**Joseph G. Mahler** Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary (Principal Financial Officer and Principal Accounting Officer)

INDEX OF EXHIBITS

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