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 (State or Other Jurisdiction of Incorporation or Organization)	06-0853042 (I.R.S. Employer Identification Number)
3 Great Pasture Road **Danbury, Connecticut** (Address of Principal Executive Offices)	**06813** (Zip Code)

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

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	Three Months Ended July 31, 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		Nine Months Ended July 31, 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	Nine Months Ended July 31, 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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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.

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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.

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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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Notes to Consolidated Financial Statements
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(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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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)

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