PROTON ENERGY SYSTEMS INC
Form 10-Q
May 06, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2003

OR

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

For the transition period from to

Commission File Number: 000-31533

PROTON ENERGY SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**06-1461988**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

10 Technology Drive, Wallingford, CT 06492

(Address of registrant s principal executive office)

(203) 678-2000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the Registration is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

The number of shares outstanding of the registrant s common stock, par value $.01 per share, as of May 2, 2003 was 33,477,318.

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Part I FINANCIAL INFORMATION

ITEM 1.

FINANCIAL STATEMENTS

PROTON ENERGY SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2003	December 31, 2002
ASSETS	**(unaudited)**	
Current assets:		
Cash and cash equivalents	$ 23,654,385	$ 16,415,337
Marketable securities (Note 4)	122,476,909	133,944,034
Accounts receivable	600,321	874,579
Inventories and deferred costs (Note 5)	5,981,248	5,698,377
Other current assets	1,210,493	2,164,128
Total current assets	153,923,356	159,096,455
Fixed assets, net	16,673,672	16,553,182
Other assets, net	637,433	655,767
Total assets	$ 171,234,461	$ 176,305,404
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 339,150	$ 335,400
Accounts payable	511,827	674,069
Accrued expenses	1,069,559	858,379

Accrued construction costs		473,669
Accrued compensation	749,967	386,210
Accrued service costs (Note 8)	1,742,660	2,093,046
Deferred revenue	3,012,900	2,704,015
Customer advances	51,334	53,078
Total current liabilities	7,477,397	7,577,866
Long term liabilities:		
Long-term debt	6,353,032	6,440,632
Total liabilities	13,830,429	14,018,498
Commitments and contingencies (Note 8)		
Stockholders equity:		
Preferred stock, undesignated, $.01 par value per share; 5,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 100,000,000 shares authorized; 33,472,306 and 33,451,084 shares issued and outstanding, respectively	334,723	334,511
Additional paid-in capital	241,995,596	242,025,701
Unearned compensation	(477,374)	(660,166)
Accumulated other comprehensive income	665,994	1,052,009
Accumulated deficit	(85,114,907)	(80,465,149)
Total stockholders equity	157,404,032	162,286,906
Total liabilities and stockholders equity	$ 171,234,461	$ 176,305,404

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

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PROTON ENERGY SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,	
	2003	**2002**
	(unaudited)	**(unaudited)**
Contract revenue	$ 43,403	$ 721,357
Product revenue	129,333	216,576
Total revenues	172,736	937,933

Costs and expenses:		
Costs of contract revenue	162,680	456,572
Costs of production	781,459	567,555
Research and development	1,968,883	2,216,965
General and administrative	2,719,091	1,705,758
Total costs and expenses	5,632,113	4,946,850
Loss from operations	(5,459,377)	(4,008,917)
Loss on disposal of assets	(24,863)	
Interest income, net	834,482	1,721,684
Gain on sale of marketable securities		23,759
Net loss attributable to common stockholders	$ (4,649,758)	$ (2,263,474)
Basic and diluted net loss per share attributable to common stockholders	$ (0.14)	$ (0.07)
Shares used in computing basic and diluted net loss per share attributable to common stockholders	33,457,139	33,243,842

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

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PROTON ENERGY SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2003	**2002**
	(unaudited)	**(unaudited)**
Cash flows from operating activities:		
Net loss	$ (4,649,758)	$ (2,263,474)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	350,489	178,721
Amortization of premiums on securities	198,360	328,605
Non-cash stock-based expense	131,012	169,625
Loss on disposal of assets	24,863	
Gain from sale of marketable securities		(23,759)
Changes in operating assets and liabilities:		

Accounts receivable	274,258	220,418
Inventories and deferred costs	(282,871)	(780,808)
Other current assets	953,635	(206,904)
Other assets	11,577	5,472
Accounts payable and accrued expenses	(411,360)	766,566
Deferred revenue and contract advances	307,141	(25,273)
Net cash used in operating activities	(3,092,654)	(1,630,811)
Cash flows from investing activities:		
Purchases of fixed assets	(491,060)	(3,326,758)
Proceeds from the sale of fixed assets	1,975	
Purchases of marketable securities	(105,493,250)	(15,091,990)
Proceeds from maturities and sales of marketable securities	116,376,000	20,040,881
Proceeds from repayment of related party note		29,755
Net cash provided by investing activities	10,393,665	1,651,888
Cash flows from financing activities:		
Borrowings from long term debt		1,653,182
Payments of long term debt	(83,850)	
Proceeds from sale of common stock	17,278	14,720
Proceeds from exercise of stock options	4,609	14,368
Net cash (used in) provided by financing activities	(61,963)	1,682,270
Net increase in cash	7,239,048	1,703,347
Cash and cash equivalents at beginning of period	16,415,337	1,836,899
Cash and cash equivalents at end of period	$ 23,654,385	$ 3,540,246
Cash paid during the period for interest	$ 64,098	11,663

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

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PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS

Proton Energy Systems, Inc. (the Company) was incorporated in Delaware on August 16, 1996 to design, develop and manufacture proton exchange membrane (PEM) electrochemical products. The Company employs PEM electrochemical products in hydrogen generation and power generating and storage devices for use in a variety of commercial applications. The Company manufactures products for the domestic and international industrial gas market and operates in a single segment.

