

FUELCELL ENERGY INC

Form 10-Q

September 09, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

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

**For the quarterly period ended July 31, 2011
OR**

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

For the transition period from _____ to _____

**Commission file number: 1-14204
FUELCELL ENERGY, INC.**

(Exact name of registrant as specified in its charter)

Delaware

06-0853042

(State or other jurisdiction of incorporation or organization)

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

**3 Great Pasture Road
Danbury, Connecticut**

06813

(Address of principal executive offices)

(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Number of shares of common stock, par value \$.0001 per share, outstanding at September 6, 2011: 127,390,616

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FUELCELL ENERGY, INC.
Consolidated Balance Sheets
(Unaudited)

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

| | July 31, 2011 | October 31, 2010 |
|---|--------------------------|-----------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 31,480 | \$ 20,467 |
| Investments U.S. treasury securities | 18,040 | 25,019 |
| Accounts receivable, net | 16,692 | 18,066 |
| Inventories | 38,732 | 33,404 |
| Other current assets | 7,047 | 5,253 |
| Total current assets | 111,991 | 102,209 |
| Property, plant and equipment, net | 23,320 | 26,679 |
| Investments U.S. treasury securities | | 9,071 |
| Investment in and loans to affiliate | 10,287 | 9,837 |
| Other assets, net | 11,287 | 2,733 |
| Total assets | \$ 156,885 | \$ 150,529 |
| LIABILITIES AND EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt and other liabilities | \$ 3,638 | \$ 976 |
| Accounts payable | 15,493 | 10,267 |
| Accounts payable due to affiliate | 429 | 575 |
| Accrued liabilities | 25,380 | 16,721 |
| Deferred revenue | 37,607 | 25,499 |
| Preferred stock obligation of subsidiary | 6,954 | |
| Total current liabilities | 89,501 | 54,038 |
| Long-term deferred revenue | 7,250 | 8,042 |
| Long-term preferred stock obligation of subsidiary | 13,528 | |
| Long-term debt and other liabilities | 4,140 | 4,056 |
| Total liabilities | 114,419 | 66,136 |
| Redeemable preferred stock of subsidiary | | 16,849 |
| Redeemable preferred stock (liquidation preference of \$64,020 at July 31, 2011 and October 31, 2010) | 59,857 | 59,857 |
| Total (Deficit) Equity: | | |
| Shareholders (deficit) equity | | |
| Common stock (\$.0001 par value); 225,000,000 shares authorized; 127,116,539 and 112,965,725 shares issued and outstanding at July 31, 2011 and October 31, 2010, | 12 | 11 |

respectively

| | | |
|--|------------|------------|
| Additional paid-in capital | 677,713 | 663,951 |
| Accumulated deficit | (694,271) | (655,623) |
| Accumulated other comprehensive income | 15 | 11 |
| Treasury stock, Common, at cost (5,679 shares at July 31, 2011 and October 31, 2010) | (53) | (53) |
| Deferred compensation | 53 | 53 |
| Total shareholders (deficit) equity | (16,531) | 8,350 |
| Noncontrolling interest in subsidiaries | (860) | (663) |
| Total (deficit) equity | (17,391) | 7,687 |
| Total liabilities and (deficit) equity | \$ 156,885 | \$ 150,529 |

See accompanying notes to consolidated financial statements.

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

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

| | Three Months Ended | |
|---|---------------------------|-------------|
| | July 31, | |
| | 2011 | 2010 |
| Revenues: | | |
| Product sales and revenues | \$ 29,382 | \$ 16,218 |
| Research and development contracts | 1,778 | 2,655 |
| Total revenues | 31,160 | 18,873 |
| Costs and expenses: | | |
| Cost of product sales and revenues | 29,133 | 20,050 |
| Cost of research and development contracts | 1,890 | 2,579 |
| Administrative and selling expenses | 3,578 | 4,185 |
| Research and development expenses | 3,918 | 4,618 |
| Total costs and expenses | 38,519 | 31,432 |
| Loss from operations | (7,359) | (12,559) |
| Interest expense | (847) | (10) |
| Loss from equity investment | (94) | (183) |
| Interest and other income, net | 496 | 296 |
| Loss before redeemable preferred stock of subsidiary | (7,804) | (12,456) |
| Accretion of redeemable preferred stock of subsidiary | | (603) |
| Loss before provision for income taxes | (7,804) | (13,059) |
| Provision for income taxes | (26) | (55) |
| Net loss | (7,830) | (13,114) |
| Net loss attributable to noncontrolling interest | 76 | 88 |
| Net loss attributable to FuelCell Energy, Inc. | (7,754) | (13,026) |
| Preferred stock dividends | (800) | (799) |

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| | | | | |
|---------------------------------|----|---------|----|----------|
| Net loss to common shareholders | \$ | (8,554) | \$ | (13,825) |
|---------------------------------|----|---------|----|----------|

Loss per share basic and diluted:

| | | | | |
|---|----|--------|----|--------|
| Net loss per share to common shareholders | \$ | (0.07) | \$ | (0.15) |
|---|----|--------|----|--------|

| | | | | |
|---|--|-------------|--|------------|
| Basic and diluted weighted average shares outstanding | | 126,923,550 | | 93,512,868 |
|---|--|-------------|--|------------|

See accompanying notes to consolidated financial statements.

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

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

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | July 31, | |
| | 2011 | 2010 |
| Revenues: | | |
| Product sales and revenues | \$ 81,815 | \$ 42,033 |
| Research and development contracts | 6,032 | 8,043 |
| Total revenues | 87,847 | 50,076 |
| Costs and expenses: | | |
| Cost of product sales and revenues | 94,652 | 57,183 |
| Cost of research and development contracts | 6,244 | 7,942 |
| Administrative and selling expenses | 12,082 | 12,888 |
| Research and development expenses | 12,662 | 14,327 |
| Total costs and expenses | 125,640 | 92,340 |
| Loss from operations | (37,793) | (42,264) |
| Interest expense | (1,829) | (118) |
| Loss from equity investment | (149) | (576) |
| Interest and other income, net | 1,530 | 979 |
| Loss before redeemable preferred stock of subsidiary | (38,241) | (41,979) |
| Accretion of redeemable preferred stock of subsidiary | (525) | (1,763) |
| Loss before provision for income taxes | (38,766) | (43,742) |
| Provision for income taxes | (79) | (68) |
| Net loss | (38,845) | (43,810) |
| Net loss attributable to noncontrolling interest | 197 | 270 |
| Net loss attributable to FuelCell Energy, Inc. | (38,648) | (43,540) |
| Adjustment for modification of redeemable preferred stock of subsidiary | (8,987) | |

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| | | |
|---|-------------|-------------|
| Preferred stock dividends | (2,400) | (2,401) |
| Net loss to common shareholders | \$ (50,035) | \$ (45,941) |
| Loss per share basic and diluted: | | |
| Net loss per share to common shareholders | \$ (0.41) | \$ (0.52) |
| Basic and diluted weighted average shares outstanding | 122,306,465 | 87,510,734 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended | |
|---|--------------------------|-----------------|
| | July 31, | |
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net loss | \$ (38,845) | \$ (43,810) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Share-based compensation | 2,049 | 2,168 |
| Loss from equity investment | 149 | 576 |
| Accretion of redeemable preferred stock of subsidiary | 525 | 1,763 |
| Interest receivable on loan to affiliate | (135) | (111) |
| Loss on derivatives | 96 | 6 |
| Depreciation | 4,813 | 5,581 |
| Amortization of bond premium and interest expense | 1,784 | 74 |
| Provision for doubtful accounts | 153 | 52 |
| Decrease (increase) in operating assets: | | |
| Accounts receivable | 1,221 | 8,971 |
| Inventories | (5,328) | (5,141) |
| Other assets | (10,209) | 1,150 |
| Increase (decrease) in operating liabilities: | | |
| Accounts payable | 5,080 | (934) |
| Accrued liabilities | 9,320 | 2,680 |
| Deferred revenue | 11,316 | 3,875 |
| Net cash used in operating activities | (18,011) | (23,100) |
| Cash flows from investing activities: | | |
| Capital expenditures | (1,175) | (2,012) |
| Convertible loan to affiliate | (600) | (600) |
| Treasury notes matured | 49,000 | 10,500 |
| Treasury notes purchased | (33,019) | (55,680) |
| Net cash provided by (used in) investing activities | 14,206 | (47,792) |
| Cash flows from financing activities: | | |
| Repayment of debt | (232) | (299) |
| Proceeds from revolving line of credit, net | 2,600 | |
| Payment of preferred dividends and return of capital | (9,994) | (2,897) |
| Proceeds from sale of common stock, net of registration fees | 22,440 | 32,131 |
| Common stock issued for stock plans and related expenses | | (151) |
| Net cash provided by financing activities | 14,814 | 28,784 |

| | | |
|---|-----------|-----------|
| Effects on cash from changes in foreign currency rates | 4 | 13 |
| Net increase (decrease) in cash and cash equivalents | 11,013 | (42,095) |
| Cash and cash equivalents-beginning of period | 20,467 | 57,823 |
| Cash and cash equivalents-end of period | \$ 31,480 | \$ 15,728 |
| Supplemental cash flow disclosures: | | |
| Cash interest paid | \$ 115 | \$ 118 |
| Noncash financing and investing activity: | | |
| Common stock issued in settlement of prior year bonus obligation | \$ 707 | \$ 673 |
| Common stock issued for Employee Stock Purchase Plan in settlement of prior year accrued employee contributions | \$ 125 | \$ 109 |
| Adjustment for modification of redeemable preferred stock of subsidiary | \$ 8,987 | \$ |
| See accompanying notes to consolidated financial statements. | | |

Table of Contents**Note 1. Nature of Business and Basis of Presentation**

FuelCell Energy, Inc. and subsidiaries (the Company, FuelCell Energy, we, us, or our) is a Delaware corporation engaged in the development, manufacture and service of high temperature fuel cells for clean electric power generation. Our Direct FuelCell power plants produce ultra-clean, efficient and reliable 24/7 base load electricity for commercial, industrial, government and utility customers. We have commercialized our stationary carbonate fuel cells and are also pursuing the complementary development of planar solid oxide fuel cell and other fuel cell technologies. We continue to invest in new product and market development and, as such, we are not currently generating positive cash flow from our operations. Our operations are funded primarily through cash generated from product sales and research and development contracts, license fee income and sales of equity and debt securities. In order to produce positive cash flow from operations, we need to be successful at increasing annual order volume and implementing our cost reduction efforts.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial information. Accordingly, they do not contain all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements. In the opinion of management, all normal and recurring adjustments necessary to fairly present our financial position as of July 31, 2011 have been included. All intercompany accounts and transactions have been eliminated.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The balance sheet at October 31, 2010 has been derived from the audited financial statements at that date, but it does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements should be read in conjunction with our financial statements and notes thereto for the year ended October 31, 2010, which are contained in our Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. The results of operations for the interim periods presented are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year.

Use of Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Estimates are used in accounting for, among other things, revenue recognition, excess, slow-moving and obsolete inventories, product warranty costs, reserves on long-term service agreements, allowance for uncollectible receivables, depreciation and amortization, impairment of assets, taxes, and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. Due to the inherent uncertainty involved in making estimates, actual results in future periods may differ from those estimates.

Concentrations

We contract with a concentrated number of customers for the sale of products and for research and development contracts. Significant revenues from individual customers for the three and nine months ended July 31, 2011 and 2010 included POSCO Power (POSCO), which is a related party and owns approximately 9 percent of the outstanding common shares of the Company, BioFuels Fuel Cells, LLC, UTS BioEnergy, LLC and Rancho California Water District.

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

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------|---------------------------|-------------|--------------------------|-------------|
| | July 31, | | July 31, | |
| | 2011 | 2010 | 2011 | 2010 |
| POSCO | 34% | 46% | 49% | 57% |
| BioFuels Fuel Cells, LLC | 19% | | 16% | |
| UTS BioEnergy, LLC | 15% | | 6% | |
| Rancho California Water District | 13% | | 5% | |
| Combined | 81% | 46% | 76% | 57% |

Subsequent Events

We have evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements. There were no subsequent events requiring disclosure.

