DISTRIBUTED ENERGY SYSTEMS CORP
Form 10-K
March 17, 2008
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2007

Or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 000-50453

DISTRIBUTED ENERGY SYSTEMS CORP.

(Exact name of Registrant as specified in its charter)

Delaware	**20-0177690**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

10 TECHNOLOGY DRIVE, WALLINGFORD, CT 06492

(Address of principal executive offices)

Registrant s telephone number, including area code (203) 678-2000

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $.01 par value

Registered on the NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ¨ YES x NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. ¨ YES x NO

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. x YES ¨ NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form10-K. ¨

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

Large accelerated filer ¨	Accelerated filer x

Non-accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). ¨ YES x NO

The aggregate market value of the voting stock held by non-affiliates of the Registrant on June 29, 2007 was approximately $51.8 million based on the price of the last reported sale as reported by The NASDAQ Global Market on June 29, 2007. The number of shares outstanding of the Registrant s Common Stock on March 5, 2008 was 39,993,822.

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Distributed Energy Systems Corp.

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This report contains forward-looking statements for purposes of the safe harbor provisions under The Private Securities Litigation Reform Act of 1995. Statements contained herein that are not statements of historical fact may be deemed to be forward-looking information. Without limiting the foregoing, words such as anticipates, believes, could, estimate, expect, intend, may, might, should, will, and would and other forms of these words or similar words are intended to identify forward-looking information. You should read these statements carefully, because our actual results may differ materially from those indicated by these forward-looking statements as a result of various important factors. We disclaim any obligation to update these forward-looking statements. Our actual results could differ significantly from those anticipated in these forward looking statements as a result of certain factors, including those set forth below under Risk Factors and Legal Proceedings, and critical accounting policies set forth below under Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies.

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ITEM 1. Business

General

Our annual report on Form 10-K, quarterly reports on Form 10-Q, and other periodic filings are available free of charge through the Investors section of the Company s Internet website (www.distributed-energy.com) as soon as practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission. The information on our website is not a part of, or incorporated by reference into, this Annual Report on Form 10-K. Our website address is included as an inactive textual reference only.

In this report, Distributed Energy, the Company, we, us and our refer to Distributed Energy Systems Corp., including its consolidated subsidiaries Proton Energy Systems, Inc., or Proton, and Northern Power Systems, Inc., or Northern.

Recent Developments

Starting at the beginning of 2007, management has focused on refinancing the Company, reducing operating expenses and building a sustainable business for the future. Our Proton subsidiary develops and sells on-site hydrogen gas delivery systems. Proton continued to execute on the business model that has been in place for several years with an objective of achieving profitability. Our Northern subsidiary is systematically narrowing its business to focus on the design and sale of direct drive wind turbines. The decision to focus Northern s business on the sale of direct drive wind turbines is based on the intellectual property that Northern has developed and what we believe to be the market potential for this type of product, combined with Northern s inability to generate consistent positive gross margins on projects in the highly competitive distributed power and engineering, procurement and construction business. Throughout 2007, Northern completed projects in the distributed power and engineering, procurement and construction businesses, while declining to sign any new additional projects in this area. These projects were typically multi-year projects and in most cases were unprofitable. We are continuing to complete the final phases of a small number of projects and are evaluating the sustainability of our power generation service business. We closed our Waitsfield, Vermont facility and consolidated all of our Northern operations in our Barre, Vermont facility. We reduced our Company s headcount from 331 at the end of December 2006, to 200 at the end of December 2007, a reduction of 131 for the year. Of these headcount reductions, 85 were a result of our restructuring plan announced in January 2007 and the remaining headcount reductions were through voluntary turnover and were not replaced. A total of 110 were at our Northern subsidiary.

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On March 7, 2007, we entered into a Joint Venture Agreement with Morgan Stanley Wind LLC, a subsidiary of Morgan Stanley, or MSW. This agreement established a framework for us and MSW to work together to develop, finance, own and operate projects utilizing waste-to-energy technology, combined-heat-and-power technology and other advanced energy technologies. This agreement was terminated in February 2008 and the Company received a payment of $500,000 from MSW. We exited this relationship as a result of our decision to focus our Northern subsidiary on our wind turbine business. No projects were entered into during the term of this agreement.

In connection with the execution of the Morgan Stanley Wind LLC Joint Venture Agreement, we also issued to MSW on March 7, 2007 a Common Stock Purchase Warrant entitling MSW to purchase up to 10% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. This warrant vests in multiple tranches as described below:

- The warrant is immediately vested as to 8% of our common stock outstanding from time to time, at a purchase price equal to the lower of $2.25 per share or 80% of the fair market value of the common stock on the date of exercise, but in no event less than $2.10 per share. This 8% tranche of the warrant is exercisable until the second anniversary of the grant date, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least $2.25.

- The warrant would have vested in four subsequent tranches, each as to 0.5% of our common stock outstanding from time to time, at such time as MSW funded certain defined investments in projects developed under the Joint Venture Agreement or we have entered into EPC or O&M contracts with projects sourced by MSW. Given that the joint venture agreement has been terminated, there will be no vesting in these subsequent additional tranches of warrants.

The warrant may only be exercised in cash. The warrant to purchase 8% of our common stock remains outstanding after the termination of the joint venture agreement.

To address our need to raise additional working capital, we entered into a securities purchase agreement with Perseus Partners VII, L.P. , or Perseus, on May 10, 2007. Pursuant to the terms of the agreement, on June 1, 2007 we closed on an initial $12.5 million loan by Perseus to us. In connection with this initial loan, we executed a senior secured promissory note in favor of Perseus, or the initial note, and issued to Perseus an initial investment warrant, or the initial warrant. The initial note had an interest rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at our discretion, and was due on March 1, 2008. The loan was secured by a security interest in all of our assets and those of our material subsidiaries. The initial warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of our common stock at an exercise price of $0.80 per share.

On August 24, 2007, pursuant to the terms of the securities purchase agreement, we closed on a subsequent $15.0 million loan by Perseus to us, or the subsequent funding. In connection with this loan, the initial note was repaid and cancelled, and we executed a senior secured convertible promissory note in favor of Perseus, or the subsequent convertible note, and issued to Perseus a subsequent investment warrant, or the subsequent warrant. The net amount received by us was $2,140,411, after deduction of the amounts sufficient to repay in full the principal and interest due on the initial note.

The subsequent convertible note has an original principal amount of $15.0 million, bears interest at a rate of 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008 or earlier upon an event of default, a change of control or our liquidation or dissolution. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or additional convertible notes, which have the same terms as the subsequent convertible note. At Perseus s election, the principal and any unpaid interest under the subsequent convertible note and additional convertible notes are convertible immediately after issuance into shares of our common stock at a conversion price of $0.57 per share. Assuming that (a) we pay all interest expense in kind and (b) Perseus fully converts the subsequent convertible note of $15.0 million and all of the additional convertible notes, Perseus would receive 30,779,675 shares of our common stock. The loan is secured by a security interest in all of our assets and those of our material subsidiaries.

The subsequent warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of our common stock at exercise prices ranging from $0.80 to $3.00 per share.

Perseus, through its right to convert the subsequent convertible note into our common stock and exercise the initial warrant and the subsequent warrant, could acquire enough shares of our common stock to raise its ownership to greater than 50% of our total outstanding common stock. In addition, under the terms of the securities purchase agreement, upon the closing of the subsequent funding, we were obligated to reduce the size of our board of directors to five members, and at that time Perseus became entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of the subsequent convertible note. Based upon our current capitalization, Perseus now has the right under this provision to name a majority of the directors on our board.

On August 24, 2007, we and Perseus entered into a letter agreement regarding Perseus s board representation rights, or the letter agreement. Pursuant to the letter agreement, (i) Perseus acknowledged that it had waived the requirement that we reduce the size of our board of directors to five members, (ii) Perseus and we agreed to set the size of the board at seven members, and (iii) Perseus agreed to name two directors, rather than a majority, and we agreed to permit Perseus to send an observer to meetings of our board of directors. Perseus retains its rights to, at any time, (a) require us to reduce the size of its board of directors to five and (b) name additional members of the board of directors to give Perseus representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of the subsequent convertible note.

On November 19, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, because of the appointment of Bernard H. Cherry as the Company s Interim Chief Executive Officer, we no longer had a majority of independent directors as required by Nasdaq Marketplace Rule 4350(c)(1). To regain compliance with this rule, on November 21, 2007, Michael L. Miller, a Perseus representative, resigned from our board of directors. On November 21, 2007, in connection with Mr. Miller s resignation, we entered into an agreement with Perseus pursuant to which we agreed to permit Mr. Miller to attend meetings of our board of directors as an observer. We also agreed to reappoint Mr. Miller to the board if we name an additional independent director and would therefore be able to maintain compliance with Nasdaq Marketplace Rule 4350(c)(1) with Mr. Miller on the board.

On October 31, 2007, Ambrose L. Schwallie resigned as the chief executive officer. The board of directors of the company elected Bernard H. Cherry, the current chairman of the company s board of directors, as interim chief executive officer. Mr. Cherry retained his position as chairman of the board.

On November 19, 2007, the Company agreed to terminate Walter W. Schroeder s employment with the Company without cause, effective January 1, 2008.

On March 13, 2008, we and our subsidiaries, Northern, Proton and Technology Drive, L.L.C., entered into a First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement, or the Amendment, with Perseus. The Amendment amends the securities purchase agreement and the related Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement.

Pursuant to the Amendment, we agreed to sell and issue to Perseus, and Perseus agreed to purchase, an Additional Investment Note, or the Additional Note. The Additional Note has an original principal amount of

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$1.5 million, bears interest at 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. At Perseus s election, the principal and any unpaid interest under the Additional Note are convertible into shares of our common stock at a conversion price of $0.33 per share. Assuming that (a) we pay all interest in kind and (b) Perseus fully converts the Additional Note and all of the Additional Convertible Notes, Perseus would receive 4,966,213 shares of our common stock. The loan is secured by a security interest in all of our assets and those of our material subsidiaries. The Additional Note contains customary affirmative and negative covenants. The Additional Note also specifies events of default that would cause the Additional Note to become immediately due and payable. The events of default under the Additional Note include any time that our (1) working capital, as defined in the Additional Note, falls below $3.5 million or (2) unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Additional Note will also constitute an event of default under the previous notes issued to Perseus.

In addition, pursuant to the Amendment, in the event of an investment by an investor approved by Perseus in a project, joint venture, partnership or other transaction for the purpose of developing our wind turbine products, we agreed to:

- if the project uses an entity other than Distributed Energy, issue to Perseus, for no additional consideration, a 5% fully-diluted interest in such entity; or

- if the investor makes an investment directly in Distributed Energy, issue to Perseus, for no additional consideration, a warrant to purchase, at an exercise price of $0.33 per share, up to 909,090 shares of our common stock.

Further, in the event of a sale of assets by us or any of our affiliates (other than sales in the ordinary course of business), we agreed to:

- use all or part of the net proceeds to repay some or all of our obligations to Perseus;

- deliver an irrevocable letter of credit to Perseus in the amount of the net proceeds less any repayment of obligations owed to Perseus;

- place the net proceeds less any repayment of obligations owed to Perseus in a restricted cash account; or

- otherwise secure the obligations owed to Perseus or make such other arrangements with respect to the net proceeds as requested by Perseus in each case as directed by Perseus.

Under the Securities Purchase Agreement, we had undertaken to use commercially reasonable efforts to sell our Proton subsidiary. The Amendment permits us to suspend active efforts to sell Proton, but Perseus retains the right to reinstate the requirement at any time.

On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common

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stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

While we recently obtained funding from Perseus as described above, we do not expect that our current capital resources will be sufficient to operate our business beyond the next thirty to forty-five days, and we will need to raise additional capital within the next thirty to forty-five days to continue to operate. We are continuing our efforts to raise working capital for our company through on-going meetings and discussions with potential investors including Perseus. Our ability to secure additional equity capital funding or debt funding in the near future on terms acceptable to us or at all is not assured. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive.

Our Business

We do business through two subsidiaries. Proton designs, develops, sells and manufactures on-site hydrogen gas delivery systems. This business has its headquarters in Wallingford, Connecticut and conducts business worldwide. Northern has been in a broad range of businesses including the design and sale of power generation equipment, engineering, procurement and construction of distributed power systems, the design and sale of direct drive wind turbines, and the servicing of fossil fuel power generation equipment. As described above in Recent Developments, management of Northern is systematically narrowing its focus to the design and sale of direct drive wind turbines and associated power electronics. Throughout 2007, Northern completed projects in the distributed power and engineering, procurement and construction businesses, while declining to sign any new additional projects in this area. We are continuing to complete the final phases of a small number of projects and are evaluating the sustainability of our power generation service business.

Our Proton Subsidiary

Overview

Since 1996, we have been designing, developing and manufacturing PEM electrochemical products. Our proprietary PEM technology is embodied in two families of products: hydrogen generators and regenerative fuel cell systems. Our hydrogen generators produce hydrogen from electricity and water in a clean and efficient process. We are currently manufacturing and delivering our hydrogen generators to customers for use in commercial applications, including cooling applications for large, electric utility power plants. Our regenerative fuel cell systems, currently being developed, combine our hydrogen generation technology with a fuel cell power generator to create an energy device that is able to produce and store hydrogen fuel that it can later use to generate electricity. By providing the hydrogen fuel used by fuel cells, our PEM electrolysis technology can enable fuel cells to function not only as power generating devices, but also as energy storage devices.

We are designing our products to meet the needs of customers in both near-term and longer-term markets. Our hydrogen generators have been designed to address the existing demand for industrial hydrogen in a variety of manufacturing, power plant, research and laboratory applications, in a safer and more cost-effective manner than truck-delivered hydrogen. In the longer term, as fuel cell markets develop, we believe our hydrogen generators can be a key component of the hydrogen supply infrastructure that will be needed to provide the hydrogen used by fuel cells in transportation, stationary power generation and portable power generation applications. We are developing our regenerative fuel cell systems to address the demand for highly reliable backup power systems. In particular, the increased use of computers, computer networks and communications networks are all creating an increase in the demand for highly reliable backup power to avoid the costs and lost revenue associated with power disruptions. In the longer term, our regenerative fuel cell systems may enable renewable energy solutions by facilitating the storage of energy produced by non-depleting, non-polluting energy sources, such as solar, wind and hydroelectric power.

We believe we are among the first companies to manufacture and deliver systems incorporating PEM technology for use in commercial applications. We have delivered HOGEN series hydrogen generators to domestic and international customers for use in industrial and research applications. The HOGEN series products can be sized to produce various outputs in the 20 to 240 standard cubic feet per hour range. We also offer a small, laboratory-sized HOGEN product that produces outputs in the 200 to 600 cubic centimeters per minute range. In the utility power plant market, where hydrogen is required to cool power generators, we believe the higher purity hydrogen produced by our HOGEN series products enables improved generator efficiency, extended generating equipment life and gains in plant capacity.

In the longer term, we believe our PEM hydrogen generation technology will be an important part of the infrastructure needed to provide hydrogen for fuel cell vehicles. Our research and product development efforts include the development of a high-pressure hydrogen generator, capable of providing hydrogen for fuel cell vehicles. This product will be based on our industrial hydrogen generator platform, and we anticipate the majority of product development funding to come from government or other third party sources. Our goal for the future in this area is to deliver additional units for demonstration sites by early adopters and to gather important technical data in real world applications.

In November 2006, we successfully launched the StableFlow Hydrogen Control System. Designed for power plants, this technology is integrated into current hydrogen supply systems to automatically control pressure, purity and dew point. Customer benefits include increased fuel efficiency, maximized generator capacity, and extended generator life with resulting cost savings associated with each. Eight StableFlow products were delivered in 2007.

Government and private development contracts have supported the development and commercialization of our hydrogen generators, fueling systems and regenerative fuel cell systems. We intend to continue to seek government and other third party support to fund the majority of our design and product development work. We had development contracts in 2007 with the Connecticut Clean Energy Fund, or CCEF, the Missile Defense Agency, NASA, the US Navy, the US Army and the Department of Energy.

Products

Hydrogen Generators. Our HOGEN hydrogen generators convert water and electricity into high purity, pressurized hydrogen gas, using PEM electrolysis. PEM electrolysis is a process in which water is divided into its component elements to produce pure hydrogen gas, with oxygen and heat as the only by-products. Many users can connect our hydrogen generators directly to existing water and electrical sources, allowing them to be installed and used in a wide range of locations.

We have shipped commercial models of our HOGEN series hydrogen generators with production capacities from 300 cubic centimeters per minute up to 240 cubic feet per hour of hydrogen. Our laboratory generators are compact and designed to sit on a countertop for use in laboratory applications. Our HOGEN S series units are freestanding, roughly the size of a household washing machine, and are intended for indoor placement. Our HOGEN H series hydrogen generator is a larger freestanding unit, approximately 6.5 ft. (h) x 6.5 ft. (l) x 3 ft. (w). We expect to increase production of our commercial HOGEN GC, S and H series hydrogen generators in 2008.

We are currently developing high-pressure hydrogen generation modules capable of supplying the hydrogen fueling needs of fuel cell vehicles and other hydrogen power applications. We anticipate the high-pressure modules to be largely based on the designs of our industrial hydrogen generators. These generators will be appropriately scaled and designed to operate at typical gas station locations using ordinary water and electricity. We will continue development and demonstration testing of this product in 2008, mostly under government or third party sponsorship.

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An important feature of our hydrogen production technology is the ability to produce hydrogen at pressure without mechanical compression. Our current commercial products produce hydrogen at pressures up to 225 psi. Our prototype HIPRESS PEM cell stack designs have produced high-purity hydrogen at pressures up to 3,000 psi without mechanical compression using solid state compression within the electrochemical cell stack. We believe our ability to generate higher pressure hydrogen will be an important feature in future fuel cell vehicle fueling and backup power applications. We plan to continue research and development of high-pressure cell stack technology for potential use in current and future products as market conditions dictate, mostly under government or third party sponsorship as available.

We expect to continue to invest in internal research and product development to reduce costs of manufacturing our PEM cell stacks and hydrogen generators. We currently sell commercial units into high-value applications requiring industrial hydrogen. We believe higher volumes, lower cost materials, more refined production processes, as well as other potential technologies; will enable us to reduce the cost of our cell stack and hydrogen generators. As we reduce our costs, we believe our products will become competitive in additional applications and markets.

StableFlow Hydrogen Control System, a product that enables electric power generating plants to produce more electricity more efficiently from less coal, oil or natural gas, was launched in November, 2006. We believe our StableFlow Hydrogen Control System will provide substantial production and economic benefits to utilities and other power plant operators by modernizing how they control the flow of hydrogen needed to cool their generating equipment.

StableFlow effectively maintains the hydrogen cooling gas within the generator casing at or above the generator s original equipment manufacturer, or OEM specifications. StableFlow Hydrogen Control Systems automatically regulate the rate of hydrogen gas venting from the generator, allowing for the continuous replenishment of gas from a high purity source. This process is effective whether the cooling hydrogen is produced on site by Proton s HOGEN(R) electrolysis-based system or from traditional trucked-in hydrogen. StableFlow technology enables a continuous purge through the electric generator that measurably increases operating efficiency and, as a result, the plant generates its power with less fuel than it would otherwise need to use.

Our StableFlow system enables power plants to realize cost savings by maintaining hydrogen purity, pressure and dew point levels in compliance with OEM specifications. It continuously monitors the generator casing on a real- time basis, controlling impure hydrogen venting and providing pure hydrogen replenishment as required. Its automated control replaces manual periodic hydrogen refilling and the resulting variability from OEM specifications.

Technology

PEM-Based Hydrogen Generators. Our hydrogen generators are electrochemical devices that convert water and electricity into hydrogen gas using a process known as PEM electrolysis. The core of a hydrogen generator is an electrolysis cell consisting of a solid electrolyte, also known as a proton exchange membrane. Catalyst material is bonded to both sides of the membrane, forming two electrodes. To generate hydrogen, water is introduced to one side of the membrane and voltage is applied to the electrodes. This process divides the water into protons, electrons and oxygen. The protons are drawn through the proton exchange membrane and recombined with the electrons at the opposite side of the membrane to form hydrogen. The oxygen is removed from the cells with the excess water flow. This process produces hydrogen with a high level of purity and at significant pressures.

A single electrolysis cell is typically integrated into a complete cell assembly that includes flow field structures that provide mechanical support, conduct current and provide a means to introduce water and remove gases. These cell assemblies are stacked and compressed between two end plates along with other support components to form a complete cell stack. The hydrogen production capability of a cell stack is approximately proportional to the area of each cell, the number of cells in the stack and the electric current supplied.

PEM-Based Fuel Cell Power Generators. In a PEM fuel cell, which is very similar to our PEM electrolysis cell, the opposite reaction occurs. To generate electricity, hydrogen and air, or oxygen, are introduced to opposite sides of the cell. The hydrogen passes over an electrode structure adjacent to the proton exchange membrane, where it is divided into its component protons and electrons. When the electrons are separated from the protons, the electrons are conducted in the form of a usable electric current. The protons travel through the proton exchange membrane and recombine with the electrons and oxygen to produce water.

The regenerative fuel cell systems we are developing will incorporate the ability to support both an electrolysis reaction and a fuel cell reaction. Our proprietary design operates in the electrolysis mode by using water and electricity to generate hydrogen at elevated pressure and then reverses the process and consumes the hydrogen with air to generate electricity. The resulting product functions like a rechargeable battery in which hydrogen is produced through electrolysis, stored and then used for power generation. Because our regenerative fuel cell systems use hydrogen produced through electrolysis rather than extracted from hydrocarbon fuels using a high temperature process called reforming, electricity can be produced at room temperature, without lengthy start-up times or carbon-based emissions and in areas where fossil fuels such as natural gas, propane or gasoline are not available.

Distribution and Marketing

We sell our hydrogen generators through a combination of distribution arrangements with third parties and direct sales by our personnel. Our hydrogen generators are appropriate for small and medium volume hydrogen users typically served by cylinders or tube trailers. We are focusing our sales and marketing efforts on the channels that these customers use to purchase their gases and equipment. We are selling HOGEN hydrogen generators to leading industrial gas providers through direct sales or existing distribution arrangements to place at their customer sites. In addition, we have established distributor and agent relationships serving end users in many countries including but not limited to, the U.S., U.K., Western and Eastern Europe, China, Japan, South America, India and Mexico. We have established relationships with manufacturers and equipment representatives that sell specific models of our hydrogen generator products. We intend to expand our sales and distribution arrangements with industrial gas suppliers and distributors, as well as original equipment manufacturers.

As the market to supply hydrogen fuel for fuel cell vehicles develops, we also plan, where possible, to leverage existing distribution channels. We believe that existing energy suppliers will need to begin supplying new forms of automotive fuel as fuel cell vehicles come to market. Accordingly, we intend to establish or expand relationships with major energy or industrial gas companies to explore ways of supplying our hydrogen generators for installation at local service stations. In addition, we believe that automobile manufacturers providing introductory and fleet fuel cell vehicles will be interested in our refueling technology, and therefore we will seek to establish relationships with these manufacturers.

Currently, backup power equipment is sold by a few large manufacturers to commercial end users through diverse reseller networks, including integrators and qualified resellers. In the future, we plan to sell our backup power products to these existing manufacturers, integrators and qualified resellers.

Manufacturing

We are currently manufacturing hydrogen generators at our facility in Wallingford, Connecticut. Key aspects of this process include formulation of our proprietary catalysts, deposition of the catalyst on the proton exchange membrane and fabrication of cells into cell stacks. The balance of the manufacturing process consists of integrating cell stacks into systems that perform fluids and electrical management of the electrochemical process.

We purchase raw proton exchange membrane material from DuPont, although we have identified other companies we believe are capable of providing suitable membrane material. We purchase other components used

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in our systems from third-party suppliers. We regularly consult with our suppliers to evaluate ways to lower the cost of other components or subassemblies while meeting the performance needs of our products. In this regard, we have considered and will continue to evaluate the option of having subassemblies that we currently produce in-house produced to our specifications by others if lower costs can be achieved.

In 2007, we successfully completed our annual ISO 9001:2000 audit. We believe this registration, a quality assurance model for companies that design, produce, install and service products as part of their business will provide us with an advantage over competitors that are not ISO 9001:2000 registered. In some cases, this registration is a condition of doing business with customers.

Proprietary Technology and Intellectual Property

We have developed proprietary technology and intellectual property relating to various aspects of our electrolysis cells, regenerative fuel cell systems and related systems.

We aggressively protect our intellectual property assets using patent, trade secret, trademark and copyright law, but no single patent, trademark or trade name is material to our business as a whole. Our protection of these assets has continued to accelerate, and we have to date been issued 67 U.S. patents and 1 European patent, covering aspects of our hydrogen generator and electrolysis cell designs. We continue to aggressively seek intellectual property protection in the U.S. and internationally. Our pending patent applications cover not only our current electrolysis products, but also technologies we have developed related to fuel cells, backup and renewable power systems and hydrogen fueling systems. It is possible, however, that any patents issued to us may not provide us with any competitive advantages, that we may not develop future proprietary products or technologies that are patentable, and that the patents of others may seriously limit our ability to conduct our distributed generation business.

In addition to our patented assets, we hold U.S. registered and unregistered trademarks pertaining to our distributed generation business. Our registered trademarks include PROTON®, HOGEN®, and UNIGEN®. Our unregistered trademarks include StableFlow , FUELGEN , HIPRESS™ and TRANSFORMING ENERGY™.

Competition

Our hydrogen generators compete with current suppliers of delivered hydrogen and with other manufacturers of on-site hydrogen generators. Competitors in the delivered hydrogen market include Airgas, Inc., Air Liquide, Air Products and Chemicals, Inc., Linde AG and Praxair Technology, Inc. Our hydrogen generators also compete with older generations of electrolysis-based hydrogen generation equipment sold by Hydrogenics Corporation, Statoil Hydro, Teledyne Energy Systems, Inc. and other companies. These competing systems are generally larger in size than our generators. Some of these systems require manual operation and supervision; most contain hazardous liquid electrolyte, and some require the assistance of mechanical compressors to produce hydrogen at pressure.

There are a number of companies located in the United States, Canada and abroad that are developing PEM fuel cell technology. These companies include Ballard Power Systems Inc., General Motors Corporation, Giner, Inc., Honda Motor Company, Toyota Motor Corporation, SANYO Electric Co., Ltd., IdaTech LLC, Hydrogenics Corporation, Nuvera Fuel Cells, Plug Power Inc. and United Technologies Corporation. Although we believe these companies are currently primarily targeting vehicular and residential applications, they could decide to enter the hydrogen generation and backup power markets we address. We may also encounter competition from companies that have developed or are developing fuel cells based on non-PEM technology, as well as other distributed hydrogen generation technologies.

Research and Development

We are currently developing several products for both our hydrogen generation and fuel cell and distributed generation businesses.

The regenerative fuel cell systems we are developing will integrate our PEM hydrogen generation technology with PEM fuel cell technology to create a power quality device that produces hydrogen from water and electricity, stores the hydrogen, and later uses the hydrogen as fuel for the production of electricity. In the hydrogen generation or electrolysis mode, the regenerative fuel cell works like a hydrogen generator, producing hydrogen, which is stored. In the power generation or fuel cell mode, the process is reversed and the stored hydrogen is combined with air to produce electricity efficiently and without any harmful by-products. Our regenerative fuel cell architecture is designed to use fuel cells produced by other developers and manufacturers to enable their fuel cells to become energy storage devices.

We seek to obtain external funding for our target research and development efforts in order to offset internal development costs wherever possible. We have recently received funding from the Department of Energy, including its National Renewable Energy Laboratory, The Consortium for Electric Reliability Technology Solutions and the California Energy Commission in support of our programs.

We incurred approximately $1.0 million, $2.4 million and $3.5 million in research and development expenditures for the years ended December 31, 2007, 2006 and 2005, respectively.

Employees

As of December 31, 2007, our Proton subsidiary had approximately 69 employees, of whom approximately 50% were engineers, scientists, and other degreed professionals. No employees are represented by a labor union and we consider our relations with our employees to be good.

Customers

For the years ended December 31, 2007, 2006 and 2005, revenue from government-sponsored agencies accounted for approximately 30%, 14% and 37% of Proton revenue, respectively. Revenue from international customers accounted for approximately 15%, 34% and 35% of Proton revenue for the years ended December 31, 2007, 2006 and 2005, respectively. For the years ended December 31, 2007 and 2006, five customers accounted for 42% and 31% of Proton revenue, respectively. For the year ended December 31, 2005, six customers accounted for 42% of Proton revenue. For the year ended December 31, 2007, three customers accounted for 48% of Proton accounts receivable. For the year ended December 31, 2006, two customers accounted for 35% of Proton accounts receivable. At December 31, 2007 and 2006, Proton accounts receivable from government-sponsored agencies accounted for approximately 27% and 23%, respectively. Proton accounts receivable due from international customers was 10% and 19% for the years ended December 31, 2007 and 2006, respectively.

Backlog

The backlog for our Proton subsidiary as of December 31, 2007, 2006 and 2005 was approximately $5.1 million, $5.0 million and $3.2 million, respectively. The backlog reflects orders that we considered firm. However, cancellations may occur and will be reflected in our backlog when known. We expect to realize our backlog at December 31, 2007 as revenue during 2008.

Our Northern Subsidiary

Overview

From the period of the merger of Proton and Northern in 2003 through the early part of 2007, Northern engaged in several business areas related to the design, construction and maintenance of a variety of distributed power systems. Northern s oldest business line, dating to its founding over 30 years ago, is the design and sale of wind turbines with an emphasis on equipment for locations with harsh weather conditions. Northern sold its systems both to grid-connected customers and to customers who needed power solutions for remote locations.

Northern s distributed generation systems produce electricity from conventional fuels and from sustainable sources such as wind, sunlight and biofuels, using power generation technologies integrated with custom controls and power electronics. It installed systems worldwide over 30 years of operation both prior to and subsequent to its merger with Proton. Northern has installed its systems for remote applications, such as oil and gas pipelines and telecommunications facilities, and to grid-connected customers who used the systems for large commercial office buildings and manufacturing facilities. Customers have included Petróleos Mexicanos (PEMEX), S. C. Johnson & Son, Inc., Equity Office Properties Trust, The Timberland Company and Honeywell International Inc.

Given the financial condition of Northern and its market opportunities, we concluded in 2007 that Northern s primary focus would be on the design and sale of its 100 kilowatt direct drive wind turbines and associated power electronics. The decision to focus Northern s business on the sale of direct drive wind turbines is based on the intellectual property that Northern has developed and what we believe to be the market potential for this type of product, combined with Northern s inability to generate consistent positive gross margins on projects in the highly competitive distributed power and engineering, procurement and construction business. Throughout 2007 and into 2008, we worked to complete and dispose of customer commitments that were outside of Northern s new focus on wind and power electronics businesses. We believe that non-wind customer commitments will continue to decline throughout 2008.

We believe the rising price of energy and the reliability limitations of traditional grid-based power systems are placing strong pressures on energy users to find ways to maximize the usefulness of today s limited resources, as well as leverage new and advanced technologies to address the energy challenges they will face in the future. With over 30 years of experience in the design and sale of wind turbine and power electronics products, we believe we have established an effective channel to market for our current product offerings and for introducing new technologies and products into these markets.

Competitive Strengths

We believe our competitive strengths include the following:

Well positioned for growth. We believe there are significant growth opportunities for the wind and power electronics products and services we presently provide. The market for utility scale wind turbines has increased meaningfully over the past five years, and we believe the market for smaller scale community or distributed wind applications is gaining momentum. We currently have commercial manufacturing capabilities for our wind turbine and power electronics products in our Barre, VT location. Our 100 kilowatt Northwind® 100 direct drive wind turbine has been manufactured in small quantities since 2000. Originally developed to serve the needs of remote wind-diesel grids in extremely cold and harsh climates, the Northwind 100 has recently been improved with an advanced permanent magnet generator, improved grid interconnect features and a lower cost profile to target applications in the balance of North America at municipal facilities, commercial farms, school campuses and industrial sites. The preliminary design of a Northwind 2.2 wind turbine, rated at 2.2 Megawatts and designed for utility scale applications, is underway with subscale generator testing at 1.5 MW as well as scale up and testing of the key power electronic subsystems completed.

Capitalizing on Unique Core Competencies. Northern s wind business has evolved over 30 years, and is grounded in an experienced, industry respected, technical team with a released product, and important and timely technology for future growth and opportunity.

Technology

The core of Northern s wind turbine design is simple direct conversion of torque to electrical power. By utilizing a direct drive generator with a permanent magnet rotor to create the fewest possible number of pieces, the shortest load path from blades to tower and a highly efficient drive train, we believe this turbine design has important industry advantages including higher energy capture, lower maintenance costs, and reduced cost of energy compared to existing gear-driven designs. Furthermore, Northern s internally developed power converter platform allows for variable speed operation, enhanced operational capabilities and advanced grid control features.