2. BASIS OF PRESENTATION

In 2001, the Company established Technology Drive LLC, a Connecticut limited liability company solely owned by the Company. Technology Drive LLC holds title to the building and approximately 44 acres of land in Wallingford, Connecticut, where the Company has completed the construction of its new headquarters, research and development and production facility. The condensed consolidated financial statements include the accounts of the Company and Technology Drive LLC, after elimination of intercompany transactions.

The condensed consolidated financial statements as of March 31, 2003 and for the three-month periods ended March 31, 2003 and 2002 is unaudited. In the opinion of management, all adjustments, which consist solely of normal recurring adjustments, necessary to present fairly in accordance with accounting principles generally accepted in the United States of America, the financial position, results of operations and cash flows for all periods presented, have been made. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for the full year.

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. These condensed consolidated financial statements should be read in conjunction with the Company s audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K filed on March 25, 2003.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net loss and other gains and losses affecting stockholders equity that are not the result of transactions with owners. The following table sets forth the components of comprehensive income (loss):

	March 31, 2003	March 31, 2002
	(unaudited)	(unaudited)
Net loss	$ (4,649,758)	$ (2,263,474)
Unrealized losses on marketable securities	(386,015)	(1,101,602)
Total comprehensive loss	$ (5,035,773)	$ (3,365,076)

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PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-Based Compensation

Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, prescribes accounting and reporting standards for all stock-based compensation plans, including employee stock option plans. As allowed by SFAS No. 123, the Company has elected to continue to account for stock based compensation issued to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Under APB 25, compensation expense is computed to the extent that the fair market value of the underlying stock on the date of grant exceeds the exercise price of the employee stock option or stock award. Compensation so computed is then recognized over the vesting period.

The following table illustrates the effect on net loss and loss per share had compensation costs for the stock-based compensation plan been determined based on grant date fair values of awards under the provisions of SFAS No. 123, for the three months ended March 31 (in thousands, except per share data):

	2003	2002
Net loss attributable to common stockholders:		
As reported	$ (4,649,758)	$ (2,263,474)
Add: Stock based employee compensation included in net income	131,012	169,625
Less: Total stock-based employee compensation expense determined under fair value-based method for all awards	(1,401,705)	(1,487,216)
Pro forma	$ (5,920,451)	$ (3,581,065)
Net loss per share applicable to common stockholders, basic and diluted		
As reported	$ (.14)	$ (.07)
Pro forma	$ (.18)	$ (.11)

Reclassifications

Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 presentation.

3. RECENT ACCOUNTING GUIDANCE

In September 2002, SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities was issued. This statement provides guidance on the recognition and measurement of liabilities associated with exit or disposal activities and requires that such liabilities be recognized when incurred. This statement is effective for exit or disposal activities initiated on or after January 1, 2003. Adoption of this standard is not expected to impact the timing of recognition of costs associated with future exit and disposal activities.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34. FIN 45 clarifies the requirements of FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), relating to the guarantor s accounting for, and disclosure of, the issuance of certain types of guarantees. The disclosure requirements of FIN 45, which are effective for the year ended December 31, 2002, are included in Note 2 to the consolidated financial statements in the Company s Annual Report on Form 10-K filed on March 25, 2003.

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PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FAS 123 (SFAS 148). SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation, in addition to certain new disclosure requirements. The disclosure provisions of SFAS 148 are included in the accompanying Notes to the Condensed Consolidated Financial Statements.

4. MARKETABLE SECURITIES

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. As of March 31, 2003, the Company s investment portfolio consisted of U.S. government and agency securities held by two major banking institutions. The maturities of marketable securities are as follows:

	March 31, 2003	December 31, 2002
Less than one year	$ 82,938,652	$ 113,546,928
One to five years	39,538,257	20,397,106
	$ 122,476,909	$ 133,944,034

Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders equity. The unrealized gain from marketable securities was $665,994 and $1,052,009 at March 31, 2003 and December 31, 2002, respectively. At March 31, 2003, the Company had seven callable agency securities with a fair market value totaling approximately $44.0 million. Additionally, four investments approximating $31.3 million were called at par in 2003. These securities generate a higher relative rate of interest for the Company, in return for the issuer s right to call, at par value, the security before its maturity date.

5. INVENTORIES AND DEFERRED COSTS

Inventories are stated at the lower of cost or market value. Cost is determined by the first-in, first-out method.

	March 31, 2003	December 31, 2002
Raw materials	$ 1,741,093	$ 1,542,813
Work in process	2,018,722	2,253,458
Finished goods	2,221,433	1,902,106
	$ 5,981,248	$ 5,698,377

Deferred costs of $2,006,388 and $1,613,546 are included in finished goods as of March 31, 2003 and December 31, 2002, respectively. These deferred costs represent costs of production on units shipped to customers for which the related product revenue is deferred until the expiration of the product warranty period. In addition, costs incurred under our contract with STM of $957,941are included in work in process as of March 31, 2003 and December 31, 2002.

6. LOSS PER SHARE

Net loss per share has been computed by dividing the net loss attributable to common stockholders by the weighted average common shares outstanding. No effect has been given to the exercise of common stock options and stock warrants since the effect would be antidilutive for all reporting periods.

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PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. STOCK OPTION GRANTS

During 1999 and 2000, the Company issued common stock options at less than the fair value of its common stock. The compensation expense for such options is amortized over the vesting periods of the related options. Accordingly, the Company recorded stock-based compensation expense of $107,829 and $175,412 for the three-month periods ended March 31, 2003 and March 31, 2002, respectively.