Comprehensive Loss

Comprehensive loss for the periods presented was as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | July 31, | | July 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Net loss | \$ (7,830) | \$ (13,114) | \$ (38,845) | \$ (43,810) |
| Foreign currency translation adjustments | | | 4 | 13 |
| Comprehensive loss | \$ (7,830) | \$ (13,114) | \$ (38,841) | \$ (43,797) |

Note 2. Recent Accounting Pronouncements**Recently Adopted Accounting Guidance**

In April 2010, the FASB provided guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon the achievement of milestone events. An entity may only recognize consideration that is contingent upon the achievement of a milestone in its entirety in the period the milestone is achieved only if the milestone meets certain criteria. We adopted this guidance effective November 1, 2010 and it did not impact our financial statements. In December 2009, the FASB issued revised guidance related to the consolidation of variable interest entities (VIE). The revised guidance requires reporting entities to evaluate former qualified special purpose entities for consolidation, changes the approach to determining a VIE s primary beneficiary from a quantitative assessment to a qualitative assessment designed to identify a controlling financial interest, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a VIE. It also clarifies, but does not significantly change, the characteristics that identify a VIE. We adopted this guidance effective November 1, 2010 and it did not impact our financial statements.

In October 2009, the FASB issued guidance updating accounting standards for revenue recognition for multiple-deliverable arrangements. The stated objective of the update was to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services separately rather than as a combined unit. The guidance provides amended methodologies for separating consideration in multiple-deliverable arrangements and expands disclosure requirements. We adopted this guidance for revenue arrangements entered into or materially modified after November 1, 2010 and it did not have an impact on our financial statements or disclosures to date. The Company evaluates all new contracts and expects that there will be contracts in the fourth quarter of fiscal

2011 that will likely be impacted under the new multi-element revenue guidance.

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In June 2009, the FASB issued accounting guidance which requires a company to perform ongoing reassessment of whether it is the primary beneficiary of a variable interest entity (VIE). Specifically, the guidance modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The guidance clarifies that the determination of whether a company is required to consolidate a VIE is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the VIE that most significantly impact the VIE's economic performance. The guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a VIE and enhanced disclosures of the company's involvement in VIEs and any significant changes in risk exposure due to that involvement. We adopted this guidance effective November 1, 2010 and it did not have an impact on our financial statements.

Recent Accounting Guidance Not Yet Effective

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

Note 3. Equity investments

Versa Power Systems, Inc. (Versa) is one of our sub-contractors under the Department of Energy's (DOE) large-scale hybrid project to develop a coal-based, multi-megawatt solid oxide fuel cell (SOFC) based hybrid system. Versa is a private company founded in 2001 that is developing advanced SOFC systems for various stationary and mobile applications. We have a 39 percent ownership interest in Versa and account for Versa under the equity method of accounting. We recognize our share of the income (loss) as income (loss) from equity investments on the consolidated statements of operations.

In May 2011, we loaned Versa \$0.6 million in the form of a convertible note (the 2011 Convertible Note). We have also loaned Versa \$2.0 million in the form of a convertible note in 2007 (the 2007 Convertible Note) and \$0.6 million in each year 2009 and 2010 in the form of convertible notes (the 2009 Convertible Note and the 2010 Convertible Note , respectively). The 2011 Convertible Note matures in May 2021, the 2010 Convertible Note matures April 2020, the 2009 Convertible Note matures November 2018 and the 2007 Convertible Note matures May 2017, unless certain prepayment events occur. In conjunction with the Convertible Notes, we received warrants for the right to purchase 4,830 shares of Versa common stock at a weighted average exercise price of \$157 per share. Our ownership percentage would increase to 47 percent if the Convertible Notes and warrants are converted into common stock.

We have determined that the above warrants represent derivatives subject to fair value accounting. The fair value is determined based on the Black-Scholes valuation model using historical stock price, volatility (based on a peer group since Versa's common stock is not publicly traded) and risk-free interest rate assumptions. The fair value of the warrants is included within investment and loan to affiliate on the consolidated balance sheets and changes in the fair value of the warrants are included in interest and other income on the consolidated statements of operations. The fair value of the warrants as of July 31, 2011 was \$0.3 million and it was \$0.2 million as of October 31, 2010. The change in the fair value of the warrants was not material to the consolidated financial statements for the three and nine months ended July 31, 2011 and 2010. The carrying value of our investment in and loans to Versa was \$10.3 million as of July 31, 2011 and \$9.8 million as of October 31, 2010.

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We classify our investments as held-to-maturity and record them at amortized cost. These investments consist entirely of U.S. treasury securities. The following table summarizes the amortized cost basis and fair value (based on quoted market prices) at July 31, 2011 and October 31, 2010:

| | Amortized cost | Gross unrealized gains | Gross unrealized (losses) | Fair value |
|------------------------------------|-------------------|------------------------------|---------------------------------|------------|
| <i>U.S. government obligations</i> | | | | |
| As of July 31, 2011 | \$ 18,040 | \$ 23 | \$ | \$ 18,063 |
| As of October 31, 2010 | \$ 34,090 | \$ 74 | \$ | \$ 34,164 |

The following table summarizes the contractual maturities of investments at amortized cost and fair value as of July 31, 2011:

| | Amortized cost | Fair value | Weighted average yield to maturity |
|---------------------|-------------------|------------|---|
| Due within one year | \$ 18,040 | \$ 18,063 | 1.2% |
| Due after one year | | | |
| Total investments | \$ 18,040 | \$ 18,063 | 1.2% |

Note 5. Inventories

The components of inventory at July 31, 2011 and October 31, 2010 consisted of the following:

| | July 31, 2011 | October 31, 2010 |
|--|------------------|---------------------|
| Raw materials | \$ 18,376 | \$ 15,509 |
| Work-in-process | 22,210 | 22,786 |
| Gross Inventory | \$ 40,586 | \$ 38,295 |
| Less amount to reduce certain inventories to lower of cost or market | (1,854) | (4,891) |
| Net inventory | \$ 38,732 | \$ 33,404 |

Raw materials consist mainly of various nickel powders and steels, various other components used in producing cell stacks and purchased components for balance of plant. Work-in-process inventory is comprised of material, labor, and overhead costs incurred to build fuel cell stacks, which are subcomponents of a power plant. Work in process also includes costs related to power plants in inventory which have not yet been dedicated to a particular commercial customer contract. The above inventory amounts include a lower of cost or market adjustment to write down the carrying value of certain legacy inventory to its estimated market value.

Table of Contents**Note 6. Accounts Receivable**

Accounts receivable at July 31, 2011 and October 31, 2010 consisted of the following:

| | July 31, 2011 | October 31, 2010 |
|----------------------------|--------------------------|-----------------------------|
| U.S. Government: | | |
| Amount billed | \$ 150 | \$ 223 |
| Unbilled recoverable costs | 814 | 605 |
| | 964 | 828 |
| Commercial Customers: | | |
| Amount billed | 3,633 | 9,718 |
| Unbilled recoverable costs | 12,095 | 7,520 |
| | 15,728 | 17,238 |
| | \$ 16,692 | \$ 18,066 |

We bill customers for power plant and module sales based on certain milestones being reached. We bill the U.S. government for research and development contracts based on actual recoverable costs incurred, typically in the month subsequent to incurring costs. Unbilled recoverable costs relate to revenue recognized on customer contracts that have not been billed. Accounts receivable are presented net of an allowance for doubtful accounts of \$0.5 million and \$0.4 million at July 31, 2011 and October 31, 2010, respectively.

Note 7. Other Assets, net

Other assets, net at July 31, 2011 and October 31, 2010 consisted of the following:

| | July 31, 2011 | October 31, 2010 |
|---|--------------------------|-----------------------------|
| Long-term stack residual value ⁽¹⁾ | \$ 9,923 | \$ 2,050 |
| Other ⁽²⁾ | 1,364 | 683 |
| Other Assets, net | \$ 11,287 | \$ 2,733 |

(1) Relates to stack replacements performed under the Company's long-term service agreements. The cost of the stack is recorded as a long term asset and is depreciated over its expected life.

(2) Includes security deposits and notes and interest receivable.

Note 8. Accrued Liabilities

Accrued liabilities at July 31, 2011 and October 31, 2010 consisted of the following:

| | July 31, 2011 | October 31, 2010 |
|--|--------------------------|-----------------------------|
| Accrued payroll and employee benefits ⁽¹⁾ | \$ 3,607 | \$ 3,430 |
| Accrued contract and operating costs ⁽²⁾ | 230 | 2,126 |

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| | | |
|--|-----------|-----------|
| Reserve for product warranty cost ⁽³⁾ | 595 | 696 |
| Reserve for long-term service agreement costs ⁽⁴⁾ | 8,395 | 7,742 |
| Reserve for B1200 repair and upgrade program ⁽⁴⁾ | 10,582 | |
| Accrued taxes, legal, professional and other ⁽⁵⁾ | 1,971 | 2,727 |
| | \$ 25,380 | \$ 16,721 |

- (1) Balance relates to amounts owed to employees for compensation and benefits as of the end of the period.
- (2) Balance includes estimated losses accrued on product sales contracts and amounts estimated as owed to customers related to contract performance.

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- (3) Activity in the reserve for product warranty costs during the nine months ended July 31, 2011 included additions for estimates of potential future warranty obligations of \$0.2 million on contracts in the warranty period and reserve reductions related to actual warranty spend and reversals to income of \$0.3 million as contracts progress through the warranty period or are beyond the warranty period.
- (4) Refer to discussion below.
- (5) Balance includes accrued sales, use and payroll taxes as well as estimated legal, professional and other expense estimates as of the end of the period.

Reserve for long-term service agreement costs (LTSA)

The Company provides for reserves on all LTSA agreements when the estimated future stack replacement and service costs are estimated to exceed the remaining contract value. This includes power plants with our legacy 3-year stack design. We expect the replacement of these older 3-year stack designs to continue into mid 2012. Reserve estimates for future costs on LTSA agreements are determined by a number of factors including the estimated life of the stack, used replacement stacks available, our limit of liability on service agreements and future operating plans for the power plant. Our reserve estimates include cost assumptions based on what we anticipate the service requirements will be to fulfill obligations on a contract by contract basis, which in many cases is in excess of our contractual limit of liability under LTSAs which is limited to the amount of remaining service fees payable under the contract.

Reserve for B1200 repair and upgrade program

During the second quarter of fiscal 2011, the Company incurred an obligation to repair and upgrade a select group of 1.2 megawatt (MW) fuel cell modules produced between 2007 and early 2009. The repair and upgrade obligation was based on events that occurred and knowledge obtained concerning the performance of this select group of modules during the second fiscal quarter of 2011 however, the formal agreement to begin the repair and upgrade program was not finalized until May 2011. The program commenced in the third quarter of 2011 and is expected to conclude by mid-2012. The Company recorded a charge of approximately \$8.8 million during the quarter ended April 30, 2011 recorded as a cost of product sales and revenues on the consolidated statements of operations. The charge consisted of the costs associated with the replacement of modules of \$9.5 million and the costs associated with the repair of other modules of \$4.1 million, partially off-set by the estimated fair value at the end of the respective LTSA contract terms for upgraded assets being deployed in the program of approximately \$4.8 million, which will be returned to the Company at the expiration of the respective LTSA agreements if the customer does not renew the LTSA agreement through at least the remaining useful life of the upgraded assets. The reserve reflected on the consolidated balance sheet as of April 30, 2011 was approximately \$11.3 million as certain costs were previously incorporated in the Company's LTSA reserve. During the three months ended July 31, 2011, the Company incurred actual repair and upgrade costs of approximately \$0.7 million resulting in a net reserve balance of \$10.6 million at July 31, 2011.

Note 9. Revolving Credit Facility

In January 2011, the Company entered into a \$5.0 million revolving credit facility with JPMorgan Chase Bank, N.A. and the Export-Import Bank of the United States. The credit facility is to be used for working capital to finance the manufacture and production and subsequent export sale of the Company's products or services. The agreement has a one year term with renewal provisions. The outstanding principal balance of the facility will bear interest, at the option of the Company of either the one-month LIBOR plus 1.5 percent or the prime rate of JP Morgan Chase. The facility is secured by certain working capital assets and general intangibles, up to the amount of the outstanding facility balance. Aside from certain negative covenants limiting the Company's ability to merge or acquire another company, sell non-inventory assets, create liens against collateral or change the organizational structure or identity, the facility does not require compliance with any financial covenants. At July 31, 2011, the outstanding amount owed under this facility was \$2.6 million and is classified as current portion of long-term debt and other liabilities on the consolidated balance sheets.