Markets

Northern has established a positive performance record in Alaska with the NorthWind 100 in a niche market for remote, wind-diesel systems. Northern is now positioned to expand in the mainstream global market with a commercialized version of the turbine, which will provide a clean energy source for domestic and international remote villages and a cost-effective energy alternative for North American customers.

U.S. Domestic Market

Fueled by net-metering laws, which allow customers to sell wind generated electricity at retail rates by offsetting their consumption, and state-level renewable portfolio standards coupled with state and federal incentive programs, USDA grants and loan packages, the current domestic interest in the NorthWind 100 is positive. We believe an addressable market in excess of 1,000 units per year exists based upon surveys of U.S. domestic applications. Success of the NorthWind 100 in fully penetrating these, as well as other potential market segments, e.g., domestic turbine replacement market, will require:

Developing local sales channels to expand penetration and provide local expertise;

Building awareness in and preference for the NorthWind 100 within the marketplace;

Completing cost-reduction activities already in process;

Completing product revisions already in process to include features necessary for large-scale commercialization;

Continuously improving supply chain economics through strategic partnerships, volume buys, and global and second-sourcing;

Expanding on current service capabilities and use of existing service partners; and

Ramping manufacturing capabilities and utilizing excess facility capacity.

International Markets

The primary international markets for remote village power systems include India, Russia, Africa, Philippines, Korea, China and Pacific Islands. For example, the Indian government has recently increased its commitment to wind power current estimates are that approximately 3,000 of these villages would be appropriate for 100 kilowatt machines including the NorthWind 100, with the necessary government incentives. Effectively building market share in these large, fast growing markets will require building strategic alliances with in-county partners.

Competition

Competitors in the distributed wind market include Entegrity (60kW), AOC-Canada (60kW), Vergnet (60kW and 220kW), Enercon (100kW), and Fuhrlander (100kW and 250kW), as well as a variety of refurbished turbines from manufacturers such as Vestas (35kW, 66kW and 90kW) that are sporadically available in secondary markets,. The fact that the Northwind 100 offers permanent magnet direct drive technology and is available at competitive price points for many markets gives it a potential advantage in the marketplace.

Research and Development

We incurred approximately $1.6 million, $1.3 million and $0.5 million in research and development expenditures for the years ended December 31, 2007, 2006 and 2005, respectively. These expenditures were for the engineering and development readiness for the NW100 product, which is currently in production, and development of our larger, 2.2 megawatt direct drive turbine.

Employees

As of December 31, 2007, our Northern subsidiary had approximately 118 employees, of whom approximately 50% were engineers, scientists, and other degreed professionals. No employees are represented by a labor union and we consider our relations with our employees to be good. There are 13 employees on Distributed Energy Systems corporate administrative staff.

Customers

Contract revenue from international customers accounted for approximately 20%, 23% and 28% of our total revenue for the years ended December 31, 2007, 2006 and 2005.

For the year ended December 31, 2007, one customer accounted for approximately 22% of contract revenues. For the years ended December 31, 2007 and 2006, one customer accounted for approximately 18% and 11%, respectively, of contract revenues and another customer accounted for approximately 10% and 4%, respectively, of contract revenues. For the year ended December 31, 2005, one customer accounted for 14% of contract revenues. For the year ended December 31, 2007, one customer accounted for 11% of service revenues. For the years ended December 31, 2006 and 2005, one customer accounted for 20% and 10%, respectively, of service revenues.

At December 31, 2007 and 2006, accounts receivable from international customers accounted for approximately 41% and 41%, respectively, of our total accounts receivable.

Backlog

The backlog for our Northern subsidiary as of December 31, 2007, 2006 and 2005 was approximately $4.1 million, $15.2 million and $17.6 million, respectively. The backlog reflects orders that we considered firm. However, cancellations may occur and will be reflected in our backlog when known. We expect to realize our backlog at December 31, 2007 as revenue during 2008.

Executive Officers of the Registrant

Our executive officers, and their ages as of March 5, 2008, are as follows (positions are with Distributed Energy Systems unless otherwise noted):

Name	Age	Title
Bernard H. Cherry	68	Interim chief executive officer and chairman
Robert J. Friedland	42	Senior vice president
Peter J. Tallian	49	Chief financial officer

Bernard H. Cherry joined the Company as a member of the board of directors in January 2007. Mr. Cherry became Interim Chief Executive Officer in November 2007. Previously, Mr. Cherry served as president and chief executive officer of the Foster Wheeler Global Power Group of Foster Wheeler Ltd., a provider of design, engineering, construction, manufacturing, management, plant operations and environmental services for the power and process sectors worldwide. From September 1985 to November 2002, Mr. Cherry served as president and chief operating officer of the Oxbow Energy and Minerals Group, a source of solid fuel supply, bulk material logistics and clean electric power generation.

Robert J. Friedland, one of Proton s founders, has served as our, or Proton s, senior vice president since September 2001. From Proton s founding in August 1996 through September 2001, Mr. Friedland served as Proton s vice president of operations. From 1995 to August 1996, Mr. Friedland served as a program operations manager for United Technologies Corporation, a diversified aerospace and building systems company.

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Peter J. Tallian joined the Company as Chief Financial Officer in November 2006. From 2001 to 2006, Mr. Tallian served as senior vice president, CFO and treasurer of Transwitch Corporation, a provider of high-speed semiconductors for voice, data and video communications. Previously, he spent six years as executive vice president and CFO of Metavante Corporation, the banking and payments technology subsidiary of Marshall & Ilsley Corporation. From 1982 to 1995, Mr. Tallian held several financial management positions with IBM Corporation, and his experience included both domestic and international finance and planning assignments. He holds an MBA from the University of Chicago and a bachelor of science degree in economics from the Wharton School of the University of Pennsylvania.

ITEM 1A. Risk Factors

The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Annual Report on Form 10-K and presented elsewhere by management from time to time.

RISKS RELATING TO OUR COMPANY

We need to raise sufficient additional funds in as short as 30-45 days to continue operations.

Our cash and marketable securities on hand as of December 31, 2007, together with our 2008 forecasted revenues and existing backlog will not be sufficient to fund operations through December 31, 2008. We received funding from Perseus in June and August 2007 and March 2008 in an aggregate amount of $16.5 million. We will need to repay these convertible notes with accrued interest due to Perseus in November 2008 in the amount of approximately $19.2 million. If we are unable to repay our obligations to, or obtain an extension of the loans from, Perseus, Perseus will have the right to exercise its rights as a secured creditor and foreclose on the majority of our assets, which could have the effect of forcing us to cease operations. As a secured creditor, Perseus would have the right to be repaid ahead of our shareholders.

In addition to the funds raised through March 2008, we need to raise additional funds in as short as 30-45 days to continue operations.

Management will need to take additional actions to further reduce operating expenses. Sufficient funds may not be available to us on terms that we deem acceptable, if they are available at all. If we cannot raise sufficient additional funds, we will have to cease operations.

We may not be able to execute our plan to increase revenue, improve margins and raise additional capital.

As we attempt to execute our plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance, a number of factors pose risk and uncertainty, including:

- Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues;

- Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow;

- Our ability to control operating expenses;

- Our ability to sell our Waistfield, Vermont facility or to find additional suitable tenants;

- The potential acceleration of debt service payments by one of our lenders as the result of subjective acceleration clauses in our debt agreements;

Our ability to secure additional equity capital funding or debt funding in the near future on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

If we are unable to execute our plan, we may have to cease operations.

As a secured creditor, Perseus has rights not available to our stockholders.

Under the terms of the securities purchase agreement, as amended, and the notes issued or issuable pursuant thereto, Perseus has rights as a secured creditor that would allow it to be repaid ahead of our stockholders, grant it veto rights over certain of our actions and permit Perseus, in its discretion, to appoint a majority of our board of directors. Perseus has a lien on the assets securing their loan. In the event that we fail to repay any of our debt as it becomes due, become insolvent or become involved in an insolvency proceeding, Perseus, as well as our other secured creditors, would have the right to foreclose on our assets. Perseus and our other secured creditors would be entitled to receive all of the proceeds from liquidating our assets ahead of our stockholders until our obligations to them are repaid in full. Additionally, Perseus s consent is required before we can, among other things, (i) incur any debt in excess of $1,000,000, (ii) recapitalize or reorganize ourselves or any of our subsidiaries, (iii) authorize, declare or pay any dividend, (iv) redeem or repurchase any shares of our stock, except in certain limited instances, (v) make any material change in the principal line of business of ourselves or any of our subsidiaries, (vi) acquire assets or make capital expenditures in excess of $1,500,000, (vii) institute or settle any material litigation or claim, (viii) approve our annual budget, and (ix) hire a chief executive officer. We have granted Perseus a right of first refusal to fund any future financing transactions we might pursue, with limited exceptions, and we have agreed to register for resale all the shares issuable to Perseus. Perseus also has the right to appoint a majority of our board of directors. Currently, one Perseus representative, John Fox, serves on our board of directors.

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2007 with respect to our ability to continue as a going concern.

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2007 with respect to our ability to continue as a going concern. This modification may negatively affect our stock price, our capital-raising efforts or our ability to enter into new contracts with customers. Even after our Perseus funding, there remains substantial doubt about our ability to continue as a going concern. Our consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. If we became unable to continue as a going concern, our secured creditors, including Perseus, would have the right to foreclose on our assets. As secured creditors, they would be entitled to the proceeds received from liquidating our assets ahead of our stockholders until our obligations to them are repaid in full.

Perseus has the right to acquire a controlling share of our stock and to appoint a majority of our board of directors, and Perseus s interests may differ from other stockholders.

Perseus, through its right to convert its convertible notes into our common stock and to exercise its warrants, could acquire enough shares of our common stock to raise its ownership to greater than 50% of our total outstanding common stock. In addition, under the terms of the securities purchase agreement, Perseus is entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of its convertible notes. Based upon our current capitalization, Perseus now has the right under this provision to name a majority of the directors on our board. Pursuant to subsequent agreements between us and Perseus, Perseus has not exercised its right to name a majority of our directors, but it retains the right to do so at any time. Perseus currently has one nominee, John Fox, serving on our board of directors.

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Through its right to obtain majority ownership of our common stock or to name a majority of our directors, Perseus would be able to control all key decisions regarding our company, including mergers or other business combinations and acquisitions, dispositions of assets, future issuances of our common stock or other securities, the incurrence of debt by us and amendments to our certificate of incorporation and bylaws. In addition, Perseus s right to acquire a controlling interest could discourage a change of control that our other stockholders may favor. If Perseus exercises its rights, it could also use such control for its own advantage to the detriment of our other stockholders and our company. This in turn could have an adverse effect on the market price of our common stock.

The warrant we issued to Morgan Stanley Wind LLC allows them to purchase up to 8% of our common stock outstanding from time to time; accordingly, any dilution resulting from future issuances of our common stock, options, warrants or other convertible securities will be increased by the effect of this warrant.

In connection with our execution of the joint venture agreement with MSW in March 2007, we issued to MSW a warrant entitling them to purchase up to 10% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. We exited the joint venture agreement with MSW in February 2008, however the warrant we issued to MSW, which now allows them to purchase up to 8% of our common stock remains in place. Accordingly, if we issue any new shares of our common stock, or issue any options or warrants to purchase our common stock or other securities convertible into our common stock, this will trigger a right of MSW under its warrant to acquire additional shares equal to 8% of the new issuance. This feature of the warrant has the effect of increasing the dilution to current stockholders that would result from any issuances of our common stock or securities related to our common stock, including an issuance in connection with any financing transaction we may undertake.

Our revenue and results of operations may fluctuate significantly as a result of factors outside of our control, which could cause the market price of our common stock to decline.

We expect our revenue and results of operations to vary significantly from quarter to quarter. As a result, quarterly comparisons of our financial results are not necessarily meaningful and should not be relied on as an indication of our future performance. In addition, due to our stage of development, we cannot predict our future revenue or results of operations with a precise degree of accuracy. As a consequence, our results may fall below the expectations of securities analysts and investors, which could cause the price of our common stock to decline. Factors that may affect our results include:

- the status of development of our technology, products and manufacturing capabilities;
- the cost and availability of raw materials and key components;
- warranty and service cost for products in the field;
- the introduction, timing and market acceptance of new products introduced by us or our competitors;
- the development of strategic relationships and distribution channels;
- general economic conditions, which can affect customers capital investments and the length of sales cycles;
- the development of vehicular PEM fuel cells and renewable energy markets; and
- government regulation.

We expect to continue to make investments in select areas of our business, particularly in research and product development and in expanding our manufacturing capability. Because the investments associated with these activities are relatively fixed in the short-term, we may be unable to adjust our spending quickly enough to offset any unexpected shortfall in our revenue growth. In addition, because we are in the very early stages of selling our products and have a limited number of customers, we expect our order flow to be uneven from period to period.

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We have incurred, and expect to continue to incur, substantial losses, and we may never become profitable.

We have incurred substantial losses since we were founded and anticipate we will continue to incur substantial losses in the future. As of December 31, 2007, we had an accumulated deficit of $239 million. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing capability and selling, general and administrative functions. As a result, we anticipate that we will continue to incur losses until we can achieve enough contract business at favorable margins and achieve high enough volumes to cost-effectively produce and sell our hydrogen generators and wind turbine products. Even if we achieve profitability, we may be unable to sustain or increase our profitability in the future.

Our future success is uncertain because of our limited commercial history selling many of our products.

We have only been shipping commercial models of our hydrogen generators during the last five years. We began shipping commercial models of our 100 kilowatt wind turbine in 2004 and have shipped in very low volumes since that time. Accordingly, there is only a limited basis upon which to evaluate our products, business and prospects, and our future success is uncertain. You should consider the challenges, expenses, delays and other difficulties typically involved in the establishment of a new business, including the continued development of products, development of fully functioning manufacturing operations, refinement of processes and components for our commercial products, recruitment of qualified personnel, ability to manufacture a product which meets cost, reliability and efficiency needs, and achievement of market acceptance for our products.

Our businesses are dependent on a small number of customers, and termination of a project by one or more of these customers could harm our business.

Typically, sales are made to customers under single contracts. For the year ended December 31, 2007, our largest 5 customers accounted for 31% of our revenues and our largest 10 customers accounted for 44% of our revenues. Because such a high percentage of our sales are concentrated in so few contracts, failure by us or our customers to perform or deliver on any one of these contracts could have a major impact on our annual results of operations. In addition, most of our customer contracts are terminable on short notice. This high concentration of sales in a small number of customers also subjects us to a high degree of customer credit risk and risk of non-performance by our vendors. A single vendor s late delivery of a key component required for a project, for example, could significantly delay our completion of the project and might trigger liquidated or consequential damages or other penalties as may be stipulated in our contracts with our customers.

In the past, we have experienced performance problems with our hydrogen generators.

In the past, we have experienced performance problems with some components of our hydrogen generators, specifically hydrogen sensor modules, power supplies and cell stacks, which have required component replacement. We cannot guarantee that further problems related to these or other components or products will not occur and require additional corrective measures. If we are unable to solve these problems, potential purchasers of our products may decline to purchase them, which could affect our ability to grow our revenues. We could also face liability to our customers and harm to our reputation as a result.

We may not be able to grow our business if we do not achieve widespread commercial acceptance of our hydrogen generators in the market for delivered hydrogen.

We market our hydrogen generators to small and medium volume users of delivered hydrogen. Our method of supplying hydrogen by producing it on-site using PEM electrolysis represents a significant departure from conventional means of supplying hydrogen to end users. PEM electrolysis is a new technology in the markets we are targeting, and we do not know if our targeted customers will accept our product. Our business depends on the widespread commercial acceptance of our hydrogen generators, and we may be unable to grow our business if our targeted customers do not purchase substantial numbers of our hydrogen generators. Our targeted customers, or the distributors whom we intend to use to market to these customers, may not purchase our hydrogen generators at all or in sufficient quantities to support the growth of our business. Our hydrogen generators will require our target customers to make a substantial initial investment.

We expect to incur significant expenses as we continue to expand our manufacturing production, and we may not be successful in these efforts.

We have expanded our hydrogen generator and wind turbine manufacturing facilities in anticipation of increased demand for our products. If this demand does not materialize, we will not generate sufficient revenue to offset the costs of maintaining, expanding and operating these facilities, which could increase our losses and prevent us from growing our business. We expect to expand production and may experience delays or problems in our expected expansion that could compromise our ability to increase our sales and grow our business. Factors that could delay or prevent our expected production expansion include:

- the inability to purchase parts or components in adequate quantities or sufficient quality, including from sole source vendors;
- the cost and availability of raw materials;
- the failure to increase assembly and test operations;
- the failure to hire and train additional manufacturing personnel; and
- the failure to develop and implement cost-efficient manufacturing processes and equipment.

In addition, we may incur significant manufacturing costs and may experience unforeseen delays and expenses in our product design and manufacturing efforts. If the commercialization of our products is delayed, potential purchasers may also decline to purchase them or choose alternative technologies, both of which could impair our ability to generate revenue in the future.

We may not be able to increase revenues in the future if we do not complete the development of new products and technologies.

We anticipate that a portion of our future revenue from our business will be derived from the sale or licensing of regenerative fuel cell, wind turbine and power electronics products and technologies which we are currently developing or have only recently made commercially available. Many of these new products and technologies are based on new and unproven designs, and it is difficult to predict whether they will be commercially viable. If we fail to successfully develop and commercialize these products and technologies on the timetable we anticipate or at all, we will be unable to recover the investments we have made in their development and will be unable to grow our revenue from their sale or licensing. In addition, we may not be successful in developing product designs and manufacturing processes that permit the manufacture of our hydrogen generators and fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, we sell some of our products for less than it costs to produce them. New technology developments or cost reductions in existing technologies may also delay or prevent the development or sale of some or all of our planned products or make our planned products uncompetitive or obsolete.

We rely on third party suppliers and subcontractors for certain components and services, and we could suffer losses if these suppliers and subcontractors fail to fulfill our needs.

Many of the components in our distributed generation and hydrogen generation systems, including the proton exchange membrane material used in our PEM products, hydrogen purification system and custom-designed power supplies used in our products, are available only from a limited number of suppliers and in some

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cases only a single supplier. Some of our suppliers are small- and medium-size companies that may not be able to increase production in an acceptable time period or at acceptable prices or quality levels. In addition, to the extent these components are proprietary products of our suppliers, or the processes used by our suppliers to manufacture these components are proprietary, we may be unable to obtain licenses on commercially reasonable terms or at all, and we may be unable to obtain comparable components from alternative suppliers. Often our suppliers custom engineer components to our specifications for use in our systems. Delayed deliveries, poor quality and warranty issues can delay production of our products or completion of our projects, reduce our profits and damage our relationships with our customers.

We have an agreement with one customer providing for construction of power systems that utilize Stirling engine technology. On February 16, 2007, we were notified that the manufacturer of these engines, STM Power, Inc., had ceased operations. We have informed the customer that, due to STM s cessation of operations, we are likely unable to complete and maintain these power systems as planned. As of December 31, 2007 the Company has recorded additional estimated project losses of approximately $0.8 million, which represents our best estimate of the costs required to resolve the contract. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

We rely heavily on electrical, mechanical, civil and structural subcontractors to build and install our distributed generation systems at our customers facilities based on detailed specifications and drawings that we provide. Often these subcontracted services account for a high percentage of the overall project cost. Our subcontractors failure to perform their services in a timely and quality manner can lead to significant schedule delays, increased costs and performance issues on our projects. These issues can trigger penalties in our contracts, expose us to claims for liquidated and consequential damages, increase our warranty exposure, reduce our profits and damage our relationships with customers if not managed appropriately.

Market factors affect our costs and availability of materials.

Our products contain a number of materials, from metals to computer components. In particular, platinum is a key component of our PEM fuel cells. Platinum is a scarce natural resource and we are dependent upon a sufficient supply of this commodity. Decreases in the availability or increases in the prices of the commodities or other components of our products could impair our ability to acquire the materials necessary to meet our manufacturing requirements and result in significantly higher prices for those materials, either of which could cause delayed or lost sales and an increase in our manufacturing costs.

We may be unable to sell our systems and products and generate revenue if we fail to establish development, engineering, distribution or other strategic relationships.

We currently work with a number of other parties who facilitate and enhance many aspects of our distributed generation systems and wind turbine businesses; including technology development, component supply, sales lead generation, engineering support and project installation. We must continue to expand these relationships and develop new relationships in order to grow our business. Failure to do so would negatively affect our future sales growth and results of operations.

Because we intend to sell some of our products through third-party distributors, the financial benefits to us of commercializing our products will be dependent on the efforts of others. We intend to enter into additional distribution agreements or other collaborative relationships to market and sell our products. If we are unable to enter into additional distribution agreements, or if our third-party distributors do not successfully market and sell our products, we may be unable to generate revenue and grow our business. We may seek to establish relationships with third-party distributors who also compete with us. In addition, our third-party distributors may require us to provide volume price discounts and other allowances, or customize our products, either of which could reduce the potential profitability of these relationships.

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We may not recognize revenue in the full amount of our backlog, which could harm our business.

Our backlog was approximately $9.2 million as of December 31, 2007. Our backlog includes orders under contracts that in some cases extend for several years. Our estimate of the portion of the backlog as of December 31, 2007 from which we expect to recognize revenue in fiscal 2008 may be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog. The actual accrual of revenue on engagements included in backlog may never occur or may change because a contract could be reduced, modified or terminated early. If we fail to realize revenue from engagements included in our backlog as of December 31, 2007, our revenue and results of operations for fiscal 2008 as well as future reporting periods may be materially harmed.

We depend on government contracts for a portion of our revenue and profits and to fund a portion of our research and development relating to new products.

Our government contracts relate to research and development on renewable energy technologies, hybrid system architectures and advanced power electronics. Changes in government policy toward distributed generation or budget restrictions may reduce or eliminate funding for these types of research and development activities. Generally, our U.S. government research and development contracts are subject to the risk of termination at the convenience of the contracting agency and require us to obtain or produce components for our systems from sources located in the United States rather than foreign countries. There can be no assurance that our current contracts will be fully funded or that we will be able to secure additional government contracts for similar activities in the future. If such funding were discontinued, we may not have sufficient internal funding to continue with these development efforts and may therefore have to reduce our development of these products, delay their development or abandon them altogether. Discontinuation or delay in our development of proprietary products and technology could limit our ability to execute our business plan and may have an adverse impact on our ability to increase revenues and generate a profit. We are also subject to annual audits of our incurred costs on government contracts by the Defense Contracting Audit Agency, or DCAA. If our actual overhead cost included in our incurred costs is less than the allowable overhead costs billed on these contracts, we may be required to refund the excess overhead costs to the government upon completion of the DCAA audit. Such a refund would negatively affect our financial position and our results of operations in the year in which such costs were incurred.

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

We currently face and will continue to face significant competition, which could cause us to lose sales or render our products and services uncompetitive or obsolete.

The distributed generation and wind turbine markets are highly competitive and evolving rapidly. We face a wide variety of competitors, including equipment manufacturers, distributors, packagers, system integrators, general contractors, engineering firms, project developers and energy service companies. Many of our competitors are significantly larger and better capitalized than we are and have greater access to financial and other resources, and therefore may be able to devote more resources to the following activities that may allow them to establish a competitive advantage in the marketplace:

- sales and marketing of their products and services;
- seller financing for the sale of their products or services;
- development and commercialization of new technologies;

- partnering and other collaborative efforts with sales channel partners, vendors and technology providers;
- adaptation to changes in customer requirements;
- expanded design, engineering and other performance and service capabilities; and
- system and other infrastructure development that reduces costs.

The markets for delivered hydrogen and reliable backup power are highly competitive. There are a number of companies located in the United States, Canada and abroad that deliver hydrogen, sell hydrogen generation equipment or are developing PEM fuel cell technology. There are a number of companies that are large, established and well capitalized wind turbine manufacturers. Many of these companies have substantially greater financial and other resources than we do, including a worldwide presence, name recognition and better historical performance. Each of these companies has the potential to capture market share in the markets we intend to address, which could cause us to lose sales and prevent us from growing our business. New developments in technology may also delay or prevent the development or sale of some or all of our products or make our products uncompetitive or obsolete. If this were to occur, we would not be able to generate sufficient revenue to offset the cost of developing our hydrogen generators and regenerative fuel cell systems.

Our regenerative fuel cell systems and wind turbines are among a number of power technology products being developed today to provide high quality, highly reliable backup power to the existing electric transmission system, or grid. These products include advanced batteries, ultracapacitors, microturbines, flywheels, internal combustion generator sets, superconducting magnetic energy storage devices, other fuel cell types and fuel cells using alternative hydrogen supply applications. Improvements are also being made to the existing electric grid. Technological advances in power technology products and improvements in the electric grid may reduce the attractiveness of our products.

We depend on our intellectual property, and our failure to protect it could enable competitors to market products with similar features that may reduce demand for our products.

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to ours, which could reduce demand for our products. Our success depends substantially upon the internally developed technology that is incorporated in our products. We rely on patent, trademark and copyright laws, trade secret protection and confidentiality or license agreements with our employees, customers, strategic partners and others to protect our intellectual property rights. The steps we take to protect our intellectual property rights, however, may be inadequate. We may be unable to prevent unauthorized parties from attempting to copy or otherwise obtaining and using our products or technology. Policing unauthorized use of our technology is difficult, and we may not be able to prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our intellectual property as fully as those in the United States. Others may circumvent the trade secrets, trademarks and copyrights that we own, and any of the U.S. patents or foreign patents owned by us or subsequently issued to us may be invalidated, circumvented, challenged or rendered unenforceable. In addition, we may not be issued any patents as a result of our pending and future patent applications, and even if any patents are issued, they may not protect our intellectual property rights, and third parties may challenge the validity or enforceability of issued patents. In addition, other parties may independently develop similar or competing technologies designed around any patents that may be issued to us.

Most of our intellectual property is not covered by any patent or patent application. We seek to protect this proprietary intellectual property, which includes intellectual property that may not be patented or patentable, in part by confidentiality agreements with our contactors, distributors, employees and others. These agreements afford only limited protection and may not provide us with adequate remedies for any breach or prevent other persons or institutions from asserting rights to intellectual property arising out of these relationships.

Unauthorized parties may attempt to copy aspects of our products or to obtain and use our proprietary information. Litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets and to determine the validity and scope of the proprietary rights of others. Any litigation could result in substantial costs, the diversion of resources and the distraction of management, with no assurance of success.

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We could incur substantial costs defending against claims that our products infringe on the proprietary rights of others.

The patent situation in the field of wind turbine, distributed generation and PEM fuel cell technology is complex. A large number of patents, including overlapping patents, relating to this technology have been granted worldwide. We are aware of patents in the wind turbine and distributed generation fields held by potential competitors and other third parties, including Ballard Power Systems Inc., General Electric Company, Asea Brown Boveri Ltd., Siemens AG, Gamesa Corporacion Tecnologica, S.A., ENERCON GmbH and Mitsubishi Corporation. We are also aware of patents in the fuel cell architecture field held by potential competitors and other third parties, including Ballard Power Systems Inc., General Motors Corporation, Giner, Inc., Oronzio deNora Impianti Elettrochimici S.p.A., Parker-Hannifin Corporation, Hydrogenics Corporation, Lynntech, Inc., Plug Power Inc., Shinko Pantec Co., Ltd., Siemens AG, Toyota Motor Corporation, United Technologies Corporation and Whatman Inc. Third parties could claim infringement by us with respect to these patents or other patents or proprietary rights, and we may incur significant costs defending ourselves in such proceedings, and there is no assurance that we will prevail in any such proceeding.

While we have a limited license under a patent held by General Electric Company with respect to variable-speed wind turbines, if we incorporate this type of technology into future wind-related generation products and are not able to design and engineer non-infringing technology, we may be required to extend or modify our license on this technology. If we are unsuccessful in developing non-infringing technologies, we may be required to cease or redirect our development efforts or obtain licensing, royalty or other agreements. There can be no assurance that we can obtain such licensing or other agreements on favorable terms or at all, in which case our ability to execute our business plan, grow our sales and generate a profit may be adversely affected.

In addition, some of our employees are parties to assignment of invention and nondisclosure agreements with their former employers. These agreements generally grant the former employer rights to technology developed by the employee while employed by the former employer and prohibit disclosure of that technology or other employer information to third parties. We cannot assure you that such employers will not assert claims against us or our employees alleging a breach of those agreements or other violations of their proprietary rights or alleging rights to inventions by our employees, or that we would prevail in any such proceeding.

Any infringement claims against us, whether meritorious or not, could:

- be time-consuming;
- result in costly litigation or arbitration and diversion of technical and management personnel; or
- require us to develop non-infringing technology or to enter into royalty or licensing agreements.

We might not be successful in developing non-infringing technologies. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, or at all, and could significantly harm our business and results of operations. A successful claim of infringement against us or our failure or inability to license the infringed or similar technology could require us to pay substantial damages and could harm our business because we would not be able to sell the affected product without redeveloping the product or incurring significant additional expense. In addition, to the extent we agree to indemnify customers or other third parties against infringement of the intellectual property rights of others, a claim of infringement could require us to incur substantial time, effort and expense to indemnify these customers and third parties and could disrupt or terminate their ability to use, market or sell our products.

International intellectual property protection is particularly uncertain and costly, and we have not obtained or sought patent or trademark protection in many foreign countries where our products and services may be developed, manufactured, marketed or sold.

Intellectual property law outside the United States is even more uncertain and costly than in the United States and is currently undergoing review and revision in many countries. Further, the laws of some foreign

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countries may not protect our intellectual property rights to the same extent as U.S. laws. Moreover, we have not sought, obtained or maintained patent and trademark protection in many foreign countries in which our products and services may be developed, manufactured, marketed or sold by us or by others.

We may be exposed to lawsuits and other claims if our products or systems malfunction or fail or we fail to deliver services, which could increase our expenses, harm our reputation and prevent us from growing our business.

Our distributed generation systems often use new and untested technologies. Many of these new technologies have not reached a level of maturity that allows for a predictable level of reliability and may be subject to malfunction or failure when subjected to prolonged use in non-test conditions. Should these new technologies fail to perform as specified by their vendors, we may incur significant warranty and other costs and our relationships with our customers may suffer. Also, many vendors of these new technologies have limited financial resources and may not be able to adequately support their products in the field. All these issues could reduce our growth and profitability. Many of our systems are also located in very remote locations with extremely harsh climates that are difficult and expensive to access. The possibility of system failures could cause us to incur significant expense to redesign, reengineer, repair and/or replace defective systems or system components. In addition, as we expand our overhaul, operations and maintenance services business, we may be subject to additional liability for maintaining distributed generation equipment, including performance of equipment, uptime availability of equipment, maintenance and warranty cost.

Because our products are power-producing devices, it is possible that consumers could be injured or killed by our products, whether by product malfunctions, defects, improper installation or other causes. In particular, hydrogen is a flammable gas and can pose safety risks if not handled properly. We have experienced instances with our products where hydrogen appears to have caused a flame that burned several components in the system. Further investigation of this unit revealed the presence of pinholes in the cell membranes, resulting in hydrogen leakage and cell failure. We cannot be certain that future similar instances will not occur. In addition, our products may require modifications to operate properly under extreme temperatures. Potential customers will also rely upon our products for critical needs, such as backup power. A malfunction of our products could result in significant tort or warranty claims. In addition, a well-publicized actual or perceived problem could adversely affect the market s perception of our products. This could result in a decline in demand for our products, which would reduce our revenue and harm our business. In addition, since sales of our existing products have been modest and the products we are developing incorporate new technologies and use new installation methods, we cannot predict whether or not product liability claims will be brought against us in the future or the effect of any resulting adverse publicity on our business. Moreover, we may not have adequate resources in the event of a successful claim against us. We have evaluated the potential risks we face and believe that we have appropriate levels of insurance for product liability claims. We rely on our general liability insurance to cover product liability claims and have not obtained separate product liability insurance. The successful assertion of product liability claims against us could result in potentially significant monetary damages, and if our insurance protection is inadequate to cover these claims, we could be required to make significant payments.

We conduct business in many countries that are politically and economically unstable.

The potential for political unrest, acts of terrorism and war, and economic collapse exists in many countries in which we currently, or may in the future, do business. The occurrence of any such events at or near the site of our projects could lead to delay, cancellation or significant damage to our projects or equipment. The occurrence of any such events could also cause harm, injury or death to our personnel working on such projects. Any such events could expose us to significant liabilities and would therefore adversely affect our results of operations and growth.

We also subcontract work or may hire temporary and permanent employees in countries that are politically and economically unstable. It is more difficult to perform background checks on these foreign workers or to be sure that their conduct and performance are in the best interests of our company and in full compliance with applicable laws.

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Our current or planned international operations subject our business to additional risks, which could cause revenues to decline.