8. COMMITMENTS AND CONTINGENCIES

In November 1999, the Company entered into an agreement with Matheson Tri-Gas, Inc. (Matheson) to develop, market and distribute hydrogen generators to be used solely in laboratory applications. This agreement granted the distributor worldwide exclusivity to the commercial sale of this product during the fifteen-year term of the contract as long as the distributor met minimum purchases, as defined in the agreement. In January 2003, the exclusive distribution agreement with Matheson Tri-Gas, Inc., was jointly terminated. Under the terms of the settlement agreement, the Company agreed to continue to support units under warranty, provide spare parts for five years, sell an additional 55 laboratory hydrogen generators, and agreed not to sell or market our own laboratory hydrogen generators under Proton s or any other brand name before June 30, 2003.

In 2001, the Company entered into a 10-year agreement with STM Power, Inc. (STM) for the exclusive supply of high-pressure hydrogen replenishment systems for Stirling Cycle Engines. Under an initial purchase order relating to this agreement, STM has agreed to provide $395,000 for the product development and delivery of prototype hydrogen replenishment systems. In 2002, the Company received purchase orders totaling approximately $563,000 for additional product development and delivery of 57 high-pressure hydrogen generators.

The Company accounts for the STM contract in accordance with SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts , and accordingly has recorded costs of $958,000 under the contract in inventory. Additionally, at March 31, 2003, the Company has recorded $958,000 as deferred revenue representing amounts billed under the contract with STM. At March 31, 2003, accounts receivable due from STM is $0. In 2002, the Company has accrued $125,000 to cover the cost of potential warranty claims associated with the 57 units delivered.

Also in 2001, the Company entered into an agreement with the Connecticut Clean Energy Fund (CCEF). The agreement provides the Company with financial assistance for up to $1.5 million to accelerate commercial deployment of the UNIGEN product. The Company is required to repay CCEF 110% of the amounts advanced by them under the agreement beginning at such time as revenues from UNIGEN products reach $25 million annually. However, prior to the achievement of milestones described in this agreement, these funds are subject to repayment provisions based upon the occurrence of certain events. These events include a failure to maintain a Connecticut presence, the purchase of a controlling interest in the Company by a third party, the sale of substantially all of the Company s assets, the consolidation or merger of the company with a third party, or the granting of the exclusive license to a third party to manufacture or use the UNIGEN product line. Because of these repayment provisions, the Company records funds received as liabilities until it achieves the contract milestones. At December 31, 2001, $200,000 had been received and was recorded in customer advances. During the first half of 2002 an additional $400,000 had been received. During 2002, the Company achieved the contract milestones and recognized the related $600,000 as an offset against costs and expenses.

In October 2002, the Company learned of problems with sensor modules in its HOGEN 40 series units at customer locations that might have been affected by moisture blockage, thereby impairing the sensor s ability to

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PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

detect the presence of hydrogen in the oxygen gas stream. Further investigation of these units revealed the presence of pinholes in the cell membranes, resulting in hydrogen leakage and cell failure. To address these problems, the Company has contacted all of its HOGEN 40 series customers to arrange appropriate sensor testing and modifications. Additionally, the Company intends to replace defective cell stacks that are experiencing leakage. The Company is taking the approach that all HOGEN 40 series sensor and cell stack components in the field may need to be replaced. The Company is also working to develop and implement design improvements to extend cell lifetime. For the year ended December 31, 2002 the Company recorded $2,462,000 for these anticipated future service costs. As of March 31, 2003 $1,743,000 remains accrued for potential future service costs. The liability for such service costs reflects management s estimate, as of the date of this report, of the remaining cost of the program. The actual amount of such costs could be less than this accrual but they could also materially exceed the amount accrued.

9. RELATED PARTIES

In 2001, the Company loaned $275,000 to Walter W. Schroeder, the President, Chief Executive Officer, and a director of the Company. The loan had a two-year term and was payable in monthly 7 installments of $10,000 each with a final payment due at maturity. The loan, which accrued interest at the prime rate, contained no penalty for early repayment. In July 2002, the loan was paid in full.

In 2001, the Company entered into a contract with STM to develop and deliver hydrogen generators (see Note 8). Richard A. Aube, a member of the Company s Board of Directors, is also a member of STM s Board of Directors.

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ITEM 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto appearing elsewhere in this Form 10-Q and with our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2002. This Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar word statements that contain these words carefully because they discuss our future expectations and contain projections of our future results of operation or of our financial position or state other forward-looking information. However, there may be events in the future that we are unable to predict accurately or control. The factors in the section captioned Critical Accounting Policies contained in our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2002, and below in this Form 10-Q under the Legal Proceedings and Certain Factors That May Affect Future Results captions, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

Overview

We were founded in 1996 to design, develop and manufacture PEM electrochemical products for commercial applications. Our proprietary PEM technology is incorporated in two families of products: hydrogen generators, of which we are currently manufacturing and delivering commercial models to customers, and regenerative fuel cell systems, which we are currently developing. Since our inception, we have funded our operations through private financings that raised approximately $61.6 million, including $50.1 million raised in a private financing in April 2000, and an initial public offering in October 2000 that raised net proceeds of approximately $125.8 million.

We have generated cumulative losses since our inception, and as of March 31, 2003 our accumulated deficit was $85.1 million, of which $50.7 million is attributable to deemed preferred dividends and accretion and $34.4 million is attributable to net losses since inception. We expect to continue to make significant investments in new product design and development for the foreseeable future. We believe that our success is dependent on increasing our customer base, developing products that leverage our proprietary technology, and maintaining a proper alignment between our cost structure and our revenue goals. We expect to incur operating losses in 2003 and for the next several years and cannot predict when we will become profitable, if ever.