Table of Contents**Note 10. Share-Based Compensation Plans**

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

Share-based compensation reflected in the consolidated statements of operations for the three and nine months ended July 31, 2011 and 2010 was as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | July 31, | | July 31, | |
| | 2011 | 2010 | 2011 | 2010 |
| Cost of product sales and revenues | \$ 201 | \$ 191 | \$ 604 | \$ 583 |
| Cost of research and development contracts | 34 | 53 | 105 | 130 |
| General and administrative expense | 98 | 408 | 989 | 974 |
| Research and development expense | 108 | 139 | 349 | 480 |
| Total share-based compensation | \$ 441 | \$ 791 | \$ 2,047 | \$ 2,167 |

The following table summarizes stock option activity for the nine months ended July 31, 2011:

| | Number of | Weighted |
|---------------------------------|------------------|--------------------------|
| | options | average |
| | | option price (\$) |
| Outstanding at October 31, 2010 | 5,118,201 | 10.15 |
| Granted | 216,657 | 1.98 |
| Cancelled | (1,417,550) | 13.43 |
| Outstanding at July 31, 2011 | 3,917,308 | 8.58 |

As of July 31, 2011, there were 1,918,202 RSAs outstanding with a weighted average per share fair value of \$2.16. During the three and nine months ended July 31, 2011, 95,922 and 1,393,538 RSA s respectively, were granted and forfeitures totaled 236,407 during this period.

For the three and nine months ended July 31, 2011, 69,561 and 129,643 shares respectively, were issued under the ESPP at a per share cost of \$0.97. There were 998,060 shares of common stock reserved for issuance under the ESPP as of July 31, 2011.

Table of Contents**Note 11. Shareholders Equity****Registered Direct Offering**

On January 13, 2011 we sold an aggregate of 10,160,428 units at a negotiated price of \$1.87 per unit, with each unit consisting of (i) one share of FuelCell Energy, Inc. common stock, par value \$0.0001 per share (Common Stock) and (ii) one warrant to purchase 1.0 share of Common Stock, in a registered direct offering for gross proceeds of \$19.0 million. The net proceeds from the sale of the units, after deducting the placement agent fees and other estimated offering expenses, was approximately \$17.8 million. We have used and intend to use the proceeds from this offering for product development, project financing, expansion of manufacturing capacity, and general corporate purposes. The warrants have an exercise price of \$2.29 per share and are exercisable beginning on the date that is six months and one day after the closing date and will expire twenty one months after issuance.

FuelCell Energy also has the right, subject to certain conditions, to require the investor to purchase up to 10.0 million additional shares approximately nine months after the initial closing date of the transaction. The sale price for the additional shares will be based on a fixed ten percent discount to a volume weighted average price (VWAP) measurement at the time FuelCell Energy exercises the option. FuelCell Energy cannot require the investor to purchase more than \$20 million of additional shares.

Common Stock Sales

The Company may sell common stock on the open market from time to time to raise funds in order to pay obligations related to the Company s outstanding Series 1 and Series B preferred shares. During the nine months ended July 31, 2011, we sold 2,519,000 shares of the Company s common stock on the open market and raised approximately \$4.7 million, net of fees.

Changes in shareholders (deficit) equity

Changes in shareholders equity were as follows for the nine months ended July 31, 2011:

| | Total Shareholders (Deficit) Equity | Noncontrolling interest | Total (Deficit) Equity |
|---|--|------------------------------------|---------------------------------------|
| Balance at October 31, 2010 | \$ 8,350 | \$ (663) | \$ 7,687 |
| Sale of Common Stock and related fees | 22,440 | | 22,440 |
| Share-based compensation | 2,049 | | 2,049 |
| Common stock issued in settlement of prior year bonus obligation | 707 | | 707 |
| Stock issued under benefit plans, net of taxes paid upon vesting of restricted stock awards | (46) | | (46) |
| Preferred dividends Series B | (2,400) | | (2,400) |
| FuelCell Ltd. (adjustment from Series 1 modification) | (8,987) | | (8,987) |
| Effect of foreign currency translation | 4 | | 4 |
| Net loss | (38,648) | (197) | (38,845) |
| Balance at July 31, 2011 | \$ (16,531) | \$ (860) | \$ (17,391) |

Table of Contents**Note 12. Loss Per Share**

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-------------|-------------------|-------------|
| | July 31, | | July 31, | |
| | 2011 | 2010 | 2011 | 2010 |
| Numerator | | | | |
| Net loss | \$ (7,830) | \$ (13,114) | \$ (38,845) | \$ (43,810) |
| Net loss attributable to noncontrolling interest | 76 | 88 | 197 | 270 |
| Adjustment for modification of redeemable preferred stock of subsidiary | | | (8,987) | |
| Preferred stock dividend | (800) | (799) | (2,400) | (2,401) |
| Net loss to common shareholders | \$ (8,554) | \$ (13,825) | \$ (50,035) | \$ (45,941) |
| Denominator | | | | |
| Weighted average basic common shares | 126,923,550 | 93,512,868 | 122,306,465 | 87,510,734 |
| Effect of dilutive securities ⁽¹⁾ | | | | |
| Weighted average diluted common shares | 126,923,550 | 93,512,868 | 122,306,465 | 87,510,734 |
| Basic loss per share | \$ (0.07) | \$ (0.15) | \$ (0.41) | \$ (0.52) |
| Diluted loss per share ⁽¹⁾ | \$ (0.07) | \$ (0.15) | \$ (0.41) | \$ (0.52) |

(1) Diluted loss per share was computed without consideration to potentially dilutive instruments as their inclusion would have been antidilutive. Potentially dilutive instruments include stock options, warrants and convertible preferred stock. At July 31, 2011 and 2010, there were options to purchase 3.9 million and 5.2 million shares of common stock, respectively. There were outstanding warrants of 10.2 million as of July 31, 2011 and there were no warrants outstanding as of July 31, 2010. Refer to our Annual Report on Form 10-K for the year ended October 31, 2010 for information on our convertible preferred stock.

Note 13. Commitments and Contingencies

We have pledged approximately \$9.7 million of our cash and cash equivalents as collateral and letters of credit for certain banking requirements and contracts. As of July 31, 2011, outstanding letters of credit totaled \$8.7 million. These expire on various dates through May 2012.

Note 14. Redeemable Preferred Stock*Series 1 Preferred Share Obligation*

On March 31, 2011, the Company entered into an agreement with Enbridge, Inc. (Enbridge) to modify the provisions of the Class A Cumulative Redeemable Exchangeable Preferred Shares (the Series 1 Preferred Shares) of FCE FuelCell Energy Ltd. (FCE Ltd.), a wholly-owned subsidiary of the Company. Enbridge is the sole holder of the Series 1 Preferred Shares. Consistent with the previous Series 1 preferred share agreement FuelCell Energy, Inc. continues to guarantee the return of principal and dividend obligations of FCE Ltd. to the Series 1 preferred shareholders under the modified agreement.

Under the original Series 1 Preferred Shares provisions, FCE Ltd. had an accrued and unpaid dividend obligation of approximately Cdn. \$12.5 million representing the deferral of dividends plus additional dividends thereon. Payment was originally due to Enbridge as of December 31, 2010, but was subsequently extended based on mutual consent.

Under the modified share provisions, this obligation will be settled as (i) equal quarterly return of capital cash payments to the holders of the Series 1 Preferred Shares on the last day of each calendar quarter starting on March 31, 2011 and ending on December 31, 2011 and (ii) additional return of capital cash payments, as consideration for the one-year deferral, calculated at a 9.8 percent rate per annum on the unpaid Cdn. \$12.5 million obligation, which additional payments will also be made to the holders of the Series 1 Preferred Shares on the last day of each calendar quarter starting on March 31, 2011 and ending on December 31, 2011.

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Under the original Series 1 Preferred Shares provisions, FCE Ltd. was to make annual dividend payments totaling Cdn. \$1,250,000. The modified terms of the Series 1 Preferred Shares adjust these payments to (i) annual dividend payments of Cdn\$500,000 and (ii) annual return of capital payments of Cdn. \$750,000, in each case payable in cash. These payments commenced on March 31, 2011 and will end on December 31, 2020. Additional dividends accrue on cumulative unpaid dividends at a 1.25 percent quarterly rate, compounded quarterly, until payment thereof. On December 31, 2020 the amount of all accrued and unpaid dividends on the Series 1 Preferred Shares and the balance of the principal redemption price shall be paid to the holders of the Series 1 Preferred Shares. FCE Ltd. has the option of making dividend payments in the form of common stock or cash under the Series 1 Preferred Shares provisions.

On March 31, 2011, the modified instrument had a carrying value of Cdn. \$25.2 million. The Company assessed the accounting guidance related to the classification of the preferred shares after the modification on March 31, 2011 and concluded that the preferred shares should be classified as a mandatorily redeemable financial instrument, and presented as a liability on the consolidated balance sheet. Due to the reclassification of the instrument to a liability, the Company has accounted for this modification of the Series 1 Preferred shares as an extinguishment and therefore the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock on our balance sheet prior to the modification represents a return to the preferred stockholder and treated in a manner similar to the treatment of dividends paid on preferred stock. Accordingly, the difference between (1) the fair value of the Series 1 Preferred shares and (2) the carrying amount of the Series 1 Preferred shares on our balance sheet prior to the modification was subtracted from net loss to arrive at loss to common stockholders in the calculation of earnings per share.

The previous model used to value the original Series I Preferred shares was modified to value the pre-modification contract, to reflect the new cash-flows discussed above. The notional amount of the instrument is amortizing beginning in 2011 to correspond to the initial four quarterly returns of capital payments in 2011 and to the quarterly \$187,500 paid from 2011-2020 as return of capital. It is assumed that the Company will exercise the call option to force conversion in 2020. The conversion feature is modeled using a lattice approach. Call option strikes are adjusted for cumulative dividends and the conversion ratio is adjusted by the notional schedule. The stock is projected in the future assuming a log-normal distribution. The stock volatility, the interest rate curve, the foreign exchange rates and credit spreads are assumed to be deterministic. The cumulative dividend is modeled as a quarterly cash dividend component and a cumulative payment in 2020.

As previously modeled, the variable dividend component is valued using a Monte-Carlo simulation approach. Its value is defined as the difference between a 5% annual dividend payment stream and the value of a stock price and foreign exchange rate linked dividend payment stream. Future stock price and exchange rates are simulated assuming a Geometric Brownian motion to determine the dividend amount up to 2020, when the Preferred Shares are assumed to be force converted.

The revaluation of the Series 1 Preferred shares resulted in a reduction of additional paid in capital of \$9.0 million, which is also presented on the consolidated statements of operations as a charge to modification of redeemable preferred stock of subsidiary to arrive at net loss to common shareholders and is included in the calculation of earnings per share for net loss to common shareholders. The reason for the change in the value of the obligation was that the original obligation had been accounted for under purchase price accounting at the time of the Global Thermoelectric Inc. acquisition in November 2003. The valuation at that time included a market risk discount and used the exchange rate at the time of the acquisition. Under the new valuation, the future estimated cash flows were discounted using the current exchange rate.

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During the three and nine months ended July 31, 2011, the Company made scheduled payments of Cdn.\$3.7 million and Cdn. \$7.4 million, respectively, under the terms of the modified agreement, including interest expense of approximately Cdn. \$0.8 million and Cdn. \$1.7 million, respectively. As of July 31, 2011, the carrying value of the Series 1 Preferred shares was Cdn.\$19.5 million (\$20.5 million USD) and is classified as Preferred stock obligation of subsidiary on the consolidated balance sheets. As of July 31, 2011 the current amount of this obligation totaled \$7.0 million and the long term amount totaled \$13.5 million. Interest expense will be recorded on the consolidated statement of operations as these balances are amortized.

Significant Terms of the Series 1 Preferred Shares

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

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

Dividends and Return of Capital - On the last day of each Calendar Quarter starting on March 31, 2011 and ending on December 31, 2020, the Company shall make (i) a return of capital payment to the holders of the Class A Preferred Shares in an aggregate amount equal to Cdn. \$187,500, and (ii) a dividend payment to the holders of the Class A Preferred Shares equal to Cdn. \$125,000 in the aggregate.