A portion of our revenue is generated from sales of equipment and projects in foreign markets. Many of these projects are delivered to distant locations, such as the Middle East, Eurasia, Africa and South America. In addition, we intend to market our hydrogen generators to small- and medium-volume users of delivered hydrogen worldwide. Selling our services and products internationally exposes us to many additional costs, risks and potential liabilities, which, if improperly managed, could limit our ability to grow in these markets and adversely affect our results of operations. These include:

- exchange controls;
- complying with U.S. legal requirements for the exporting of goods;
- complying with the commercial, regulatory and legal requirements of foreign markets, particularly in developing countries;
- obtaining and/or enforcing intellectual property protection;
- overcoming trade barriers such as duties, tariffs and taxes;
- enforcing contract terms and conditions;
- collecting receivables;
- managing operations and staff across disparate geographic areas; and
- currency risks.

In addition, a change in the value of the U.S. dollar may make our services and products less competitive in international markets.

RISKS RELATING TO OUR INDUSTRY

We may not be able to grow our revenues in the future if a sustainable market for our distributed energy, wind turbine products and hydrogen generation products and services does not develop.

Our future growth will be based in part on increased use of distributed generation, on the development of a mass market, particularly in the automobile industry, for PEM fuel cells that utilize our hydrogen generators as a fuel source and on growth in the use of renewable energy. These are emerging markets and it is difficult to predict the rate at which they will develop. If a sustainable market for distributed energy technologies fails to develop or develops more slowly than we anticipate, our ability to grow and achieve profitability will be negatively affected. Many of the factors that influence the rate of adoption of distributed energy and hydrogen generation technologies are out of our control. Some of these factors that we cannot control are:

- utility electric rates;

changes in federal, state and local regulatory requirements;

changes in federal and state incentives and subsidies;

cost, quality, performance and availability of the alternative power generation technologies used or supported by our power systems and hydrogen generators;

costs and availability of natural gas, diesel, hydrogen and other fuels used in distributed energy technologies;

changes in customers perceptions regarding distributed generation, PEM fuel cells and alternative energy;

customer reluctance to try new products and technology;

availability of financing for distributed generation vendors, developers and users;

- economic downturns and related reductions in capital spending;
- demand for and valuation of emissions trading credits generated by distributed generation systems; and
- the emergence of newer, more competitive technologies.

If we fail to retain key personnel and attract and retain additional qualified personnel, we may be unable to develop our products and generate revenue.

Our success depends upon the continued service of our executive officers and other key employees such as manufacturing and research and development personnel. The loss of any of our executive officers or key employees could impair our ability to pursue our growth strategy. We do not have employment agreements with many of our key executives. We may not be able to attract, assimilate or retain additional highly qualified personnel in the future.

We may be affected by skilled labor shortages and labor disputes.

We require experienced engineers, technicians and machinists to conduct our business. No assurance can be given that the supply of these skilled persons will always be adequate to meet our requirements or that we will be able to attract an adequate number of skilled persons. Labor disputes could also occur at our manufacturing facilities, which may affect our business. While our employees are not currently represented by labor unions or organized under collective bargaining agreements, labor disputes could occur at any of our facilities.

Declines in the price of utility-delivered electricity or our inability to continue to reduce the cost of our distributed generation systems could reduce demand for our services and products.

Our distributed generation systems compete mainly on price per delivered kilowatt-hour of electricity to the end user. In the domestic market, we compete against the cost of electricity delivered by the local utilities through the electric grid. The cost of electricity varies widely from utility to utility and from state to state and is subject to change based on factors beyond our control. We cannot accurately predict what future electricity rates will be and whether or not we can compete effectively against these rates.

The cost per delivered kilowatt-hour of electricity generated by our on-site power systems is also based primarily on the following three factors: the cost of the underlying generating technologies, the cost of financing, and the cost of fuel. All these factors are outside of our control.

- Costs of alternative power generation technologies like solar panels and wind turbines have generally been falling over the past several years, but there can be no assurance that they will continue to fall in the future. Without federal or state subsidies or incentives, the cost of these technologies is often not competitive with traditional generating technologies or the cost of utility power. If the costs of these alternative technologies do not continue to fall or subsidies are no longer available, our ability to sell systems and services based on these technologies will be diminished.
- Financing costs are critical to the cost competitiveness of renewable energy. Since fuel from the wind or sun is free, financing costs represent the single largest operating cost. Financing costs are also highly variable and subject to change beyond our control. If financing costs increase, it could reduce demand for our products.
- For reciprocating engine or turbine-based power systems, fuel is the largest operating cost. The predominant fuel for these systems is natural gas. The price of natural gas has been highly volatile and is currently projected to remain high for several years based on increased demand and limited domestic supply. Sustained high gas prices reduce the economic benefit of the on-site power systems we sell and may therefore cause us to experience reduced sales and revenue growth.

Utility companies could place barriers to our entry into the market, and we may not be able to effectively sell our products and systems.

Utility companies could place barriers on the installation of our products and systems or their interconnection with the electric grid. Further, they may charge additional fees to customers who install on-site generation systems, thereby reducing the electricity they take from the utility, or who use power from the grid for backup or standby purposes. These types of restrictions, fees or charges could impair the ability of our potential customers to install or effectively use our products and systems or increase the cost to our potential customers for using our products and systems. This could make our products and systems less desirable, thereby adversely affecting our revenue and profitability potential.

Decreases in the price of oil and gas could reduce demand for our distributed generation and wind turbine systems, which would harm our ability to grow our business.

Most of our wind turbine products are sold for use in power systems used by remote communities to replace or augment internal combustion engines. Demand for our wind turbines from this market segment depends in part on the current and future commodity prices of oil and gas. Higher oil and gas prices provide incentives for customers to invest in technologies such as wind turbines that reduce their need for petroleum-based fuels. Conversely, lower oil and gas prices would tend to reduce the incentive for customers to invest in capital equipment to produce electrical power.

Continued uncertainty in domestic and world economies and energy markets may limit our growth.

Current uncertainty among our target customers over the health of the economy and its impact on their business has restricted their capital spending and made it harder for us to sell our distributed generation systems and services. Other market uncertainties that also affect our ability to increase sales include the future of deregulation of the domestic electricity market, the future price of oil and natural gas, political instability in the Middle East and other regions where we do business, and domestic and international policy responses to environmental issues.

Because sales of our distributed generation systems are reliant in part on federal and state subsidies and incentives, any reduction in federal or state subsidy programs could harm our business.

The domestic market for our distributed generation systems currently benefits from many federal and state programs designed to promote increased use of renewable and distributed generation technologies. The federal government, for example, offers tax credits for energy produced by wind and solar generators. States like California, New York, New Jersey, Connecticut and Massachusetts offer cash incentives which reduce the initial capital cost to customers who invest in renewable and distributed generation systems. All these federal and state incentive and subsidy programs have specific expiration dates and there can be no assurance that these programs will be extended. Termination of one or more of these programs may have an adverse impact on our future growth. Additionally, there can be no assurance that new programs will be created. In an economic downturn, with resulting budget deficits, funding for many of the state programs may be at risk of being diverted to other needs.

Government regulations may impair our ability to market and sell our products.

Our products and projects are potentially subject to federal, state, local and foreign laws and regulations governing, among other things, waste water discharge and air emissions as well as laws relating to occupational health and safety. We may incur substantial costs or liabilities in complying with governmental regulations. Our potential customers must also comply with numerous laws and regulations, which could affect their interest in our products and projects. We could incur potentially significant expenditures in complying with environmental and health and safety laws, regulations and requirements that may be adopted or imposed in the future.

Electricity generation and delivery are both heavily regulated by federal and state governments. While deregulation and restructuring of the U.S. power industry may ultimately expand the market for distributed generation systems of the type that we sell, recent problems associated with deregulation in key domestic markets like California may impose additional barriers to distributed generation. California and other states, for example, allow utilities to impose exit fees, standby charges and other penalties on customers who install distributed generation systems. Federal and state regulations regarding air quality and interconnection to the utility grid also impose additional costs and potential liabilities on our business. Changes in these regulations could reduce or eliminate our access to certain of our target markets. Changes in regulatory standards or policies could reduce the level of investment in the research and development of alternative power sources. Any reduction or termination of such programs can increase the cost to our potential customers, making our systems less desirable, and thereby adversely affecting our revenue and results of operations.

Compliance with environmental regulations can be expensive, and noncompliance with these regulations may result in adverse publicity and potentially significant monetary damages and fines.

We are required to comply with all federal, state, local and foreign regulations regarding protection of the environment. If more stringent regulations are adopted in the future, the costs of compliance with these new regulations could be substantial. If we fail to comply with present or future environmental regulations, we may be required to pay substantial fines, suspend production or cease operations. We use, generate and discharge toxic, volatile and otherwise hazardous chemicals and wastes in our research and development and manufacturing activities. Any failure by us to control the use of, or to restrict adequately the discharge of, hazardous substances could subject us to potentially significant monetary damages and fines or suspensions in our business operations. In addition, under some foreign, federal and state statutes and regulations, we may be deemed responsible for investigative and remedial costs at formerly owned or operated locations, or at third party sites at which our wastes were disposed.

OTHER RISKS

Our stock may be delisted, which would affect its ability to be readily traded

On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

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Our stock price is likely to be highly volatile and may result in substantial losses for investors purchasing shares.

The market price of our common stock is likely to continue to be highly volatile. The stock market in general and the market for technology-related stocks in particular, has been highly volatile. As a result, investors in our common stock may experience a decrease in the value of their common stock regardless of our operating performance or prospects. Our common stock may not trade at the same levels as other technology-related stocks, and technology-related stocks in general may not sustain their current market prices. In addition, an active public market for our securities may not be sustained.

The trading price of our common stock could be subject to wide fluctuations in response to:

- our perceived prospects;
- variations in our operating results and achievement of key business targets;
- changes in securities analysts recommendations or earnings estimates;
- the inclusion of a going concern modification in our independent registered public accountant s audit report;
- differences between our reported results and those expected by investors and securities analysts;
- announcements of new products by us or our competitors;
- market sentiment toward power technology and alternative energy stocks in general or to us in particular;
- trading of options or other derivatives on our common stock;
- market reaction to any acquisition, joint venture or strategic investments announced by us or our competitors; and
- general economic or stock market conditions unrelated to our operating performance.

In the past, securities class action litigation has often been instituted against companies following periods of volatility in their stock price. This type of litigation could result in substantial costs and divert management s attention and resources.

Provisions of our certificate of incorporation and bylaws and Delaware law could inhibit a takeover that stockholders may consider favorable and diminish the voting rights of the holders of our common stock.

There are provisions in our certificate of incorporation and bylaws that make it more difficult for a third party to acquire, or attempt to acquire, control of us, even if a change in control may be considered favorable by our stockholders. For example, our board of directors has the authority to issue up to 5,000,000 shares of preferred stock. The board of directors can fix the price, rights, preferences, privileges and restrictions of the preferred stock without any further vote or action by our stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. As a result, the market price of our common stock and the voting and other rights of our stockholders may be adversely affected. The issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

Our certificate of incorporation and bylaws contain other provisions that could have an anti-takeover effect, including:

- only one of the three classes of directors is elected each year;
- stockholders have limited ability to remove directors;
- stockholders cannot take actions by written consent;

stockholders cannot call a special meeting of stockholders; and

stockholders must give advance notice to nominate directors or submit proposals for consideration at stockholder meetings.

In addition, we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which regulates corporate acquisitions. These provisions could discourage potential acquisition proposals and could delay or prevent a change in control transaction. They could also have the effect of discouraging others from making tender offers for our common stock. These provisions may also prevent changes in our management.

Because we do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.

We anticipate that we will retain our earnings to support operations and to finance the growth and development of our business and do not expect to pay cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.

ITEM 1B. ***Unresolved Staff Comments***

None.

ITEM 2. ***Properties***

Our corporate office and our Proton subsidiary are located in a 100,000 square foot facility in Wallingford, Connecticut.

Our Northern subsidiary relocated its principal executive offices from Waitsfield, Vermont during January, 2007 to principal executive offices located in its 110,000 square-foot manufacturing facility in Barre, Vermont. The Barre facility was purchased in October 2005. Northern qualified for assistance from VEDA, which together with Vermont s Merchants Bank, provided financing for a substantial portion of the purchase.

Northern currently leases four offices used primarily for their Sales and Service departments in California, Texas and New York.

In March 2003, Northern entered into a financing agreement with the Vermont Economic Development Authority, or VEDA, regarding the purchase, construction, sale, and lease of its approximately 28,000 square- foot facility in Waitsfield, Vermont. In March 2003, a condominium association, Northern Power Systems Commercial Condominium Association, Inc., or NPS Condo Association, was formed for the purpose of managing the land, building, and improvements related to the facility. Northern owns 50% of the NPS Condo Association and has the ability to exercise significant influence over the NPS Condo Association. Northern transferred certain property and development rights under NPS Condo Association to the Central Vermont Economic Development Corporation, or CVEDC. In consideration, CVEDC secured a $2,790,000 loan from VEDA to complete the facility and lease back such facility to Northern. The terms of the lease include an initial term of ten years, lease payments equal to the debt payments plus an administrative fee, and a purchase option for Northern equal to the outstanding loan amount. Northern is required to maintain certain levels of insurance over the facility, is required to maintain $150,000 of restricted cash for performance under the agreements and indemnifies CVEDC from liability or lawsuit relating to the facility.

In December 2007, we entered into an agreement to lease approximately 13,000 square feet of office space in our vacant Waitsfield, Vermont building (Building #2) to the existing tenant of our other Waitsfield, Vermont building (Building #1) and simultaneously terminate the existing lease. The new lease has a six-year term, which runs through November 30, 2013, with rent payment escalations each year of the agreement. We are recognizing the rental income on a straight-line basis over the lease term. The rental income under the terms of the lease is as follows: 2008-$85,243; 2009-$88,650; 2010-$92,189; 2011-$95,869; 2012-$99,673; 2013-$94,765.

Northern entered into an agreement to sublease its 3,960 square foot of leased facility in San Leandro, California. The 15 month lease term is from November 1, 2007 through January 31, 2009. Pursuant to this sublease, the minimum rental payments due to Northern are $29,383 and $2,455 in 2008 and 2009, respectively.

ITEM 3. ***Legal Proceedings***

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton s IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court s certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit s decision. On April 6, 2007, the Second Circuit denied plaintiffs rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On June 25, 2007, the District Court signed an Order terminating the settlement. Proton believes it has meritorious defenses to the claims made in the complaints and Proton intends to contest the lawsuits vigorously. However, there can be no assurances that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

In 2005, our Northern subsidiary entered into an Engineering Procurement and Construction Contract with Aarhus Karlshamn USA, Inc., or Aarhus, for the design and installation of a combined heat and power system for a facility located in Newark, New Jersey. The proposed system used Stirling engines manufactured by a third party, STM Power, Inc. On February 20, 2007, STM Power ceased operations. As a result of STM Power s cessation of operations, they are unable to provide the components and warranty assistance needed for the engines.

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On October 19, 2007, Aarhus filed suit against us in the Superior Court of New Jersey, Essex County, alleging breach of contract, breach of warranty and negligence and seeking compensatory and consequential damages in excess of $4 million. We have two applicable insurance polices in an aggregate amount of $3 million, and both insurance carriers are participating in the defense of the claims. We believe we have meritorious defenses to the claims made in the complaint, and we intend to contest the lawsuit vigorously. There can be no assurances that we will be successful in our defense of the claims, however, and an adverse resolution of the lawsuit could exceed our insurance coverage and could have a material adverse effect on our financial position and results of operation in the period in which it is resolved. The range of potential loss for this matter is $0 to $4 million. We have accrued approximately $0.8 million for this matter, which represents our best estimate of the potential loss in this matter. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

ITEM 4. ***Submission of Matters to a Vote of Security Holders***

Not Applicable.

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Part II

ITEM 5. ***Market for Registrant s Common Stock and Related Stockholder Matters***

The range of high and low sales prices per share of our common stock as reported on the NASDAQ Global Market under the symbols DESC for 2007 and 2006 is shown below:

Year and Quarter	High	Low
2006		
First Quarter	$ 11.00	$ 6.24
Second Quarter	7.19	4.47
Third Quarter	5.30	2.90
Fourth Quarter	4.50	3.01
2007		
First Quarter	$ 3.90	$ 1.37
Second Quarter	1.85	0.64
Third Quarter	1.39	0.70
Fourth Quarter	0.82	0.28

As of March 5, 2008 there were approximately 504 stockholders of record.

Use of Proceeds

On September 28, 2000, Proton closed an initial public offering of its common stock, $.01 par value. The effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed was September 28, 2000, and the Commission file number assigned to the registration statement is 333-39748. After deducting underwriting discounts and commissions and offering expenses, our net proceeds from the offering were approximately $125.8 million. The net proceeds have been allocated for general corporate purposes and capital expenditures, including the purchase of equipment for leasehold improvements to our manufacturing facility, and the possible acquisition of businesses, products or technologies that are complementary to our business. We have also raised additional funding through means other than our initial public offering. On April 10, 2006, we entered into an equity distribution agreement with UBS Securities LLC. The equity distribution agreement provided that the we would offer and sell up to 3,000,000 shares of the Company s common stock from time to time through UBS Securities LLC, as sales agent or principal. The compensation to UBS Securities LLC for acting as sales agent was 4% of the first $15 million of gross sales price of the shares sold, and 3% of the gross sales price of the shares in excess of $15 million. From April 12, 2006 to May 5, 2006, we sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in proceeds of approximately $7.5 million. On May 17, 2006, we discontinued sales under the equity distribution agreement.

We made a cash distribution of $1.00 per share payable on June 20, 2003 to stockholders of record as of June 6, 2003. The aggregate amount of this distribution was $33,927,297. In December 2006, we paid approximately $136,000 cash to our board of directors based on our revised director compensation plan. No other portion of the proceeds of Proton s initial public offering were paid directly or indirectly to any director, officer or general partner of us or our associates, persons owning ten percent or more of any class of our equity securities, or an affiliate of us. As of December 31, 2007, we have expended cash in excess of the net proceeds from the IPO and the equity distribution agreement. As of December 31, 2007, approximately $138.6 million of the net proceeds of the public offerings had been used to fund operations and purchase fixed assets and $26.5 million has been used in the acquisition of Northern. At December 31, 2007, our cash and marketable securities balance was approximately $5.1 million.

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Equity Compensation Plan Information

The following table sets forth, as of December 31, 2007, the number of securities outstanding under our equity compensation plans, the weighted average exercise price of such securities and the number of securities available for grant under these plans:

Equity Compensation Plan Information as of December 31, 2007

Plan Category	Number of Shares to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding Column (a))
Equity Compensation Plans Approved by Shareholders:			
Employee Stock Purchase Plan			144,963
1996, 1998, 2000 and 2003 Stock Option Plans	5,306,284	$ 5.50	753,067
Equity Compensation Plans Not Approved by Shareholders (1)	500,000	$ 8.84	

(1) This represents options which were granted in 2006 without stockholder approval as an inducement grant in accordance with NASDAQ rules related to the hiring of Mr. Schwallie as our chief executive officer.

In January 2006, we granted Ambrose L. Schwallie, our former chief executive officer, an option to purchase 500,000 shares of our common stock at an exercise price of $8.84 per share. The Company also issued Mr. Schwallie 28,280 shares of common stock at a price of $.01 per share. These shares are fully vested. In addition, we issued Mr. Schwallie 100,000 shares of restricted common stock at a price of $.01 per share. Such shares were subject to a re-acquisition right that has now lapsed. We also agreed to issue Mr. Schwallie up to 300,000 shares of common stock at a price of $.01 per share under conditions that can no longer be met. These option and stock awards were made as inducement grants pursuant to Section 4350(i)(1)(A)(iv) of the NASD Marketplace Rules.

Contemporaneously with the commencement of his employment, Mr. Schwallie also purchased 56,561 shares of common stock from us in a private placement at a purchase price of $8.84 per share.

On October 31, 2007 Mr. Schwallie voluntarily resigned from the Company. The vesting of any unvested stock options terminated at that time. Mr. Schwallie had the right to exercise all vested options for 90 days following the termination date. Mr. Schwallie did not exercise any of his vested options during such period, and such options have now terminated.

On December 27, 2007 Walter Schroeder terminated his employment with the Company. Pursuant to a Transition Agreement, any and all stock options, as of the termination date, immediately accelerated and vested on the termination date. All options that were previously vested or that vested on the termination date shall be exercisable until the earlier of (i) the tenth anniversary of the original grant date of the respective option or (ii) December 31, 2008.

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ITEM 6. ***Selected Financial Data***

The data set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and notes thereto included elsewhere in this report. The selected financial data for 2003 include the full year of Proton s operations and the period from December 11, 2003 through December 31, 2003 for Northern and Distributed Energy.

	Year Ended December 31,				
	2007	**2006**	**2005**	**2004**	**2003**
	(In thousands, except per share data)				
Statement of Operations Data					
Revenues					
Contract	$ 17,911	$ 26,826	$ 34,197	$ 18,963	$ 2,810
Product	4,772	11,270	6,310	2,825	1,229
Service	6,705	6,997	4,473	672	155
Total revenue	29,388	45,093	44,980	22,460	4,194
Cost of revenues					
Contract	22,201	26,268	31,549	16,826	3,146
Product	3,829	10,226	6,207	3,904	2,223
Service	8,281	7,327	3,120	765	155
Total cost of revenue	34,311	43,821	40,876	21,495	5,524
Gross margin	(4,923)	1,272	4,104	965	(1,330)
Operating expenses					
Research and development	2,596	3,660	4,059	6,254	7,716
Restructuring costs	703				
Intangible impairment		1,450			
Goodwill impairment		24,191			
Selling, general and administrative	32,007	26,335	16,930	17,953	10,024
Total operating expenses	35,305	55,636	20,989	24,207	17,740
Loss from operations	(40,228)	(54,364)	(16,885)	(23,242)	(19,070)
Interest income	502	1,421	1,072	1,144	2,535
Interest expense	(7,245)	(747)	(483)	(335)	(243)
Gain (loss) on debt conversion and other	(2,903)	335	52	(4)	10
Net loss	$ (49,874)	$ (53,355)	$ (16,244)	$ (22,437)	$ (16,768)
Basic and diluted net loss per share	$ (1.25)	$ (1.38)	$ (0.45)	$ (0.63)	$ (0.50)
Shares used in computing basic and diluted net loss per share	39,813	38,622	36,271	35,465	33,830
Balance Sheet Data at year end					
Cash, cash equivalents and marketable securities	$ 5,085	$ 18,168	$ 40,666	$ 59,135	$ 73,848
Working capital	$ 4,649	$ 22,865	$ 44,068	$ 58,902	$ 76,804
Total assets	$ 41,751	$ 69,890	$ 111,146	$ 124,571	$ 144,032
Current liabilities	$ 16,467	$ 14,814	$ 16,156	$ 16,307	$ 13,636
Long term liabilities	$ 2,360	$ 8,335	$ 9,934	$ 8,830	$ 9,283
Total stockholders equity	$ 22,923	$ 46,740	$ 85,056	$ 99,434	$ 121,113
Cash Flow Data					
Net cash used in operating activities	$ (25,993)	$ (21,760)	$ (17,783)	$ (18,050)	$ (13,871)
Net cash (used in) provided by investing activities	$ 18,447	$ (2,409)	$ 30,205	$ 19,979	$ 35,803
Net cash provided by (used in) financing activities	$ 7,720	$ 8,480	$ 2,189	$ (215)	$ (34,072)

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ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with Selected consolidated financial data and our consolidated financial statements and the related notes included in this Annual Report on Form 10-K. Throughout this discussion and analysis, we discuss our two business segments for financial reporting purposes, Northern and Proton. Northern is our distributed generation and wind turbine systems business segment and Proton is our hydrogen generator business segment. This discussion contains forward-looking statements that are based on management s current expectations, estimates and projections about our business and operations. Our actual results may differ materially from those anticipated and expressed in such forward-looking statements and as a result of several factors, including the factors described under Risk Factors and elsewhere in this Annual Report on Form 10-K for the year ended December 31, 2007 and other Securities Exchange Act filings.

OVERVIEW

We do business through two subsidiaries. Proton designs, develops, sells and manufacturers on-site hydrogen gas delivery systems. This business has its headquarters in Wallingford, Connecticut and conducts business worldwide. Northern has been in a broad range of businesses including the design and sale of power generation equipment, engineering, procurement and construction of distributed power systems, the design and sale of direct drive wind turbines, and the servicing of fossil fuel power generation equipment. As described above in the Business section, management of Northern is systematically narrowing its focus to the design and sale of direct drive wind turbines and associated power electronics. Throughout 2007, Northern completed projects in the distributed power and engineering, procurement and construction businesses, while declining to sign any new additional projects in this area. We are continuing to complete the final phases of a small number of projects and are evaluating the sustainability of our power generation service business.

Update on our Financial Condition; Perseus Transaction

Since December 31, 2006, our financial condition has deteriorated significantly. We had anticipated that our previously announced revenue initiatives would improve sales and margins, but our sales and gross margins in the quarter and the twelve months ended December 31, 2007 were below our expectations in particular in our Northern subsidiary. Our previously announced joint venture with Morgan Stanley Wind LLC did not generate new business in 2007 and therefore we exited this joint venture in February, 2008 and received a one-time payment of $500,000 from Morgan Stanley Wind LLC for our 15% ownership share of the joint venture. Accordingly, we have been required to raise additional funds and significantly cut our costs in order for our business to survive.

To address our need to raise additional working capital, we entered into three loan transactions with Perseus Partners VII, L.P., or Perseus, which are described in more detail in Notes 1 and 10 to our consolidated financial statements included in this Annual Report on Form 10-K. On June 1, 2007, we closed on the first of these transactions, in which we borrowed $12.5 million from Perseus and issued to Perseus a warrant to purchase shares of our common stock. This loan bore interest at the rate of 12.5% per annum and was secured by all of our assets and those of our material subsidiaries. On August 24, 2007, we closed on the second of the two transactions, in which we borrowed $15.0 million from Perseus, used a portion of these proceeds to repay the principal and accrued interest on the initial loan and issued another warrant to Perseus to purchase additional shares of our common stock. The net amount we received in the second loan, after deducting the amount necessary to repay the principal and accrued interest due on the initial note, was $2.1 million. On March 13, 2008 we borrowed an additional $1.5 million from Perseus. This additional convertible debt bears interest at 12.5% per annum and is due in full November 30, 2008.

On September 14, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, for the previous 30 consecutive business days, the bid price of our common stock had closed below the minimum $1.00 per share requirement for continued inclusion under NASDAQ Marketplace Rule 4450(a)(5). In accordance with NASDAQ Marketplace Rule 4450(e)(2), we were provided 180 calendar days, or until March 12, 2008, to regain compliance. On January 30, 2008, our board of directors authorized us to apply to transfer the listing of our shares from the NASDAQ Global Market to the NASDAQ Capital Market. On February 14, 2008, the NASDAQ Listing Qualifications Department informed us that our application to transfer the listing of our shares to the NASDAQ Capital Market had been approved, and on February 19, 2008, our shares began trading on the NASDAQ Capital Market.

As a result of the transfer of the listing of our common shares to the NASDAQ Capital Market, we have been afforded the NASDAQ Capital Market s additional 180 calendar-day period, or until September 8, 2008, to regain compliance with the minimum bid price requirement. To regain compliance, the bid price of our common stock must close at $1.00 per share or more for a minimum of ten consecutive business days at any time prior to September 8, 2008. If we do not regain compliance, our common stock will be delisted. If our common stock is delisted from the NASDAQ Capital Market, our common stock may be eligible to trade on the National Association of Securities Dealers Over-the-Counter Bulletin Board System, another over-the-counter quotation system, or on the pink sheets. There can be no assurance that our common stock will be eligible for trading on any alternative system, and, even if it is so eligible, the liquidity and marketability of shares of our common stock will decrease.

We incurred significant operating losses and negative cash flows from operating activities in each of the last three years and during the quarter and the twelve months ended December 31, 2007. Such circumstances raise substantial doubt about our ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under its current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

While we recently obtained funding from Perseus as described above, we do not expect that our current capital resources will be sufficient to operate our business beyond the next thirty to forty-five days, and we expect that we will need to raise additional capital within the next thirty days to continue to operate. Our ability to continue our operations in the long term will be subject to a number of factors that pose additional risk and uncertainty, including:

- Our ability to secure additional capital funding or debt funding in the near future on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

- Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues.

- Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow.

- Our ability to control operating expenses.

- The potential acceleration of debt service payments by one or more of our lenders as the result of subjective acceleration clauses in our debt agreements.

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CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared by us in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, depreciable lives of equipment, warranty obligations and contingency accruals. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in this Annual report on Form 10-K. Our audit committee has discussed our critical accounting policies with management and our independent registered public accounting firm.

Our critical accounting policies include the following:

Revenue Recognition Product Revenue

All of our product revenue is derived from the operations of our Proton segment. For product sales for which adequate product warranty information exists, we record revenue when a firm sales agreement is in place, delivery has occurred, sales price is fixed or determinable, and collectibility is reasonably assured. If customer acceptance of products is not assured, revenue is recorded only upon formal customer acceptance. Customer acceptance provisions included in our product sales agreements may include written acceptance from the customer, acceptance upon servicing and installation of the equipment, and acceptance after a period of time. Revenue for product sales to distributors, for which there are no rights of return or price adjustments on unsold inventory, is recognized on a gross basis upon shipment to the distributors, as they assume title and risk of loss, subject to the deferral provisions below. For all product sales where adequate product warranty information does not yet exist to reasonably estimate warranty costs, we defer revenue and costs until the expiration of the product warranty period.

During 2006, we determined that we had adequate warranty information and experience to begin recognizing product revenue related to our HOGEN H-series hydrogen generators. Therefore, in the third quarter of 2006 we began recognizing product revenue related to sales of H-series hydrogen generators upon shipment. Prior to the third quarter of 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment.

During 2005, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN S-series and our laboratory generators. Therefore, in the first quarter of 2005, we began recognizing product revenue related to sales of laboratory generators with a two-year warranty upon shipment, and in the third quarter of 2005, we began recognizing product revenue related to sales of our HOGEN S-series hydrogen generators upon shipment.

We also earn revenue from the rental of our HOGEN products. We account for the agreements as operating leases under the provisions of Statement of Financial Accounting Standards, or SFAS, No. 13, Accounting for Leases. The agreements are cancelable at any time by either party without penalty. Rental revenue is recognized monthly over the term of the rental agreement.

Revenue Recognition Contract Revenue

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and wind turbine and power electronics products lines at our Northern subsidiary. For projects with a duration of greater than three months where we have the ability to reasonably estimate total project costs to complete the contract, we recognize revenue utilizing the percentage-of-completion method as prescribed by Statement of Position, or SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-

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Type Contracts , based on the relationship of costs incurred to total estimated contract costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be judgmental. Approximately 69%, 79% and 77% of our contract revenue for the years ended December 31, 2007, 2006 and 2005, respectively, was recognized under the percentage-of-completion method.

We also derive contract revenues from government-sponsored research and development contracts and from commercial customers. For government-sponsored research and development contracts that are fixed-price, we recognize revenue using the percentage-of-completion method under SOP 81-1. For fixed-price-incentive, or cost-reimbursement contracts that do not require us to meet specific obligations, we record revenue as work is performed. For those research and development contracts that require us to meet specified obligations, including delivery and acceptance obligations, we recognize amounts advanced as contract liabilities until such obligations are met. Once the obligations are met, we recognize the amounts as contract revenue. For all other commercial contracts, we recognize revenue under the completed contract method.

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our gross margin percentage for contract revenue may be affected by these changes in estimates and has fluctuated from 7.7% to 2.0% and (23.9)% for the years ended December 31, 2005, 2006 and 2007, respectively.

Revenue Recognition Service Revenue

For service and repair contracts, we recognize revenue as work is performed. For operating and maintenance contracts where we have agreed to provide routine maintenance services over a period of time for a fixed price, we recognize revenue ratably over the service period.

Allowance for Doubtful Accounts

The Company evaluates credit risk on its accounts receivable and estimates an allowance for doubtful accounts accordingly. The Company evaluates the adequacy of the allowance for doubtful accounts on a periodic basis. The evaluation includes historical loss experience, adverse situations that may affect a customer s ability to repay, and prevailing economic conditions. The Company makes adjustments to its allowance if the evaluation of allowance requirements differs from the actual aggregate reserve. This evaluation is inherently subjective and estimates may be revised as more information becomes available.

Inventory

We record inventory at the lower of cost or market value. We determine cost by the average cost method. This policy requires us to write down our inventory for the excess of the carrying value, which is typically the original cost, over the amount we expect to realize from the ultimate sale or other disposal of the inventory based upon on our assumptions regarding forecasted consumer demand, market conditions, inventory aging and technological obsolescence. If any of our estimates are inaccurate, for example because of changes in technology that affect demand for certain products in an unforeseen manner, we may be exposed to losses or gains in excess of our established reserve, and those gains and losses could be material. A 10% change in our inventory reserve as of December 31, 2007 would have affected our pre-tax loss by approximately $61,000 for the year ended December 31, 2007.