Recent Developments

The following significant events occurred in 2003:

We installed a HOGEN 380 hydrogen generator for a hydrogen fuel cell bus program in Barth, Germany.

We reached agreement to end our Development, Marketing and Distribution Agreement for small laboratory hydrogen generators with Matheson Tri-Gas.

Featured at White House-sponsored event to promote President Bush s $1.2 billion Freedom Car and Fuel initiative.

We successfully tested our HIPRESS^{TM} high-pressure cell stack modules, thereby achieving a key milestone in our Naval Research Laboratory contract funded by the Defense Advance Research Projects Agency.

We received a contract to develop a 1 kW regenerative solar/Proton Exchange Membrane fuel cell demonstration system from Jacobs Sverdrup Technology, Inc, a subcontractor to the U.S. Navy, for testing at the Naval Air Weapons Station at China Lake, California.

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We strengthened our intellectual property position by bringing our total U.S. and foreign patent filings to 114. We now hold 11 issued U.S. patents and two issued European patents.

In April 2003, we resumed production and shipment of our HOGEN 40 hydrogen generators and are accepting new orders for units to be delivered in the third quarter of 2003.

We continue to replace cell stacks in customer units under a previously announced program. We anticipate that all customer cell stacks will be replaced by the third quarter 2003.

Critical Accounting Judgments and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared by us in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, investments, income taxes, depreciable lives of equipment, warranty obligations and contingency accruals. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. For a complete description of our accounting policies, see Note 2 to our consolidated financial statements included in the Company s Annual Report on Form 10-K filed on March 25, 2003.

Results of Operations

Comparison of the Three Months Ended March 31, 2003 and March 31, 2002

Contract revenue. Contract revenue decreased from $721,000 for the three months ended March 31, 2002 to $43,000 for the comparable period in 2003. The decrease was due to research and development activity under the Naval Research Laboratory (NRL) contract, which was substantially completed in December 2002. In the future, we expect to generate revenue from government sponsored research and development contracts to supplement our research and development efforts.

Product revenue. Product revenue decreased from $217,000 for the first quarter of 2002 to $129,000 for the first quarter of 2003. Product revenue for the three months ended March 31, 2003 is predominantly comprised of laboratory generator product revenue.

In the fourth quarter of 2002, we discovered performance issues relating to the operation of cell stacks and associated sensors in its HOGEN 40 series units. Our investigation revealed the presence of previously unknown pinholes in cell membranes in the field that resulted in hydrogen leakage and cell failure. As a result, we determined that recognizing revenue on shipment of our HOGEN 40 series units was no longer appropriate because of significant uncertainty surrounding the reliability of the existing design of the PEM electrolyzer (cell stack) within our HOGEN 40 series generators. We are making modifications to the existing cell stack design to improve its performance and anticipates deferring product revenue until we have compiled sufficient warranty history on units containing modified cell stacks. For this reason, product revenue from HOGEN 40 series shipments made subsequent to September 30, 2002 is deferred until the expiration of the product warranty period.

Costs of contract revenue. Costs of contract revenue decreased from $457,000 for the first quarter of 2002 to $163,000 for the first quarter of 2003. The decrease in 2003 was due primarily to research and development activity under the Naval Research Laboratory (NRL) contract, which was substantially completed in December 2002. Additionally, in 2003, we recorded cost overruns under the China Lake contract of approximately $30,000.

Costs of production. Costs of production increased from $568,000 for the first quarter of 2002 to $781,000 for the first quarter of 2003. The amounts in 2002 and 2003 reflect costs associated with manufacturing, refining

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and delivering our hydrogen generators as well as warranty costs on units in the field. Additionally, in 2003, costs of production includes excess labor costs associated with our decision to suspend production of our HOGEN 40 series units. Cost of production could increase if warranty experience deteriorates.

In January 2003, the exclusive distribution agreement with Matheson Tri-Gas, Inc., was jointly terminated by agreement with Matheson Tri-Gas. Under the terms of the settlement agreement we agreed to continue to support units under warranty, provide spare parts for five years, sell an additional 55 laboratory hydrogen generators to Matheson Tri-Gas, and not sell or market laboratory hydrogen generators under our or any other brand name before June 30, 2003. To date, under our agreement with Matheson Tri-Gas, Inc., we have recognized costs in excess of our contracted sales price in the amount of $820,000.

Research and development expenses. Research and development expenses decreased from $2.2 million for the first quarter of 2002 to $2.0 million for the first quarter of 2003. The decrease was due to a decrease in our research and development activities related to our PEM technology in our regenerative fuel cell systems and our hydrogen generators. These research and development activities primarily related to salaries and benefits for our research and development staff and materials to support our research and development projects. We expect our research and development expenses to remain level for the next twelve months.

General and administrative expenses. General and administrative expenses increased from $1.7 million for the first quarter of 2002 to $2.7 million for the first quarter of 2003. This change reflects an increase in salaries and benefits of approximately $300,000 and an increase in professional fees of approximately $450,000.

Interest income, net. Interest income decreased from $1.7 million for the first quarter of 2002 to $834,000 for the first quarter of 2003. The decrease resulted from decreased cash and marketable securities balances as well as lower average interest rates.

Liquidity and Capital Resources

Since our inception in August 1996, we have financed our operations through the series A, A-1, B, B-1 and C convertible preferred stock issuances and our initial public offering that, in total, raised approximately $187.4 million. As of March 31, 2003, we had $146.1 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was $3.1 million for the three months ended March 31, 2003 and was primarily attributable to our net loss, offset by decreases in other current assets. Cash used in operating activities was $1.6 million for the comparable 2002 period and was primarily attributable to our net loss and increases in inventory and deferred costs, offset by increases in accounts payable and accrued expenses.