On the last day of each Calendar Quarter starting on March 31, 2011 and ending on December 31, 2011, the Company shall make (i) a return of capital payment to the holders of the Class A Preferred Shares equal to Cdn. \$3.1 million in the aggregate (the 2010 Capital Repayment), and (ii) a return of capital payment to the holders of the Class A Preferred Shares at the rate of 9.8% per annum on the 2010 Capital Payment for the period from January 10, 2011 to the date the 2010 Capital Payment is made.

Dividend payments can be made in cash or common stock of the Company, at the option of FCE Ltd., and if common stock is issued it may be unregistered. If FCE Ltd. elects to make such payments by issuing common stock of the Company, the number of common shares is determined by dividing the cash dividend obligation by 95 percent of the volume weighted average price in US dollars at which board lots of the common shares have been traded on NASDAQ during the 20 consecutive trading days preceding the end of the calendar quarter for which such dividend in common shares is to be paid converted into Canadian dollars using the Bank of Canada s noon rate of exchange on the day of determination.

Redemption The Series 1 Preferred Shares are redeemable by FCE Ltd. for Cdn.\$25 per share less any amounts paid as a return of capital in respect of such share plus all unpaid dividends and accrued interest. Holders of the Series 1 Preferred Shares do not have any mandatory or conditional redemption rights.

Liquidation or Dissolution In the event of the liquidation or dissolution of FCE Ltd., the holders of Series 1 Preferred Shares will be entitled to receive Cdn.\$25 per share less any amounts paid as a return of capital in respect of such share plus all unpaid dividends and accrued interest. The Company has guaranteed any liquidation obligations of FCE Ltd.

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Exchange Rights A holder of Series 1 Preferred Shares has the right to exchange such shares for fully paid and non-assessable common stock of the Company at the following exchange prices:

Cdn\$129.46 per share of common stock after July 31, 2010 until July 31, 2015;

Cdn\$138.71 per share of common stock after July 31, 2015 until July 31, 2020; and

at any time after July 31, 2020, at a price equal to 95 percent of the then current market price (in Cdn.\$) of the Company's common stock at the time of conversion.

The exchange rates set forth above shall be adjusted if the Company: (i) subdivides or consolidates the common stock; (ii) pays a stock dividend; (iii) issues rights, options or other convertible securities to the Company's common stockholders enabling them to acquire common stock at a price less than 95 percent of the then-current price; or (iv) fixes a record date to distribute to the Company's common stockholders shares of any other class of securities, indebtedness or assets.

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

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (including exhibits and any information incorporated by reference herein) contains both historical and forward-looking statements that involve risks, uncertainties and assumptions. The statements contained in this report that are not purely historical are forward-looking statements that are subject to the safe harbors created under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions and strategies for the future. These statements appear in a number of places in this Report and include all statements that are not historical statements of fact regarding our intent, belief or current expectations with respect to, among other things: (i) our ability to achieve our sales plans and cost reduction targets; (ii) trends affecting our financial condition or results of operations; (iii) our growth and operating strategy; (iv) our product development strategy; (v) our financing plans; (vi) the timing and magnitude of future contracts; (vii) changes in the regulatory environment; (viii) potential volatility of energy prices; and (ix) rapid technological change or competition. The words *may*, *would*, *could*, *should*, *will*, *expect*, *anticipate*, *believe*, *intend*, *plans* and similar expressions and variations thereof are intended to identify forward-looking statements. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risk and uncertainties, many of which are beyond our ability to control, and that actual results may differ materially from those projected in the forward-looking statements as a result of various factors discussed herein, including those discussed in detail in our filings with the Securities and Exchange Commission (SEC), including in our Annual Report on Form 10-K for the fiscal year ended October 31, 2010 in the section entitled Item 1A. Risk Factors.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is provided as a supplement to the accompanying financial statements and footnotes to help provide an understanding of our financial condition, changes in our financial condition and results of operations. The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Estimates are used in accounting for, among other things, revenue recognition, excess, slow-moving and obsolete inventories, product warranty costs, reserves on long-term service agreements, allowance for uncollectible receivables, depreciation and amortization, impairment of assets, taxes, and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. Due to the inherent uncertainty involved in making estimates, actual results in future periods may differ from those estimates. The following discussion should be read in conjunction with information included in our Annual Report on Form 10-K for the year ended October 31, 2010 filed with the SEC. Unless otherwise indicated, the terms *Company*, *FuelCell Energy*, *we*, *us* and *our* refer to FuelCell Energy Inc. and its subsidiaries. All tabular dollar amounts are in thousands.

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OVERVIEW AND RECENT DEVELOPMENTS

Overview

We are a world leader in the development, manufacture and service of ultra-clean, efficient and reliable fuel cell power plants for commercial, industrial, government and utility customers. Our ultra-clean, efficient Direct FuelCell® (DFC®) power plants are generating power at over 50 locations worldwide. Our products have generated over 850 million kWh of power using a variety of fuels including renewable biogas from wastewater treatment and food processing, as well as clean natural gas.

Our vision is to provide ultra-clean, highly efficient, reliable distributed generation baseload power at a cost per kilowatt hour that is less than the cost of grid-delivered electricity. Our power plants provide electricity that is priced competitively to grid-delivered electricity in certain high cost regions of the United States.

Our Company was founded in Connecticut in 1969 and reincorporated in Delaware in 1999. Our core fuel cell products (Direct FuelCell® or DFC® Power Plants) offer highly efficient stationary power generation for customers. In addition to our commercial products, we continue to develop our carbonate fuel cells, planar solid oxide fuel cell (SOFC) technology and other fuel cell technology with our own and government research and development funds.

Our proprietary carbonate DFC Power Plants electrochemically (without combustion) produce electricity directly from readily available fuels such as natural gas and biogas in a highly efficient process. The primary byproducts of the fuel cell process are heat and water. Due to the lack of combustion, our fuel cells emit virtually zero pollutants such as NO_x, SO_x or particulate matter.

Our fuel cells operate 24 hours per day seven days per week providing reliable power to both on-site customers and grid-support applications. Our DFC Power Plants can be part of a total on-site power generation solution with our high efficiency products providing base load power. Our power plants can also work in conjunction with intermittent power, such as solar or wind, or less efficient combustion-based equipment that provide peaking and load following. Our products are also well suited for meeting the needs of utility grid-support applications.

Higher fuel efficiency results in lower emissions of carbon dioxide (CO₂), a major greenhouse gas, and also results in less fuel needed per kWh of electricity generated and Btu of heat produced. The high efficiency of the DFC Power Plant results in significantly less CO₂ per unit of power production compared to the average U.S. fossil fuel power plant. Greater efficiency reduces customers' exposure to volatile fuel costs, minimizes operating costs, and provides maximum electrical output from a finite fuel source. DFC Power Plants achieve electrical efficiencies of 47 percent to 60 percent or higher depending on configuration, location, and application, and up to 90 percent total efficiency in combined heat and power applications.

A fuel cell power plant includes the fuel cell stack module that produces the electricity, and balance-of-plant (BOP). The mechanical balance-of-plant processes the incoming fuel such as natural gas or renewable biogas and includes various fuel handling and processing equipment such as pipes and blowers. The electrical balance-of-plant processes the power generated for use by the customer and includes electrical interface equipment such as inverters.

Our fuel cells operate on a variety of fuels, including natural gas, renewable biogas, propane, methanol, coal gas, and coal mine methane.

Compared to other power generation technologies, our products offer significant advantages including:

Near-zero pollutants;

High efficiency;

Ability to site units locally as distributed power generation;

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Potentially lower cost power generation;

High quality heat ideal for cogeneration applications;

High efficiency and cogeneration reduce carbon emissions

Reliable around-the-clock base load power;

Quiet operation; and

Fuel flexibility.

Typical customers for our products include utilities, universities, manufacturers, mission critical institutions such as correction facilities and government installations, hotels, natural gas letdown stations and customers who can use renewable biogas for fuel such as municipal water treatment facilities, breweries, and food processors. With increasing demand for renewable and ultra-clean power options and increased volatility in electric markets, our products offer our customers greater control over power generation economics, reliability, and emissions.

Our DFC Power Plants are protected by 67 U.S. and 52 international patents. We currently have 28 U.S. and 114 international patents under application.

Recent Developments

POSCO Power 70MW Order

In May 2011, the Company announced a \$129 million order for 70 megawatts of fuel cell kits and other equipment and services to POSCO Power. The delivery of fuel cell kits will begin in October 2011 and occur monthly through October 2013. Payment terms include a down payment and progress payments during the term of the contract, with approximately 40 percent of the contract value received by October 2011. POSCO Power is an independent power producer in South Korea and subsidiary of POSCO, a global steel producer.

Series 1 Preferred Share Obligation

On March 31, 2011, the Company entered into an agreement with Enbridge, Inc. (Enbridge) to modify the Class A Cumulative Redeemable Exchangeable Preferred Shares agreement (the Series 1 preferred share agreement) between FCE FuelCell Energy Ltd. (FCE Ltd), a wholly-owned subsidiary of FuelCell Energy, and Enbridge, the sole holder of the Series 1 preferred shares. Consistent with the previous Series 1 preferred share agreement, FuelCell continues to guarantee the return of principal and dividend obligations of FCE Ltd. to the Series 1 preferred shareholders under the modified agreement. The modification of the Series 1 preferred share agreement resulted in a reclassification of the instrument on the consolidated balance sheet from redeemable minority interest to a liability (preferred stock obligation of subsidiary). As a result of this reclassification, the Company revalued the instrument. The revaluation of the Series 1 Preferred shares resulted in a reduction of additional paid in capital of \$9.0 million, which is also presented on the consolidated statement of operations as a charge to modification of redeemable preferred stock of subsidiary to arrive at net loss to common shareholders and is included in the calculation of earnings per share for net loss to common shareholders. The Company made its scheduled payment of Cdn.\$3.7 million during the third fiscal quarter under the terms of the modified agreement, including the recording of interest expense of approximately Cdn.\$0.8 million. As of July 31, 2011, the carrying value of the Series 1 Preferred shares was Cdn.\$19.5 million (\$20.5 million USD) and is classified as preferred stock obligation of subsidiary on the consolidated balance sheets. Refer to Note 14 of Notes to Consolidated Financial Statements for more information.

B1200 Repair and Upgrade Program

During the second quarter of fiscal 2011, the Company incurred an obligation to repair and upgrade a select group of 1.2 megawatt (MW) fuel cell modules produced between 2007 and early 2009. The repair and upgrade obligation was based on events that occurred and knowledge obtained concerning the performance of this select group of modules during the second fiscal quarter of 2011 however, the formal agreement to begin the repair and upgrade program was not finalized until May 2011. The program commenced in the third quarter of 2011 and is expected to conclude by mid-2012. The Company recorded a charge of approximately \$8.8 million during the quarter ended April 30, 2011

recorded as a cost of product sales and revenues on the consolidated statements of operations. The charge consisted of the costs associated with the replacement of modules of \$9.5 million and the costs associated with the repair of other modules of \$4.1 million, partially off-set by the estimated fair value at the end of the respective LTSA contract terms for upgraded assets being deployed in the program of approximately \$4.8 million, which will be returned to the Company at the expiration of the respective LTSA agreements if the customer does not renew the LTSA agreement through at least the remaining useful life of the upgraded assets.

Table of Contents**RESULTS OF OPERATIONS**

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

Results of Operations are presented in accordance with accounting principles generally accepted in the United States (GAAP) and as adjusted for certain items referenced below. Management also uses non-GAAP measures which exclude non-recurring items in order to measure operating periodic performance. Adjustments to GAAP are referenced below under Revenues and Costs of Revenues and Net Loss to Common Shareholders . We have added this information because we believe it helps in understanding the results of our operations on a comparative basis. This adjusted information supplements and is not intended to replace performance measures required by U.S. GAAP disclosure.