Goodwill

We have adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. These standards require the use of the purchase method of accounting for business combinations, set forth the accounting for the initial recognition of acquired intangible assets and goodwill, and describe the accounting for intangible assets and goodwill subsequent to initial recognition. Under the provisions of these standards, goodwill and certain intangible assets are deemed to have indefinite lives and are no longer subject to amortization. All other intangible assets are amortized over their estimated useful lives. SFAS 142 requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis or more frequently in certain circumstances. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of our reporting units with the reporting unit s carrying amount, including goodwill. We generally determine the fair value of our reporting units using the expected present value of future cash flows, giving consideration to the market comparable approach. If the carrying amount of our reporting units exceeds the reporting unit s fair value, we perform the second step of the goodwill impairment test to determine the amount of impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of our reporting unit s goodwill with the carrying amount of that goodwill. In the second step, the implied fair value of the reporting unit s goodwill is determined by allocating the reporting unit s fair value to all of its assets and liabilities other than goodwill (including any unrecognized intangible assets) in a manner similar to a purchase price allocation. The resulting implied fair value of the goodwill that results from the application of this second step is then compared to the carrying amount of the goodwill and an impairment charge is recorded for the difference.

In the fourth quarter 2006 and throughout 2006, Northern s operating results were significantly less than expected due to revenue shortfalls and higher than anticipated costs. Additionally, Northern s backlog also decreased since the third quarter of 2006 as work was performed on existing contracts, with no significant new contracts added to the backlog through December 31, 2006. In the fourth quarter of 2006, we completed preparation of our 2007 operating plan and our related long-term projections, which indicated lower than previously estimated revenue growth, gross margins and related operating cash flows. These projections were used to estimate the fair value of the Northern reporting unit and it was determined that the carrying value of the reporting unit exceeded the fair value, which indicated goodwill impairment. We then compared the implied fair value of the Northern goodwill with the carrying value of that goodwill and recorded a $24.2 million goodwill impairment charge. The impairment review process involved significant judgment regarding Northern s projected future cash flows and expected market conditions, and their impact on the selection of the discount rate used in estimating the fair value of Northern. As a result of this process, all of Northern s goodwill has been written off at December 31, 2006.

Intangible Assets

Intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for intangible assets subject to amortization is based on the amount the carrying value exceeds the fair value of the asset.

In the third quarter of 2007, we determined that there were indications of impairment of the intangible assets related to the Crown acquisition. As a result of our impairment analysis, we determined that the value associated with the projected cash flows of acquired service and non-compete contracts has decreased resulting in the recognition of an impairment loss of approximately $1.1 million in the third quarter of 2007.

In the fourth quarter of 2006, we began an initiative to combine the operations of Northern and Proton to reduce costs and strengthen our systems sales, engineering, production, service and technology development. In conjunction with that effort we determined that we would eliminate both the Proton and Northern brands, and operate in the marketplace under a single unified brand, Distributed Energy. At that time, we had planned to cease use of the Northern tradename by April 2007. Therefore, at December 31, 2006, we determined that the Northern tradename had been impaired and recorded an impairment charge of $1,450,000. The fair value of the Northern tradename was determined utilizing the income approach-relief from royalty method. In the fourth quarter of 2007, in connection with our narrowing of Northern s focus to the design and sale of direct drive wind turbines and associated power electronics, we concluded that we would maintain the Northern tradename. This decision does not result in any change to the impairment charge taken in 2006.

See discussion below regarding the impairment review we conducted of our long-lived assets. We have assessed the useful lives of our other existing intangible assets and believe that estimated useful lives remain appropriate. We have approximately $1.3 million of intangibles remaining as of December 31, 2007.

Long-Lived Assets

We evaluate potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. We would be required to recognize an impairment loss if the carrying amount of long-lived assets is not recoverable based on their undiscounted cash flows. The measurement of impairment loss is then based on the difference between the carrying amount and the fair value of the asset. If actual results are not consistent with our assumptions and judgments used in estimating future cash flows and asset fair values, we may be exposed to additional impairment losses that could be material to our results of operations.

In January 2007, we announced that we were combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. We also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility. As a result of our decision to exit the Waitsfield facility and consolidate our Northern operations in Barre, Vermont, we revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated depreciation charges. Therefore, we recorded additional depreciation expense in 2007 of approximately $2.4 million.

Northern s results in the fourth quarter and for the year ended December 31, 2007 were significantly less than expected due to lower revenue and higher than anticipated costs and the carrying value of Proton s long-lived assets depends on our ability to achieve gross margins sufficient to cover operating expenses and generate positive cash flow in the normal course of business. These factors indicated that the carrying value amount of our long-lived assets may not be recoverable. During the quarter ended December 31, 2007 we conducted an impairment review of our long-lived assets and concluded there was no impairment on the basis that the carrying amount of our long-lived assets will be recoverable from the asset grouping s expected undiscounted cash flows. We conducted this review separately for our two asset groups those related to Northern and those related to Proton.

Our impairment review of long lived assets has been done assuming we continue as a going concern business. As described above, we do not expect that our current working capital resources will be sufficient to operate our business beyond the next thirty days, and we will need to raise additional capital in order to continue to operate. The projections of undiscounted cash flows we used in our impairment analysis assume that we raise sufficient capital to continue our business on a long term basis. If we do not raise sufficient capital in the near term, or if we do raise sufficient capital but our projections of undiscounted cash flows are not realized, there is a risk that additional impairment charges would need to be recorded. If we do not raise sufficient capital in the near

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term, we may reorganize or liquidate our assets, and we may receive significantly less than the value at which they are carried in the financial statements.

Warranty Costs

Our warranty to customers is limited to replacement parts and services and generally expires one year from the date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. We record estimated warranty obligations in the period in which we recognize the related revenue or when a project is installed or commissioned. We quantify and record an estimate for warranty related costs; this estimate is principally based on historical experience. The accounting for warranties requires us to make assumptions and apply judgments when estimating product failure rates and expected material and labor costs. We make adjustments to accruals as warranty claim data and historical experience warrant. If actual results are not consistent with the assumptions and judgments used to calculate our warranty liability, because either failure rates or repair costs differ from our assumptions, we may be exposed to gains or losses that could be material. A 10% change in the warranty reserve at December 31, 2007 would have affected our pre-tax loss by approximately $57,000 for the year ended December 31, 2007.

Stock-Based Compensation

Stock-Based Compensation Employee Stock-Based Awards

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the ESPP based on estimated fair values. SFAS 123(R) supersedes our previous accounting under APB 25, Accounting for Stock Issued to Employees for periods beginning in fiscal year 2006. In March 2005, the SEC issued SAB 107 providing supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. We adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from January 1, 2006. Our Consolidated Financial Statements, as of and for the year ended December 31, 2007 and 2006, reflect the impact of adopting SFAS 123(R). Non-cash stock compensation expense for the years ended December 31, 2007 and 2006 was $1,351,824 and $5,291,351, respectively, which consisted primarily of stock-based compensation expense related to employee stock options recognized under SFAS 123(R). In addition, stock-based compensation expense for the years ended December 31, 2007 and 2006 of $22,821 and $92,354, respectively, was recognized related to our ESPP.

Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123, Accounting for Stock-Based Compensation. Under the intrinsic value method, no stock-based compensation expense for employee stock options had been recognized in our Consolidated Statements of Operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method we used in adopting SFAS 123(R), our results of operations prior to 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R). Additionally, under the modified prospective transition method, we were permitted to calculate a cumulative memo balance of windfall tax benefits from post-1995 years for purposes of accounting for future tax shortfalls. We elected to apply the long-form method for determining the pool of windfall tax benefits and have a pool of windfall tax benefits totaling approximately $700,000 at December 31, 2007 and 2006, respectively.

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized

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in the year ended December 31, 2006 and 2007, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the fair value on the grant date estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 31, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all stock-based awards granted will be recognized using the ratable single-option method. As stock-based compensation expense recognized in our results is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option s expected term and the price volatility of the underlying stock. We have determined that historical volatility is most reflective of the market conditions and the best indicator of expected volatility.

If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. Therefore, we believe it is important for investors to be aware of the high degree of subjectivity involved when using option pricing models to estimate share-based compensation under SFAS 123(R). There is risk that our estimates of the fair values of our share-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those share-based payments in the future. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly in excess of the fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with SFAS 123(R) and the Securities and Exchange Commission s Staff Bulletin No. 107, or SAB 107, using an option pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Estimates of share-based compensation expenses are significant to our financial statements, but these expenses are based on the option valuation model and will never result in the payment of cash by us. For this reason, and because we do not view share-based compensation as related to our operational performance, we exclude estimated share-based compensation expense when evaluating the business performance of our operating segments.

The following table highlights the impact that each of the various assumptions has on determining the fair value of an option or award when using an option-pricing model:

Impact of Inputs to Value of Equity Instrument

Volatility of Stock	Higher the volatility	Higher the value
Expected Term	Longer the term	Higher the value
Risk Free Rate	Higher the rate	Higher the value
Dividend Yield	Lower the yield	Higher the value
Exercise Price	Lower the exercise price (A)	Higher the value
Stock Price (fair value)	Higher the stock price	Higher the value

(A) presumes exercise price is less than fair value

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Stock-Based Compensation Non-Employee Stock Options

We account for stock-based compensation issued to non-employees in accordance with SFAS 123(R) and the consensus in Emerging Issues Task Force 96-18. These pronouncements require the fair value of equity instruments given as consideration for services rendered to be recognized as a non-cash charge to income over the shorter of the vesting or service period. The equity instruments must be revalued on each subsequent reporting date until performance is complete with a cumulative catch-up adjustment recognized for any changes in their fair value.

Also see Note 13 to the Consolidated Financial Statements on Stock-Based Compensation.

RECENT ACCOUNTING PRONOUNCEMENTS

The Company adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) on January 1, 2007. As a result of the implementation of FIN 48, the Company performed a comprehensive review of any uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company believes it has no uncertain tax positions and, accordingly, did not record any charges.

In February 2007, FASB issued SFAS No, 159, The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No.115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets and liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the potential impact of this statement.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. Since its initial issuance, the FASB has received considerable input regarding the implications of the standard on the valuation of non-financial assets and liabilities. As a result, the FASB is proposing to amend the scope of SFAS 157 to exclude its application to lease accounting and clarify its disclosure requirements relative to pension and other post-retirement employee benefit assets and liabilities. In light of the changes being proposed and the underlying implications of the overall pronouncement, we are currently evaluating its potential impact to our financial statements and results of operations.

RESULTS OF OPERATIONS

Comparison of Years 2007 and 2006

Revenues:

	Year ended			
Net revenues	**December 31, 2007**	**December 31, 2006**	**Increase (decrease)**	
Contract	$ 17,911,178	$ 26,825,372	$ (8,914,194)	-33%
Product	4,772,526	11,270,186	(6,497,660)	-58%
Service	6,704,577	6,997,234	(292,657)	-4%
Total	$ 29,388,281	$ 45,092,792	$ (15,704,511)	-35%

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The net decrease in contract revenues is a result of decreased contract revenue associated with our Northern subsidiary, offset in part by increased contract revenue associated with our Proton subsidiary. Northern contract revenues decreased approximately $11.7 million in 2007 compared to 2006. The decrease in Northern s contract revenues relates primarily to decreases in its power distributor, oil and gas and contract research and development businesses of approximately $4.9 million, $6.2 million and $2.3 million, respectively. Our products in these areas were not competitive. Our financial condition in 2007 made orders difficult to obtain. As a result of our decision to focus the Northern business on the wind business, we completed several of our in-process projects in the distributed power and engineering, procurement and construction business, and we did not sign any new significant projects in this area. Fewer contracts remained active during 2007 compared to 2006. These decreases were offset in part by increases in Northern s wind business of approximately $1.7 million. Proton s contract revenues increased approximately $2.8 million in 2007 compared to 2006. The increase in Proton s contract revenue is due primarily to an increased number and expanded scope of existing contracts from 2006.

The decrease in product revenues of approximately $6.5 million in 2007 compared to 2006 primarily relates to Proton s HOGEN H-series units. HOGEN H-series revenue decreased from $7.9 million in 2006 to $2.1 million in 2007. In the third quarter of 2006, we determined we had adequate warranty history on HOGEN H-Series generators to recognize revenue and establish an accurate warranty provision upon shipment. Therefore, the revenue recognized in 2006 includes $4.0 million of revenue recognized upon product warranty expiration related to units shipped in 2005, and $3.8 million of revenue related to units shipped in 2006. HOGEN S-series revenue also decreased from $2.5 million in 2006 to $1.3 million in 2007 due to fewer unit shipments. These decreases were partially offset by increased revenue associated with higher shipments of laboratory generators and revenue associated with Proton s new Stable Flow product.

Hydrogen generator units shipped:

The following table presents hydrogen generator unit shipment details:

Hydrogen generator unit shipments	**December 31, 2007**	**December 31, 2006**	**Increase (decrease)**
S series	18	45	(27)
H series	13	23	(10)
Laboratory generators	77	75	2
Stableflow	8		8
Total	116	143	(27)

The $0.3 million net decrease in service revenue in 2007 compared to 2006 relates primarily to Northern s international field service business offset in part by an increase in the number of Proton units in the field resulting in additional spare parts sales.

As of December 31, 2007, our backlog was valued at approximately $9.2 million, consisting of contract and service backlog valued at approximately $4.1 million for Northern and $2.8 million for Proton, and product backlog for Proton valued at approximately $2.3 million.

Costs of revenues:

	Year ended			
Cost of revenues	**December 31, 2007**	**December 31, 2006**	**Increase (decrease)**	
Contract	$ 22,200,896	$ 26,267,642	$ (4,066,746)	-15%
Product	3,829,518	10,226,329	(6,396,811)	-63%
Service	8,280,929	7,326,987	953,942	13%
Total	$ 34,311,343	$ 43,820,958	$ (9,509,615)	-22%

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Costs of contract revenues as a percentage of contract revenues increased from approximately 98% in 2006 to approximately 124% in 2007. Northern s cost of contract revenues as a percentage of contract revenues increased from approximately 99% in 2006 to approximately 152% in 2007. This increase in costs and decrease in gross margins is due in part to the recording of additional costs aggregating approximately $1.1 million associated with two contracts utilizing Stirling engine technology. On February 16, 2007, we were notified that the manufacturer of these engines, STM Power Inc., had ceased operations, and as a result, we provided for additional contract costs to either complete these contracts with alternative technology or settle our obligation under the contracts. We settled our obligation under one of the contracts in January 2008 and resolution or settlement of the remaining contract is currently outstanding. Additionally, Northern s gross margins decreased due to contract cost overruns and loss provisions, particularly in its on-site power distributor business as well as from fewer, less profitable contracts in its oil and gas and contract research and development businesses. The estimated costs to complete one of our on-site power distributor projects increased approximately $2.3 million in 2007 due to changing conditions and new developments associated with completing the project. Proton s cost of contract revenues as a percentage of contract revenues decreased from approximately 89% in 2006 to approximately 72% in 2007 as a result of an increase in the number of active contracts as well as a change in contract mix from lower margin cost-share arrangements to higher margin fixed-price and cost-plus-fixed-fee contracts.

Product cost of revenues as a percentage of product revenue decreased from approximately 91% in 2006 to approximately 80% in 2007. The decrease in cost of product revenues as a percentage of product revenues was primarily attributable to a reduction in warranty costs associated with Proton s hydrogen generators in 2007 as compared to 2006.

Service cost of revenues as a percentage of service revenues increased from approximately 105% in 2006 to approximately 124% in 2007. This increase in cost of service revenues was attributable primarily to a change in Northern s mix of service contracts from higher margin international field service contracts to lower margin long-term domestic operating and maintenance contracts. In 2007, approximately 74% of Northern s service revenues were primarily from domestic field service and long-term operating and maintenance contracts compared to approximately 67% of service contract revenues for 2006. In addition, we determined in 2007 that there were indications of impairment of the intangible assets related to the Crown acquisition. As a result of our impairment analysis, we determined that the value associated with the projected cash flows of the acquired Crown service contracts and noncompete agreement had decreased resulting in the recognition of an impairment loss of approximately $1.1 million in 2007.

Research and development expenses:

The following chart reflects the amounts and percentage change of significant research and development costs:

	Year ended			
Research and development	**December 31, 2007**	**December 31, 2006**	**Increase (decrease)**	
Employee related	$ 1,719,991	$ 2,185,962	$ (465,971)	-21%
Project material	215,142	1,013,722	(798,580)	-79%
Depreciation and amortization	331,804	450,777	(118,973)	-26%
Stock based compensation	106,773	200,402	(93,629)	
Other	222,081	(191,154)	413,235	216%
Total	$ 2,595,790	$ 3,659,709	$ (1,063,919)	-29%

Employee-related research and development costs and project material costs decreased based on fewer employees, less developmental efforts associated with Proton s hydrogen generators, and lower project material costs at Northern, related to its power distributor products business. Other costs increased primarily due to the recognition of $0.5 million of credits in 2006 from achieving specified milestones on Proton s Connecticut Clean Energy Fund programs. Only $0.3 million of credits related to these programs were recognized in the comparable period of 2007. Additionally, other research and development costs increased in 2007 due to costs associated with the execution of a $0.1 million settlement agreement for a terminated development contract with a reduced credit with CCEF for $0.3 million.

Restructuring costs:

During the year ended December 31, 2007, we recorded severance charges of approximately $0.7 million resulting from our strategic re-organization announced in January 2007. The re-organization effort eliminated approximately 60 jobs in January and an additional 25 jobs in May. *(Refer to Note 12 of the financial statements for information related to our 2007 strategic reorganization)*

Selling, general and administrative expenses:

The following chart reflects the amounts and percentage change of significant selling, general and administrative costs:

	Year ended			
Selling, general and administrative	**December 31, 2007**	**December 31, 2006**	**Increase (decrease)**	
Employee related	$ 10,300,935	$ 11,710,743	$ (1,409,808)	-12%
Marketing and advertising	672,663	1,183,510	(510,847)	-43%
Depreciation, amortization	3,913,208	1,510,889	2,402,319	159%
Stock based compensation	1,139,790	4,914,695	(3,774,905)	-77%
Legal, consulting and accounting	3,409,516	1,800,101	1,609,416	89%
Warrants issued	6,386,736		6,386,736	100%
Other	6,184,016	5,214,875	969,141	19%
Total	$ 32,006,864	$ 26,334,813	$ 5,672,051	22%

The decrease of approximately $1.4 million in employee-related costs for the year ended December 31, 2007 reflects the cost reductions related to our 2007 strategic reorganization. The increase in depreciation and amortization of approximately $2.4 million is due primarily to accelerated depreciation related to our Waitsfield, Vermont facility based on our cessation of use on June 30, 2007. The decrease in stock-based compensation for the year ended December 31, 2007 primarily relates to the absence in 2007 of approximately $1.3 million of stock compensation expense associated with restricted stock granted to our former chief executive officer in January 2006 as part of his employment arrangement. The additional decrease in stock-based compensation for the year ended December 31, 2007 relates to fewer unvested stock options outstanding resulting from employee terminations. The increase in legal, consulting and accounting expenses for the year ended December 31, 2007 primarily relates to the legal fees associated with the joint venture agreement with Morgan Stanley Wind, LLC and costs associated with financing efforts and real estate advice related to our Waitsfield building exit plan. The increase in 2007 in other selling, general and administrative expenses primarily relates to approximately $1.3 million bad debt expense at Northern and $6.4 million of non-cash charges associated with warrants issued to Morgan Stanley Wind, LLC in connection with our joint venture agreement.

Loss on conversion of debt: In connection with our August loan from Perseus, the initial note was repaid and cancelled and the remaining unamortized portion of the related debt issuance costs and unamortized discount of approximately $1.3 million and $2.0 million, respectively, were written off, resulting in a loss on extinguishment of debt of approximately $3.3 million in the third quarter of 2007.

Interest income: Interest income decreased from $1.4 million for the twelve months ended December 31, 2006 to $0.5 million for the comparable period in 2007. The decrease resulted from lower cash balances. The average interest rates for the twelve months ended December 31, 2007 and 2006 were relatively stable at 5.6% and 4.9 %, respectively. The average cash and marketable securities balances for the twelve months ended December 31, 2007 and 2006 were approximately $9.0 million and $29.1 million, respectively.

Interest expense: Interest expense increased from $0.7 million for the year ended December 31, 2006 to $7.2 million for the year ended December 31, 2007. The increase was primarily the result of interest charges associated with our notes payable to Perseus described in the Update on our Financial Condition section above. These charges included amortization of the debt discount, debt issuance costs, and beneficial conversion feature related to these notes.

Comparison of Years 2006 and 2005

Revenues:

	Year ended			
Net revenues	**December 31, 2006**	**December 31, 2005**	**Increase (decrease)**	
Contract	$ 26,825,372	$ 34,197,326	$ (7,371,954)	-22%
Product	11,270,186	6,309,524	4,960,662	79%
Service	6,997,234	4,472,792	2,524,442	56%
Total	$ 45,092,792	$ 44,979,642	$ 113,150	0%

Northern s on-site revenue decreased approximately $5.0 million in 2006 compared to 2005 due to the timing and size of the contracts for which revenue was recognized in each period. Northern s industrial infrastructure revenue decreased approximately $2.4 million in 2006 from 2005 due to several projects in the full construction stage in 2005 compared to several projects being completed in 2006 without a comparable amount of new projects being started. Revenue associated with wind contracts decreased by approximately $1.7 million due to a decrease in the number of contracts, offset by an increase in power distributor contracts of $1.8 million as Northern entered this market in 2006. Northern s government contract revenue decreased approximately $1.1 million due to fewer active projects in 2006 compared to 2005.

The increase in Proton s contract revenue is due to the recognition of approximately $1.1 million related to its hydrogen fueling contract with Shell Hydrogen as well as an increase of approximately $0.6 million over the prior year related to the increased number of active government sponsored contracts. These increases were partially offset by the completion of contracts with the Defense Advanced Research Projects Agency, E-Vermont Fueling, and Department of Energy that totaled $0.7 million.

HOGEN H-series revenue increased from $1.1 million in 2005 to $7.8 million in 2006. In the third quarter of 2006, we determined we had adequate warranty history on HOGEN H-Series generators to recognize revenue and establish an accurate warranty provision upon shipment. Therefore, the revenue recognized in 2006 includes $4.0 million of revenue recognized upon product warranty expiration related to units shipped in 2005, and $3.8 million of revenue related to units shipped in 2006. All of the revenue recognized in 2005 related to revenue recognized upon expiration of the product warranty period.

HOGEN S-series revenue decreased from $4.0 million in 2005 to $2.7 million in 2006. For the twelve months ended December 31, 2006, we recognized $2.7 million of revenue associated with our HOGEN S-series generators upon shipment. In the third quarter of 2005, we determined we had adequate warranty history on HOGEN S-series generators to recognize revenue and establish an accurate warranty provision upon shipment. Therefore, the revenue recognized in 2005 includes $1.9 million of revenue recognized upon product warranty expiration related to units shipped in 2004, and $2.1 million of revenue related to units shipped in 2005.

Our laboratory generator revenue decreased from $1.1 million in 2005 to $0.7 million in 2006. For the twelve months ended December 31, 2006, we recognized $0.7 million of revenue associated with our laboratory

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generator upon shipment. In the first quarter of 2005, we determined we had adequate warranty history and began recognizing revenue on our laboratory generators sold with a two-year warranty. The revenue recognized in 2005 includes previously deferred revenue of $0.4 million recognized upon expiration of the warranty and $0.7 million related to units shipped in 2005.

The decrease in rental and other revenue relates to fewer rental units in the field. Some rental units were sold or returned in 2006.

Northern s long-term domestic operating and maintenance service revenue increased approximately $3.2 million due its entry into this market in the third quarter of 2005 as well as from revenues recognized on contracts acquired from Crown in 2006. This increase was offset by a $0.9 million decrease in Northern s international field service revenue due to the completion of commissioning on two pipelines.

The increase in service revenue associated with the Proton segment relates to an increase in the number of units in the field resulting in additional spare part sales.

Costs of revenue:

	Year ended			
Cost of revenues	**December 31, 2006**	**December 31, 2005**	**Increase (decrease)**	
Contract	$ 26,267,642	$ 31,548,547	$ (5,280,905)	-17%
Product	10,226,329	6,207,001	4,019,328	65%
Service	7,326,987	3,120,089	4,206,898	135%
Total	$ 43,820,958	$ 40,875,637	$ 2,945,321	7%

The decrease in Northern s cost of contract revenue was due to the previously noted decrease in contract revenue. Cost of contract revenues as a percentage of contract revenues increased from 93% in 2005 to 99% in 2006. The decreased contract margins primarily relate to an increase in unabsorbed overhead costs. The increase in unabsorbed overhead costs is a result of less contract activity at Northern in 2006 as compared with 2005 and increased hiring in anticipation of increased contract volume.

The increase in Proton s cost of contract revenue was due to the previously noted increase in contract revenue recognized for the year ended December 31, 2006. Proton s cost of contract revenue as a percentage of contract revenue increased from approximately 80% in 2005 to approximately 89% in 2006. This decrease in gross margin relates to cost overruns on certain contracts that completed during the year and a higher proportion of lower margin contracts in 2006.

HOGEN H-series cost of revenue increased from $1.9 million in 2005 to $7.6 million in 2006. In the third quarter of 2006, we determined we had adequate warranty history on HOGEN H-Series generators to recognize revenue and establish an accurate warranty provision upon shipment. Therefore, the cost of product revenues recognized in 2006 includes $3.9 million of cost of revenue recognized upon product warranty expiration related to units shipped in 2005, $3.1 million of cost of revenue related to units shipped in 2006 and $0.6 million related to warranty and other costs of production. All of the cost recognized in 2005 related to costs associated with units whose warranty period had expired. Our gross margins related to this product line increased from -73% to 3% in 2006 primarily due to fewer lower of cost or market adjustments, increased selling prices and favorable warranty experience.

HOGEN S-series cost of revenue decreased from $2.9 million in 2005 to $1.7 million in 2006. All of the cost recognized in 2006 related to costs associated with units which had shipped and for which revenue was recognized during 2006. In the third quarter 2005, we determined we had adequate warranty history on HOGEN

S series generators to recognize revenue and establish an accurate warranty provision upon shipment. Therefore, the cost of product revenues recognized in 2005 includes $1.3 million of cost recognized upon product warranty expiration related to units shipped in 2004 and $1.6 million of cost related to units shipped in 2005. Our gross margin related to this product line increased from 27% in 2005 to 37% in 2006 primarily due to increased selling prices and favorable warranty experience.

Our laboratory generator cost of revenue decreased from $1.3 million in 2005 to $0.8 million in 2006. All of the cost recognized in 2006 related to costs associated with units which had shipped and for which revenue was recognized during 2006. In the first quarter of 2005, we determined we had adequate warranty history and began recognizing revenue on our laboratory generators sold with two-year warranties. The cost of revenue recognized in 2005 includes previously deferred cost of $0.5 million and $0.8 million of cost related to units shipped in 2005. Our gross margin associated with this product was -14% and -18% for the years ended December 31, 2006 and 2005, respectively.

The increase in Northern s cost of service revenue was due to the previously noted increase in active and/or completed contracts. Service cost of revenue as a percentage of service revenue increased from 70% in 2005 to 104% in 2006. This increase in cost of service revenue was primarily attributable to a change in Northern s mix of service contracts. Service revenues were primarily from one-time higher margin international field service time and material contracts in 2005. In 2006, revenue was derived primarily from longer term, multi year domestic operating and maintenance contracts, which tend to have lower margins. Additionally, 2006 costs include additional overhead costs associated with our growing service business. We do not believe the negative gross margins in 2006 are indicative of loss contracts.

The increase in Proton s service cost revenues relates to the increased number of hydrogen generator units in the field.

Hydrogen generator units shipped:

The following table presents hydrogen generator unit shipment details:

Hydrogen generator unit shipments	December 31, 2006	December 31, 2005	Increase (decrease)
S series	45	33	12
H series	23	30	(7)
Laboratory generators	75	83	(8)
Total	143	146	(3)

During the third quarter of 2006, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN H-series products. During 2005, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN S-series and our laboratory generators. Therefore, in the first quarter of 2005, we began recognizing product revenue related to sales of laboratory generators with a two-year warranty upon shipment, and in the third quarter of 2005 we began recognizing product revenue related to sales of our HOGEN S-series hydrogen generators upon shipment.

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Research and development expenses:

The following chart reflects the amounts and percentage change of significant research and development costs:

	Year ended			
Research and development	**December 31, 2006**	**December 31, 2005**	**Increase (decrease)**	
Employee related	$ 2,185,962	$ 2,558,814	$ (372,852)	-15%
Project material	1,013,722	1,259,270	(245,548)	-19%
Depreciation and amortization	450,777	775,369	(324,592)	-42%
Stock based compensation	200,402		200,402	
Other	(191,154)	(534,139)	342,985	64%
Total	$ 3,659,709	$ 4,059,314	$ (399,605)	-10%

Employee-related costs and project material decreased primarily due to less development effort associated with Proton s hydrogen generators, offset by increased project costs at Northern related to development of its power distributor products. Depreciation and amortization decreased as certain capitalized equipment reached its estimated useful life at the end of 2005. Stock-based compensation increased due to the adoption of FAS 123(R) in January 2006. The increase in other costs was primarily due to a decrease in CCEF program milestone-related credits of $0.5 million and $0.9 million for the years ended December 31, 2006 and 2005, respectively.

Selling, general and administrative expenses:

The following chart reflects the amounts and percentage change of significant selling, general and administrative costs:

	Year ended			
Selling, general and administrative	**December 31, 2006**	**December 31, 2005**	**Increase (decrease)**	
Employee related	$ 11,710,743	$ 9,315,978	$ 2,394,765	26%
Marketing and advertising	1,183,510	801,759	381,751	48%
Depreciation, amortization	1,510,889	1,148,370	362,519	32%
Stock based compensation	4,914,695	550,775	4,363,920	792%
Legal, consulting and accounting	1,800,101	1,440,213	359,888	25%
Other	5,214,875	3,672,845	1,542,030	42%
Total	$ 26,334,813	$ 16,929,940	$ 9,404,873	56%

The increased employee-related costs were primarily due to an increase in the number of employees particularly at Northern, an increase in travel related costs, as well as costs associated with the addition of our new chief executive officer in January 2006. The increase in marketing and advertising was generally due to increased new market development costs. The increase in depreciation and amortization was primarily due to increased capital expenditures in the fourth quarter of 2005, related to our Barre, Vermont facility and intangible assets associated with the Crown acquisition in the second quarter of 2006. Stock-based compensation increased due to the recognition of expense related to the adoption of SFAS 123(R) in January 2006. The increase in legal, consulting and accounting expenses was primarily related to increased audit-related fees. The increase in other costs was primarily due to maintenance and repair expenses related to the Barre facility, recruiting expense, non-capitalizable software implementation costs and increased bad debt expense, particularly at Northern.

Goodwill and Intangible impairment: As described in Critical Accounting Judgments and Estimates, we recorded a $24.2 million goodwill impairment charge and a $1.5 million impairment on the Northern tradename.

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Interest income: Interest income increased from $1.1 million for the year ended December 31, 2005 to $1.4 million for the year ended December 31, 2006. The increase resulted from higher average interest rates, offset by lower average cash and marketable securities balances. The average interest rates on our cash and marketable securities balances for the years ended December 31, 2006 and 2005 were approximately 4.9% and 2.3%, respectively. The average cash and marketable securities balances for the years ended December 31, 2006 and 2005 were approximately $29.1 million and $47.6 million, respectively.

Interest expense: Interest expense increased from $0.5 million for the year ended December 31, 2005 to $0.7 million for the year ended December 31, 2006. The increase was generally the result of increased interest rates being charged on our debt and capital lease obligations and a greater amount of average debt outstanding including new capital lease obligations.

Other income: Other income increased for the year ended December 31, 2006 due primarily to rental income of $0.3 million related to the sublease of a portion of our Wallingford, Connecticut office space and our Barre, Vermont facility.

Liquidity and Capital Resources

While we recently obtained funding from Perseus as described below, we do not expect that our current capital resources will be sufficient to operate our business beyond the next thirty to forty-five days, and we will need to raise additional capital within the next thirty to forty-five days to continue to operate.

Cash flows

Since its inception in August 1996 through December 2007, Proton has financed its operations through convertible preferred stock issuances, an initial public offering, and an equity distribution agreement that, in total, raised approximately $194.9 million. As of December 31, 2007, Distributed Energy had approximately $5.1 million in unrestricted cash and cash equivalents.