Cash provided by investing activities was $10.4 million for the three months ended March 31, 2003 and was primarily attributable to maturities of marketable securities offset by purchases of marketable securities and fixed assets. Cash provided by investing activities was $1.7 million for the three months ended March 31, 2002 and was primarily attributable to maturities of marketable securities offset by purchases of marketable securities and fixed assets.

Cash used in financing activities was $62,000 for the three months ended March 31, 2003. Cash provided by financing activities was $1.7 million for the three months ended March 31, 2002 and was primarily attributable to borrowings under our debt agreement.

We anticipate that our cash and marketable securities on hand as of March 31, 2003 will be adequate to fund our operations, working capital and capital expenditure requirements for at least the next 12 months. Over the next 12 months, we expect to continue to fund the production of our hydrogen generators and to continue our research and development activities on our regenerative fuel cell systems. We cannot ensure that we will not require additional financing to fund our operations or that, if required, any further financing will be available to

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us on acceptable terms, or at all. If sufficient funds are not available, we may be required to delay, reduce or eliminate some of our research and development or manufacturing programs. The terms of any additional financing may require us to relinquish rights to our technologies or potential products or other assets.

Certain Factors That May Affect Future Results

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

Our future success is uncertain because we have a limited operating history.

We face many risks and uncertainties. If we are unsuccessful in addressing these risks and uncertainties, we may be unable to generate revenue and grow our company. We were formed in 1996 to research and develop PEM electrochemical products. We began shipping late-stage development models of our hydrogen generators in 1999 and have not yet manufactured commercial regenerative fuel cell systems. Accordingly, there is only a limited basis upon which you can evaluate our business and prospects and our future success is uncertain. You should consider the challenges, expenses, delays and other difficulties typically involved in the establishment of a new business, including the continued development of our products, development of fully functioning manufacturing operations, refinement of processes and components for our commercial products, recruitment of qualified personnel, ability to manufacture a product which meets cost, reliability and efficiency needs, and achievement of market acceptance for our products.

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

We have incurred substantial losses since we were founded and we anticipate we will continue to incur substantial losses in the future. As of March 31, 2003, we had an accumulated deficit of approximately $85.1 million. In 2002, we experienced increased cash burn and increased our headcount. We cannot predict when we will operate profitably, if ever. We expect to continue to incur expenses related to research and development activities, expansion of our manufacturing facilities and general administrative functions. As a result, we anticipate that we will continue to incur losses until we can cost-effectively produce and sell our hydrogen generators. Even if we do achieve profitability, we may be unable to sustain or increase our profitability in the future.

We have experienced performance problems with our hydrogen generators

We have experienced performance problems with certain components of our hydrogen generators, specifically hydrogen sensor modules and cell stacks, which have required component replacement. Further problems related to these or other components may occur and require additional corrective measures. If we are unable to solve these problems, potential purchasers of our products may decline to purchase them. In addition, if our hydrogen generators fail after purchases, our warranty exposure would increase, resulting in higher costs to us.

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

Our success depends upon the continued service of our executive officers and other key employees such as manufacturing and research and development personnel. The loss of any of our executive officers or key employees, especially Walter W. Schroeder, president and chief executive officer, Larry M. Sweet, Chief Operating Officer, Trent M. Molter, senior vice president of technology and new business, Robert J. Friedland, senior vice president of products and manufacturing, and Terry V. Derrico, senior vice president of sales and

marketing, could impair our ability to pursue our growth strategy and slow our product development processes. We do not have employment agreements with any of our key executives. We may not be able to attract, assimilate or retain additional highly qualified personnel in the future.

We may not be able to generate revenue in the future if we do not complete the development of our regenerative fuel cell systems.

Our regenerative fuel cell systems are still in the development stage. We do not know when or whether we will successfully complete research and development of commercial regenerative fuel cell systems. If we are unable to develop commercial regenerative fuel cell systems, we may not be able to generate future revenue and we may not recover the losses we have incurred in attempting to develop these products. If we experience delays in meeting our development milestones or if our regenerative fuel cell systems exhibit technical defects or cannot meet cost or performance goals, including output, useful life and reliability goals, potential purchasers of our products may decline to purchase them or choose alternative technologies. We may be unable to make the substantial technological advances necessary to produce commercial regenerative fuel cell systems that provide the features and performance specifications required by customers at a competitive price. For example, we must identify improved hydrogen storage technologies and fuel cell module structures. If we are unable to successfully complete these development activities, we may be unable to commercially market our products. In some cases, we are attempting to expedite our development efforts by utilizing third parties for important engineering work. These third parties include vendors of hydrogen storage, purification systems, power supply and control components. If these third parties are unable to successfully complete their development activities on our behalf, we may be unable to commercially market our products.

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

We intend to market our hydrogen generators to small- and medium-volume users of delivered hydrogen. Our business depends on the widespread commercial acceptance of our hydrogen generators and we may be unable to grow our business if our targeted customers do not purchase substantial numbers of our hydrogen generators. Our targeted customers, or the distributors whom we intend to use to market to these customers, may not purchase our hydrogen generators at all or in sufficient quantities to support the growth of our business. Our hydrogen generators will require our target customers to make a substantial initial investment, currently ranging from approximately $40,000 to $200,000 per unit for our HOGEN models. Our method of supplying hydrogen by producing it on-site using PEM electrolysis represents a significant departure from conventional means of supplying hydrogen to end users. PEM electrolysis is a new and unproven technology in the markets we are targeting, and we do not know if our targeted customers will accept our product. We are also working to develop and implement design improvements to extend the life of our cell stack components. If we are unable to successfully complete these activities, sales of our hydrogen generators may be reduced.