Comparison of Three Months Ended July 31, 2011 and July 31, 2010**Revenues and Costs of revenues**

Our revenues and cost of revenues for the three months ended July 31, 2011 and 2010 were as follows:

| | Three Months Ended | | Change | |
|--|---------------------------|-------------|---------------|----------|
| | July 31, | | | |
| | 2011 | 2010 | \$ | % |
| Revenues: | | | | |
| Product sales and revenues | \$ 29,382 | \$ 16,218 | \$ 13,164 | 81 |
| Research and development contracts | 1,778 | 2,655 | (877) | (33) |
| Total | \$ 31,160 | \$ 18,873 | \$ 12,287 | 65 |
| Cost of revenues: | | | | |
| Product sales and revenues | \$ 29,133 | \$ 20,050 | \$ 9,083 | 45 |
| Research and development contracts | 1,890 | 2,579 | (689) | (27) |
| Total | \$ 31,023 | \$ 22,629 | \$ 8,394 | 37 |
| Gross Margin: | | | | |
| Gross margin from product sales and revenues | \$ 249 | \$ (3,832) | \$ 4,081 | 106 |
| Gross margin from research and development contracts | (112) | 76 | (188) | (247) |
| Total | \$ 137 | \$ (3,756) | \$ 3,893 | 104 |
| Product Sales Cost-to-revenue ratio ⁽¹⁾ | 0.99 | 1.24 | | 20 |

⁽¹⁾ Cost-to-revenue ratio is calculated as cost of product sales and revenues divided by product sales and revenues. Total revenues for the three months ended July 31, 2011 increased \$12.3 million, or 65 percent to \$31.2 million from \$18.9 million during the same period last year. Total cost of revenues for the three months ended July 31, 2011 increased \$8.4 million, or 37 percent to \$31.0 million from \$22.6 million during the same period last year. A discussion of the change in product sales and revenues and research and development contracts follows.

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Product sales and revenues

Product sales and revenues increased \$13.2 million, or 81 percent in the third quarter 2011 to \$29.4 million compared to \$16.2 million for the prior year period. Product sales and revenues for the third quarter of 2011 included \$21.2 million of revenue from power plants and fuel cell kits, \$5.5 million primarily from installation services and revenue from the 100 kilowatt joint development agreement with POSCO Power, and \$2.7 million of revenue from service and power purchase agreements.

Cost of product sales and revenues increased \$9.1 million, or 45 percent, in the third quarter 2011 to \$29.1 million compared to \$20.0 million in the same period the prior year. This increase is primarily due to the significant increase in revenue in the third quarter of fiscal 2011 as compared to the third quarter of fiscal 2010. Margins for product sales and revenues increased by \$4.1 million over the prior year quarter primarily due to increased production levels resulting in improved absorption of fixed overhead costs. Higher revenue from balance of plant component sales and construction revenue in the quarter also contributed to improved margins. The product cost-to-revenue ratio was 0.99-to-1.00 in the third quarter of 2011 compared to 1.24-to-1.00 in the third quarter of 2010.

Cost of product sales and revenues includes costs to manufacture and ship our power plants and fuel cell kits to customers, site engineering and construction costs where we are responsible for power plant system installation, costs for stack module assembly and conditioning equipment sold to POSCO, warranty expense, liquidated damages and costs to service power plants for customers with long-term service agreements (including maintenance and stack replacement costs incurred during the period), power purchase agreement (PPA) operating costs and lower of cost or market inventory adjustments.

Total product sales and service backlog as of July 31, 2011 was \$230.6 million compared to \$79.8 million as of July 31, 2010. Product order backlog was \$152.9 million and \$55.2 million as of July 31, 2011 and 2010, respectively. Product backlog as of July 31, 2011 totaled 78.5 megawatts (MW) of power plants and fuel cell kits. During the quarter we added 70.0 MW of new orders and shipped 8.2 MW. During the three months ended July 31, 2011 the Company removed a 1.4 MW contract totaling \$5.4 million from backlog. While the Company has a firm contract and received an initial down payment, the customer has not met certain contractual requirements. Backlog for long-term service agreements was \$77.7 million and \$24.6 million as of July 31, 2011 and 2010, respectively.

We contract with a concentrated number of customers for the sale of our products and for research and development contracts. Refer to Note 1 of notes to consolidated financial statements for more information on customer concentrations.

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

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Research and development contracts

Research and development contract revenue decreased \$0.9 million to \$1.8 million for the three months ended July 31, 2011 compared to \$2.7 million for the same period in 2010. Cost of research and development contracts decreased \$0.7 million to \$1.9 million for the three months ended July 31, 2011 compared to \$2.6 million during the same period in 2010. The decrease in revenue was due to lower research activities over the prior period primarily related to the solid oxide fuel cell development program with the U.S. Department of Energy (DOE). The decline in margins is due to the level of cost share we are required to contribute.

The Company's research and development backlog totaled \$13.6 million (\$2.1 million funded) as of July 31, 2011 compared to \$7.4 million (\$5.1 million funded) as of July 31, 2010. The increase is primarily due to SECA Phase III program award.

Administrative and selling expenses

Administrative and selling expenses were \$3.6 million for the three months ended July 31, 2011 compared to \$4.2 million for the same period in 2010. Administrative and selling was lower primarily due to lower overall salary expense, sales and marketing costs and stock based compensation, compared to the prior year period.

Research and development expenses

Research and development expenses were \$3.9 million for the three months ended July 31, 2011 a decrease of \$0.7 million compared to last year's period as a result of lower overall headcount and increased support of commercial projects during the period which are classified as cost of sales.

Loss from operations

Loss from operations decreased to \$7.4 million for the three months ended July 31, 2011 compared to \$12.6 million for same period last year. The decrease in loss from operations is primarily due to improved margins on product sales as well as lower administrative and selling expenses and research and development expenses.

Interest Expense

Interest expense, increased to \$0.8 million for the three months ended July 31, 2011 compared to less than \$0.1 million for the same period in 2010. The increase is due to the modification of redeemable preferred stock of subsidiary. Accounting guidance now requires amortization of this instrument post-modification to be recorded as interest expense.

On March 31, 2011, the modified instrument had a carrying value of Cdn. \$25.2 million. The Company assessed the accounting guidance related to the classification of the preferred shares after the modification on March 31, 2011 and concluded that the preferred shares should be classified as a mandatorily redeemable financial instrument, and presented as a liability on the consolidated balance sheet. As of July 31, 2011, the carrying value of the Series 1 Preferred shares was Cdn.\$19.5 million (\$20.5 million USD) and is classified as Preferred stock obligation of subsidiary on the consolidated balance sheets. As of July 31, 2011 the current amount of this obligation totaled \$7.0 million and the long term amount totaled \$13.5 million. Amortization of this balance will be recorded as interest expense on the consolidated statement of operations. For the three months ended July 31, 2011, interest expense totaled approximately \$0.8 million.

Income (loss) from equity investment

Our share of equity loss in Versa was \$0.1 million for the three months ended July 31, 2011 compared to a loss of \$0.2 million for the three months ended July 31, 2010.

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Interest and other income, net

Interest and other income, net, increased to \$0.5 million for the three months ended July 31, 2011 compared to \$0.3 million for the same period in 2010. The increase is due to higher royalty income related to our license agreements with POSCO Power.

Accretion of Preferred Stock of Subsidiary

The Series 1 Preferred Shares issued by our subsidiary, FCE Ltd., to Enbridge were originally recorded at a substantial discount to par value (fair value discount). On a quarterly basis, the carrying value of the Series 1 Preferred Shares was increased to reflect the passage of time with a corresponding non-cash charge (accretion). The accretion of the fair value discount was \$0 and \$0.6 million for the three months ended July 31, 2011 and 2010, respectively.

The modification of the Series 1 preferred share agreement resulted in a reclassification of the instrument on the consolidated balance sheets from redeemable minority interest to a liability (preferred stock obligation of subsidiary). Refer to Recent Developments above as well as the section discussing the adjustment for modification of redeemable preferred stock of subsidiary below and Note 14 of Notes to Consolidated Financial Statements for more information.

Provision for income taxes

We have not paid federal or state income taxes in several years due to our history of net operating losses, although we have paid foreign taxes in South Korea. For the three months ended July 31, 2011 our provision for income taxes was \$.03 million, which related to South Korean tax obligations. During 2009, we began manufacturing products that are gross margin profitable on a per unit basis; however, we cannot estimate when production volumes will be sufficient to generate taxable domestic income. Accordingly, no tax benefit has been recognized for our U.S. federal or state net operating losses or other deferred tax assets as significant uncertainty exists surrounding the recoverability of these deferred tax assets.

Net loss attributable to noncontrolling interest

The net loss attributed to the noncontrolling interest for the quarters ended July 31, 2011 and July 31, 2010 was \$0.1 million.

Preferred Stock dividends

Dividends recorded on the Series B Preferred Stock were \$0.8 million in each of the quarters ended July 31, 2011 and 2010.

Net loss to common shareholders and loss per common share

Net loss to common shareholders represents the net loss for the period less the net loss attributable to noncontrolling interest less the preferred stock dividends on the Series B Preferred Stock. For the quarters ended July 31, 2011 and 2010, net loss to common shareholders was \$8.6 million and \$13.8 million, respectively and loss per common share was \$(0.07) and \$(0.15), respectively.

Table of Contents**Comparison of Nine Months Ended July 31, 2011 and July 31, 2010****Revenues and Costs of revenues**

Our revenues and cost of revenues for the nine months ended July 31, 2011 and 2010 were as follows:

| | Nine Months Ended July 31, | | Change | |
|---|-------------------------------|-------------|-----------|------|
| | 2011 | 2010 | \$ | % |
| Revenues: | | | | |
| Product sales and revenues | \$ 81,815 | \$ 42,033 | \$ 39,782 | 95 |
| Research and development contracts | 6,032 | 8,043 | (2,011) | (25) |
| Total | \$ 87,847 | \$ 50,076 | \$ 37,771 | 75 |
| Cost of revenues: | | | | |
| Product sales and revenues | \$ 94,652 | \$ 57,183 | \$ 37,469 | 66 |
| Research and development contracts | 6,244 | 7,942 | (1,698) | (21) |
| Total | \$ 100,896 | \$ 65,125 | \$ 35,771 | 55 |
| Gross Margin: | | | | |
| Gross margin from product sales and revenues | \$ (12,837) | \$ (15,150) | \$ 2,313 | 15 |
| Gross margin from research and development Contracts | (212) | 101 | (313) | 310 |
| Total | \$ (13,049) | \$ (15,049) | \$ 2,000 | 13 |
| Product Sales Cost-to-revenue ratio ⁽¹⁾ | 1.16 | 1.36 | | 15 |

(1) Cost-to-revenue ratio is calculated as cost of product sales and revenues divided by product sales and revenues.

| | Nine Months Ended July 31, | | Change | |
|---|-------------------------------|-------------|------------|-------|
| | 2011 | 2010 | \$ | % |
| Non-GAAP Adjustment to cost of product sales and revenues: | | | | |
| B1200 Repair and Upgrade Cost | \$ (8,752) | \$ | \$ (8,752) | N/M |
| Gross Margin (non-GAAP): | | | | |
| Gross margin from product sales and revenues | \$ (4,085) | \$ (15,150) | \$ 11,065 | 73 |
| Gross margin from research and development contracts | (212) | 101 | (313) | (310) |
| Total | \$ (4,297) | \$ (15,049) | \$ 10,752 | 71 |
| Product Sales Cost-to-revenue ratio | 1.05 | 1.36 | | 23 |

Total revenues for the nine months ended July 31, 2011 increased \$37.7 million, or 75 percent to \$87.8 million from \$50.1 million during the same period last year. Total cost of revenues for the nine months ended July 31, 2011 increased \$35.8 million, or 55 percent to \$100.9 million from \$65.1 million during the same period last year. A discussion of the changes in product sales and revenues and research and development contracts follows.

Product sales and revenues

Product sales and revenues increased \$39.8 million, or 95 percent in the first nine months of 2011 to \$81.8 million compared to \$42.0 million for the prior year period. Product sales and revenues for the first nine months of 2011 included \$63.0 million from the sale of power plants, fuel cell kits, fuel cell modules, and other fuel cell power plant components, \$10.1 million of revenue primarily from the design and delivery of capital equipment to POSCO Power for their fuel cell module assembly facility as well as construction and installation services, and \$8.7 million of revenue from service and power purchase agreements.

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Cost of product sales and revenues increased \$37.5 million, or 66 percent in the first nine months of 2011 to \$94.7 million compared to \$57.2 million in the same period the prior year. This increase is primarily due to the significant growth in revenues in the first nine months of fiscal 2011 as compared to the first nine months of fiscal 2010 as well as the B1200 repair and upgrade program charge discussed above. Margins for product sales and revenues increased by \$2.3 million over the prior year due to improved product margins partially offset by the B1200 repair and upgrade program charges. The product cost-to-revenue ratio was 1.16-to-1.00 in the first nine months of 2011 (1.05-to-1.00 excluding the \$8.8 million B1200 repair and upgrade charge) compared to 1.36-to-1.00 in the first nine months of 2010.