Cash used in operating activities was $26.0 million for the year ended December 31, 2007 and was primarily attributable to our net loss, increase in inventory and deferred costs, reduction of accounts payable and accrued expenses and increase in billings in excess of cost offset in part by a reduction of accounts receivable, a decrease in cost in excess of billings and non-cash charges. Our net loss for the year ended December 31, 2007 included significant non-cash charges including warrants issued to Morgan Stanley Wind of $6.4 million, depreciation and amortization of $5.2 million, amortization of debt discount of $5.2 million relating to warrants issued in the Perseus financing, loss on conversion of debt of $3.3 million and impairment of Crown intangible assets of $1.1 million. Cash used in operating activities was $21.7 million for the year ended December 31, 2006 and was primarily attributable to our net loss, decrease in deferred revenue and customer advances, and increase in cost in excess of billings offset in part by a reduction in inventory and deferred costs, an increase of accounts payable and accrued expenses and non-cash charges. Our net loss for the year ended December 31, 2006 included significant non-cash charges including goodwill and intangible impairment charge of $25.6 million, stock compensation of $5.4 million and depreciation and amortization of $2.6 million.

Cash provided by investing activities was $18.4 million for the year ended December 31, 2007 and was primarily attributable to a decrease in restricted cash as a result of us repaying the Wallingford facility mortgage and net proceeds from the sale of marketable securities. Cash used by investing activities was $2.4 million for the year ended December 31, 2006 and was primarily attributable to an increase in restricted cash and cash paid for the Crown acquisition, offset in part by a decrease in proceeds from maturities and sales of marketable securities.

Cash provided by financing activities was $7.7 million for the year ended December 31, 2007 and was attributable to the net proceeds from borrowing under the Perseus Agreement of approximately $15.0 million, partially offset by the repayment of the outstanding mortgage on our Wallingford, CT facility of approximately

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$5.6 million and closing costs associated with the Perseus lending of approximately $2.0 million. Cash provided by financing activities was $8.5 million for the year ended December 31, 2006 and was attributable to the proceeds from the sale of the common stock through our equity distribution agreement and from cash received from the exercise of stock options and warrants.

Debt Agreements

On June 1, 2007, pursuant to the terms of our securities purchase agreement with Perseus, the Company closed on a $12.5 million loan by Perseus to the Company. In connection with this loan, the Company executed the Initial Note and issued to Perseus an Initial Warrant. The Initial Note bore interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and was due in full on March 1, 2008. As a result, the Company recorded approximately $1.8 million of total interest expense related to the Initial Note in 2007. The loan was secured by a security interest in all of the Company s assets and those of its material subsidiaries.

The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the Company s common stock at an exercise price of $0.80 per share. The Company accounted for the Initial Note pursuant to APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants . The fair value of the Initial Warrant was determined to be approximately $3.7 million. The Company used the following assumptions to estimate fair value of the warrants: expected term of five years; expected volatility of 80.8%; risk free rate of 4.92%; and no dividend yield. Accordingly, based on the relative fair values of the debt and the warrant at the time of issuance the Company allocated approximately $2.9 million of the $12.5 million proceeds to the Initial Warrant. The amount attributed to the Initial Warrant resulted in a discount on the Initial Note. The debt discount was being amortized over the term of the Initial Note and accordingly the Company recognized approximately $893,000 within interest expense related to this amortization during 2007. Additionally, the Company incurred approximately $1.8 million of debt issuance costs associated with this financing which was being amortized over the life of the debt and recorded approximately $559,000 within interest expense in 2007.

On August 24, 2007, the Company repaid and cancelled the Initial Note in connection with the issuance of the Subsequent Convertible Note. The Company accounted for this exchange of notes under EITF 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments and EITF 06-06, Debtor s Accounting for a Modification (or Exchange) of Convertible Debt Instruments. The exchange resulted in extinguishment accounting because the Subsequent Convertible Note contained a substantial conversion feature not contained within the Initial Note. In 2007, the Company recognized a loss on extinguishment of approximately $3.3 million which represented the remaining unamortized balance of debt discount of $2.0 million and deferred financing costs of $1.3 million, respectively, with respect to the Initial Note.

The calculation of the loss at the time of exchange is as follows (in thousands):

Initial Note, at par		$ 12,500	
Debt discount	(2,897)		
Accumulated amortization	893		
		(2,004)	
Debt issuance costs	(1,814)		
Accumulated amortization	559		
		(1,255)	
Initial Note, net			$ 9,241
Initial Note repaid			12,500
Loss on extinguishment			$ 3,259

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Perseus Senior Secured Convertible Promissory Note (Subsequent Convertible Note)

On August 24, 2007, the Company repaid the $12.5 million Initial Note and accrued interest of $0.4 million. In connection with this subsequent loan, the Initial Note was cancelled, and the Company executed the Subsequent Convertible Note, and received additional cash of approximately $2.1 million after paying the Initial Note and accrued interest and issued to Perseus the Subsequent Warrant. The Subsequent Convertible Note has an original principal amount of $15.0 million, bears interest at a rate of 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008 or earlier upon an event of default, a change of control of the Company or the liquidation or dissolution of the Company. As a result, the Company recorded approximately $5.0 million of total interest expense related to the Subsequent Convertible Note for the year ended December 31, 2007. The Company may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. Assuming that (a) the Company pays all interest expense, estimated to be $2.3 million, in kind and (b) Perseus fully converts the Subsequent Convertible Note and all of the Additional Convertible Notes, Perseus would receive 30,779,675 shares of the Company s common stock.

The Subsequent Convertible Note is secured by a security interest in all of the Company s assets and those of its material subsidiaries. The Subsequent Warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of the Company s common stock at exercise prices ranging from $0.80 to $3.00 per share. The Company accounted for the Subsequent Convertible Note pursuant to APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants . The fair value of the Subsequent Warrant was determined to be approximately $13.2 million. The Company used the following assumptions to estimate fair value of the Subsequent Warrants: expected term of five years; expected volatility of 81.4%; risk free rate of 4.42%; and no dividend yield. Accordingly, based on the relative fair values of the debt and the warrant at the time of issuance the Company allocated approximately $7.0 million of the $15.0 million proceeds to the Subsequent Warrant. The amount attributed to the Subsequent Warrant results in a discount on the Subsequent Convertible Note. The debt discount is amortized over the term of the Subsequent Convertible Note and accordingly the Company recognized approximately $2.0 as interest expense related to this amortization during year ended December 31, 2007. Additionally, the Company incurred approximately $0.2 million of debt issuance costs associated with this Subsequent Convertible Note financing which is being amortized over the life of the debt and recorded approximately $54,720 as interest expense during 2007.

At Perseus s election, the Subsequent Convertible Note and any additional convertible notes issued to Perseus are convertible into shares of the Company s common stock at a conversion price of $0.57 per share compared to the Company s closing stock price of $0.74 at the time the Subsequent Convertible Note was issued. As a result, the Subsequent Convertible Note contains a beneficial conversion feature. The Company accounted for the beneficial conversion feature under EITF 00-27, Application of Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features, to Certain Convertible Instruments . After consideration of the allocation of the proceeds to the Subsequent Convertible Note and Subsequent Warrant in accordance with APB 14, the Company calculated the Subsequent Convertible Note has an effective conversion price of $0.30 per share. This resulted in a beneficial conversion of $0.44 per share or approximately $11.5 million, however, the Company recorded approximately $8.0 million as a beneficial conversion feature which represented the remaining debt proceeds available for such allocation. The beneficial conversion feature was recorded as a debt discount and an increase additional paid in capital. The debt discount is amortized over the term of the Subsequent Convertible Note and accordingly the Company recognized approximately $2.3 within interest expense related to this amortization during the period ended December 31, 2007.

Wallingford, Connecticut facility mortgage

On September 18, 2006, Technology Drive LLC, a subsidiary of Proton, entered into an amendment to the construction loan agreement with Webster Bank, National Association. These amendments relate to a loan to Technology Drive from the bank made December 7, 2001 in the original principal amount of $6,975,000. The effect of the amendments was to change the interest rate on the loan from LIBOR plus 237.5 basis points (6.67%

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per annum at December 31, 2005) to LIBOR plus 200 basis points (7.35 % per annum at December 31, 2006) and to eliminate the requirement that Technology Drive maintain cash and marketable securities of $20,000,000. The amendment further provided for the pledge by Technology Drive to the bank of an account with the bank having a balance equal to the amount payable under the loan. During the second quarter of 2007, the Company paid the Webster Bank mortgage in full in the amount of $5,192,672 and the pledged funds were released to the company.

Restricted cash

In connection with the construction of our Wallingford, Connecticut facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement with the Connecticut Development Authority. The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. Proton was required under the agreement to place $419,250 in escrow related to these recapture clauses. By agreement the amount held in escrow was reduced to $294,710 as of December 31, 2007 and is included in short term restricted cash. $419,250 is included within restricted cash as part of long-term assets as of December 31, 2006.

At December 31, 2007, a financial institution has issued letters of credit of $912,615 on behalf of Northern. The Company classified $571,696 as short term restricted cash and $375,000 as long-term restricted cash which serves as collateral for the letters of credit. At December 31, 2006, a financial institution has issued letters of credit totaling of $1,016,749 on behalf of Northern. In connection with these letters of credit, the same amount was held in escrow which is classified as restricted cash on our consolidated balance sheet. Northern, in connection with its facility debt also maintains approximately $150,000 of restricted cash.

Waistfield, Vermont capital lease

In March 2003, a condominium association, Northern Power Systems Commercial Condominium Association, Inc., or NPS Condo Association, was formed for the purpose of managing the land, building, and improvements related to Northern s new facility. Northern owns 50% of the NPS Condo Association and has the ability to exercise significant influence over the NPS Condo Association. We transferred certain property and development rights under NPS Condo Association to the Central Vermont Economic Development Corporation, or CVEDC. In consideration, CVEDC secured a $2,790,000 loan from the Vermont Economic Development Authority, or VEDA, to complete the facility and lease back the facility to Northern. The terms of the lease include an initial term of ten years, lease payments equal to the debt payments plus an administrative fee, and a purchase option for Northern equal to the outstanding loan amount. The lease is being accounted for as a capital lease and total payments under the lease less the interest portion of the lease is recorded as a liability. Northern is required to maintain certain levels of insurance over the facility, is required to maintain $150,000 of restricted cash for performance under the agreements and indemnifies CVEDC from liability or lawsuit relating to the facility. Maturities under the capital lease obligation at December 31, 2007 are as follows: 2008 $146,755; 2009 $146,755; 2010 $146,755; 2011 $146,755; 2012 $146,755 and thereafter $1,665,553.

Barre, Vermont facility

In October 2005, Northern completed the purchase of a 110,000 square-foot manufacturing facility in Barre, Vermont. This facility, a portion of which had been leased by Northern since 2004, added capacity for Northern s power systems and product business. Under the purchase, Northern qualified for assistance from VEDA, which together with Vermont s Merchants Bank provided financing for a substantial portion of the facility, land, and future facility improvements.

VEDA made available a total of $740,000, at a variable rate equal to two percentage points less than VEDA s prevailing rate for taxable financing with a maturity date of October 6, 2015, which was 6.50% per annum at December 31, 2007. The VEDA debt currently requires 120 monthly payments of $5,567 and a final balloon payment in October, 2015. As of December 31, 2007, Northern has drawn down a total of $688,935 on this loan. Maturities under the obligation at December 31, 2007 are as follows: 2008 $30,880; 2009 $30,880; 2010 $30,880; 2011 $30,880; 2012 $30,880 and thereafter $455,856.

Merchants Bank provided $925,000 at a fixed rate of 7.42% per annum. In 2007, this note was sold to Waring Investments (Waring). Waring requires 119 monthly payments of $8,535 beginning November, 2005, and a final balloon payment of approximately $435,000 on October 6, 2015. The loan is collateralized by the Barre, Vermont property. Scheduled maturities under the obligation as of December 31, 2007 are as follows: 2008 $40,898; 2009 $44,038; 2010 $47,420; 2011 $51,060; 2012 $54,980 and thereafter $609,275.

Classification of debt

The Company s Vermont facility mortgage with Waring contains a material adverse change clause which allows Waring, at its option, to declare the loan to be in default and immediately payable if there has been a material adverse change in our financial condition. We have incurred recurring operating losses and cash outflows and as a result of these conditions, there is more than a remote chance that Waring may declare the loan immediately payable. The Company s loan agreements with VEDA on the Barre facility and Perseus each contain cross-default provisions which provide that any event of default in any secured borrowing would result in the Perseus and VEDA loans being in default and immediately payable. Accordingly, the Waring loan, and the Perseus and VEDA loans with cross-default provisions, have been classified as short term. None of our lenders have accelerated our scheduled loan payments as a result of these provisions.

Management s Plan

Since December 31, 2006, our financial condition has deteriorated significantly. We had anticipated that our previously announced revenue initiatives would improve sales and margins, but our sales and gross margins in the quarter and the twelve months ended December 31, 2007 were below our expectations, in particular in our Northern subsidiary. Our previously announced joint venture with Morgan Stanley Wind LLC did not generate new business in 2007 and therefore we exited this joint venture in February, 2008 and received a one time payment of $500,000 from Morgan Stanley Wind LLC for our 15% ownership share of the joint venture. Accordingly, we have been required to raise additional funds and significantly cut our costs in order for our business to survive.

To address our need to raise additional working capital, we entered into three loan transactions with Perseus Partners VII, L.P., or Perseus, which are described in more detail above and in Notes 1 and 10 to our consolidated financial statements included in this Annual Report on Form 10-K. On June 1, 2007, we closed on the first of these transactions, in which we borrowed $12.5 million from Perseus and issued to Perseus a warrant to purchase shares of our common stock. This loan bore interest at the rate of 12.5% per annum and was secured by all of our assets and those of our material subsidiaries. On August 24, 2007, we closed on the second of the three transactions, in which we borrowed $15.0 million from Perseus, used a portion of these proceeds to repay the principal and accrued interest on the initial loan and issued another warrant to Perseus to purchase additional shares of our common stock. The net amount we received in the second loan, after deducting the amount necessary to repay the principal and accrued interest due on the initial note, was $2.1 million.

On March 13, 2008, we and our subsidiaries, Northern, Proton and Technology Drive, L.L.C., entered into a First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement, or the Amendment, with Perseus. The Amendment amends the securities purchase agreement and the related Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement.

Pursuant to the Amendment, we agreed to sell and issue to Perseus, and Perseus agreed to purchase, an Additional Investment Note, or the Additional Note. The Additional Note has an original principal amount of

$1.5 million, bears interest at 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. At Perseus s election, the principal and any unpaid interest under the Additional Note are convertible into shares of our common stock at a conversion price of $0.33 per share. Assuming that (a) we pay all interest in kind and (b) Perseus fully converts the Additional Note and all of the Additional Convertible Notes, Perseus would receive 4,966,213 shares of our common stock. The loan is secured by a security interest in all of our assets and those of our material subsidiaries. The Additional Note contains customary affirmative and negative covenants. The Additional Note also specifies events of default that would cause the Additional Note to become immediately due and payable. The events of default under the Additional Note include any time that our (1) working capital, as defined in the Additional Note, falls below $3.5 million or (2) unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Additional Note will also constitute an event of default under the previous notes issued to Perseus.

In addition, pursuant to the Amendment, in the event of an investment by an investor approved by Perseus in a project, joint venture, partnership or other transaction for the purpose of developing our wind turbine products, we agreed to:

- if the project uses an entity other than Distributed Energy, issue to Perseus, for no additional consideration, a 5% fully-diluted interest in such entity; or

- if the investor makes an investment directly in Distributed Energy, issue to Perseus, for no additional consideration, a warrant to purchase, at an exercise price of $0.33 per share, up to 909,090 shares of our common stock.

Further, in the event of a sale of assets of us or any of our affiliates (other than sales in the ordinary course of business), we agreed to:

- use all or part of the net proceeds to repay some or all of our obligations to Perseus;

- deliver an irrevocable letter of credit to Perseus in the amount of the net proceeds less any repayment of obligations owed to Perseus;

- place the net proceeds less any repayment of obligations owed to Perseus in a restricted cash account; or

- otherwise secure the obligations owed to Perseus or make such other arrangements with respect to the net proceeds as requested by Perseus in each case as directed by Perseus.

Under the Securities Purchase Agreement, we had undertaken to use commercially reasonable efforts to sell our Proton subsidiary. The Amendment permits us to suspend active efforts to sell Proton, but Perseus retains the right to reinstate the requirement at any time.

We incurred significant operating losses and negative cash flows from operating activities in each of the last three years and during the quarter and the twelve months ended December 31, 2007. Such circumstances raise substantial doubt about our ability to continue as a going concern. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, sell our Proton subsidiary and certain operating assets, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under its current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

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While we recently obtained funding from Perseus as described above, we do not expect that our current capital resources will be sufficient to operate our business beyond the next thirty days, and we expect that we will need to raise additional capital within the next thirty days to continue to operate. Our ability to continue our operations in the long term will be subject to a number of factors that pose additional risk and uncertainty, including:

- Our ability to secure additional capital funding or debt funding in the near future on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.
- Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues.
- Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow.
- Our ability to control operating expenses.
- The potential acceleration of debt service payments by one or more of our lenders as the result of subjective acceleration clauses in our debt agreements.

Management has developed a plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance. This plan includes:

- Continue to raise working capital for our company through on-going meetings and discussions with potential investors including Perseus.
- Continue our current strategy including revenue growth and bringing the business to sustained cash flow and positive performance in our Proton subsidiary.
- Continue to complete and disposition non wind and power electronics related businesses in our Northern subsidiary
- Focus our sales, marketing and engineering resources on continuing to grow our Northwind 100 wind turbine business. The process to focus solely on wind turbines and related power electronics started in early, 2007 and is expected to continue through the end of 2008.
- Develop the larger megawatt wind turbine as resources and financing become available.
- Continue cost and expense reduction activities in both of our subsidiaries and in our corporate headquarters.
- Continue the process of either selling or fully leasing our Waitsfield, Vermont facility.

Our independent registered public accountants have modified their report for our fiscal year ended December 31, 2007 with respect to our ability to continue as a going concern. This modification may negatively affect our capital-raising efforts or our ability to sign new contracts with customers.

ITEM 7A. ***Quantitative and Qualitative Disclosures about Market Risk***

Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material. Additionally, we are exposed to market risk due to variable interest rates under our financing arrangements.

At December 31, 2007, we had $0.6 million outstanding under our ten-year term note that is subject to a variable interest rate. The note bears interest at a variable rate equal to two percentage points less than the Vermont Economic Development Authority s prevailing rate for taxable financing, which was 6.50% per annum at December 31, 2007, with a maturity date of October 6, 2015. If our variable interest rate were to increase or decrease by 10%, we do not believe such a change would have a material impact on our financial position or results of operations.

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ITEM 8. Financial Statements and Supplementary Data
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Report of Independent Registered Public Accounting Firm

To the Board of Directors &

Stockholders of Distributed Energy Systems Corp.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Distributed Energy Systems Corp. and its subsidiaries at December 31, 2007 and December 31, 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing under item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has incurred significant recurring operating losses and cash outflows from operations that raise substantial doubt about its ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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

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

/s/ PricewaterhouseCoopers LLP

Hartford, Connecticut

March 14, 2008

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FINANCIAL STATEMENTS

DISTRIBUTED ENERGY SYSTEMS CORP.

CONSOLIDATED BALANCE SHEETS

	December 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,085,462	$ 4,911,704
Marketable securities (Note 3)		13,256,116
Current portion of restricted cash (Note 2)	866,406	794,705
Accounts receivable, less allowances of $1,481,644 and $688,778, respectively	6,505,526	7,857,484
Costs in excess of billings on contracts in progress (Note 7)	1,982,783	4,102,573
Inventories, net (Note 4)	5,071,553	4,784,439
Deferred costs (Note 7)	863,833	810,508
Interest receivable		100,798
Deferred financing costs, net	138,044	
Other current assets	602,614	1,060,931
Total current assets	21,116,221	37,679,258
Fixed assets, net (Note 5)	18,429,042	22,740,210
Long-term portion of restricted cash (Note 2)	727,424	6,229,176
Intangible assets, net (Notes 2, 8 and 9)	1,290,275	3,012,321
Other assets, net	187,642	228,657
Total assets	$ 41,750,604	$ 69,889,622
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt (Note 10)	$ 1,457,927	$ 1,379,460
Current portion of capital lease (Notes 5 and 10)	234,995	208,556
Perseus Senior Secured Convertible Promissory Note, net of debt discount (Note 10)	4,385,253	
Accounts payable	3,716,182	6,099,536
Accrued expenses (Notes 6 and 15)	3,327,268	2,035,599
Accrued compensation	982,671	2,122,068
Accrued taxes (Note 16)	414,937	348,050
Billings in excess of costs on contracts in progress (Note 7)	921,485	1,723,988
Deferred revenue (Note 7)	815,997	836,607
Customer advances	210,081	60,344
Total current liabilities	16,466,796	14,814,208
Long term liabilities:		
Deferred revenue (Note 7)	8,101	168,076
Long-term debt (Note 10)		5,540,411
Long-term portion of capital lease (Notes 5 and 10)	2,352,306	2,626,461
Total liabilities	18,827,203	23,149,156
Commitments and contingencies (Note 15)		
Stockholders equity (Note 13):		

Preferred stock, undesignated, $.01 par value per share; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 65,000,000 shares authorized; 39,993,822 and 39,442,180 shares issued and outstanding, respectively	399,938	394,421
Additional paid-in capital	261,667,232	235,624,657
Accumulated other comprehensive loss (Note 2)		(9,115)
Accumulated deficit	(239,143,769)	(189,269,497)
Total stockholders equity	22,923,401	46,740,466
Total liabilities and stockholders equity	$ 41,750,604	$ 69,889,622

The accompanying notes are an integral part of the consolidated financial statements.

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2007	**2006**	**2005**
Revenue			
Contract	$ 17,911,178	$ 26,825,372	$ 34,197,326
Product	4,772,526	11,270,186	6,309,524
Service	6,704,577	6,997,234	4,472,792
Total revenue	29,388,281	45,092,792	44,979,642
Cost of revenue			
Contract	22,200,896	26,267,642	31,548,547
Product	3,829,518	10,226,329	6,207,001
Service	8,280,929	7,326,987	3,120,089
Total cost of revenue	34,311,343	43,820,958	40,875,637
Gross margin	(4,923,062)	1,271,834	4,104,005
Operating expenses:			
Research and development:			
Depreciation and amortization	331,804	450,777	775,369
Other research and development (includes stock based compensation in the amount of $106,773, $200,402 and $0 respectively)	2,263,986	3,208,932	3,283,945
Restructuring costs	702,768		
Selling, general and administrative:			
Depreciation and amortization	3,946,593	1,510,889	1,148,370
Other selling, general and administrative (includes stock based compensation in the amounts of $1,139,789, $4,914,695 and $550,775, respectively)	28,060,271	24,823,924	15,781,570
Intangible impairment		1,450,000	
Goodwill impairment		24,191,187	
Total operating expenses	35,305,422	55,635,709	20,989,254
Loss from operations	(40,228,484)	(54,363,875)	(16,885,249)
Interest income	501,826	1,420,844	1,072,391
Interest expense	(7,245,475)	(747,109)	(482,996)
Other income	356,780	336,310	59,559
Loss on conversion of debt	(3,258,919)		
Loss on foreign exchange		(1,365)	(7,654)
Net loss	$ (49,874,272)	$ (53,355,195)	$ (16,243,949)
Basic and diluted net loss per share	$ (1.25)	$ (1.38)	$ (0.45)
Shares used in computing basic and diluted net loss per share	39,813,012	38,621,804	36,270,986

The accompanying notes are an integral part of the consolidated financial statements.

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY AND COMPREHENSIVE LOSS

	Common Stock							
	Shares	Amount	Additional Paid-In Capital	Unearned Compensation	Accumulated Other Comprehensive Income (loss)	Accumulated Deficit	Total Stockholders Equity	Total Comprehensive Loss
Balance at December 31, 2004	35,609,794	$ 356,097	$ 220,129,697	$ (1,023,738)	$ (358,086)	$ (119,670,353)	$ 99,433,617	$ (22,857,993)
Issuance of common stock, net	54,295	543	183,826				184,369	
Issuance of common stock upon exercises of stock options	784,089	7,841	733,372				741,213	
Issuance of common stock upon exercises of warrants	733,454	7,335	83,603				90,938	
Amortization of unearned compensation			(107,114)	569,758			462,644	
Issuance of stock option awards to consultants			88,131				88,131	
Change in unrealized gain on marketable securities (Note 3)					299,404		299,404	299,404
Net loss						(16,243,949)	(16,243,949)	(16,243,949)
Balance at December 31, 2005	37,181,632	371,816	221,111,515	(453,980)	(58,682)	(135,914,302)	85,056,367	(15,944,545)
Issuance of common stock, net	1,532,890	15,329	8,603,527				8,618,856	
Issuance of common stock upon exercises of stock options	438,218	4,382	473,851				478,233	
Issuance of common stock upon exercises of warrants	289,440	2,894	506,039				508,933	
Stock compensation			4,762,792	453,980			5,216,772	
Issuance of stock option awards to consultants			166,933				166,933	
Change in unrealized gain on marketable securities (Note 3)					49,567		49,567	49,567
Net loss						(53,355,195)	(53,355,195)	(53,355,195)
Balance at December 31, 2006	39,442,180	394,421	235,624,657		(9,115)	(189,269,497)	46,740,466	(53,305,628)
Issuance of common stock, net	254,351	2,544	134,304				136,848	
Issuance of common stock upon exercises of stock options	297,291	2,973	192,516				195,489	
Stock compensation			1,351,824				1,351,824	
Beneficial conversion feature pursuant to Perseus Subsequent Convertible Note			8,047,657				8,047,657	
Issuance of common stock warrants			16,316,274				16,316,274	
Change in unrealized gain on marketable securities (Note 3)					9,115		9,115	9,115
Net loss						(49,874,272)	(49,874,272)	(49,874,272)
Balance at December 31, 2007	39,993,822	$ 399,938	$ 261,667,232	$	$	$ (239,143,769)	$ 22,923,401	(49,865,157)

The accompanying notes are an integral part of the consolidated financial statements.

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DISTRIBUTED ENERGY SYSTEMS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2007	**2006**	**2005**
Cash flows from operating activities:			
Net loss	$ (49,874,272)	$ (53,355,195)	$ (16,243,949)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	5,241,579	2,623,057	2,420,662
Provision for bad debts	1,096,613	616,006	29,871
Amortization (accretion) of premiums/discounts on marketable securities	(47,021)	(370,186)	(11,546)
Amortization of debt discount	5,231,127		
Amortization of financing costs	613,845		
Non-cash stock-based expense	1,374,645	5,383,705	550,775
Loss on conversion of debt	3,258,920		
Warrants issued to MSW (Note 14)	6,386,736		
Impairment of assets	1,113,753	25,641,187	
(Gain)/loss on disposal of assets	28,191	(9,786)	96,578
Loss from sale of marketable securities	2,175	13,688	2,200
Changes in operating assets and liabilities, excluding effect of acquisition:			
Accounts receivable	255,345	328,929	(3,542,410)
Other curent and non-current assets	543,166	(14,487)	(158,311)
Inventories and deferred costs	(340,439)	1,752,867	524,882
Costs in excess of billings	2,119,790	(2,151,347)	(1,232,123)
Accounts payable and accrued expenses	(2,231,082)	1,568,254	1,730,108
Accrued taxes payable	66,887	(54,309)	(156,283)
Billings in excess of costs	(802,503)	564,020	(2,430,612)
Deferred revenue and customer advances	(30,848)	(4,296,846)	636,699
Net cash used in operating activities	(25,993,393)	(21,760,443)	(17,783,459)
Cash flows from investing activities:			
Purchases of fixed assets	(379,991)	(2,550,682)	(3,522,263)
Proceeds from the sale of fixed assets	86,646	120,000	4,500
Purchases of marketable securities		(36,810,963)	(36,387,663)
Proceeds from maturities and sales of marketable securities	13,310,077	44,025,632	69,776,800
Cash paid for acquisition, including transaction costs, net of cash acquired		(1,175,000)	
Restricted cash	5,430,051	(6,017,758)	475,676
Net cash provided by (used in) investing activities	18,446,783	(2,408,771)	30,347,050
Cash flows from financing activities:			
Borrowings from long-term debt	25,493,324	256,661	1,543,749
Debt principal payments	(18,082,472)	(680,106)	(512,965)
Proceeds from sale of common stock, net	114,027	7,916,406	184,369
Proceeds from exercise of stock options	195,489	478,233	741,213
Proceeds from exercise of warrants		508,933	90,938
Net cash provided by financing activities	7,720,368	8,480,127	2,047,304
Net increase (decrease) in cash	173,758	(15,689,087)	14,610,895
Cash and cash equivalents at beginning of year	4,911,704	20,600,791	5,989,896

Cash and cash equivalents at end of year	$	5,085,462	$	4,911,704	$	20,600,791
Cash paid during the year for interest	$	477,471	$	698,081	$	482,996
Supplemental cash flow information						
Non-cash investing/financing activities:						
Issuance of common stock for acquistion	$		$	701,400	$	
Assets acquired through capital leases	$		$	266,827	$	141,621
Issuance of warrants in connection with debt	$	9,929,538	$		$	
Issuance of note in lieu of interest	$	190,068	$		$	

The accompanying notes are an integral part of the consolidated financial statements.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. FORMATION AND OPERATIONS OF THE COMPANY

Distributed Energy Systems Corp. (the Company , we or Distributed Energy) was incorporated in Delaware on May 19, 2003 to create and deliver products and solutions to the new energy marketplace, giving users greater control over their energy cost, quality, and reliability. Distributed Energy brought together two established businesses: Proton Energy Systems, Inc. (Proton) and Northern Power Systems, Inc. (Northern). Together, as subsidiaries of Distributed Energy, Proton and Northern offer an array of practical energy technologies, including Proton s advanced hydrogen generation products and Northern s wind turbine and fossil-fuel power systems.

To address our need to raise additional working capital, we entered into a securities purchase agreement (the Perseus Agreement), with Perseus Partners VII, L.P. (Perseus) on May 10, 2007. Pursuant to the terms of the Perseus Agreement, on June 1, 2007 we closed on an initial $12.5 million loan by Perseus to us. In connection with this initial loan, we executed a senior secured promissory note in favor of Perseus (the Initial Note), and issued to Perseus an initial investment warrant (the Initial Warrant). The Initial Note had an interest rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at our discretion, and was due on March 1, 2008. The loan was secured by a security interest in all of our assets and those of our material subsidiaries. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of our common stock at an exercise price of $0.80 per share.

On August 24, 2007, pursuant to the terms of the Perseus Agreement, we closed on a subsequent $15.0 million loan by Perseus to us, or the subsequent funding. In connection with this loan, the Initial Note was repaid and cancelled, and we executed a senior secured convertible promissory note in favor of Perseus (the Subsequent Convertible Note), and issued to Perseus a subsequent investment warrant (the Subsequent Warrant). The net amount received by us was $2,140,411, after deduction of the amounts sufficient to repay in full the principal and interest due on the Initial Note.

The Subsequent Convertible Note has an original principal amount of $15.0 million, bears interest at a rate of 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008 or earlier upon an event of default, a change of control or our liquidation or dissolution. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes on the same terms as the Subsequent Convertible Note (the Additional Convertible Notes). At Perseus s election, the principal and any unpaid interest under the Subsequent Convertible Note and any Additional Convertible Notes are convertible immediately after issuance into shares of our common stock at a conversion price of $0.57 per share. Assuming that (a) we pay all interest expense in kind and (b) Perseus fully converts the Subsequent Convertible Note of $15.0 million and all of the Additional Convertible Notes, Perseus would receive 30,779,675 shares of our common stock. The loan is secured by a security interest in all of our assets and those of its subsidiaries.

The Subsequent Warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of our common stock at exercise prices ranging from $0.80 to $3.00 per share.

Perseus, through its right to convert the Subsequent Convertible Note and Additional Convertible Note into our common stock and exercise the Initial Warrant and the Subsequent Warrant, could acquire enough shares of our common stock to raise its ownership to greater than 50% of the our total outstanding common stock. In addition, under the terms of the Perseus Agreement, upon the closing of the Subsequent Funding, we were obligated to reduce the size of our board of directors to five, and at that time Perseus became entitled to representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of the Subsequent Convertible Note. Based upon our current capitalization, Perseus now has the right under this provision to name a majority of the directors on our board.

On August 24, 2007, we and Perseus entered into a letter agreement regarding Perseus s board representation rights (the Letter Agreement). Pursuant to the Letter Agreement, (i) Perseus acknowledged that

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

it had waived the requirement that we reduce the size of our board of directors to five, (ii) Perseus and we agreed to set the size of the board at seven members, and (iii) Perseus agreed to name two directors, rather than a majority, and we agreed to permit Perseus to send an observer to meetings of our board of directors. Perseus retains its rights to, at any time, (a) require us to reduce the size of its board of directors to five members and (b) name additional members of the board of directors to give Perseus representation on our board of directors equal to at least its percentage ownership in our company, assuming exercise of its warrants and conversion of the Subsequent Convertible Note.