The success of our hydrogen generators as a fuel source for PEM fuel cells depends upon the development of a mass market for PEM fuel cells, and we may not be able to generate revenue in the future if this market does not develop.

We also intend to market our hydrogen generators for use as fuel generators for PEM fuel cells in a variety of applications, in particular fuel cell vehicles. If a mass market for PEM fuel cells fails to develop or develops more slowly than we anticipate, we may be unable to generate revenue in the future and recover the losses we will have incurred in the development of our hydrogen generators. PEM fuel cells represent an emerging commercial market, and we do not know whether end-users will want to use them. The development of a mass market for PEM fuel cells may be affected by many factors outside of our control, including

the emergence of newer, more competitive technologies;

the cost competitiveness of PEM fuel cells compared to existing and new technologies;

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the future cost of hydrogen;

regulatory requirements;

consumer perceptions of the safety, reliability and functionality of PEM fuel cells; and

consumer willingness to try a new product.

In addition, the sole market for vehicular PEM fuel cells is and will continue to be car, bus and other vehicle manufacturers. Automobile manufacturers interest in vehicular PEM fuel cells has been driven in large part by environmental laws and regulations concerning vehicle emission requirements that have been enacted in California and some northeastern states. If these laws and regulations are not kept in force or do

not become widely adopted, the demand for vehicular PEM fuel cells may be limited. Further, automobile manufacturers may be able to use other technologies to meet their regulatory requirements, such as batteries, low emission internal combustion engines and hybrid internal combustion/battery engines. Even if automobile manufacturers decide to develop vehicles powered by PEM fuel cells, it may be many years before substantial numbers of vehicles powered by PEM fuel cell systems are manufactured. Further, there are several other technologies that may be used to generate hydrogen, such as hydrocarbon reforming, and there remains a strong possibility that our means of generating hydrogen will not be used to supply fuel to fuel cells.

We may be unable to increase our revenue in the future if the use of renewable energy does not increase.

We anticipate that one of the primary uses of our regenerative fuel cell systems will be for storing energy produced by renewable power sources, such as solar, wind and hydroelectric power. If the demand for renewable energy develops more slowly than we anticipate, our ability to sell our regenerative fuel cell systems could be impaired and we may be unable to grow our business. The market for renewable energy is still in an early stage of development and the demand for renewable energy will remain limited until the cost of producing energy from renewable sources is substantially reduced. Power from renewable energy sources currently costs significantly more than power derived from nonrenewable sources, such as coal and oil. The growth of the renewable energy market will be dependent on many factors that are outside of our control, such as the emergence of new, more cost-effective power technologies and products, and domestic and international regulatory requirements.

We expect to incur significant expenses in expanding our manufacturing facilities and production and we may not be successful in these efforts.

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

- the inability to purchase parts or components in adequate quantities or sufficient quality;
- the cost of raw materials;
- the failure to increase our assembly and test operations;
- the failure to hire and train additional manufacturing personnel; and
- the failure to develop and implement manufacturing processes and equipment.

If we fail to successfully manufacture our products in commercial quantities, we may not be able to increase our revenue.

To be financially successful, we will have to manufacture our products in commercial quantities at acceptable costs while also preserving the quality levels achieved in manufacturing these products in limited

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quantities. This presents a number of technological and engineering challenges for us. We may not be successful in developing product designs and manufacturing processes that permit us to manufacture our hydrogen generators and regenerative fuel cell systems in commercial quantities at commercially acceptable costs while preserving quality. Currently, we sell some of our products for less than it costs us to produce them. In addition, we will incur significant start-up costs and may experience unforeseen delays and expenses in our product design and manufacturing efforts. If the commercialization of our products is delayed, potential purchasers may also decline to purchase them or choose alternative technologies, both of which could impair our ability to generate revenue in the future.

If our suppliers do not supply us with a sufficient amount and quality of components at acceptable prices, we may not be able to manufacture our products commercially.

Although we generally attempt to use standard components for our products, the proton exchange membrane material and hydrogen purification system used in our products are currently available only from limited sources. Also, we may be unable to purchase components of adequate quality or that meet our cost requirements. In addition, to the extent these components are proprietary products of our suppliers, or the processes used by our suppliers to manufacture these components are proprietary, we may be unable to obtain comparable components from alternative suppliers. We may experience delays in production of our products and our business and financial results would suffer if we fail to identify alternate suppliers, or if our supply is interrupted or reduced or there is a significant increase in cost.

In addition, platinum is a key component of our PEM fuel cells. Platinum is a scarce natural resource and we are dependent upon a sufficient supply of this commodity. We may not be able to produce commercial products, or the cost of producing our products may significantly increase, if there are any shortages in the supply of platinum.

We may be unable to sell our products and generate revenue if we fail to establish distribution relationships.

Because we intend to sell some of our products through third-party distributors, the financial benefits to us of commercializing our products will be dependent on the efforts of others. We intend to enter into additional distribution agreements or other collaborative relationships to market and sell our products. If we are unable to enter into additional distribution agreements, or if our third-party distributors do not successfully market and sell our products, we may be unable to generate revenue and grow our business. We may seek to establish relationships with third-party distributors who also indirectly compete with us. For example, we have targeted industrial gas suppliers as potential distributors of our hydrogen generators. Because industrial gas suppliers currently sell hydrogen in delivered form, adoption by their customers of our hydrogen generation products could cause them to experience declining demand for delivered hydrogen. For this reason, industrial gas suppliers may be reluctant to become distributors of our hydrogen generators. In addition, our third-party distributors may require us to provide volume price discounts and other allowances, or customize our products, either of which could reduce the potential profitability of these relationships.