Cost of product sales and revenues includes costs to manufacture and ship our power plants and power plant components to customers, site engineering and construction costs where we are responsible for power plant system installation, costs for stack module assembly and conditioning equipment sold to POSCO, warranty expense, liquidated damages and costs to service power plants for customers with long-term service agreements (including maintenance and stack replacement costs incurred during the period), PPA operating costs and lower of cost of market inventory adjustments.

We contract with a concentrated number of customers for the sale of our products and for research and development contracts. Refer to Note 1 of notes to consolidated financial statements for more information on customer concentrations.

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

Research and development contracts

Research and development contract revenue decreased \$2.0 million to \$6.0 million for the nine months ended July 31, 2011 compared to \$8.0 million for the same period in 2010. Cost of research and development contracts decreased \$1.7 million to \$6.2 million for the nine months ended July 31, 2011 compared to \$7.9 million during the first nine months of 2010. The decrease in revenue was due to lower levels of research activities over the prior period as phase II of the solid oxide fuel cell development program with the U.S. Department of Energy (DOE) ended. The Company began phase III of this program towards the end of the second quarter 2011. The decline in margins is due to the level of cost share we are required to contribute.

Administrative and selling expenses

Administrative and selling expenses were \$12.1 million for the nine months ended July 31, 2011, a decrease of \$0.8 million compared to last year's period. Administrative and selling was lower primarily due to lower overall salary expense and sales and marketing costs compared to the prior year period.

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Research and development expenses

Research and development expenses were \$12.7 million for the nine months ended July 31, 2011 a decrease of \$1.7 million compared to last year's period as a result of lower overall headcount and increased support of commercial projects during the period which are classified as cost of sales.

Loss from operations

Loss from operations decreased to \$37.8 million for the nine months ended July 31, 2011 compared to \$42.3 million for same period last year. The decrease is primarily due to improved product margins.

Interest Expense

Interest expense, increased to \$1.8 million for the nine months ended July 31, 2011 compared to \$0.1 million for the same period in 2010. The increase is due to the modification of redeemable preferred stock of subsidiary as amortization of this instrument post-modification is recorded as interest expense.

Loss from equity investment

Our share of equity losses in Versa decreased to \$0.1 million for the nine months ended July 31, 2011 compared to \$0.6 million for the nine months ended July 31, 2010.

Interest and other income, net

Interest and other income, net, increased to \$1.5 million for the nine months ended July 31, 2011 compared to \$1.0 million for the same period in 2010. The increase is due to higher royalty income related to our license agreements with POSCO Power.

Accretion of Preferred Stock of Subsidiary

The accretion of the fair value discount on the Series 1 Preferred Shares was \$0.5 million and \$1.8 million for the nine months ended July 31, 2011 and 2010, respectively.

The modification of the Series 1 preferred share agreement resulted in a reclassification of the instrument on the consolidated balance sheets from redeemable minority interest to a liability (preferred stock obligation of subsidiary). Refer to Recent Developments as well as the section on adjustment for modification of redeemable preferred stock of subsidiary below and Note 14 of Notes to Consolidated Financial Statements for more information.

Provision for income taxes

We have not paid federal or state income taxes in several years due to our history of net operating losses, although we have paid foreign taxes in South Korea. For the nine months ended July 31, 2011 our provision for income taxes was \$0.1 million, which related to South Korean tax obligations. During 2009, we began manufacturing products that are gross margin profitable on a per unit basis; however, we cannot estimate when production volumes will be sufficient to generate taxable income. Accordingly, no tax benefit has been recognized for these net operating losses or other deferred tax assets as significant uncertainty exists surrounding the recoverability of these deferred tax assets.

Net loss attributable to noncontrolling interest

The net loss attributed to the noncontrolling interest for the nine months ended July 31, 2011 and July 31, 2010 was \$0.2 million and \$0.3 million, respectively.

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Adjustment for modification of redeemable preferred stock of subsidiary

Modification of redeemable preferred stock of subsidiary resulted in a charge of \$9.0 million for the nine month period ended July 31, 2011.

Due to the reclassification of the instrument to a liability, the Company has accounted for this modification of the Series 1 Preferred shares as an extinguishment and therefore the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock on our balance sheet prior to the modification represents a return to the preferred stockholder and treated in a manner similar to the treatment of dividends paid on preferred stock. Accordingly, the difference between (1) the fair value of the Series 1 Preferred shares and (2) the carrying amount of the Series 1 Preferred shares our balance sheet prior to the modification was subtracted from net loss to arrive at loss to common stockholders in the calculation of earnings per share.

The revaluation of the Series 1 Preferred shares resulted in a reduction of additional paid in capital of \$9.0 million, which is also presented on the consolidated statements of operations as a charge to modification of redeemable preferred stock of subsidiary to arrive at net loss to common shareholders and is included in the calculation of earnings per share for net loss to common shareholders. The Company made its scheduled payment of Cdn.\$3.7 million during the third fiscal quarter of 2011 under the terms of the modified agreement, including interest of approximately Cdn.\$0.8 million. For the nine months ended July 31, 2011, interest expense recorded on this instrument totaled approximately \$1.7 million.

Preferred Stock dividends

Dividends recorded on the Series B Preferred Stock were \$2.4 million in each of the nine month periods ended July 31, 2011 and 2010.

Net loss to common shareholders and loss per common share

Net loss to common shareholders represents the net loss for the period less the net loss attributable to noncontrolling interest less the preferred stock dividends on the Series B Preferred Stock and the \$9.0 million adjustment for the modification of redeemable preferred stock of subsidiary. For the nine months ended July 31, 2011 and 2010, net loss to common shareholders was \$50.0 million and \$45.9 million, respectively and loss per common share was \$(0.41) and \$(0.52), respectively.

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Excluding the two charges discussed above related to the B1200 repair and upgrade program and the modification of redeemable preferred stock of subsidiary recorded in the second quarter of 2011, net loss to common shareholders was \$32.3 million or \$(0.26) per basic and diluted share, compared to \$45.9 million or \$(0.52) per basic and diluted share for the nine months ended July 31, 2011 and 2010, respectively. Reconciliation of GAAP to Non-GAAP results are as follows:

| | Nine Months Ended July 31, | |
|---|---------------------------------------|-------------|
| | 2011 | 2010 |
| Net loss to common shareholders (GAAP) | \$ (50,035) | \$ (45,941) |
| Net loss per share to common shareholders (GAAP) | | |
| Basic | \$ (0.41) | \$ (0.52) |
| Diluted | \$ (0.41) | \$ (0.52) |
| Non-GAAP Adjustments | | |
| B1200 Repair and Upgrade Cost | \$ (8,752) | \$ |
| Adjustment for modification of redeemable preferred stock of Subsidiary | \$ (8,987) | \$ |
| Total | \$ (17,739) | \$ |
| Net loss to common shareholders (non-GAAP) | \$ (32,296) | \$ (45,941) |
| Net loss per share to common shareholders (non-GAAP) | | |
| Basic | \$ (0.26) | \$ (0.52) |
| Diluted | \$ (0.26) | \$ (0.52) |

LIQUIDITY AND CAPITAL RESOURCES

Our future liquidity will be dependent on obtaining the order volumes and cost reductions necessary to achieve profitable operations. We estimate that we can achieve Company profitability at an annual production rate of 80 MW to 90 MW based on sales mix. Actual results will depend on product mix, volume, future service costs, and market pricing.

We have been engaged in a formal commercial cost-out program since 2003 to reduce the total life cycle costs of our power plants and have made significant progress primarily through value engineering our products, manufacturing process improvements, higher production levels, technology improvements and global sourcing. During fiscal 2009, we began production of our newest megawatt-class power plants. These power plants incorporate fuel cell stacks with outputs of 350 kilowatts (kW) compared to 300 kW previously, along with lower component and raw material costs. As a result, we have experienced significant improvement in our margins and cost ratios as these product sales are gross margin positive on a per unit basis.

During fiscal 2010, our manufacturing run-rate was an annualized 22 MW. In response to the increased level of orders added to backlog, we increased our production run rate to 35 megawatts per year during the fourth quarter of fiscal year 2010 and recently increased this rate to 56 MW annually.

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Our current manufacturing capacity is up to 90 MW, depending on product mix and other factors and we expect to invest approximately \$4 million to \$6 million for upgrades and maintenance of production assets. With increasing order flow, our plan is to expand production capacity to approximately 150 MW within our existing Torrington facility. This expansion will require the addition of equipment (e.g. furnaces, tape casting and other equipment) to increase the capacity of certain manufacturing operations. Due to the economies of scale and equipment required, we believe it is more cost effective to add capacity in large blocks. We estimate that the expansion to 150 MW will require additional capital investments of \$30 to \$40 million, although this expansion may occur in stages depending on the level of market demand.

In addition to increasing annual order volume and reducing product costs, we may also raise capital through debt or equity offerings; however, there can be no assurance that we will be able to obtain additional capital in the future. The timing and size of any financing will depend on multiple factors including market conditions, future order flow and the need to adjust production capacity. If we are unable to raise additional capital, our growth potential may be adversely affected and we may have to modify our plans. We anticipate that our existing capital resources, together with anticipated revenues and cash flows, will be adequate to satisfy our financial requirements and agreements through at least the next twelve months.

Cash Flows

Cash, cash equivalents, and investments in U.S. treasuries totaled \$49.5 million as of July 31, 2011 compared to \$54.6 million as of October 31, 2010. Excluding the net proceeds of \$17.8 million from the registered direct offering of common stock and revolver net borrowings of \$2.6 million, net use of cash, cash equivalents and investments for the first nine months of 2011 was \$25.4 million. This compared to net use of \$29.1 million in the first nine months of 2010, excluding net proceeds of \$32.1 million from the underwritten public offering in July 2010. Cash receipts from progress payments for commercial orders combined with the favorable impact of improved product margins resulted in lower cash, cash equivalents and investments in US treasuries utilization during the first nine months of 2011 compared to the prior year, partially offset by higher return of capital payments on the Company's Series 1 Preferred Share Obligation (Refer to Recent Developments for further information).

Cash and cash equivalents as of July 31, 2011 was \$31.5 million compared to \$20.5 million as of October 31, 2010. The key components of our cash inflows and outflows were as follows:

Operating Activities Cash used in operating activities was \$18.0 million during the first nine months of 2011 compared to \$23.1 million used in operating activities during the first nine months of 2010. The decrease in operating cash use compared to the prior year nine month period is a result of an increase in deferred revenue due to new order milestone payments and a decrease in accounts receivable on customer collections. These were partially offset by increased inventory due to increased production volumes and increased other assets primarily due to restacks under LTSA's (refer to discussion of Critical Accounting Policies and Estimates below).

Investing Activities Cash provided by investing activities was \$14.2 million during the first nine months of 2011 compared to net cash used in investing activities of \$47.8 million during the first nine months of 2010. The increase of \$62.0 million was mainly due to the net maturity of U.S treasuries during the first nine months 2011 of \$16.0 million, compared to a net purchase of U.S. treasuries of \$45.2 million during the first nine months 2010. During the fiscal year the Company has purchased capital equipment totaling \$1.2 million and invested \$0.6 million in Versa PowerSystems, Inc.

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Financing Activities Cash provided by financing activities was \$14.8 million during the first nine months of 2011 compared to net cash provided by financing activities of \$28.8 million in the prior year period. The decrease in financing cash in the first nine months of 2011 compared to the first nine months of 2010 was primarily due to cash received in fiscal 2011 from a registered direct stock offering which raised \$17.8 million, compared to cash received in the nine months ended July 31, 2010 from the sale and issuance of common stock of \$32.1 million. During the nine months ended July 31, 2011, the Company also sold 2,519,000 shares of the Company's common stock on the open market and raised approximately \$4.7 million, net of fees, for use to pay obligations on the Series B and Series 1 preferred stock and other operating expenses. Partially offsetting cash provided by financing activities, the Company incurred higher return of capital payments on the Series 1 Preferred Share Obligation (Refer to Recent Developments for further information) during the nine months ended July 31, 2011, compared to the prior year period.

The Company closed on a \$5.0 million revolving credit facility with JPMorgan Chase Bank, N.A. and the Export-Import Bank of the United States during the first nine months of 2011 and had net borrowings of \$2.6 million during the period. The credit facility is to be used for working capital to finance the manufacture and production and subsequent export sale of the Company's products or services.