On November 19, 2007, we received a notification from the NASDAQ Listing Qualifications Department providing notification that, because of the appointment of Bernard H. Cherry as the Company s Interim Chief Executive Officer, we no longer had a majority of independent directors as required by Nasdaq Marketplace Rule 4350(c)(1). To regain compliance with this rule, on November 21, 2007, Michael L. Miller, a Perseus representative, resigned from our board of directors. On November 21, 2007, in connection with Mr. Miller s resignation, we entered into an agreement with Perseus pursuant to which we agreed to permit Mr. Miller to attend meetings of our board of directors as an observer. We also agreed to reappoint Mr. Miller to the board if we name an additional independent director and would therefore be able to maintain compliance with Nasdaq Marketplace Rule 4350(c)(1) with Mr. Miller on the board.

On March 13, 2008, we and Perseus entered into another loan agreement whereby Perseus agreed to lend us an additional $1.5 million as discussed in Note 19. As a result of this agreement, Perseus removed the earlier requirement in the Perseus Agreement to use commercially reasonable efforts to sell our Proton subsidiary, and we have ended our efforts to sell Proton. Perseus is entitled to have an observer at our board meetings and also has the right to approve specified significant actions by us. We have also granted to Perseus a right of first refusal to fund any future financing transactions we might pursue, with limited exceptions. In addition, we have agreed to register for resale all the shares issuable to Perseus. Refer to Note 10 for additional information on the Initial Note and Subsequent Convertible Note.

Liquidity

We incurred significant operating losses and negative cash flows from operating activities in each of the last three years and during the year ended December 31, 2007. Such circumstances raise substantial doubt about our ability to continue as a going concern even with the proceeds of the Perseus transaction. The accompanying consolidated financial statements of the Company were prepared on a going concern basis, which contemplates the realization of assets and liabilities in the normal course of business. The realization of assets and the satisfaction of liabilities in the normal course of business are dependent on, among other things, our ability to raise additional capital, reduce our operating losses and operate profitably, to generate cash flows from operations, as well as our ability to maintain credit under its current debt agreements adequate to conduct our business. If we became unable to continue as a going concern, we would have to reorganize or liquidate our assets, and we might receive significantly less than the value at which they are carried on our condensed consolidated financial statements.

While we recently obtained funding from Perseus as described above, we do not expect that our current capital resources will be sufficient to operate our business beyond the next thirty to forty-five days, and we expect that we will need to raise additional capital within the next thirty to forty-five days to continue to operate. Our ability to continue our operations in the long term will be subject to a number of factors that pose additional risk and uncertainty, including:

Our ability to secure additional capital funding or debt funding in the near future on terms acceptable to us or at all. Our ability to obtain additional funding will be subject to a number of factors, including

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

market conditions, our operating performance, the consent of our existing lenders and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding unattractive. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

Our ability to enter into new contracts and receive sales orders that will generate contract, product and service revenues.

Our ability to achieve gross margins sufficient to cover our operating expenses and generate positive cash flow.

Our ability to control operating expenses.

The potential acceleration of debt service payments by one or more of our lenders as the result of subjective acceleration clauses in our debt agreements.

Management has developed a plan to increase revenue, improve gross margin, reduce expenses, potentially sell assets and raise additional capital in order to increase our cash balance. This plan includes:

Continue to raise working capital for our company through on-going meetings and discussions with potential investors including Perseus.

Continue our current strategy including revenue growth and bringing the business to sustained cash flow and positive performance in our Proton subsidiary.

Continue to complete and disposition non wind and power electronics related businesses in our Northern subsidiary

Focus our sales, marketing and engineering resources on continuing to grow our Northwind 100 wind turbine business. The process to focus solely on wind turbines and related power electronics started in early 2007 and is expected to continue through the end of 2008.

We will develop the larger megawatt wind turbine as resources and financing become available.

Continue cost and expense reduction activities in both of our subsidiaries and in our corporate headquarters.

Continue the process of either selling or fully leasing our Waitsfield, Vermont facility.

Provided we raise sufficient cash, we believe our plan is sufficient to meet all of our obligations as they come due throughout 2008. If we are unable to raise sufficient additional capital in the short term or to execute our plan, we may have to cease operations.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies followed in the preparation of these financial statements are as follows:

Principles of Consolidation

The consolidated financial statements include the accounts of Distributed Energy and its wholly owned subsidiaries after elimination of significant intercompany transactions.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, Distributed Energy evaluates its estimates and judgments, including those related to revenue recognition, the costs to complete contracts, valuation allowances (specifically A/R reserve and warranty, inventory lower-of-cost-or market and other allowances); accounting for patent legal defense costs; the valuation of goodwill, other intangible assets and tangible long-lived assets, estimates used in accounting for acquisitions; assumptions used in valuing stock-based compensation instruments, evaluation of loss contingencies; and valuation allowances for deferred tax assets. Actual amounts could differ materially from these estimates. Distributed Energy bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the amounts of revenue and expenses that are not readily apparent from other sources.

Revenue Recognition

The Company generates revenue from three principal sources: product sales, long-term contracts, and service contracts.

Product Revenue:

Our product revenue is primarily derived from the operations of our Proton segment. For product sales for which adequate product warranty information exists, we record revenue when a firm sales agreement is in place, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. If customer acceptance of products is not assured, revenue is recorded only upon formal customer acceptance. Customer acceptance provisions included in our product sales agreements may include written acceptance from the customer, acceptance upon servicing and installation of the equipment, and acceptance after a period of time. Revenue for product sales to distributors, for which there are no rights of return or price adjustments on unsold inventory, is recognized on a gross basis upon shipment to the distributors, as they assume title and risk of loss, subject to the deferral provisions below. For all product sales where adequate product warranty information does not yet exist to reasonably estimate warranty costs, we defer revenue and costs until the expiration of the product warranty period.

During 2006, we determined that we had adequate warranty information and experience to begin recognizing product revenue related to our HOGEN H-series hydrogen generators. Therefore, in the third quarter of 2006 we began recognizing product revenue related to sales of H-series hydrogen generators upon shipment. Prior to the third quarter of 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment.

During 2005, we determined that we had adequate product warranty information and experience to begin recognizing product revenue related to our HOGEN S-series and our laboratory generators. Therefore, in the first quarter of 2005, we began recognizing product revenue related to sales of laboratory generators with a two-year warranty upon shipment, and in the third quarter of 2005, we began recognizing product revenue related to sales of our HOGEN S-series hydrogen generators upon shipment.

We also earn revenue from the rental of our HOGEN products. We account for the agreements as operating leases under the provisions of Statement of Financial Accounting Standards, or SFAS, No. 13, Accounting for Leases. The agreements are cancelable at any time by either party without penalty. Rental revenue is recognized monthly over the term of the rental agreement. Rental revenue for the years ended December 31, 2007, 2006 and 2005 was approximately $140,100, $22,300 and $96,000, respectively, costs of these related rentals, which consists primarily of depreciation expense, was approximately $85,000, $53,000 and $140,000 respectively.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contract Revenue:

We principally generate commercial contract revenue from projects in our remote infrastructure, on-site generation, and renewable energy field product lines at our Northern segment. For projects with a duration of greater than three months where we have the ability to reasonably estimate total project costs to complete the contract, we recognize revenue utilizing the percentage-of-completion method as prescribed by SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts or SOP 81-1 , based on the relationship of costs incurred to total estimated contract costs. Where we do not have the ability to estimate costs or the contract contains restrictive provisions, such as title not transferring until the end of the contract, we use the completed contract method under SOP 81-1. The selection of methods under SOP 81-1 in some circumstances can be judgmental. Approximately 67%, 79% and 77% of our contract revenue for the years ended December 31, 2007, 2006 and 2005, respectively, was recognized under the percentage-of-completion method.

We also derive contract revenues from government-sponsored research and development contracts and from commercial customers. For government-sponsored research and development contracts that are fixed-price, we recognize revenue using the percentage-of-completion method under SOP 81-1. For fixed-price-incentive, or cost-reimbursement contracts that do not require us to meet specific obligations, we record revenue as work is performed. For those research and development contracts that require us to meet specified obligations, including delivery and acceptance obligations, we recognize amounts advanced as contract liabilities until such obligations are met. Once the obligations are met, we recognize the amounts as contract revenue. For all other commercial contracts, we recognize revenue under the completed contract method.

The recognition of revenue from contracts accounted for under SOP 81-1 requires significant judgment to estimate the costs to complete contracts in progress, which has a significant impact on the amount and timing of recognition of revenue, cost of sales, gross margin and the recording of assets and liabilities. Contract costs may be incurred over a period of several months to several years and the long-term nature and complexity of these contracts can affect our ability to estimate costs precisely. For example, delays, changes in scope, increases in labor and material costs or other unforeseen events could result in actual costs to complete being different from our original estimates, and those differences could be material. Change orders that modify the scope of contracts are common in our business and often require significant judgment and estimation due to the uncertainty of negotiating with customers. We base our estimates on historical experience, vendor quotes, and other projected costs we expect to incur over the term of the contract. We review and update our cost estimates on a quarterly basis or when circumstances change and warrant a modification to a previous estimate. If our estimates of the costs to complete a contract exceed anticipated revenue on a contract, we immediately recognize a loss at the time the loss becomes anticipated. Estimates of costs to complete that are too low would result in revenue being recognized too early and gross margins being too high at the onset of the contract. Our annual gross margin percentage for contract revenue may be affected by these changes in estimates and has fluctuated from 8% to 2% to (23.9)% for the years ended December 31, 2005, 2006 and 2007.

Service Revenue:

For service and repair contracts, revenue is recognized as work is performed. For operating and maintenance contracts where we have agreed to provide routine maintenance services over a period of time for a fixed price, we recognize revenue ratably over the services period.

Cost of Revenue

Adjustments to cost estimates are made periodically and losses expected to be incurred on contracts in progress are charged to operations in the period such losses are determined. The aggregate of costs incurred and

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

income recognized on uncompleted contracts accounted for under percentage of completion method in excess of related billings and deferred costs on contracts accounted for under the completed contract method of accounting are shown as current assets. The aggregate of billings on uncompleted contracts accounted for under percentage of completion method in excess of related costs incurred and income recognized and deferred revenue are shown as current liabilities

All costs incurred in the shipping and handling of customers goods are included in cost of production and cost of contract revenue.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with original maturity dates of three months or less as of the purchase date to be cash equivalents. The Company invests excess cash primarily in a money market account at a major banking institution, which is subject to credit and market risk.

Restricted Cash

At December 31, 2007 and 2006, respectively, the Company has classified $866,406 and $794,705 as short-term restricted cash and $727,424 and $6,229,176 as long-term restricted cash in connection with the following agreements:

At December 31, 2006 the Company had $5,437,882 held in a blocked interest-bearing deposit account by and on behalf of Webster Bank National Association, as a pledge under the terms of its construction loan agreement, as amended in September 2006. During 2007 the loan was paid in full and the pledged funds were released to the Company. As of December 31, 2006 the Company classified $400,200 as short term restricted cash and $5,037,682 as long-term restricted cash. The related loan balance was $5,342,182 at December 31, 2006.

At December 31, 2007, a financial institution has issued letters of credit of $912,615 on behalf of Northern. At December 31, 2007 the Company classified $571,696 as short term restricted cash and $375,000 as long-term restricted cash which serves as collateral for the letters of credit. At December 31, 2006, a financial institution has issued letters of credit of $1,016,749 on behalf of Northern. At December 31, 2006 the Company classified $394,505 as short term restricted cash and $622,244 as long-term restricted cash which serves as collateral for the letters of credit.

Northern, in connection with its debt facility and in support of certain of its commercial contracts, also maintains approximately $352,424 and $150,000 of long-term restricted cash at December 31, 2007 and 2006, respectively.

In connection with the construction of its Wallingford facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement (the Agreement) with the Connecticut Development Authority (the Authority). The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. Proton was required under the Agreement to place $419,250 in escrow related to these recapture clauses. By agreement the amount held in escrow was reduced to $294,710 as of December 31, 2007 and is included in short-term restricted cash. As of December 31, 2006, $419,250 is included in long-term restricted cash.

Marketable Securities

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. At December 31, 2006, the Company s investment portfolio consisted of U.S. government and agency securities that were held by one major banking institution.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securities are carried at fair value with the unrealized appreciation (loss) reported as a separate component of stockholders equity under the caption total comprehensive income (loss). The specific identification method was used to determine cost in computing the unrealized gain or loss. If the Company determines that such losses are other than temporary, they will be charged to earnings.

Fair Value of Financial Instruments

The Company s financial instruments, including cash, cash equivalents, accounts receivable, and accounts payable are carried at cost, which approximates their fair value because of the short-term maturity of these instruments. The carrying amounts of the Company s long-term debt and capital lease obligation debt approximates the fair value of such instruments based upon management s best estimate of interest rates that would be available to the Company for similar debt obligations, except for the Perseus Senior Secured Convertible Promissory Note (Subsequent Convertible Note). As described in Note 10, the Subsequent Convertible Note was issued at a discount which is being amortized over the term of the note. As a result, at December 31, 2007, the Subsequent Convertible Note is carried on the balance sheet at a discount. The stated value of the Subsequent Convertible Note of $15 million approximates the fair value of this instrument.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net loss and other gains and losses affecting stockholders equity that are not the result of transactions with owners. The following tables set forth the components of comprehensive income (loss) resulting from our investment activities:

	2007	2006	2005
Net loss	$ (49,874,272)	$ (53,355,195)	$ (16,243,949)
Reclassification adjustments for loss from the sale of marketable securities included in net loss	2,175	13,688	2,200
Unrealized gain arising during the year	6,940	35,879	297,204
Total comprehensive loss	$ (49,865,157)	$ (53,305,628)	$ (15,944,545)

Allowance for Doubtful Accounts

The Company evaluates credit risk on its accounts receivable and estimates an allowance for doubtful accounts accordingly. The Company evaluates the adequacy of the allowance for doubtful accounts on a periodic basis. The evaluation includes historical loss experience, adverse situations that may affect a customer s ability to repay, and prevailing economic conditions. The Company makes adjustments to its allowance if the evaluation of allowance requirements differs from the actual aggregate reserve. This evaluation is inherently subjective and estimates may be revised as more information becomes available.

Inventory

We record inventory at the lower of cost or market value. We determine cost by the average cost method. This policy requires us to write down our inventory for the excess of the carrying value, which is typically the original cost, over the amount we expect to realize from the ultimate sale or other disposal of the inventory based upon on our assumptions regarding forecasted consumer demand, market conditions, inventory aging and technological obsolescence. If any of our estimates are inaccurate, for example because of changes in technology that affect demand for certain products in an unforeseen manner, we may be exposed to losses in excess of our established reserve, and those losses could be material.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fixed Assets

Fixed assets are stated at cost and are depreciated using the straight-line method over the following estimated useful lives by asset category:

Asset Category	Estimated Useful Life
Buildings	30 years
Capital lease asset	30 years
Machinery and equipment	7 years
Leasehold improvements	Shorter of remaining life of lease or 7 years
Office furniture, fixtures and equipment	3-7 years
Rental equipment	3 years

When assets are sold or retired, the related cost and accumulated depreciation are removed from their respective accounts and any resulting gain or loss is included in income. The Company periodically reviews the carrying value of its fixed assets to assess recoverability based upon the expectation of non-discounted future cash flows.

Long-lived Assets

We evaluate potential impairment of long-lived assets and long-lived assets to be disposed of in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes procedures for the review of recoverability and measurement of impairment, if necessary, of long-lived assets held and used by an entity. SFAS No. 144 requires that those assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. We would be required to recognize an impairment loss if the carrying amount of long-lived assets is not recoverable based on their undiscounted cash flows. The measurement of impairment loss is then based on the difference between the carrying amount and the fair value of the asset. If actual results are not consistent with our assumptions and judgments used in estimating future cash flows and asset fair values, we may be exposed to additional impairment losses that could be material to our results of operations.

In January 2007, we announced that we were combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. We also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility. As a result of our decision to exit the Waitsfield facility and consolidate our Northern operations in Barre, Vermont, we revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated depreciation charges. Therefore, we recorded additional depreciation expense in 2007 of approximately $2.4 million.

Northern s results for the year ended December 31, 2007 were significantly less than expected due to lower revenue and higher than anticipated costs and the carrying value of Proton s long-lived assets depends on our ability to achieve gross margins sufficient to cover operating expenses and generate positive cash flow in the normal course of business. These factors indicated that the carrying value amount of our long-lived assets may not be recoverable. During the quarter ended December 31, 2007 we conducted an impairment review of our long-lived assets, and concluded there was no impairment on the basis that the carrying amount of our long-lived assets will be recoverable from the asset grouping s expected undiscounted cash flows. We conducted this review separately for our two asset groups those related to Northern and those related to Proton.

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our impairment review of long lived assets has been done assuming we continue as a going concern business. As described above, we do not expect that our current working capital resources will be sufficient to operate our business beyond the next thirty to forty-five days, and we will need to raise additional capital in order to continue to operate. The projections of undiscounted cash flows we used in our impairment analysis assume that we raise sufficient capital to continue our business on a long term basis. If we do not raise sufficient capital in the near term, or if we do raise sufficient capital but our projections of undiscounted cash flows are not realized, there is a risk that additional impairment charges would need to be recorded. If we do not raise sufficient capital in the near term, we may reorganize or liquidate our assets, and we may receive significantly less than the value at which they are carried in the financial statements.

Goodwill

As part of our acquisitions of Northern in 2003 and the Crown service business in 2006, we recorded approximately $24.8 million of goodwill and $5.7 million in intangible assets. Goodwill represents costs in excess of fair values assigned to the underlying net assets of the acquired business.

The Company has adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. These standards require the use of the purchase method of accounting for business combinations, set forth the accounting for the initial recognition of acquired intangible assets and goodwill, and describe the accounting for intangible assets and goodwill subsequent to initial recognition. Under the provisions of these standards, goodwill and certain intangible assets are deemed to have indefinite lives and are no longer subject to amortization. All other intangible assets are amortized over their estimated useful lives. SFAS 142 requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis or more frequently in certain circumstances.

The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company s reporting units with the reporting unit s carrying amount, including goodwill. The Company generally determines the fair value of its reporting units using the expected present value of future cash flows, giving consideration to the market comparable approach. If the carrying amount of the Company s reporting units exceeds the reporting unit s fair value, the Company performs the second step of the goodwill impairment test to determine the amount of impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the Company s reporting unit s goodwill with the carrying amount of that goodwill. In the second step, the implied fair value of the reporting unit s goodwill is determined by allocating the reporting unit s fair value to all of its assets and liabilities other than goodwill (including any unrecognized intangible assets) in a manner similar to a purchase price allocation. The resulting implied fair value of the goodwill that results from the application of this second step is then compared to the carrying amount of the goodwill and an impairment charge is recorded for the difference.

In the fourth quarter 2006 and throughout 2006, Northern s operating results were significantly less than expected due to revenue shortfalls and higher than anticipated costs. Additionally, Northern s backlog also decreased since the third quarter of 2006 as work was performed on existing contracts, with no significant new contracts added to the backlog through December 31, 2006. In the fourth quarter we completed preparation of our 2007 operating plan and our related long-term projections, which indicated lower than previously estimated revenue growth, gross margins and related operating cash flows. These projections were used to estimate the fair value of the Northern reporting unit and it was determined that the carrying value of the reporting unit exceeded the fair value, which indicated goodwill impairment. The Company then compared the implied fair value of the Northern goodwill with the carrying value of that goodwill and recorded a $24.2 million goodwill impairment

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

charge in 2006. The impairment review process involved significant judgment regarding Northern s projected future cash flows and expected market conditions, and their impact on the selection of the discount rate used in estimating the fair value of Northern.

Intangible Assets

Intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for intangible assets subject to amortization is based on the amount the carrying value exceeds the fair value of the asset. Intangible assets include acquired technologies, backlog, trade name, and non-compete agreements. Of the $5.7 million in intangible assets, $4.2 million are intangible assets with a useful life ranging from 1-7 years and $1.5 million is an intangible asset with indefinite life. The intangible assets balance, net of amortization and write-offs, is $1.3 million and $3.0 million at December 31, 2007 and 2006, respectively.

In the third quarter of 2007, we determined that there were indications of impairment of the intangible assets related to the Crown acquisition. As a result of our impairment analysis, we determined that the value associated with the projected cash flows of acquired service and non-compete contracts has decreased resulting in the recognition of an impairment loss of approximately $1.1 million in the third quarter of 2007.

In the fourth quarter 2006, we began an initiative to combine the operations of Northern and Proton to reduce costs and strengthen its systems sales, engineering, production, service and technology development. In conjunction with that effort we determined that we would eliminate both the Proton and Northern brands, and operate in the marketplace under a single unified brand, Distributed Energy. At that time, we had planned to cease use of the Northern tradename by April 2007. Therefore, at December 31, 2006, we determined that the Northern tradename had been impaired and recorded an impairment charge of $1,450,000. The fair value of the Northern tradename was determined utilizing the income approach-relief from royalty method. In the fourth quarter of 2007, in connection with our narrowing of Northern s focus to the design and sale of direct drive wind turbines and associated power electronics, we concluded that we would maintain both the Proton and Northern tradenames. This decision does not result in any change to the impairment charge taken in 2006. We have assessed the useful lives of our other existing intangible assets and believe that the estimated useful lives remain appropriate.

Research and Development

Research and development costs are expensed as incurred.

Warranty Costs

Our warranty to customers is limited to replacement parts and services and generally expires one year from the date of shipment or contract completion, except with respect to laboratory hydrogen generators, where the warranty period is two years. Estimated warranty obligations are recorded in the period in which the related revenue is recognized or when a project is installed or commissioned. We quantify and record an estimate for warranty related costs; this estimate is principally based on historical experience. The accounting for warranties requires us to make assumptions and apply judgments when estimating product failure rates and expected material and labor costs. We make adjustments to accruals as warranty claim data and historical experience warrant. If actual results are not consistent with the assumptions and judgments used to calculate our warranty liability, because either failure rates or repair costs differ from our assumptions, we may be exposed to gains or losses that could be material.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The changes in accrued product and service warranties for the years ended December 31, 2005, 2006 and 2007 are as follows:

Balance as of December 31, 2004	$ 273,027
Warranties issued in 2005	398,653
Adjustments to provision	(36,744)
Warranty claims	(217,242)
Balance as of December 31, 2005	417,694
Warranties issued in 2006	883,636
Adjustments to provision	479,537
Warranty claims	(967,422)
Balance as of December 31, 2006	813,445
Warranties issued in 2007	592,143
Adjustments to provision	(161,573)
Warranty claims	(673,954)
Balance as of December 31, 2007	$ 570,061

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. A valuation allowance is established against net deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the net deferred tax assets will not be realized.

Concentration of Credit Risks

Concentration of credit risk exists with respect to cash and cash equivalents, accounts receivable, investments, revenue and vendors. The Company maintains its cash and cash equivalents and investments with high quality financial institutions. At times, amounts may exceed federally insured deposit limits. In addition, certain critical product components are only available from one source for which the source maintains proprietary rights.

For the years ended December 31, 2007, 2006 and 2005, contract revenue from government-sponsored agencies accounted for approximately 14%, 13% and 14% of our total revenue, respectively. Contract revenue from international customers accounted for approximately 18%, 25% and 11% of our total revenue for the years ended December 31, 2007, 2006 and 2005, respectively. For the year ended December 31, 2007, three customers accounted for 17%, 16% and 11% of product revenue. For the year ended December 31, 2006, one customer accounted for 14% of product revenue and another customer accounted for 11% of product revenue. For the year ended December 31, 2005, one customer accounted for 10% of product revenue. For the year ended December 31, 2007, approximately 13% of international product sales were to two customers. For the years ended December 31, 2007, 2006 and 2005, approximately $5.2 million, $14.9 million and $13.3 million in sales were made to international customers. At December 31, 2007 and 2006, accounts receivable from government-sponsored agencies accounted for approximately 13% and 8% of total Company accounts receivable, respectively. At December 31, 2007, there was two customer accounts receivable greater than 10% of total receivables.

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Loss per Share

Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average common shares outstanding. Diluted EPS is calculated by adjusting weighted average common shares outstanding by assuming conversion of all potentially dilutive shares. In periods where a net loss is recorded, no effect is given to potentially dilutive securities since the effect would be antidilutive. Accordingly, no effect has been given to the assumed exercise of 651,396, 1,992,011, and 2,878,925 common stock options outstanding for the years ended December 31, 2007, 2006, and 2005, respectively, nor the assumed exercise of 8,589,629, 0 and 744,786 common stock warrants outstanding for the years ended December 31, 2007, 2006, and 2005 respectively, nor the assumed conversion of Perseus debt to 26,649,243 of common shares as of December 31, 2007 since the effect would be antidilutive for the reporting periods.

Segment Reporting

The Company operates in two reportable segments, Proton and Northern, as defined in Note 17, determined in accordance with SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information.

Stock-Based Compensation Employee Stock-Based Awards

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options and employee stock purchases under the ESPP based on estimated fair values. SFAS 123(R) supersedes our previous accounting under APB 25, Accounting for Stock Issued to Employees for periods beginning in fiscal year 2006. In March 2005, the SEC issued SAB 107 providing supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. We adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from January 1, 2006. Our Consolidated Financial Statements, for the year ended December 31, 2007, reflect the impact of adopting SFAS 123(R). Non-cash stock compensation expense for the year ended December 31, 2007, was $1,374,645 which consisted primarily of stock-based compensation expense related to employee stock options recognized under SFAS 123(R). In addition, stock-based compensation expense for the year ended December 31, 2007 of $22,821 was recognized related to our ESPP.

Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123, Accounting for Stock-Based Compensation. Under the intrinsic value method, no stock-based compensation expense for employee stock options had been recognized in our Consolidated Statements of Operations, because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method we used in adopting SFAS 123(R), our results of operations prior to 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R). Additionally, under the modified prospective transition method, we were permitted to calculate a cumulative memo balance of windfall tax benefits from post-1995 years for purposes of accounting for future tax shortfalls. We elected to apply the long-form method for determining the pool of windfall tax benefits and have a pool of windfall tax benefits totaling approximately $700,000 at December 31, 2007.

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in the year ended December 31, 2007 and 2006, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the fair value on the grant date estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 31, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all stock-based awards granted will be recognized using the ratable single-option method. As stock-based compensation expense recognized in our results for 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option s expected term and the price volatility of the underlying stock. The Company has determined that historical volatility is most reflective of the market conditions and the best indicator of expected volatility.

The following table illustrates the effect on net loss and loss per share had compensation costs for the stock-based compensation plan been determined based on grant date fair values of awards under the provisions of SFAS No. 123, for the years ended December 31:

	2005
Net loss:	
As reported	$ (16,243,949)
Add: Stock-based employee compensation expense included in net loss	462,644
Less: Total stock-based employee compensation expense determined under fair value-based method for all awards	(2,839,536)
Pro forma	$ (18,620,841)
Net loss per share, basic and diluted	
As reported	$ (0.45)
Pro forma	$ (0.51)

Stock-Based Compensation Non-Employee Stock Options

The Company accounts for stock-based compensation issued to non-employees in accordance with SFAS 123(R) and the consensus in Emerging Issues Task Force (EITF) 96-18. These pronouncements require the fair value of equity instruments given as consideration for services rendered to be recognized as a non-cash charge to income over the shorter of the vesting or service period. The equity instruments must be revalued on each subsequent reporting date until performance is complete with a cumulative catch-up adjustment recognized for any changes in their fair value.

Recent Accounting Pronouncements

The Company adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) on January 1, 2007. As a result of the implementation of

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FIN 48, the Company performed a comprehensive review of any uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company believes it has no uncertain tax positions and, accordingly, did not record any charges.

In February 2007, FASB issued SFAS No, 159, The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No.115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets and liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the potential impact of this statement.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. Since its initial issuance, the FASB has received considerable input regarding the implications of the standard on the valuation of non-financial assets and liabilities. As a result, the FASB is proposing to amend the scope of SFAS 157 to exclude its application to lease accounting and clarify its disclosure requirements relative to pension and other post-retirement employee benefit assets and liabilities. In light of the changes being proposed and the underlying implications of the overall pronouncement, we are currently evaluating its potential impact to our financial statements and results of operations.

3. MARKETABLE SECURITIES

The following tables summarize investments:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2007				
U.S. government securities	$	$	$	$

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2006				
U.S. government securities	$ 13,265,231	$	$ (9,115)	$ 13,256,116

As of December 31, 2007 and 2006, the approximate fair values of marketable securities by maturity date are as follows:

	2007	2006
Less than one year	$	$ 13,256,116

Securities are carried at fair value with the unrealized gains (losses) reported as a separate component of stockholders equity. Proceeds from the sale of securities in 2007, 2006, and 2005 totaled $2,639,742, $1,147,955

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and $2,002,573 respectively. The cost was determined using the specific identification method and the resulting realized losses were ($2,175), ($13,688), and $(2,200), respectively. At December 31, 2006, the Company had one callable agency security with a fair market value totaling approximately $2.6 million.

4. INVENTORIES

Inventories are as follows:

	December 31, 2007	December 31, 2006
Raw materials	$ 2,752,230	$ 3,732,561
Work in process	1,315,263	923,435
Finished goods	1,004,060	128,443
	$ 5,071,553	$ 4,784,439

The above inventory amounts are shown net of reserves for obsolescence and shrinkage of $610,715 and $493,951 at December 31, 2007 and 2006, respectively.

5. FIXED ASSETS

	December 31, 2007	December 31, 2006
Land	$ 2,663,712	$ 2,663,712
Buildings	12,261,252	12,258,252
Machinery and equipment	4,928,824	5,095,410
Leasehold improvements	454,062	454,062
Assets under capital lease	5,310,824	5,298,326
Office furniture, fixtures and equipment	4,604,757	4,627,893
Rental equipment	488,857	220,828
Construction in process	913,406	1,106,614
	31,625,694	31,725,097
Less: accumulated depreciation	(13,196,652)	(8,984,887)
	$ 18,429,042	$ 22,740,210

Depreciation expense was $4,286,322, $1,694,994, and $1,799,381 for the years ended December 31 2007, 2006 and 2005, respectively. Amortization of assets under capital leases for the years ended December 31, 2007, 2006 and 2005 was $2,674,678, $235,358 and $157,976, respectively. Accumulated amortization of assets under capital lease at December 31, 2007, 2006 and 2005 is $3,195,475, $544,118 and $308,760, respectively. Included in the amortization of assets under capital leases for 2007 is approximately $2.4 million of depreciation expense associated with the Waistfield, Vermont building as a result of a change in useful life. The carrying value of rental equipment at December 31, 2007, 2006 and 2005 is $298,630, $113,156 and $111,533, respectively. During the year ended December 31, 2007, the Company changed the estimated useful life of its Waistfield, Vermont facility as a result of its plan to exit the facility by June 30, 2007, and accordingly recorded approximately $2.4 million of accelerated depreciation in excess of what would have been recorded under the previous estimated useful life.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During 2006, we began a company wide effort to streamline and consolidate our internal enterprise wide resource planning systems. As a result we began capitalizing the costs related to the acquisition and development of our new internal use software in accordance with SOP No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. We have classified these costs as Construction in Process until the system is completely implemented and functional. Through December 31, 2007, we capitalized approximately $663,000 consisting primarily of software, software consulting, and internal labor costs associated with the implementation of our EPICOR Enterprise Resource Planning (ERP) applications. We performed a review of all ERP capitalized costs during the fourth quarter of 2007 and determined that only a portion of our previously capitalized software licenses will be deployed. This resulted in a $290,000 charge against capitalized ERP costs for the year ended December 31, 2007.

6. ACCRUED EXPENSES

Accrued expenses consist of the following:

	December 31,	
	2007	**2006**
Accrued warranty	$ 570,061	$ 813,445
Accrued purchases	316,167	455,099
Accrued project losses	1,368,944	84,373
Accrued interest	472,602	34,900
Other accruals	599,494	647,782
	$ 3,327,268	$ 2,035,599

7. DEFERRED COSTS AND REVENUE

Product and Service Revenue

In the fourth quarter of 2002, the Company discovered performance issues relating to the operation of cell stacks and associated sensors in its HOGEN S-series units. The Company s investigation of these issues revealed the presence of previously unknown pinholes in cell membranes in the field that resulted in hydrogen leakage and cell failure. As a result, the Company determined that recognizing revenue on delivery of its HOGEN S-series units was no longer appropriate because of the significant uncertainty surrounding the reliability of the existing design of the PEM electrolyzer (cell stack) within its HOGEN S-series generators. The Company made modifications to the cell stack design to improve its performance and determined to defer product revenue until either the expiration of the warranty period or the Company determines it has compiled sufficient warranty history to estimate the warranty costs. As such, product revenue from HOGEN S-series deliveries made from the fourth quarter of 2002 to the third quarter of 2005 had been deferred until the expiration of the product warranty period. In third quarter of 2005 the Company determined that it had adequate warranty history to begin recognizing product revenue upon shipment. Accordingly, $1.9 million of previously deferred revenue was recognized in 2005.