We have historically focused on research and development activities and have limited experience in marketing, selling and servicing our products.

We have primarily focused on the research and development of our hydrogen generators and regenerative fuel cell systems. Consequently, our management team has limited experience directing the commercialization efforts that are essential to our future success. To date, we only have limited experience marketing, selling and servicing our hydrogen generators, and no experience marketing, selling or servicing our regenerative

fuel cell systems. Furthermore, there are very few people anywhere who have significant experience marketing, selling or servicing PEM electrochemical products. We will have to expand our marketing and sales organization as well as

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our maintenance and support capability. We may not be successful in our efforts to market and service our products, which would compromise our ability to increase our revenue.

Our plans to market, distribute and service our products internationally subject our business to additional risks, which could prevent us from growing our business.

We intend to market, distribute and service our products internationally and we may derive a significant portion of our revenue from international sales. If we fail to successfully sell our products internationally, our ability to increase our future revenue and grow our business would be impaired. We have limited experience developing, and limited experience manufacturing, our products to comply with the commercial and legal requirements of international markets. Our success in those markets will depend on our ability to secure relationships with foreign resellers and our ability to manufacture products that meet foreign regulatory and commercial requirements. In addition, our planned international operations may be subject to a variety of additional risks, including:

- difficulties in collecting international accounts receivable;
- increased costs associated with maintaining international marketing efforts;
- compliance with U.S. Department of Commerce export controls;
- increases in duty rates;
- the introduction of non-tariff trade barriers;
- fluctuations in currency exchange rates;
- political and economic instability; and
- difficulties in enforcing intellectual property rights.

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

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

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

As the markets for PEM fuel-cell related products, on-site hydrogen generation and backup power develop, other large industrial companies may enter these fields and compete with us. These large industrial companies may have the research and development, manufacturing, marketing and sales resources necessary to commercialize hydrogen generators and regenerative fuel cell systems more quickly and effectively than we do.

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

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to our products, which could reduce demand for our products. Our success depends substantially upon the internally developed technology that is incorporated in our products. We may be unable to prevent unauthorized parties from attempting to copy or otherwise obtain and use our products or technology. Policing unauthorized use of our technology is difficult, and we may not be able to prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our intellectual property as fully as those in the United States. Others may circumvent the trade secrets, trademarks and copyrights that we own and any of the U.S. patents or foreign patents owned by us or subsequently issued to us may be invalidated, circumvented, challenged or rendered unenforceable. In addition, we may not be issued any patents as a result of our pending and future patent applications, and any patents we are issued may not have the breadth of claim coverage sought by us.

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

We could incur substantial costs defending our intellectual property from infringement by others.

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

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

The patent situation in the field of PEM fuel cell technology is complex. A large number of patents, including overlapping patents, relating to this technology have been granted worldwide. We are aware of patents in the fuel cell architecture field held by potential competitors and other third parties, including Ballard Power Systems, General Motors, Giner, H-Power, Oronzio deNora Impianti Electrochemical, Packard Instrument, Plug Power, Shinko Pantec, Siemens, Toyota, United Technologies and Whatman. Third parties could claim infringement by us with respect to these patents or other patents or proprietary rights, and we cannot assure you that we would prevail in any such proceeding.

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

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

be time-consuming;

result in costly litigation or arbitration and diversion of technical and management personnel; or

require us to develop non-infringing technology or to enter into royalty or licensing agreements.

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

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

Any liability for damages resulting from malfunctions of our products could be substantial and could increase our expenses and prevent us from growing our business. In particular, hydrogen is a flammable gas and can pose safety risks if not handled properly. We have an instance with one of our products where hydrogen appears to have leaked into the ambient oxygen stream resulting in a flame that burned several components in the system. Further investigation of this unit revealed the presence of pinholes in the cell membranes, resulting in hydrogen leakage and cell failure. Although we have taken steps to improve safety and reliability in our products, we cannot be certain that future similar instances will not occur. In addition, our products may require modifications to operate properly under extreme temperatures. Potential customers will also rely upon our products for critical needs, such as backup power. A malfunction of our products could result in tort or warranty claims. In addition, a well-publicized actual or perceived problem could adversely affect the market s perception of our products. This could result in a decline in demand for our products, which would reduce our revenue and harm our business.

Future government regulation may impair our ability to market and sell our products.

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

Our failure to manage growth could harm our business.

We intend to introduce new products, increase our production capacity and develop additional distributor relationships. If we are successful, a significant strain on our senior management team and other resources will result. In addition, we may be required to hire additional senior management personnel. Our ability to manage growth will depend in part on our ability to continue to enhance our operating, financial and management information systems. Our personnel, systems and controls may be unable to support our growth.

We may not be able to obtain sufficient funds to grow our business.

We have regularly needed to raise funds in order to operate our business and believe we may need to raise additional funds to achieve full commercialization of some or all of our products. If we are unable to raise additional funds when needed, our ability to operate and grow our business could be impaired. We do not know whether we will be able to secure additional funding or funding on terms acceptable to us. Our ability to obtain additional funding will be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional funding

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unattractive to us. If we issue additional equity securities, existing stockholders may experience dilution or be subordinated to any rights, preferences or privileges granted to the new equity holders.