Sources and Uses of Cash and Investments

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

Increasing annual order volume

We need to increase annual order volume to achieve profitability. Increased production volumes lower costs by leveraging supplier/purchasing opportunities, creating opportunities for incorporating manufacturing process improvements, and spreading fixed costs over more units. Our overall manufacturing process has a production capacity of up to 90 MW, depending on product mix and other factors. Updates on our key markets are as follows:

South Korea: The Company continues to deepen and broaden its partnership with South Korea based POSCO Power. The \$129 million order for 70 MW of fuel cell kits and other equipment and services announced in May 2011 represents the beginning of demand related to the renewable portfolio standard that takes effect in 2012 and mandates approximately 6,000 MW through 2022. FuelCell Energy will supply 2.8 MW of fuel cell kits monthly beginning in October 2011 through October 2013 under the contract to support POSCO Power's production schedule of fuel cell modules. The size of the 70 MW order combined with the multi-year term has heightened interest in Direct FuelCells from prospective partners and customers in the United States and in Europe since the announcement.

Using fuel cell components supplied by FuelCell Energy, POSCO Power assembled their first fuel cell stack during the third quarter of 2011 in their recently built fuel cell module assembly plant and installed the completed power plant at a customer site. The POSCO Power fuel cell module assembly and balance of plant facilities are designed for 100 MW annual capacity, using fuel cell components purchased from FuelCell Energy. To date, POSCO Power has ordered 140 MW of fuel cell power plants, modules and components from the Company since 2007.

POSCO Power's strategy includes developing fuel cell markets in other Asian countries by exporting fuel cell power plants assembled in South Korea from FuelCell Energy supplied fuel cell components. In order to demonstrate the ultra-clean, efficient and reliable attributes of DFC power plants, POSCO Power recently ordered a sub-megawatt module from FuelCell Energy which will be combined with balance of plant manufactured in South Korea and the complete DFC plant will be installed at a high visibility location in Indonesia. POSCO Power will establish a sales and service location in Indonesia and the fuel cell power plant will be used as a showcase as POSCO Power builds a megawatt-class fuel cell market in Southeast Asia, beginning in Indonesia.

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California: Our products address the need by utilities for ultra-clean baseload distributed generation. The installed base in California continues to grow with the installation of three new DFC plants in the San Diego region totaling 4.5 MW that are expected to begin operations soon. Orders for new projects in California are expected to grow with the introduction of new policy and programs such as the feed-in tariff that supports combined heat and power (CHP) distributed generation, including CHP configured fuel cells. Pacific Gas and Electric, one of the largest utilities in California, purchased two 1.4 MW power plants in June 2010 for installation at two California universities. We recently completed installation of these plants including the first installation of a DFC 1500 inside a building. During the third quarter of 2011, a long term service agreement was executed with PG&E for FuelCell Energy to maintain the plants.

Connecticut: Connecticut adopted a comprehensive clean energy policy in June 2011 to expand energy efficiency and adoption of renewable power, including a long-term renewable energy credit (LREC) program. Beginning in January 2012, Connecticut utilities are required to open LREC procurement contracts for low emission renewable power projects 2 MW or less, which includes fuel cells. The program funding is \$300 million in total over 20 years with \$4 million required to be spent by utilities in 2012, the first year, increasing \$4 million per year to \$20 million by year 5, and then declining in year 16 and thereafter. Utilities can pay up to \$0.20/kWh for up to a 15 year term. The legislation also created a Green Bank with a broader mission than its predecessor, the Connecticut Clean Energy Fund, including purchases of LREC s and financing of renewable energy projects.

Cost reduction efforts

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

engineering improvements;

technology advances;

supply chain management;

production volume; and

manufacturing process improvements.

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A summary of our significant future commitments and contractual obligations as of July 31, 2011 and the related payments by fiscal year are as follows:

| | Total | Payments Due by Period | | | |
|--|------------------|------------------------|-----------------|-----------------|-------------------|
| | | Less than 1 Year | 1 3 Years | 3 5 Years | More than 5 Years |
| Purchase commitments ⁽¹⁾ | \$ 45,898 | \$ 41,272 | \$ 4,626 | \$ | \$ |
| Series 1 Preferred obligation ⁽²⁾ | 23,650 | 8,122 | 2,630 | 2,630 | 10,268 |
| Term loans (principal and interest) | 4,456 | 927 | 396 | 437 | 2,696 |
| Capital and operating lease commitments ⁽³⁾ | 3,294 | 890 | 1,686 | 718 | |
| Revolving Credit Facility ⁽⁴⁾ | 2,600 | 2,600 | | | |
| Series B Preferred dividends payable ⁽⁵⁾ | | | | | |
| Totals | \$ 79,898 | \$ 53,811 | \$ 9,338 | \$ 3,785 | \$ 12,964 |

- (1) Purchase commitments with suppliers for materials, supplies and services incurred in the normal course of business.
- (2) Under the previous Series 1 preferred shares agreement, FCE Ltd. had an accrued and unpaid dividend obligation of approximately Cdn. \$12,500,000 representing the deferral of dividends plus interest from the commencement of the agreement in May 2004 to present. Payment was originally due to Enbridge as of December 31, 2010, but was subsequently extended based on mutual consent. Under the modified terms, this obligation will be settled as (i) equal quarterly returns of capital cash payments to the holders of the Series 1 preferred shares on the last day of each calendar quarter starting on March 31, 2011 and ending on December 31, 2011 and (ii) additional return of capital payments, as consideration for the one-year deferral, calculated at a 9.8 percent rate per annum on the unpaid Cdn. \$12,500,000 obligation. Under the previous Series 1 preferred shares agreement, FCE Ltd. was to make annual dividend payments totaling Cdn. \$1,250,000. The terms of the Series 1 preferred share agreement were also modified to adjust these payments to (i) an annual amount of Cdn\$500,000 for dividends and (ii) an amount of Cdn.\$750,000 as return of capital payments payable in cash. These payments commenced on March 31, 2011 and end on December 31, 2020. Additional dividends accrue on cumulative unpaid dividends at a 1.25 percent quarterly rate, compounded quarterly, until payment thereof. On December 31, 2020 the amount of all accrued and unpaid dividends on the Class A Preferred Shares and the balance of the principal redemption price shall be paid to the holders of the Series 1 preferred shares. The Company has the option of making dividend payments in the form of common stock or cash under terms outlined in the preferred share agreement. For purposes of the above table, only the final balance of the unpaid dividends on December 31, 2020 is assumed to be paid in the form of common stock.
- (3) Future minimum lease payments on capital and operating leases.
- (4) In January 2011, the Company entered into a \$5.0 million revolving credit facility with JPMorgan Chase Bank, N.A. and the Export-Import Bank of the United States. The credit facility is to be used for working capital to finance the manufacture and production and subsequent export sale of the Company's products or services. The agreement has a one year term with renewal provisions. The outstanding principal balance of the facility will bear

interest, at the option of the Company of either the one-month LIBOR plus 1.5 percent or the prime rate of JP Morgan Chase. The facility is secured by certain working capital assets and general intangibles, up to the amount of the outstanding facility balance. At July 31, 2011, the outstanding amount owed under this facility was \$2.6 million.

- (5) We are currently paying \$3.2 million in annual dividends on our Series B Preferred Stock. The \$3.2 million annual dividend payment has not been included in this table as we cannot reasonably determine the period when or if we will be able to convert the Series B Preferred Stock into shares of our common stock. We may, at our option, convert these shares into that number of shares of our common stock that are issuable at the then prevailing conversion rate if the closing price of our common stock exceeds 150 percent of the then prevailing conversion price (\$11.75) for 20 trading days during any consecutive 30 trading day period.

In April 2008, we entered into a 10-year loan agreement with the Connecticut Development Authority allowing for a maximum amount borrowed of \$4.0 million. At July 31, 2011, we had an outstanding balance of \$3.7 million on this loan. The interest rate is 5 percent and the loan is collateralized by the assets procured under this loan as well as \$4.0 million of additional machinery and equipment. Repayment terms require (i) interest only payments on outstanding balances through November 2009 and (ii) interest and principal payments commencing in December 2009 through May 2018.

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Bridgeport FuelCell Park, LLC (BFCP), one of our wholly-owned subsidiaries, has an outstanding loan with the Connecticut Clean Energy Fund, secured by assets of BFCP. Interest accrues monthly at an annual rate of 8.75 percent and repayment of principal and accrued interest is not required until the occurrence of certain events. As of July 31, 2011, no repayments of principal and interest have been made and we cannot reasonably determine when such repayments will begin. The outstanding balance on this loan, including accrued interest, is \$0.8 million as of July 31, 2011.

We have pledged approximately \$9.7 million of our cash and cash equivalents as collateral and standby letters of credit for certain banking requirements and contracts. As of July 31, 2011, outstanding standby letters of credit totaled \$8.7 million. These expire on various dates through May 2012.

As of October 31, 2010, we identified uncertain tax positions aggregating \$15.7 million and reduced our net operating loss carryforwards by this amount. Because of the level of net operating losses and valuation allowances, unrecognized tax benefits, even if not resolved in our favor, would not result in any cash payment or obligation and therefore have not been included in the contractual obligation table above.

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

Power purchase agreements

In California, we have 2.5 MW of power plant installations under power purchase agreements ranging in duration from five to ten years. As owner of the power plants, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel to run the power plants.

We qualified for incentive funding for these projects under California's SGIP and from other government programs. Funds are payable upon commercial installation and demonstration of the plant and may require return of the funds for failure of certain performance requirements during the period specified by the government program. Revenue related to these incentive funds is recognized ratably over the performance period. As of July 31, 2011, we had deferred incentive funding revenue totaling \$0.2 million.

Service and warranty agreements

We warranty our products for a specific period of time against manufacturing or performance defects. Our standard warranty period is generally 15 months after shipment or 12 months after acceptance of the product. We have agreed to warranty kits and components for 21 months from the date of shipment due to the additional shipping and customer manufacture time required. In addition to the standard product warranty, we have contracted with certain customers to provide services to ensure the power plants meet minimum operating levels for terms ranging from one to 20 years. Our standard LTSA term is five years. Pricing for service contracts is based upon estimates of future costs, which could be materially different from actual expenses. Also see Critical Accounting Policies and Estimates for additional details.

Research and development cost-share contracts

We have contracted with various government agencies to conduct research and development as either a prime contractor or sub-contractor under multi-year, cost-reimbursement and/or cost-share type contracts or cooperative agreements. Cost-share terms require that participating contractors share the total cost of the project based on an agreed upon ratio. In many cases, we are reimbursed only a portion of the costs incurred or to be incurred on the contract. While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress authorizes the funds. As of July 31, 2011, research and development sales backlog totaled \$13.6 million, of which \$2.1 million is funded. Should funding be delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Our critical accounting policies are those that are both most important to our financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Our accounting policies are set-forth below.

Revenue Recognition

We earn revenue from (i) the sale and installation of fuel cell power plants and modules (ii) the sale of component part kits and spare parts to customers, (iii) site engineering and construction services (iv) providing services under long-term service agreements (LTSA), (v) the sale of electricity under power purchase agreements (PPA) as well as incentive revenue from the sale of electricity under PPA s, and (vi) customer-sponsored research and development projects. The Company often enters into arrangements with customers that involve multiple elements of the above items. We assess such contracts to ensure that consideration under the arrangement is being appropriately allocated to each of the deliverables. Our revenue is primarily generated from customers located throughout the U.S. and Asia and from agencies of the U.S. government. Revenue from customer-sponsored research and development projects is recorded as research and development contracts revenue and all other revenues are recorded as product sales and revenues in the consolidated statements of operations.

Revenue from sales of our power plants and modules are recognized under the percentage of completion method of accounting. Revenues are recognized proportionally as costs are incurred and assigned to a customer contract by comparing total expected costs for each contract to the total contract value. We have recorded an estimated contract loss reserve of \$0.1 million and \$0.6 million as of July 31, 2011 and October 31, 2010, respectively. Actual results could vary from initial estimates and reserve estimates will be updated as conditions change.

Revenue from component part kits and spare parts sales is recognized upon shipment or title transfer under the terms of the customer contract. Terms for certain contracts provide for a transfer of title and risk of loss to our customers at our factory locations upon completion of our contractual requirement to produce and products prepare the products for shipment. A shipment in place may occur in the event that the customer is unready to take delivery of the products on the contractually specified delivery dates.