In the fourth quarter of 2003, the Company determined that it had adequate product warranty history to begin recognizing product revenue related to sales of its laboratory hydrogen generators upon shipment. As a result, in 2003 the Company recognized previously deferred revenue of $378,000. In the first quarter of 2004, the Company began selling its laboratory hydrogen generators with two-year warranties. Accordingly, revenues and costs on units with two year warranties were deferred until the Company determined that it had adequate product warranty information and experience to estimate its two-year warranty costs. In the first quarter of 2005 the

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company began recognizing revenue related to the sales of its laboratory generators upon shipment once sufficient experience had been obtained. Accordingly, $437,000 of previously deferred revenue was recognized in the first quarter of 2005.

In the third quarter of 2006, the Company determined it had adequate warranty history on its HOGEN H-series hydrogen generators to recognize revenue and establish an accurate warranty accrual upon shipment. Prior to the third quarter of 2006, revenue on such H-series units was recognized at the end of the warranty period, generally one year from the date of shipment. Accordingly, $4,053,000 of previously deferred revenue was recognized in 2006.

The Company had deferred product and service revenue of approximately $342,000 and $83,000 as of December 31, 2007 and 2006 respectively. The Company had deferred product costs of $131,000 and $0 as of December 31, 2007 and 2006 respectively.

Contract Revenue

At December 31, 2007 and 2006 deferred costs related to contracts being accounted for under the completed contract method were approximately $733,000 and $811,000, respectively. At December 31, 2007 and 2006 deferred revenue related to contracts being accounted for under the completed contract method was approximately $482,000 and $922,000.

The information on costs and billings on contracts in progress accounted for under the percentage-of-completion is as follows:

	December 31,	
	2007	**2006**
Costs incurred and estimated earnings on contracts in progress	$ 36,212,634	$ 20,969,341
Less: billings to date	35,151,336	18,590,756
Costs and earnings in excess of (less than) billings, net	$ 1,061,298	$ 2,378,585

	December 31,	
	2007	**2006**
Costs in excess of billings on contracts in progress	$ 1,982,783	$ 4,102,573
Billings in excess of costs on contracts in progress	(921,485)	(1,723,988)
Costs and earnings in excess of (less than) billings, net	$ 1,061,298	$ 2,378,585

8. ACQUISITION

On April 3, 2006, Northern acquired the operations and maintenance business of Crown Engineering and Construction, Inc. (or Crown) for $1,175,000 in cash and 105,000 shares of the Company s common stock. The fair market value of the common stock was $702,450. Transaction costs incurred as a result of this acquisition were not material.

The purchase price was allocated to the estimated fair value of the Crown net assets acquired. The following table sets forth the calculation of the purchase price.

Fair value of common stock	$ 702,450
Cash	1,175,000

	$ 1,877,450

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under the purchase method of accounting, the total purchase price was allocated to Crown s net tangible and intangible assets based on their fair value as of April 3, 2006, as adjusted for negative goodwill.

The purchase price allocation is as follows:

Tangible assets acquired:	
Vehicles	$ 61,000
Other assets	43,545
Tangible assets acquired	104,545
Amortizable intangible assets acquired:	
Service contracts	1,458,155
Non-compete agreements	314,750
Amortizable intangible assets acquired	1,772,905
Total assets acquired	$ 1,877,450

The amortizable intangible assets consisting of service contracts and non-compete agreement have useful lives not exceeding eight years. The weighted average useful life of the amortizable assets acquired was approximately 81 months at April 3, 2006.

The intangible assets acquired were valued using the Income Approach Discounted Cash Flow Method and consist of the following:

Service Contracts: Northern acquired the right, title and interest in eight operation and maintenance contracts from Crown. The remaining contract lives range from one to ten years with an average of five years remaining. An 18% discount rate was utilized based on Northern s estimated weighted average cost of capital.

Non-compete Agreement: In connection with the acquisition, Crown agreed that it will not directly or indirectly compete with Northern or Distributed Energy for engineering, procurement and construction of natural gas engine or turbine driven cogeneration projects under 10 megawatts in the State of California for a period of three years. The fair value of the agreement was determined using the Lost Profits method. An 18% discount rate was used based on Northern s estimated weighted average cost of capital.

The fair value of the assets acquired from Crown exceeded the cost of the acquisition by $568,126. This excess amount was allocated as a pro rata reduction of the values assigned to the intangible assets acquired. The result of the allocation of the excess is as follows:

	Fair Values	Allocation of Excess	Final Asset Value
Service Contracts	$ 1,925,420	$ (467,265)	$ 1,458,155
Non Compete	415,611	(100,861)	314,750
	$ 2,341,031	$ (568,126)	$ 1,772,905

Intangible assets related to Crown recorded on the balance sheet of Northern, the reportable segment to whom all intangibles of the Company are assigned as of December 31, 2006, are comprised of the following:

	Gross Amount	Accumulated Amortization
Service Contracts	$ 1,458,155	$ (141,111)
Non Compete	314,750	(78,687)
	$ 1,772,905	$ (219,798)

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As described in Note 9, in the third quarter of 2007, we determined that there were indications of impairment of the intangible assets related to the Crown acquisition. As a result of our impairment analysis, we determined that the value associated with the projected cash flows of acquired service and non-compete contracts has decreased resulting in the recognition of an impairment loss of approximately $1.1 million in the third quarter of 2007.

9. GOODWILL AND INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price and related costs over the value assigned to net tangible and identifiable intangible assets of businesses acquired and accounted for under the purchase method. Accounting rules require that we test at least annually for possible impairment. We perform our test in the fourth quarter of each year using a discounted cash flow analysis that requires certain assumptions and estimates be made regarding future profitability. We test for impairment at the operating segment level as they represent our reporting units. As a result of the 2006 impairment analysis, we determined that the goodwill balance related to Northern was impaired due to decreases in projected revenues and cash flows. Accordingly we recorded an impairment charge of $24.2 million, net of a deferred tax liability of $0.6 million (see Note 2).

We also perform an annual impairment test for indefinite lived intangible assets. In the fourth quarter 2006 the Company began an initiative to combine the operations of Northern and Proton to reduce costs and strengthen its systems sales, engineering, production, service and technology development. In conjunction with that effort the Company determined that it would eliminate both the Proton and Northern brands. Therefore, at December 31, 2006 we determined that the Northern tradename had been impaired and recorded an impairment charge of $1,450,000 (see Note 2). In the fourth quarter of 2007, in connection with our narrowing of Northern s focus to the design and sale of direct drive wind turbines and associated power electronics we concluded that we would maintain the Northern tradename. This decision does not result in any change to the impairment charge taken in 2006.

We acquired the operations and maintenance business of Crown Engineering and Construction Inc. (Crown) in April, 2006. In the third quarter of 2007, we determined that there were indications of impairment of the intangible assets related to the Crown acquisition because of our intention to find a buyer for our service business. As a result of our impairment analysis, we determined that the value associated with the projected cash flows of acquired service contracts and non-compete agreements has decreased resulting in the recognition of an impairment loss of approximately $1.1 million in the third quarter of 2007. The impaired intangible assets are reported in the Northern segment.

The remaining identifiable intangible assets are comprised of the following:

		Accumulated Amortization December 31,	
	Gross Amount	2007	2006
Amortizable intangible assets			
NW100 Technology	$ 2,270,000	$ (1,324,167)	$ (999,883)
Crown Contracts	1,458,155	$ (1,234,546)	(141,111)
Software Tools	70,000	(70,000)	(70,000)
Fleet Monitoring Software	150,000	(150,000)	(150,000)
Power Electronics	290,000	(169,167)	(127,734)
Contract Backlog	1,370,000	(1,370,000)	(1,370,000)
Non-Compete Agreements	384,750	(384,750)	(121,858)
	$ 5,992,905	$ (4,702,630)	$ (2,980,586)

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization of intangible assets for the years ended December 31, 2007, 2006 and 2005 was $1,722,044, $620,903 and $471,798, respectively. Approximately $1.1 million of the total 2007 amortization of intangible assets relates to the impairment of Crown. The weighted average life of the amortizable intangible assets acquired was approximately 57 months at December 10, 2003. The expected aggregate amortization expense for each of the next five years is as follows:

2008	$ 413,678
2009	400,843
2010	370,367
2011	35,129
2012	35,129
After 2012	35,129
	$ 1,290,275

10. DEBT

Long-term debt consists of the following at December 31:

	2007	2006
Perseus Senior Secured Convertible Promissory Note, net of $10,804,815 debt discount	$ 4,385,253	$
Wallingford, Connecticut facility mortgage		5,342,182
VEDA Barre, Vermont facility mortgage	610,256	638,861
Waring Investments, Vermont facility mortgage	847,671	883,734
Merchants Bank equipment loan		55,094
	5,843,180	6,919,871
Less current portion	5,843,180	1,379,460
	$	$ 5,540,411

Future maturities in aggregate under these debt obligations (on a gross principal basis, after accretion of debt discount) at December 31, 2007 are as follows:

2008	$ 15,261,846
2009	74,918
2010	78,300
2011	81,940
2012	85,860
2013 and thereafter	1,065,131
	$ 16,647,995

Perseus Senior Secured Promissory Note (Initial Note)

On June 1, 2007, pursuant to the terms of the Perseus Agreement, the Company closed on a $12.5 million loan by Perseus to the Company. In connection with this loan, the Company executed the Initial Note and issued to Perseus the Initial Warrant. The Initial Note bore interest at a rate of 12.5% per annum, compounded quarterly, payable in cash or in kind at the Company s discretion, and was due in full on March 1, 2008. As a result, the Company recorded approximately $1.8 million of total interest expense related to the Initial Note for the twelve months ended December 31, 2007. The loan was secured by a security interest in all of the Company s assets and those of its material subsidiaries.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the Company s common stock at an exercise price of $0.80 per share. The Company accounted for the Initial Note pursuant to APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants . The fair value of the Initial Warrant was determined to be approximately $3.7 million. The Company used the following assumptions to estimate fair value of the warrants: expected term of five years; expected volatility of 80.8%; risk free rate of 4.92%; and no dividend yield. Accordingly, based on the relative fair values of the debt and the warrant at the time of issuance the Company allocated approximately $2.9 million of the $12.5 million proceeds to the Initial Warrant. The amount attributed to the Initial Warrant resulted in a discount on the Initial Note. The debt discount was being amortized over the term of the Initial Note and accordingly the Company recognized approximately $893,000 of debt discount costs within interest expense related to this amortization during the twelve months ended December 31, 2007. Additionally, the Company incurred approximately $1.8 million of debt issuance costs associated with this financing which was being amortized over the life of the debt and recorded approximately $559,000 of debt issuance costs within interest expense during the twelve months ended December 31, 2007.

On August 24, 2007, the Company repaid and cancelled the Initial Note in connection with the issuance of the Subsequent Convertible Note. The Company accounted for this exchange of notes under EITF 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments and EITF 06-06, Debtor s Accounting for a Modification (or Exchange) of Convertible Debt Instruments. The exchange resulted in extinguishment accounting because the Subsequent Convertible Note contained a substantial conversion feature not contained within the Initial Note. For the twelve months ended December 31, 2007, the Company recognized a loss on extinguishment of approximately $3.3 million which represented the remaining unamortized balance of debt discount of $2.0 million and deferred financing costs of $1.3 million, respectively, with respect to the Initial Note.

The calculation of the loss at the time of exchange is as follows (in thousands):

Initial Note, at par		$ 12,500	
Debt discount	(2,897)		
Accumulated amortization	893		
		(2,004)	
Debt issuance costs	(1,814)		
Accumulated amortization	559		
		(1,255)	
Initial Note, net			$ 9,241
Initial Note repaid			12,500
Loss on extinguishment			$ 3,259

Perseus Senior Secured Convertible Promissory Note (Subsequent Convertible Note)

On August 24, 2007, the Company repaid the $12.5 million Initial Note and accrued interest of $0.4 million. In connection with this subsequent loan, the Initial Note was cancelled, and the Company executed the Subsequent Convertible Note, and received additional cash of approximately $2.1 million after paying the Initial Note and accrued interest and issued to Perseus the Subsequent Warrant. The Subsequent Convertible Note has an original principal amount of $15.0 million, bears interest at a rate of 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008 or earlier upon an event of default, a change of control of the Company

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

or the liquidation or dissolution of the Company. As a result, the Company recorded approximately $5.0 million of total interest expense related to the Subsequent Convertible Note for the twelve months ended December 31, 2007, including stated interest, amortization of debt discount and amortization of debt issuance costs. The Company may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. Assuming that (a) the Company pays all stated interest expense, estimated to be $2.3 million, in kind and (b) Perseus fully converts the Subsequent Convertible Note and all of the Additional Convertible Notes, Perseus would receive 30,779,675 shares of the Company s common stock.

The Subsequent Convertible Note is secured by a security interest in all of the Company s assets and those of its material subsidiaries. The Subsequent Warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of the Company s common stock at exercise prices ranging from $0.80 to $3.00 per share. The Company accounted for the Subsequent Convertible Note pursuant to APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants . The fair value of the Subsequent Warrant was determined to be approximately $13.2 million. The Company used the following assumptions to estimate fair value of the Subsequent Warrants: expected term of five years; expected volatility of 81.4%; risk free rate of 4.42%; and no dividend yield. Accordingly, based on the relative fair values of the debt and the warrant at the time of issuance the Company allocated approximately $7.0 million of the $15.0 million proceeds to the Subsequent Warrant. The amount attributed to the Subsequent Warrant results in a discount on the Subsequent Convertible Note. The debt discount is amortized over the term of the Subsequent Convertible Note and accordingly the Company recognized approximately $2.0 million as interest expense related to this amortization during the twelve months ended December 31, 2007. Additionally, the Company incurred approximately $0.2 million of debt issuance costs associated with this Subsequent Convertible Note financing which is being amortized over the life of the debt and recorded approximately $54,720 as interest expense during the twelve months ended December 31, 2007.

At Perseus s election, the Subsequent Convertible Note and any Additional Convertible Notes issued to Perseus are convertible into shares of the Company s common stock at a conversion price of $0.57 per share compared to the Company s closing stock price of $0.74 at time the Subsequent Convertible Note was issued. As a result, the Subsequent Convertible Note contains a beneficial conversion feature. The Company accounted for the beneficial conversion feature under EITF 00-27, Application of Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features, to Certain Convertible Instruments . After consideration of the allocation of the proceeds to the Subsequent Convertible Note and Subsequent Warrant in accordance with APB 14, the Company calculated the Subsequent Convertible Note has an effective conversion price of $0.30 per share. This resulted in a beneficial conversion of $0.44 per share or approximately $11.5 million, however, the Company recorded approximately $8.0 million as a beneficial conversion feature which represented the remaining debt proceeds available for such allocation. The beneficial conversion feature was recorded as a debt discount and an increase additional paid in capital. The debt discount is amortized over the term of the Subsequent Convertible Note and accordingly the Company recognized approximately $2.3 million within interest expense related to this amortization during the twelve months ended December 31, 2007.

Wallingford, Connecticut facility:

In December 2001, Technology Drive LLC, a subsidiary of Proton, which is a subsidiary of Distributed Energy Systems Corp., entered into a $6,975,000 loan agreement with Webster Bank, National Association (Webster) in connection with the construction of Proton s new facility in Wallingford, Connecticut. Under the terms of the loan, the business assets of Technology Drive LLC, including the land and building, are subject to lien. The loan agreement was structured as a one-year construction loan with monthly payments of interest only until December 2002 at which time the loan converted to a seven-year term note. The term note amortizes based upon a fifteen-year schedule with a final lump sum payment due at the maturity date of December 31, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On September 18, 2006, Technology Drive LLC, entered into an amendment to construction loan agreement with Webster. These amendments relate to a loan to Technology Drive from the bank made December 7, 2001 in the original principal amount of $6,975,000. The effect of the amendments is to change the interest rate on the loan from LIBOR plus 237.5 basis points to LIBOR plus 200 basis points (7.35% at December 31, 2006) and to eliminate the requirement that Technology Drive maintain cash and marketable securities of $20,000,000. The amendment further provides for the pledge by Technology Drive to the bank of an account with the bank having a balance equal to the amount payable under the loan. As of December 31, 2006, we have classified $400,200 as short-term restricted cash and $5,037,682 as long-term restricted cash as a result of this amendment. As of December 31, 2006, the outstanding principal balance of the loan is $5,342,182. The loan agreement contains a material adverse change clause allowing Webster, at its option, to declare the loan immediately payable if they believe there has been a material adverse change in our financial condition, however, we consider it remote that Webster will declare the loan immediately payable due to the restricted cash balance that equals the amount of the loan. During the second quarter of 2007, the Company paid the Webster Bank mortgage in full in the amount of $5,192,672 and the pledged funds were released to the company.

In connection with the loan facility, the Company incurred approximately $216,000 of loan origination costs. These costs are being amortized over the term of the loan. Amortization expense for each of the years ended December 31, 2006 and 2005 was $27,000. In 2007, we expensed the remaining unamortized loan origination costs of approximately $80,000 associated with the payoff of the Webster Bank loan.

Barre, Vermont facility

In October 2005, Northern completed the purchase of a 110,000 square-foot manufacturing facility in Barre, Vermont. This facility, a portion of which had been leased by Northern since 2004, added capacity for Northern s business. Under the purchase, Northern qualified for assistance from the Vermont Economic Development Authority, or VEDA, which together with Vermont s Merchants Bank provided financing for a substantial portion of the facility, land, and future facility improvements.

VEDA made available a total of $740,000, at a variable rate equal to two percentage points less than VEDA s prevailing rate for taxable financing with a maturity date of October 6, 2015, 6.25% at December 31, 2007. The VEDA debt currently requires 120 monthly payments of $5,567 and a final balloon payment in October 2015. As of December 31, 2007, Northern has drawn a total of $688,935 on this loan. The loan is collateralized by the Barre, Vermont property.

Merchants Bank provided $925,000 at a fixed rate of 7.42%. Merchants Bank requires 119 monthly payments of $8,535 beginning November, 2005, and a final balloon payment of approximately $435,000 on October 6, 2015. The loan agreement contains a material adverse change clause allowing Merchants Bank, at its option, to declare the loans immediately payable if they believe there has been a material adverse change in our financial condition. We have incurred recurring operating losses and cash outflows. As a result of these conditions, there is more than a remote chance that Merchants Bank may declare the loans immediately payable. Accordingly, we have classified the entire balance as a current liability. The loan is collateralized by the Barre, Vermont property. In 2007, this note was sold to Waring Investments, Inc. (Waring).

Classification of Debt

The Company s Vermont facility mortgage with Waring contains a material adverse change clause which allows Waring, at its option, to declare the loan to be in default and immediately payable if there has been a material adverse change in our financial condition. The Company s loan agreements with Perseus and the Vermont Economic Development Authority (VEDA) each contain cross-default provisions which provide that

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

any event of default in any secured borrowing would result in the Perseus and VEDA loans being in default and immediately payable. Accordingly, the Waring loan, and the Perseus and VEDA loans with cross-default provisions, have been classified as short term. None of our lenders have accelerated our scheduled loan payments as a result of these provisions.

Fixed assets:

In July 2005, Northern purchased a phone system for their Waitsfield and Barre facilities and obtained a $157,500 loan with Merchants Bank. The loan bears interest at a fixed rate of 6.87 % with monthly payments of $7,042 for a period of 2 years. The loan is guaranteed by Distributed Energy Systems. Northern is required to maintain certain levels of insurance and meet certain financial covenants. The agreement also contains a material adverse change clause. The loan has been paid in full as of December 31, 2007.

Capital Lease Obligations:

In 2002, Northern began construction of a new facility. In March 2003, Northern entered into a financing agreement with the Vermont Economic Development Authority (VEDA) regarding the purchase, construction, sale, and lease of a new facility. In March 2003, a condominium association, Northern Power Systems Commercial Condominium Association, Inc. (NPS Condo Association), was formed for the purpose of managing the land, building, and improvements related to the new facility. Northern owns 50% of the NPS Condo Association and has the ability to exercise significant influence over the NPS Condo Association. Northern transferred certain property and development rights under NPS Condo Association to the Central Vermont Economic Development Corporation (CVEDC). In consideration, CVEDC secured a $2,790,000 loan from VEDA to complete the facility and lease back such facility to Northern. The terms of the lease include an initial term of ten years, lease payments equal to the debt payments plus an administrative fee, and a purchase option for Northern equal to the outstanding loan amount. Northern is required to maintain certain levels of insurance over the facility, is required to maintain $150,000 of restricted cash for performance under the agreements and indemnifies CVEDC from liability or lawsuit relating to the facility. At December 31, 2007, $2,399,328 is outstanding under the note. The asset and related obligation is treated as a capital lease.

During 2005 Northern entered into capital lease agreements on vehicles to be used primarily by its service organization. The original principal amount of these leases is equal to $141,623. The leases are for a term of 48 months with interest rates ranging from 5.7% to 10.6%. At December 31, 2007, $63,433 is outstanding under these leases.

During 2006 Northern entered into capital lease agreements on vehicles to be used primarily by its service organization. The original principal amount of these leases is equal to $266,827. The leases are for a term of 48 months with various interest rates. At December 31, 2007, $124,538 is outstanding under these leases.

Total payments under the capital leases are as follows:

2008	$ 406,286
2009	380,745
2010	302,547
2011	274,094
2012	264,555
2013 and thereafter	1,692,620
total payments	3,320,847
less interest portion	(733,546)
	$ 2,587,301

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. CAPITAL STRUCTURE

Preferred Stock

The Company has a class of 5,000,000 authorized but undesignated shares of preferred stock, par value $.01. No preferred shares have been issued.

Common Stock

The Company has authorized 65,000,000 shares of common stock, par value $.01 per share.

In February 1998 in connection with a customer-sponsored research and development contract, Proton issued a warrant to purchase 50,000 shares of its common stock at a purchase price of $1.10 per share. The fair value of the warrant was estimated using the Black-Scholes valuation method. The value was not considered significant. In December 2005, this warrant was exercised in full, resulting in the issuance of 50,000 shares of unregistered common stock.

In December 2003 in connection with the Northern acquisition, the Company issued 1,404,004 shares of common stock to the shareholders of Northern. In addition, warrants to purchase 2,145,227 shares of the Company s common stock (acquisition warrants) at a purchase price of $2.80 per share were also issued to Northern shareholders and option holders. The acquisition warrants were immediately exercisable and expired at December 10, 2006. During the years 2006 and 2005, 475,531 and 1,360,605 acquisition warrants were exercised utilizing the cash or cashless exercise feature of the warrant, resulting in the issuance of 289,440 and 683,454 shares of common stock, respectively.

The Company issued our CEO, Mr. Schwallie 28,280 shares of common stock at a price of $.01 per share in connection with his employment at January 17, 2006. In addition, the Company issued Mr. Schwallie 100,000 shares of restricted common stock at a price of $.01 per share. Contemporaneously with the commencement of his employment, Mr. Schwallie also purchased 56,561 shares of common stock from us in a private placement at a purchase price of $8.84 per share.

On April 10, 2006, we entered into an equity distribution agreement with UBS Securities LLC. The equity distribution agreement provided that we may offer and sell up to 3,000,000 shares of the Company s common stock from time to time through UBS Securities LLC, as sales agent or principal. The compensation to UBS Securities LLC for acting as sales agent was 4% of the first $15 million of gross sales price of the shares sold, and 3% of the gross sales price of the shares in excess of $15 million. From April 12, 2006 to May 5, 2006, we sold an aggregate of 1,171,297 shares under the equity distribution agreement, at daily average prices ranging from $6.43 to $6.81 per share, resulting in proceeds of approximately $7.5 million. On May 17, 2006, we discontinued sales under the equity distribution agreement.

In connection with the execution of the Morgan Stanley Wind LLC Joint Venture Agreement, we issued to MSW on March 7, 2007 a Common Stock Purchase Warrant entitling MSW to purchase up to 8% of our common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. The warrant is immediately vested as to 8% of our common stock outstanding from time to time, at a purchase price equal to the lower of $2.25 per share or 80% of the fair market value of the common stock on the date of exercise, but in no event less than $2.10 per share. These warrants are exercisable until the second anniversary of the grant date, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least $2.25. The warrant may only be exercised in cash. The warrant to purchase our common stock remains outstanding after the termination of the joint venture agreement. To date, the warrant issued to MSW allows them to purchase 7,630,025 shares of common stock.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Common stock warrants were issued in 2007 to Perseus pursuant to both the Initial Note and the Subsequent Convertible Note. The Initial Warrant is exercisable for five years and gives Perseus the right to purchase up to 7,954,536 shares of the Company s common stock at an exercise price of $0.80 per share. The Subsequent Warrant is exercisable for five years and gives Perseus the right to purchase up to 34,989,629 shares of the Company s common stock at exercise prices ranging from $0.80 to $3.00 per share.

12. RESTRUCTURING AND RELATED COSTS

In January 2007, the Company announced that it was combining the Northern and Proton businesses under Distributed Energy. This change was aimed at reducing costs and strengthening systems sales, engineering, production, service, and technology development. The Company also announced plans to exit the Waitsfield, Vermont facility and consolidate all of the Northern operations in the Barre, Vermont facility resulting in the elimination of about 60 jobs, or 20% of the workforce. In May 2007, the Company completed another reduction of its workforce resulting in the elimination of approximately 25 additional jobs.

As a result, during the year ended December 31, 2007, the Company recorded severance charges of approximately $703,000. These costs are accounted for under SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, and were included as a charge to the results of operations for the year ended December 31, 2007. Any subsequent changes to the estimates of executing the currently approved plans of restructuring will be reflected in current results of operations.

The following table summarizes the severance provision, the severance amount paid and remaining severance costs for the 2007 restructuring costs by segment:

	Northern	Proton	Other	Total
Provision	$ 560,683	$ 78,433	$ 63,652	$ 702,768
Amounts paid	(560,683)	(78,433)	(63,652)	(702,768)
Balance at December 31, 2007	$	$	$	$

As a result of its decision to exit the Waitsfield facility and consolidate its Northern operations in Barre, Vermont by June 30, 2007, the Company revised the estimated useful life and estimated residual value of the Waitsfield facility and accelerated the related depreciation charges. Therefore, the Company recorded additional depreciation expense of approximately $2.4 million, respectively, for the year ended December 31, 2007 to reduce the facility to its estimated net residual value of approximately $2.0 million. These depreciation charges are included in selling, general and administrative expenses.

13. EMPLOYEE BENEFIT AND STOCK OPTION PLANS

Stock Option Plans

The Company has four stock option plans: the Proton 1996 Stock Option Plan (the 1996 Plan), the Northern 1998 Stock Option Plan (the 1998 Plan), the Proton 2000 Stock Option Plan (the 2000 Plan) and the 2003 Stock Incentive Plan (the 2003 Plan) (collectively the Plans). The Company has reserved a total of 8,600,000 shares of common stock for issuance under the 1996, 1998, 2000 and 2003 Plans. Together the Plans provide for the grants of non-qualified and incentive stock options, restricted stock awards and other stock-based awards to its employees, officers, directors, consultants and advisors. As determined by the Board of Directors, options are generally granted at the fair market value of the common stock at the time of grant. However, the Board of Directors has determined

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

that the exercise price for each incentive stock option shall not be less than the fair market value of the common stock at the time the incentive stock option is granted. Options generally vest ratably over four to five years and expire ten years from the date of grant. The Company has a policy of issuing new shares to satisfy option exercises.

A summary of stock option activity for the year ended December 31, 2007 under the Plans is as follows:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2006 (3,467,706 exercisable)	5,078,032	$ 6.44
Granted	1,475,518	$ 0.70
Exercised	(297,291)	$ 0.66
Cancelled or forfeited	(949,975)	$ 4.58
Outstanding at December 31, 2007 (3,809,148 exercisable)	5,306,284	$ 5.50

The total intrinsic value (the amount by which the stock price exceeds the exercise price of the option on the date of exercise) of the stock options exercised during the years ended December 31, 2007, 2006 and 2005 was $490,000, $2.3 million and $4.2 million, respectively. The weighted average grant date fair value per share of the stock options granted during the years ended December 31, 2007, 2006 and 2005 was $0.47, $5.45 and $2.61, respectively. As of December 31, 2007, the aggregate intrinsic value of options outstanding and currently exercisable options was $21,129 and $20,654, respectively.

The following table summarizes additional information about stock options outstanding at December 31, 2007:

Range of Exercise Prices		Options Outstanding: Number Outstanding at December 31, 2007	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable: Number Exercisable at December 31, 2007	Weighted Average Exercise Price
$ 0.07	$ 0.37	318,807	3.00	$ 0.33	302,983	$ 0.33
0.47	0.47	580,000	9.96	0.47	0	0.00
0.50	0.78	659,856	6.43	0.59	82,841	0.53
0.79	2.73	586,208	6.98	2.17	515,967	2.15
2.75	3.40	565,287	5.68	3.08	469,538	3.02
3.41	5.00	530,490	5.83	3.94	468,680	3.94
5.01	7.49	547,716	3.55	6.63	533,844	6.65
7.65	10.08	540,195	6.78	9.05	458,320	8.88
10.09	16.88	311,553	2.42	11.06	310,803	11.06
$ 17.00	$ 24.13	666,172	1.96	$ 17.01	666,172	$ 17.01
$ 0.07	$ 24.13	5,306,284	5.47	$ 5.50	3,809,148	$ 7.06

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes additional information about stock options granted during 2007, 2006 and 2005, respectively:

	Number of Options Granted	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date
2007 Options granted with an exercise price:			
Equal to fair market value	1,475,518	$ 0.70	$ 0.47

	Number of Options Granted	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date
2006 Options granted with an exercise price:			
Equal to fair market value	1,374,044	$ 7.83	$ 5.45

	Number of Options Granted	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date
2005 Options granted with an exercise price:			
Equal to fair market value	681,661	$ 3.65	$ 2.56
Price less than fair value	5,000	0.37	4.17

2000 and 2003 Employee Stock Purchase Plan

The Company has two Employee Stock Purchase Plans: the 2000 Employee Stock Purchase Plan (the 2000 ESPP Plan) and the 2003 Employee Stock Purchase Plan (the 2003 ESPP Plan) (collectively the ESPP Plans). A total of 550,000 shares of common stock are available for issuance under these ESPP Plans. Eligible employees can purchase common stock pursuant to payroll deductions at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each three-month offering period. Employee contributions are limited to 10% of an employee s eligible compensation not to exceed amounts allowed by the Internal Revenue Code.

The Company measures the fair value of issuances under the employee stock purchase plan using the Black-Scholes option pricing model at the end of each reporting period. The compensation cost for the Plan consists of the discount (15% of the grant date stock price) and the fair value of the option features. During the year ended December 31, 2007, 2006, and 2005, 134,067, 71,752 and 54,295 shares of common stock were issued for proceeds of $114,027, $253,474 and $184,369, respectively. As of December 31, 2007, 144,963 shares remained available for future issuance under the 2003 ESPP Plan.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-Based Compensation

Total non-cash stock compensation, including the impact of SFAS 123(R) for the year ended December 31, 2007 and 2006 was $1,374,645 and $5,383,705, respectively. This amount was recognized as follows:

	2007	2006
Selling, General and Administrative	$ 1,139,788	$ 4,914,695
Research and Development	106,773	200,402
Cost of revenue	128,084	268,608
Total non-cash stock compensation	$ 1,374,645	$ 5,383,705

As of December 31, 2007, total unamortized stock-based compensation cost, net of estimated forfeitures, related to non-vested stock options was $3.2 million, which is expected to be recognized over the remaining weighted average vesting period of 18 months. The total value of shares vested during the years ended December 31, 2007, 2006, and 2005, was $2.2 million, $5.8 million, and $7.8 million, respectively.

Upon adoption of SFAS 123(R), the Company selected the Black-Scholes option pricing model as the most appropriate model for determining the estimated fair value for stock-based awards. The use of the Black-Scholes model requires the use of extensive actual employee exercise behavior data and the use of a number of complex assumptions including expected volatility, risk-free interest rate, and expected dividends. The assumptions used to value options granted are as follows.