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

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

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

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

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

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

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

our perceived prospects;

variations in our operating results and achievement of key business targets;

changes in securities analysts recommendations or earnings estimates;

differences between our reported results and those expected by investors and securities analysts;

announcements of new products by us or our competitors;

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market reaction to any acquisition, joint venture or strategic investments announced by us or our competitors; and

general economic or stock market conditions unrelated to our operating performance.

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

Our executive officers, directors and their affiliates hold a large percentage of our stock and their interests may differ from other stockholders.

Our directors, executive officers and individuals or entities affiliated with our directors as a group beneficially own, as of March 31, 2003, approximately 25% of our outstanding common stock. If these stockholders choose to act or vote together, they will have the power to significantly influence the election of our directors, and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation and mergers or sales of substantially all of our assets. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us or our other stockholders. Also, third parties could be discouraged from making a tender offer or bid to acquire us at a price per share that is above the then-current market price.

The provisions of our charter documents and Delaware law could inhibit a takeover that stockholders may consider favorable and diminish the voting rights of the holders of our common stock.

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

may be adversely affected. The issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

Our charter documents contain other provisions that could have an anti-takeover effect, including:

- only one of the three classes of directors is elected each year;
- stockholders have limited ability to remove directors;
- stockholders cannot take actions by written consent;
- stockholders cannot call a special meeting of stockholders; and
- stockholders must give advance notice to nominate directors or submit proposals for consideration at stockholder meetings.

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

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ITEM 3. ***Quantitative and Qualitative Disclosures About Market Risk***

We hold marketable securities consisting of U.S. government and agency securities that are held by two major banking institutions. Our marketable securities portfolio of approximately $122.5 million includes seven callable agency securities with a fair market value totaling approximately $44.0 million. In 2003, four investments approximating $31.3 million were called at par. These securities generate a higher relative rate of interest for the Company; in return, the embedded call option gives the issuer the right to buy back the security. Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

ITEM 4. ***Controls and Procedures***

(a) *Evaluation of disclosure controls and procedures*. Based on their evaluation of the Company s disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities and Exchange Act of 1934) as of a date within 90 days of the filing date of this Quarterly Report on Form 10-Q, the Company s chief executive officer and principal financial and accounting officer have concluded

that the Company s disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and are operating in an effective manner.

(b) *Changes in internal controls*. There were no significant changes in the Company s internal controls or in other factors that could significantly affect these controls subsequent to the date of their most recent evaluation.

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PART II.

OTHER INFORMATION

ITEM 1. ***Legal Proceedings***

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

The Company believes it has meritorious defenses to the claims made in the complaints and intends to contest the lawsuits vigorously. However, there can be no assurance that we will be successful, and an adverse resolution of the lawsuits could have a material adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. The Company is not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial.

ITEM 2. ***Changes in Securities and Use of Proceeds***

On October 4, 2000, we closed an initial public offering of our common stock. The effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed was September 28, 2000, and the Commission file number assigned to the registration statement is 333-39748.

After deducting underwriting discounts and commissions and offering expenses, our net proceeds from the offering were approximately $125.8 million. The net proceeds have been allocated for general corporate purposes and capital expenditures, including purchase of equipment for and leasehold improvements to our planned manufacturing facility, and the possible acquisition of businesses, products or technologies that are complementary to our business. As of March 31, 2003, approximately $35.5 million of the net proceeds of the offering had been used to fund operations and purchase fixed assets. The remaining net proceeds are invested in U.S. Government and Agency securities. In October 2001, we loaned $275,000 of the proceeds to Mr. Schroeder, who is president and a director of the Company. In July 2002, the loan was paid in full. No other portion of the proceeds were paid directly or indirectly to any director, officer or general partner of us or our associates, persons owning ten percent or more of any class of our equity securities, or an affiliate of us.

ITEM 3. ***Default upon Senior Securities***

Not Applicable.

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

Not Applicable.

ITEM 5. ***Other Information***

Not Applicable.

ITEM 6. ***Exhibits and Reports on Form 8-K***

(a) Exhibits

Exhibit 99.1 Certifications

(b) Reports on Form 8-K

On February 3, 2003, the Company filed a Current Report on Form 8-K incorporating, under Item 5, a January 31, 2003 press release announcing that the Company and Matheson Tri-Gas Inc. have agreed to end their Development, Marketing and Distribution Agreement, dated November 10, 1999.

On May 6, 2003, the Company furnished a Current Report on Form 8-K under Item 9, containing a copy of its earnings release for the period ended March 31, 2003 (including financial statements) pursuant to Item 12 (Results of Operations and Financial Condition).

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SIGNATURES

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

Date: May 6, 2002

PROTON ENERGY SYSTEMS, INC.

(Registrant)

By: /s/ WALTER W. SCHROEDER

Walter W. Schroeder

President and Chief Executive Officer

By: /s/ JOHN A. GLIDDEN

John A. Glidden

Vice President of Finance

(Principal Financial and Accounting Officer)

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CERTIFICATIONS

I, Walter W. Schroeder, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Proton Energy Systems, Inc. (the Company);

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report.

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

    a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

    b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

    c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

    a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: May 6, 2003

/s/ WALTER W. SCHROEDER

Walter W. Schroeder

President and Chief Executive Officer

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CERTIFICATIONS

I, John A. Glidden, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Proton Energy Systems, Inc. (the Company);

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report.

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

    a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

    b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

    c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

    a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: May 6, 2003

/s/ JOHN A. GLIDDEN

John A. Glidden

Vice President of Finance