Site engineering and construction services revenue is recognized on a percentage of completion basis as costs are incurred.

Revenue from LTSA contracts for power plants with our 5-year stack design is earned ratably over the term of the contract by performing routine monitoring and maintenance and by meeting a certain level of power output. For our legacy LTSA contracts on power plants with our older 3-year stack design, a portion of the contract value related to the stack replacement had been deferred. Upon stack replacement, revenue is recognized ratably over the remaining contract term. Revenue related to routine monitoring and maintenance under legacy contracts is recognized ratably over the full term of the contract.

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Revenue from the sale of electricity is recognized as electricity is provided to the customer. Incentive revenue is recognized ratably over the term of the PPA.

Revenue from research and development contracts is recognized proportionally as costs are incurred and compared to the estimated total research and development costs for each contract. Revenue from government funded research and development programs are generally multi-year, cost-reimbursement and/or cost-shared type contracts or cooperative agreements. We are reimbursed for reasonable and allocable costs up to the reimbursement limits set by the contract or cooperative agreement, and on certain contracts we are reimbursed only a portion of the costs incurred. While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress has authorized the funds.

Inventories and Advance Payments to Vendors

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

As of July 31, 2011 and October 31, 2010, the legacy LCM reserve to the cost basis of inventory and advance payments to vendors was \$1.9 million and \$5.0 million, respectively, which equates to a reduction of 4 percent and 12 percent, respectively, of the gross inventory and advance payments to vendors value. As of July 31, 2011 the legacy LCM reserve is primarily applied against inventory that is expected to be used to satisfy terms of long-term service agreements.

Prior to November 1, 2009, we provided for a lower of cost or market (LCM) reserve to the cost basis of inventory at the time of purchase as our products were historically sold below cost. In the first quarter of fiscal 2010, we changed our method of estimation and currently reserve for losses on new contracts if estimated costs are expected to exceed revenue on the contract. As a result, we no longer provide for an LCM reserve on new inventory purchased. During the second half of 2009, we began production of our newest megawatt-class power plants and modules. The manufactured cost per kilowatt of these products is lower than previous models due to a 17 percent power increase and lower component and raw materials cost and are expected to continue to be gross margin positive on a unit by unit basis.

Warranty and Service Expense Recognition

We warranty our products for a specific period of time against manufacturing or performance defects. Our warranty is limited to a term generally 15 months after shipment or 12 months after installation of our products. We have agreed to warranty fuel cell kits and components for 21 months from the date of shipment due to the additional shipping and customer manufacture time required. We reserve for estimated future warranty costs based on historical experience. We also provide for a specific reserve if there is a known issue requiring repair during the warranty period. Given our limited operating experience, particularly for newer product designs, actual results could vary from initial estimates. Estimates used to record warranty reserves are updated as we gain further operating experience. As of July 31, 2011 and October 31, 2010, the warranty reserve, which is classified in accrued liabilities on the consolidated balance sheet, totaled \$0.6 million and \$0.7 million, respectively.

In addition to the standard product warranty, we have entered into LTSA contracts with certain customers to provide monitoring, maintenance and repair services for fuel cell power plants ranging from one to 20 years. Our standard service agreement term is five years. Under the terms of our LTSA, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may be subject to performance penalties or may be required to repair or replace the customer's fuel cell stack. The Company has provided for a reserve for performance guarantees which based on historical fleet performance totaled \$1.4 million and \$1.2 million as of July 31, 2011 and October 31, 2010, respectively.

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The Company provides for reserves on all LTSA agreements when the estimated future stack replacement and service costs are estimated to exceed the remaining contract value. This includes power plants with our legacy 3-year stack design. We expect the replacement of these older 3-year stack designs to continue into mid 2012. Reserve estimates for future costs on LTSA agreements are determined by a number of factors including the estimated life of the stack, used replacement stacks available, our limit of liability on service agreements and future operating plans for the power plant. Our reserve estimates include cost assumptions based on what we anticipate the service requirements will be to fulfill obligations on a contract by contract basis, which in many cases is in excess of our contractual limit of liability under LTSAs which is limited to the amount of remaining service fees payable under the contract. As of July 31, 2011, our reserve on LTSA contracts totaled \$7.0 million compared to \$6.6 million as of October 31, 2010. The increase related to changes in estimates for future expected costs. Prior to February 1, 2010, we provided for a pricing reserve if the agreement was sold below our standard pricing. As a result of our experience with these contracts and production rates of stacks and related costing, effective February 1, 2010, contract losses have been estimated as described above. The result of this change in estimate was not material to the consolidated financial statements.

At the end of our LTSA contracts, customers are expected to either renew the contract or we anticipate that the stack module will be returned to the Company as the plant is no longer being monitored or having routine service performed. In situations where the customer agrees at the time of a restack to return the stack to the Company at the end of the LTSA term, the cost of the stack is recorded as a long-term asset and depreciated over its expected life. If the Company does not obtain rights to title from the customer, the cost of the stack which is not recoverable is expensed. As of July 31, 2011, the total remaining stack value was \$9.9 million compared to \$2.0 million as of October 31, 2010. This balance is expected to increase over time as stack replacements occur. During the first nine months of fiscal 2011, depreciation on this asset category totaled approximately \$1.4 million compared to \$0 in the prior year period.

During the second quarter of fiscal 2011, the Company committed to a repair and upgrade program for a select group of 1.2 megawatt (MW) fuel cell modules produced between 2007 and early 2009. The Company recorded a charge of approximately \$8.8 million during the quarter ended April 30, 2011 recorded as a cost of product sales and revenues on the consolidated statements of operations. Refer to the B1200 repair and upgrade program discussed in Recent Developments above.

Share-Based Compensation

We account for restricted stock awards (RSAs) based on the closing market price of the Company's common stock on the date of grant. We account for stock options awarded to employees and non-employee directors under the fair value method of accounting using the Black-Scholes valuation model to estimate fair value at the grant date. The model requires us to make estimates and assumptions regarding the expected life of the option, the risk-free interest rate, the expected volatility of our common stock price and the expected dividend yield. The fair value of equity awards is amortized to expense over the vesting period, generally four years. Share-based compensation was \$2.0 million and \$2.2 million for the nine months ended July 31, 2011 and 2010, respectively.

Income Taxes

Income taxes are accounted for under the liability method. Deferred tax assets and liabilities are determined based on net operating loss (NOL) carryforwards, research and development credit carryforwards, and differences between financial reporting and income tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates and laws expected to be in effect when the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded against deferred tax assets if it is unlikely that some or all of the deferred tax assets will be realized.

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We apply the guidance regarding how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return (including a decision whether to file or not file a return in a particular jurisdiction). The company's financial statements reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts.

The evaluation of a tax position is a two-step process. The first step is recognition: the company determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is measurement: a tax position that meets the more likely than not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Certain transactions involving the Company's beneficial ownership occurred in fiscal 2010 and prior years, which could have resulted in a stock ownership change for purposes of Section 382 of the Internal Revenue Code of 1986, as amended. We have completed a detailed Section 382 study in fiscal 2010 to determine if any of our NOL and credit carryovers will be subject to limitation. Based on that study we have determined that there was no ownership change as of the end of our 2010 fiscal year under Section 382. In January 2011, the Company completed a registered direct offering to a single investor for 10.2 million shares of stock (approximately 8 percent of our outstanding common shares). While we have not performed an update to the 382 study, we estimate that, based on results of the prior study, there was no ownership change which would limit our NOL and credit carryovers as of July 31, 2011 under Section 382.

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

In April 2010, the FASB provided guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon the achievement of milestone events. An entity may only recognize consideration that is contingent upon the achievement of a milestone in its entirety in the period the milestone is achieved only if the milestone meets certain criteria. We adopted this guidance effective November 1, 2010 and it did not impact our financial statements.

In December 2009, the FASB issued revised guidance related to the consolidation of variable interest entities (VIE). The revised guidance requires reporting entities to evaluate former qualified special purpose entities for consolidation, changes the approach to determining a VIE's primary beneficiary from a quantitative assessment to a qualitative assessment designed to identify a controlling financial interest, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a VIE. It also clarifies, but does not significantly change, the characteristics that identify a VIE. We adopted this guidance effective November 1, 2010 and it did not impact our financial statements.

In October 2009, the FASB issued guidance updating accounting standards for revenue recognition for multiple-deliverable arrangements. The stated objective of the update was to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services separately rather than as a combined unit. The guidance provides amended methodologies for separating consideration in multiple-deliverable arrangements and expands disclosure requirements. We adopted this guidance for revenue arrangements entered into or materially modified after November 1, 2010 and it did not have an impact on our financial statements or disclosures to date. The Company evaluates all new contracts and expects that there will be contracts in the fourth quarter of fiscal 2011 that will likely be impacted under the new multi-element revenue guidance.

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In June 2009, the FASB issued accounting guidance which requires a company to perform ongoing reassessment of whether it is the primary beneficiary of a variable interest entity (VIE). Specifically, the guidance modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The guidance clarifies that the determination of whether a company is required to consolidate a VIE is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the VIE that most significantly impact the VIE's economic performance. The guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a VIE and enhanced disclosures of the company's involvement in VIEs and any significant changes in risk exposure due to that involvement. We adopted this guidance effective November 1, 2010 and it did not have an impact on our financial statements.

Recent Accounting Guidance Not Yet Effective

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

Table of Contents**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Interest Rate Exposure**

We typically invest in U.S. treasury securities with maturities ranging from less than three months to one year or more. We expect to hold these investments until maturity and accordingly, these investments are carried at cost and not subject to mark-to-market accounting. At July 31, 2011, U.S. treasury investments had a carrying value of \$18.0 million, which approximated fair value. These investments have maturity dates ranging from August 2011 to March 2012 and a weighted average yield to maturity of 1.2%. Cash is invested overnight with high credit quality financial institutions and therefore we are not exposed to market risk from changing interest rates. Based on our overall interest rate exposure at July 31, 2011, including all interest rate sensitive instruments, a change in interest rates of one percent would not have a material impact on our results of operations.

Foreign Currency Exchange Risk

As of July 31, 2011, less than one percent of our total cash, cash equivalents and investments were in currencies other than U.S. dollars (primarily Canadian dollars and South Korean Won). We make purchases from certain vendors in currencies other than U.S. dollars. Although we have not experienced significant foreign exchange rate losses to date, we may in the future, especially to the extent that we do not engage in currency hedging activities. The economic impact of currency exchange rate movements on our operating results is complex because such changes are often linked to variability in real growth, inflation, interest rates, governmental actions and other factors. These changes, if material, may cause us to adjust our financing and operating strategies.

Derivative Fair Value Exposure*Series 1 Preferred Stock*

The conversion feature and the variable dividend obligation of our Series 1 Preferred shares are embedded derivatives that require bifurcation from the host contract. The aggregate fair value of these derivatives included within long-term debt and other liabilities as of July 31, 2011 was \$0.6 million. The fair value was based on valuation models using various assumptions including historical stock price volatility, risk-free interest rate and a credit spread based on the yield indexes of technology high yield bonds, foreign exchange volatility as the Series 1 Preferred security is denominated in Canadian dollars, and the closing price of our common stock. Changes in any of these assumptions would change the underlying fair value with a corresponding charge or credit to earnings. However, any changes to these assumptions would not have a material impact on our results of operations.

Warrants

We hold warrants for the right to purchase an additional 4,830 shares of Versa's common stock. The fair value of the warrants at July 31, 2011 was \$0.3 million. The fair value was determined based on the Black-Scholes valuation model using historical stock price, volatility (based on a peer group since Versa's common stock is not publicly traded) and risk-free interest rate assumptions. Changes in any of these assumptions would change the fair value of the warrants with a corresponding charge or credit to earnings. However, any changes to these assumptions would not have a material impact on our results of operations.

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Item 4. CONTROLS AND PROCEDURES

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

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

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

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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

Item 1A. RISK FACTORS

There have been no material changes with respect to the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended October 31, 2010.

Item 6. EXHIBITS

Exhibit

| No. | Description |
|------------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Management Contract or Compensatory Plan or Arrangement

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on September 09, 2011.

FUELCELL ENERGY, INC.
(Registrant)

September 9, 2011

/s/ Michael Bishop

Date

Michael Bishop
Senior Vice President, Chief Financial
Officer,
Treasurer and Corporate Secretary
(Principal Financial Officer and Principal
Accounting Officer)

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INDEX OF EXHIBITS

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