	2007	2006	2005
Risk free interest rate	3.49%-5.03%	4.53%-5.07%	3.72%-4.45%
Expected dividend yield	None	None	None
Expected life of option	6 years	6 years	5 years
Expected volatility	85%	76%	91%

Beginning January 1, 2006, the Company estimated the volatility of its stock using historical volatility in accordance with guidance in SFAS 123(R) and SAB 107. Management determined that historical volatility is most reflective of market conditions and the best indicator of expected volatility. In calculating its volatility the Company excluded the period from the IPO on September 29, 2000 to June 30, 2001 due to significant fluctuations in its stock price. The Company will continue to monitor these and other relevant factors used to measure expected volatility for future option grants. Prior to the adoption of SFAS 123(R), the Company had used historical stock price volatility in accordance with SFAS 123 for purposes of pro forma information disclosed in the Notes to Consolidated Financial Statements for the related periods.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the expected term of the company s employee stock options. The dividend yield assumption is based on the Company s history and expected dividend payouts.

The expected term of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding. The Company derived the expected term assumption based on its historical settlement experience, while giving consideration to vesting schedules and stock options that have life cycles less than the contractual terms, in accordance with guidance in SFAS 123(R) and SAB 107. Prior to the adoption of SFAS 123(R), the Company used its historical settlement experience to derive the expected term for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As stock-based compensation expense recognized in our results for the year ended December 31, 2006, is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience. Prior to 2006, the Company accounted for forfeitures as they occurred for the purposes of its pro forma information under SFAS 123, as disclosed in Notes to Consolidated Financial Statements for the related periods.

CEO Awards

In the first quarter of 2006 the Company granted its CEO, Mr. Schwallie 100,000 shares of restricted common stock at a price of $.01 per share. The fair market value of these shares at the date of grant was $8.84 per share and the shares vested one year from the date of grant. In addition, the Company granted Mr. Schwallie 28,280 shares of restricted common stock at a price of $.01 per share. The fair market value of these shares at the date of grant was $8.84 per share and vested immediately. The total compensation cost reflected in selling, general and administrative expenses associated with these two grants is approximately $1.1 million for the year ended December 31, 2006.

Mr. Schwallie also has the ability to earn up to 300,000 shares of restricted stock, contingent upon achievement of various company wide performance goals, including certain revenue, cash flow and gross margin targets at various intervals through June 30, 2008. The shares subject to this agreement vest immediately upon the achievement of these performance goals. These goals have not been met. On October 31, 2007 Mr. Schwallie voluntarily resigned from the Company. The vesting of any unvested stock options terminated at that time.

Other Stock-Based Compensation

In connection with the grant of certain stock options to Northern optionholders as part of the merger consideration on December 10, 2003 (the merger options), the Company recorded unearned stock compensation representing the difference between the deemed fair market value of the common stock on the date of grant and the exercise price. Compensation related to merger options that vest over time was recorded as unearned compensation, a component of stockholders equity, and was being amortized over the vesting periods of the related merger options. Beginning January 1, 2006, the Company fair valued these options using the same assumptions as those previously described. During the years ended December 31, 2007, 2006 and 2005, the Company recorded non-cash compensation expense relating to these merger options totaling $39,335, $284,494, and $462,644, respectively. Previously, forfeitures associated with these merger options were recorded as incurred, however, FAS 123(R) requires that an estimated forfeiture rate be applied to outstanding awards. As a result, in the first quarter of 2006, the Company reversed approximately $35,000 of previously recognized compensation cost associated with these estimated forfeitures which is reflected in selling, general, and administrative expenses. The Company s deferred stock compensation balance of $453,980 as of December 31, 2005 was reclassified into additional paid-in capital upon the adoption of SFAS 123(R).

During the years ended December 31, 2007, 2006 and 2005, the Company granted non-qualified stock options with a ten-year term to non-employees to purchase 0 shares, 29,794 shares and 22,367 shares, respectively, of common stock. The Company recognized compensation expense based on the fair value of these options of $0, $166,933, and $88,130, respectively.

401(k) Plan

In 1997, the Company established a 401(k) plan covering substantially all of its employees, subject to certain eligibility requirements. Participants have the option of contributing up to 15% of their annual compensation. In January 2002, the Company adopted a 50% match of employee contributions up to 6% of

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

compensation. Employer matching contributions for the years ended December 31, 2007, 2006, and 2005 approximated $462,000, $489,000 and $394,000, respectively.

14. JOINT VENTURE

On March 7, 2007, the Company entered into a Joint Venture Agreement with Morgan Stanley Wind LLC (MSW), a subsidiary of Morgan Stanley. This agreement established a framework for the Company and Morgan Stanley to work together to develop, finance, own and operate projects utilizing waste-to-energy technology, combined-heat-and-power technology and other advanced energy technologies. The agreement provided MSW the exclusive right, but not the obligation to provide financing for projects. No projects subject to the terms of the joint venture agreement have been entered into to date. In connection with the execution of the Joint Venture Agreement and as an inducement for Morgan Stanley to enter into the agreement, the Company issued to Morgan Stanley on March 7, 2007 a Common Stock Purchase Warrant entitling Morgan Stanley to purchase up to 10% of the Company s common stock outstanding from time to time, including shares of common stock issuable upon the exercise of stock options, warrants and other convertible or exchangeable securities. The warrant may only be exercised in cash.

The warrant was immediately vested as to 8% of the Company s common stock outstanding from time to time, at a purchase price equal to the lower of $2.25 per share or 80% of the fair market value of the common stock on the date of exercise, but in no event less than $2.10 per share. This 8% tranche of the warrant is exercisable until the second anniversary of the grant date, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least $2.25.

The warrant will vest in four subsequent tranches, each as to 0.5% of the Company s common stock outstanding from time to time, at such time as MSW has funded (1) $21.25 million, (2) $42.5 million, (3) $63.75 million and (4) $85 million in the aggregate to projects developed under the Joint Venture Agreement or we have entered into engineering, procurement and construction (EPC) or operation and maintenance (O&M) contracts with projects sourced by MSW with aggregate values equal to those thresholds. Each of these subsequent tranches will have a purchase price equal to the lower of 80% of the fair market value of our common stock on the vesting date or 80% of the fair market value of the common stock on the date of exercise, but in no event less than $2.10 per share. Each subsequent tranche will be exercisable until the second anniversary of the vesting date of that tranche, except that the exercise period will be extended for an additional year if the fair market value of our common stock on such second anniversary is not at least equal to the fair market value on the vesting date.

The Company estimated the fair value of the warrant issued under this arrangement using a binomial lattice model. The fair value of the first tranche of the warrants at March 7, 2007 was determined to be $1.51 per share. As a result the company recorded a non-cash charge of approximately $5,841,000 associated with 3,868,524 shares issuable under this first tranche during the three months ended March 31, 2007. The fair value of the shares issuable upon exercise of the warrant that become available in the four subsequent tranches will be recorded when each respective funding level is achieved.

In June 2007, as a result of the issuance of the Initial Warrant, the number of shares issuable upon the exercise of the warrants issued under the first tranche to MSW was increased by 686,787 shares. The fair value of these additional shares was determined to be $0.17 per share which resulted in a non-cash charge of approximately $119,000 during the quarter ended June 30, 2007.

In August 2007, as a result of the issuance of the Subsequent Convertible Note and the Subsequent Warrant, the number of shares issuable upon the exercise of the warrants issued under the first tranche to MSW was increased by 3,074,714 shares. The fair value of these additional shares was determined to be $0.14 per share which resulted in a non-cash charge of approximately $427,000 during the quarter ended September 30, 2007.

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The joint venture agreement with Morgan Stanley Wind (MSW) was terminated in February, 2008 and the Company received a payment of $500,000 from MSW. The warrant to purchase up to 8% of the Company s stock survives the termination of the joint venture, but the subsequent tranches can no longer be earned.

15. COMMITMENTS AND CONTINGENCIES

Contracts

In 2001, Proton entered into an agreement with the Connecticut Clean Energy Fund (CCEF). The agreement provides Proton with financial assistance for up to $1.5 million, $600,000 under Phase I and $900,000 under Phase II of the agreement, to accelerate commercial deployment of the UNIGEN backup power unit. Proton is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach $25 million annually. Prior to the achievement of milestones described in this agreement, these funds were subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling interest in Proton by a third party, the sale of substantially all of Proton s assets, the consolidation or merger of Proton with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, Proton records funds received as liabilities until it achieves the contract milestones, at which time such amounts are recognized as reductions in related costs and expenses.

In addition to Phase I and Phase II, CCEF agreed in September 2004 to provide $890,000 of funding to Proton to design, build and conduct a 24-month demonstration of a 5 kilowatt Regenerative Fuel Cell (RFC) for a telecommunications site in southwestern Connecticut. In October 2004, CCEF agreed to provide $485,000 of funding for a 15 kilowatt RFC Backup Power unit for Wallingford Electric, and $418,000 of funding for an upgrade to an existing RFC system at Mohegan Sun Casino s Energy, Environment, Economics, and Education Center. The following table sets forth for the last three fiscal years, the customer advances and milestone achievements, utilized to offset certain costs and expenses incurred related to the UNIGEN product:

	CCEF Advance Balance
December 31, 2004	$ 283,012
Advances	917,167
Milestone achieved	(933,300)
December 31, 2005	$ 266,879
Advances	276,370
Milestone achieved	(543,249)
December 31, 2006	$
Advances	268,940
Milestone achieved	(268,940)
December 31, 2007	$

Sales and Use Tax Relief Program Recapture

In connection with the construction of its Wallingford facility, Proton entered into a Sales and Use Tax Relief Program Implementing Agreement (the Agreement) with the Connecticut Development Authority (the Authority). The Agreement contains certain recapture clauses for relocation, early disposition/abandonment and employment threshold. The recapture clauses for relocation and early disposition/abandonment expire

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

October 15, 2011; the employment threshold clause is subject to review by the Authority in the quarter ended December 31, 2006. The aggregate maximum dollar amount of all recaptured tax benefits and penalties payable by Proton to the Authority under the Agreement shall not exceed $419,250 (the maximum sales and use tax benefit possible under the terms of the Agreement, plus a 7.5% penalty). Proton was required under the Agreement to place $419,250 in escrow related to these recapture clauses. By agreement the amount held in escrow was reduced to $294,710 as of December 31, 2007 and is included in short-term restricted cash.

State Income, Sales, Property and Franchise Tax Accruals

The Company has recorded, within current liabilities, tax accruals of approximately $415,000 and $348,000 for certain state income and sales tax contingencies for which there may be exposure at December 31, 2007 and 2006, respectively. The determination of the amount of the accrual requires significant judgment. The assumptions used in determining the estimate of the accrual is subject to change and the actual amount could be greater or less than the accrued amount.

Legal Proceedings

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against Proton and several of its officers and directors as well as against the underwriters who handled the September 28, 2000 initial public offering of common stock, or IPO. All of the complaints were filed allegedly on behalf of persons who purchased Proton s common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege that Proton s IPO registration statement and final prospectus contained material misrepresentations and/or omissions related, in part, to excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly allocated shares of the IPO. On April 19, 2002, a single consolidated amended complaint was filed, reiterating in one pleading the allegations contained in the previously filed separate actions, including the alleged class period of September 28, 2000 through and including December 6, 2000. On July 15, 2002 Proton joined in an omnibus motion to dismiss the lawsuits filed by all issuer defendants named in similar actions which challenges the legal sufficiency of the plaintiffs claims, including those in the consolidated amended complaint. Plaintiffs opposed the motion and the court heard oral argument on the motion in November 2002. On February 19, 2003, the court issued an opinion and order, granting in part and denying in part the motion to dismiss as to Proton. In addition, in August 2002, the plaintiffs agreed to dismiss without prejudice all of the individual defendants from the consolidated complaint. An order to that effect was entered by the court in October 2002.

A special litigation committee of the board of directors has authorized Proton to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding, which was negotiated among class plaintiffs, all issuer defendants and their insurers. The parties negotiated a settlement which is subject to approval by the court. On February 15, 2005, the court issued an opinion and order preliminarily approving the settlement, provided that the parties agreed to a modification narrowing the scope of the bar order set forth in the original settlement. The parties agreed to a modification narrowing the scope of the bar order, and on August 31, 2005, the court issued an order preliminarily approving the settlement. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court s certification of the class of plaintiffs who are pursuing the claims that would be settled in the settlement against the underwriter defendants. Plaintiffs filed a Petition for Rehearing and Rehearing *En Banc* with the Second Circuit on January 5, 2007 in response to the Second Circuit s decision. On April 6, 2007, the Second Circuit denied plaintiffs rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On June 25, 2007, the District Court signed an Order terminating the settlement. Proton believes it has meritorious defenses to the claims made in the complaints and intends to contest the lawsuits vigorously. However, there can be no assurances that we

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. Proton is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

In 2005, our Northern subsidiary entered into an Engineering Procurement and Construction Contract with Aarhus Karlshamn USA, Inc., or Aarhus, for the design and installation of a combined heat and power system for a facility located in Newark, New Jersey. The proposed system used Stirling engines manufactured by a third party, STM Power, Inc. On February 20, 2007, STM Power ceased operations. As a result of STM Power s cessation of operations, they are unable to provide the components and warranty assistance needed for the engines.

On October 19, 2007, Aarhus filed suit against us in the Superior Court of New Jersey, Essex County, alleging breach of contract, breach of warranty and negligence and seeking compensatory and consequential damages in excess of $4 million. We have two applicable insurance polices in an aggregate amount of $3 million, and both insurance carriers are participating in the defense of the claims. We believe we have meritorious defenses to the claims made in the complaint, and we intend to contest the lawsuit vigorously. There can be no assurances that we will be successful in our defense of the claims, however, and an adverse resolution of the lawsuit could exceed our insurance coverage and could have a material adverse effect on our financial position and results of operation in the period in which it is resolved. The range of potential loss for this matter is $0 to $4 million. We have accrued approximately $0.8 million for this matter, which represents our best estimate of the potential loss in this matter. The amount accrued does not consider any proceeds we would receive from our insurance coverage.

Operating Leases

Rent expense under the non-cancelable operating leases was approximately $239,000, $202,000 and $119,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

Minimum lease payments under the noncancelable leases at December 31, 2007 are as follows:

2008	230,583
2009	133,595
2010	85,067
2011	6,528
Total	455,773

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. INCOME TAXES

The Company s gross deferred tax assets and liabilities were as follows:

	December 31, 2007	December 31, 2006
Gross deferred tax assets:		
Net operating loss carryforwards	$ 56,648,000	$ 42,852,000
Deferred compensation	1,847,000	1,847,000
Research and development tax credits	1,970,000	1,936,000
Deferred revenue	640,000	230,000
Inventory reserves	178,000	193,000
Warranty reserves	222,000	316,000
Bad debt reserves	577,000	199,000
Amortization intangibles at acquisition	108,000	
Accrued expenses and other	1,181,000	467,000
	63,371,000	48,040,000
Gross deferred tax liabilities:		
Amortizable intangibles at acquisition		517,000
Fixed asset basis step-up at acquisition	87,000	87,000
Depreciation	103,000	176,000
Convertible debt beneficial conversion feature	2,222,000	
Deferred costs	336,000	100,000
	2,748,000	880,000
Net deferred tax asset	60,623,000	47,160,000
Less: valuation allowance	(60,623,000)	(47,160,000)
Net deferred tax asset (liability)	$	$

The Company s effective income tax rate differed from the Federal statutory rate as follows:

	Years Ended December 31, 2007	2006	2005
Federal statutory rate	-34.0%	-34.0%	-34.0%
Deferred state taxes, net of federal benefit	-5.0%	-5.0%	-5.0%
Tax credits	0.0%	0.0%	0.0%
Non-deductible stock-based compensation expense	6.0%	4.0%	0.0%
Impairment of goodwill and other intangibles	0.0%	19.0%	0.0%
Valuation allowance	33.0%	16.0%	39.0%
	0.0%	0.0%	0.0%

At December 31, 2007, the Company had approximately $147.1 million of federal net operating loss carryforwards that expire beginning in the year 2011 through 2027 and approximately $133.8 million of state net operating loss carryforwards that expire beginning in the year 2020 through 2027. For the years ended December 31, 2007, 2006 and 2005, the valuation allowance increased $13,463,000, $8,607,000, and $7,023,000, respectively. The increase is attributable to the current year provision and is due primarily to the increase in net operating loss carryforwards.

The amount of the net operating loss and research and development tax credit carryforwards that may be utilized annually to offset future taxable income and tax liability may be limited as a result of certain ownership changes pursuant to Section 382 of the Internal Revenue Code.

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DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company will recognize accrued interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, the Company did not have any tax-related interest or penalties. The Company files income tax returns in the U.S. federal and various state jurisdictions. The Company is not currently under examination by The Internal Revenue Service (IRS) or any other state jurisdictions. Generally, the tax years 2003-2006 remain subject to examination**.**

17. SEGMENT FINANCIAL DATA

Management has chosen to organize its enterprise around its two operating subsidiaries, Proton and Northern. Proton, our hydrogen generator and fuel cell business, develops and manufactures proton exchange membrane, or PEM, electrochemical products. Northern, our distributed generation business, designs, builds and installs both stand-alone and grid-connected electric power systems for industrial, commercial and government customers. For management reporting and control, the Company is divided into the operating segments as presented below. Each segment has general autonomy over its business operations.

Financial information as of and for the years ended December 31, 2007, 2006 and 2005 (all amounts in 000s) is summarized below.

	2007	2006	2005
Revenues:			
Proton	$ 12,253	$ 15,472	$ 9,171
Northern	17,135	29,621	35,809
Consolidated	$ 29,388	$ 45,093	$ 44,980

	2007	2006	2005
Loss from operations:			
Proton	$ (3,466)	$ (6,908)	$ (7,489)
Northern	(23,280)	(39,021)	(5,733)
Eliminations and other	(13,482)	(8,435)	(3,663)
Consolidated	$ (40,228)	$ (54,364)	$ (16,885)

	2007	2006	2005
Interest income:			
Proton	$ 12	$ 27	$ 24
Northern	56	57	25
Eliminations and other	434	1,336	1,023
Consolidated	$ 502	$ 1,420	$ 1,072

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	2007	2006	2005
Net loss:			
Proton	$ (3,426)	$ (6,881)	$ (7,863)
Northern	(23,445)	(39,238)	(5,845)
Eliminations and other	(23,003)	(7,236)	(2,536)
Consolidated	$ (49,874)	$ (53,355)	$ (16,244)

	2007	2006	2005
Total assets:			
Proton	$ 65,473	$ 73,489	$ 85,197
Northern	15,648	25,380	47,018
Eliminations and other	(39,370)	(28,979)	(21,070)
Consolidated	$ 41,751	$ 69,890	$ 111,145

All the assets of the Company are located in the United States.

18. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following tables set forth certain unaudited quarterly statement of operations data for the eight quarters ended December 31, 2007. This data has been derived from unaudited financial statements that, in the Company s opinion, include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such information when read in conjunction with the Company s consolidated financial statements and related notes. The operating results for any quarter are not necessarily indicative of results for any future period.

	2007 Quarters			
	First	Second	Third	Fourth
	Amounts in 000s except for per share amounts			
Revenues	8,424	$ 6,828 $	$ 7,143	6,993
Costs and expenses	23,193	16,530	16,601	13,293
Loss from operations	(14,769)	(9,702)	(9,458)	(6,300)
Net loss	(14,629)	(10,289)	(15,244)	(9,712)
Basic and diluted net loss per share attributable to common stockholders	(0.37)	(0.26)	(0.38)	(0.24)

	2006 Quarters			
	First	Second	Third	Fourth
	Amounts in 000s except for per share amounts			
Revenues	$ 7,637	$ 9,412 $	$ 14,755	13,289
Costs and expenses	15,251	16,237	21,304	46,665
Loss from operations	(7,614)	(6,825)	(6,549)	(33,376)
Net loss	(7,345)	(6,536)	(6,315)	(33,159)
Basic and diluted net loss per share attributable to common stockholders	(0.20)	(0.17)	(0.16)	(0.84)

DISTRIBUTED ENERGY SYSTEMS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

19. SUBSEQUENT EVENT

On March 13, 2008, we and our subsidiaries, Northern, Proton and Technology Drive, L.L.C., entered into a First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement, or the Amendment, with Perseus. The Amendment amends the Securities Purchase Agreement and the related Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement agreements.

Pursuant to the Amendment, we agreed to sell and issue to Perseus, and Perseus agreed to purchase, an Additional Investment Note, or the Additional Note. The Additional Note has an original principal amount of $1.5 million, bears interest at 12.5% per annum, compounded quarterly, and is due in full on November 30, 2008. We may choose to pay the interest in cash or in kind by the issuance of additional senior secured convertible promissory notes, or the Additional Convertible Notes. At Perseus s election, the principal and any unpaid interest under the Additional Note are convertible into shares of our common stock at a conversion price of $0.33 per share. Assuming that (a) we pay all interest in kind and (b) Perseus fully converts the Additional Note and all of the Additional Convertible Notes, Perseus would receive 4,966,213 shares of our common stock. The loan is secured by a security interest on all of our assets and those of our material subsidiaries. The Additional Note contains customary affirmative and negative covenants. The Additional Note also specifies events of default that would cause the Additional Note to become immediately due and payable. The events of default under the Additional Note include any time that our (1) working capital, as defined in the Additional Note, falls below $3.5 million or (2) unrestricted cash and cash equivalents fall below $1.0 million, excluding proceeds from any sale of assets outside the ordinary course. Any event of default under the Additional Note will also constitute an event of default under the previous notes issued to Perseus.

In addition, pursuant to the Amendment, in the event of an investment by an investor approved by Perseus in a project, joint venture, partnership or other transaction for the purpose of developing our wind turbine products, we agreed to:

- if the project uses an entity other than Distributed Energy, issue to Perseus, for no additional consideration, a 5% fully-diluted interest in such entity; or
- if the investor makes an investment directly in Distributed Energy, issue to Perseus, for no additional consideration, a warrant to purchase, at an exercise price of $0.33 per share, up to 909,090 shares of our common stock.

Further, in the event of a sale of assets of us or any of our affiliates (other than sales in the ordinary course of business), we agreed to:

- use all or part of the net proceeds to repay some or all of our obligations to Perseus;
- deliver an irrevocable letter of credit to Perseus in the amount of the net proceeds less any repayment of obligations owed to Perseus;
- place the net proceeds less any repayment of obligations owed to Perseus in a restricted cash account; or
- otherwise secure the obligations owed to Perseus or make such other arrangements with respect to the net proceeds as requested by Perseus in each case as directed by Perseus.

Under the Securities Purchase Agreement, we had undertaken to use commercially reasonable efforts to sell our Proton subsidiary. The Amendment permits us to suspend active efforts to sell Proton, but Perseus retains the right to reinstate the requirement at any time.

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Schedule II VALUATION AND QUALIFYING ACCOUNTS

	Allowance for Doubtful Accounts	Reserve for Inventory
Balance as of December 31, 2004	$ 184,948	$ 477,812
Charged to costs and expenses	29,872	228,869
Deductions and write-offs	(142,048)	(138,383)
Balance as of December 31, 2005	$ 72,772	$ 568,298
Charged to costs and expenses	616,006	181,335
Deductions and write-offs		(255,682)
Balance as of December 31, 2006	$ 688,778	$ 493,951
Charged to costs and expenses	1,232,947	403,609
Deductions and write-offs	(303,747)	(286,845)
Collections from reserved amount	(136,334)	
Balance as of December 31, 2007	$ 1,481,644	$ 610,715

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
Not applicable.

ITEM 9A. Controls and Procedures
Disclosure Controls and Procedures

The Company s management, with the participation of the Company s principal executive officer and principal financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of December 31, 2007. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company s disclosure controls and procedures as of December 31, 2007, the Company s principal executive officer and principal financial officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

Management s report on the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) is included below. The independent registered public accounting firm s related audit report is included in Item 8 of this Form 10-K and is incorporated herein by reference.

No change in the Company s internal control over financial reporting occurred during the fiscal quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

Management s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for us. Internal control over financial reporting is defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

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

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

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

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

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment, management concluded that, as of December 31, 2007, our internal control over financial reporting is effective based on those criteria.

The effectiveness of our internal control over financial reporting as of December 31, 2007 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report, which is included herein.

ITEM 9B. Other Information

Not applicable.

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Part III

Certain information required by Part III is omitted from this Annual Report as we intend to file our definitive proxy statement for our Annual Meeting of Stockholders to be held on June 19, 2008, or the proxy statement, pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Report, and certain information included in the Proxy Statement is incorporated herein by reference.

ITEM 10. Directors, Executive Officers and Corporate Governance

The information regarding our directors and corporate governance required by this item will be incorporated by reference from our proxy statement. Information regarding our executive officers is set forth under the caption Executive Officers of the Registrant in Part I.

ITEM 11. Compensation Discussion and Analysis

The information required by this item will be incorporated by reference from the proxy statement.

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

The information required by this item will be incorporated by reference from the proxy statement.

ITEM 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item will be incorporated by reference from the proxy statement.

ITEM 14. Principal Accountant Fees and Services

The information required by this item will be incorporated by reference from the proxy statement.

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Part IV

ITEM 15. Exhibits and Financial Statement Schedules
(a) The following documents are filed as part of this Report:

1. **Financial Statements See Index to Financial Statements in Item 8 of this Report**

2. **Financial Statement Schedules**

The following financial statement schedule of Distributed Energy has been included: Schedule II Valuation and Qualifying Accounts. All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

3. **Exhibits See Item 15(b) of this Report below.**

(b) Exhibits

Exhibit	Description
3.1(a)	Third Amended and Restated Certificate of Incorporation of the Registrant, as amended.
3.2(b)	Amended and Restated By-Laws of the Registrant.
4.1(b)	Specimen common stock certificate.
4.2(b)	See Exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and By-Laws of the Registrant defining the rights of holders of common stock of the Registrant.
10.1(c)	2003 Stock Incentive Plan.
10.2(d)	2003 Employee Stock Purchase Plan.
10.4(b)	Lease Agreement, dated March 28, 2003, between Northern Power Systems, Inc. and the Central Vermont Economic Development Corporation.
10.5(b)	Construction Loan Agreement dated as of December 7, 2001 between Technology Drive, LLC, a limited liability company wholly owned by the Registrant, and Webster Bank.
10.6(b)	Construction Mortgage Note dated as of December 7, 2001 between Technology Drive, LLC, a limited liability company wholly owned by the Registrant, and Webster Bank.
10.7(b)	Open-End Construction Mortgage Deed and Security Agreement dated as of December 7, 2001 between Technology Drive, LLC, a limited liability company, wholly owned by us of the Registrant, and Webster Bank.
10.8(b)	Guaranty Agreement dated as of December 7, 2001 between the Registrant and Webster Bank.
10.9(e)	Agreement and Plan of Merger, dated as of May 22, 2003, as amended, by and among the registrant, Proton Energy Systems, Inc., Northern Power Systems, Inc., PES-1 Merger Sub, Inc., and PES-2 Merger Sub, Inc.
10.10(f)	Escrow Agreement, dated December 10, 2003, by and among the Registrant, Paul F. Koeppe, Philip Deutch, and Webster Bank.
10.11(g)	Agreement between the Company and Walter W. Schroeder dated January 27, 2006.
10.12(h)	Form of Incentive Stock Option Agreement under the Company s 2003 Stock Incentive Plan.

10.13(i)	Form of Nonstatutory Stock Option Agreement under the Company s 2003 Stock Incentive Plan.
10.14(j)	Letter Agreement with Peter J. Tallian October 17, 2006.

Exhibit	Description
10.15(k)	Joint Venture Agreement dated March 7, 2007 between registrant and Morgan Stanley Wind LLC.
10.16(l)	Common Stock Purchase Warrant issued on March 7, 2007 by registrant to Morgan Stanley Wind LLC.
10.17(m)	Securities Purchase Agreement dated May 10, 2007 between the registrant and Perseus Partners VII, L.P.
10.18(n)	Senior Secured Promissory Note dated June 1, 2007 between registrant and Perseus Partners VII, L.P.
10.19(o)	Initial Investment Warrant dated June 1, 2007 between the registrant and Perseus Partners VII, L.P.
10.20(p)	Senior Secured Convertible Promissory Note dated August 24, 2007 between registrant and Perseus Partners VII, L.P.
10.21(q)	Subsequent Investment Warrant dated August 24, 2007 between the registrant and Perseus Partners VII, L.P.
10.22(r)	Letter Agreement between the Registrant and Perseus Partners VII, L.P.
10.23(s)	Form of Indemnification Agreement between the Registrant and Perseus Partners VII, L.P.
10.24(t)	Amendment to Employment Agreement between the Registrant and Walter W. Schroeder Dated September 26, 2007.
10.25(u)	Letter agreement between the Company and BH Cherry LLC dated November 16, 2007.
10.26(v)	Letter agreement between the Company and Perseus Partners VII, L.P. dated November 21, 2007.
10.27(w)	Severance Benefit Plan adopted by the registrant s compensation committee on December 3, 2007.
10.28(x)	Nonstatutory Option Agreement between the registrant and Bernard H. Cherry, dated as of December 7, 2007.
10.29(y)	Letter Agreement between the registrant and Bernard H. Cherry, dated as of December 7, 2007.
10.30(z)	Transition Agreement and Release between the registrant and Ambrose L. Schwallie, effective December 17, 2007.
10.31(aa)	Termination Agreement between the registrant and Morgan Stanley Wind LLC, dated as of January 16, 2008.
10.32(bb)	First Amendment to Purchase Agreement, Company Security and Pledge Agreement, Subsidiary Security and Pledge Agreement and Registration Rights Agreement between the registrant, Northern Power Systems, Inc., Proton Energy Systems, Inc., Technology Drive, L.L.C. and Perseus Partners VII, L.P. dated March 13, 2008, including exhibits.
10.33(cc)	Additional Investment Senior Secured Convertible Promissory Note dated March 13, 2008.
21.1	Subsidiaries of the Registrant.
23.1	Consent of PricewaterhouseCoopers LLP.
31	Certifications pursuant to 18 U.S.C. sec. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications pursuant to 18 U.S.C. sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(a): Incorporated herein by reference to exhibit 3.1 of the Company s report on Form 8-K filed August 27, 2007.
(b): Incorporated herein by reference to the identically numbered exhibit of the Company s registration statement on Form S-4, SEC File No. 333-108515.
(c): Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed June 20, 2005.
(d): Incorporated herein by reference to exhibit 10.2 of the Company s report in Form 8-K filed June 20, 2005.
(e): Incorporated herein by reference to exhibit 2.1 of the Company s registration statement on Form S-4, SEC File No. 333-108515.
(f): Incorporated herein by reference to exhibit 10.10 of the Company s annual report on Form 10-K for the fiscal year ended December 31, 2003.
(g): Incorporated herein by reference to exhibit 99.1 of the Company s report on Form 8-K filed February 2, 2006.
(h): Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed January 14, 2005.
(i): Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed January 14, 2005.
(j): Incorporated herein by reference to exhibit 10.17 of the Company s report on Form 10-K filed March 13, 2007.
(k): Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed March 9, 2007.
(l): Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed March 9, 2007.
(m): Incorporated herein by reference to exhibit 1.1 of the Company s report on Form 8-K filed May 16, 2007.
(n): Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed June 6. 2007.
(o) Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed June 6, 2007.
(p) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed August 27, 2007.
(q) Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed August 27, 2007.
(r) Incorporated herein by reference to exhibit 10.3 of the Company s report on Form 8-K filed August 27, 2007.
(s) Incorporated herein by reference to exhibit 10.4 of the Company s report on Form 8-K filed August 27, 2007.
(t) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed October 1, 2007.
(u) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed November 21, 2007.
(v) Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed November 21, 2007.
(w) Incorporated herein by reference to exhibit 99.1 of the Company s report on Form 8-K filed December 5, 2007.
(x) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed December 13, 2007.
(y) Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed December 13, 2007.
(z) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed December 18, 2007.
(aa) Incorporated herein by reference to exhibit 99.1 of the Company s report on Form 8-K filed January 18, 2008.
(bb) Incorporated herein by reference to exhibit 10.1 of the Company s report on Form 8-K filed March 13, 2008.
(cc) Incorporated herein by reference to exhibit 10.2 of the Company s report on Form 8-K filed March 13, 2008.

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SIGNATURES

In accordance with Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DISTRIBUTED ENERGY SYSTEMS CORP.

/s/ BERNARD H. CHERRY
Bernard H. Cherry, Interim Chief Executive Officer

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

Signature	Capacity	Date
/s/ BERNARD H. CHERRY **Bernard H. Cherry**	Interim Chief Executive Officer and Chairman (Principal executive officer)	March 14, 2008
/s/ PETER J. TALLIAN **Peter J. Tallian**	Chief Financial Officer (Principal financial and accounting officer)	March 14, 2008
/s/ JAMES H. OZANNE **James H. Ozanne**	Director	March 14, 2008
/s/ PAUL F. KOEPPE **Paul F. Koeppe**	Director	March 14, 2008
/s/ THEODORE STERN **Theodore Stern**	Director	March 14, 2008
/s/ JOHN C. FOX **John C. Fox**	Director	March 14, 2008