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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 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: _____

ACTIVE POWER, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

2128 W. Braker Lane, BK12, Austin, Texas
(Address of Principal Executive Offices)

74-2961657
(I.R.S. Employer
Identification No.)

78758
(Zip Code)

(512) 836-6464
(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

The number of shares of common stock outstanding at September 30, 2003 was 42,070,529.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

ACTIVE POWER, INC.

BALANCE SHEETS

(Thousands)

	September 30, 2003	December 31, 2002
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 55,159	\$ 62,934
Accounts receivable, net	2,232	1,510
Inventories	3,565	6,511
Prepaid expenses and other	1,417	613
	<u>62,373</u>	<u>71,568</u>
Total current assets	62,373	71,568
Property and equipment, net	11,069	12,095
Investments in marketable securities	21,034	27,110
	<u>94,476</u>	<u>110,773</u>
Total assets	\$ 94,476	\$ 110,773
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,003	\$ 352
Accrued expenses	3,585	3,761
Deferred revenue	368	—
	<u>4,956</u>	<u>4,113</u>
Total liabilities	4,956	4,113
Stockholders' equity:		
Common Stock	42	42
Treasury stock	(2)	(2)
Deferred stock compensation	(51)	(198)
Additional paid-in capital	214,938	214,548
Accumulated deficit	(125,638)	(108,315)
Other accumulated comprehensive income	231	585
	<u>89,520</u>	<u>106,660</u>
Total stockholders' equity	89,520	106,660
Total liabilities and stockholders' equity	\$ 94,476	\$ 110,773

See accompanying notes.

ACTIVE POWER, INC.
STATEMENTS OF OPERATIONS
(Thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Revenues:				
Product revenue	\$ 2,988	\$ 2,185	\$ 6,484	\$ 7,417
Development contract	—	1,000	—	3,000
Total revenue	2,988	3,185	6,484	10,417
Operating expenses:				
Cost of product revenue	3,629	3,718	9,801	12,047
Cost of development contract	—	888	—	2,432
Research and development	2,236	2,671	7,130	7,945
Selling, general & administrative	2,594	3,012	8,210	8,979
Amortization of deferred stock compensation	17	109	83	1,197
Total operating expenses	8,476	10,398	25,224	32,600
Operating loss	(5,488)	(7,213)	(18,740)	(22,183)
Interest income	423	786	1,429	2,520
Other income (expense)	(1)	12	(12)	2
Net loss	\$ (5,066)	\$ (6,415)	\$ (17,323)	\$ (19,661)
Net loss per share, basic & diluted	\$ (0.12)	\$ (0.15)	\$ (0.41)	\$ (0.48)
Shares used in computing net loss per share, basic & diluted	41,995	41,415	41,869	41,132
Comprehensive loss:				
Net loss	\$ (5,066)	\$ (6,415)	\$ (17,323)	\$ (19,661)
Unrealized gain (loss) on investments in marketable securities	(147)	108	(353)	400
Comprehensive loss	\$ (5,213)	\$ (6,307)	\$ (17,676)	\$ (19,261)

See accompanying notes.

ACTIVE POWER, INC.
STATEMENTS OF CASH FLOWS

(Thousands)
(unaudited)

	Nine Months Ended September 30,	
	2003	2002
Operating activities		
Net loss	\$ (17,323)	\$ (19,661)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	1,869	2,896
Retirement of fixed assets	(4)	428
Amortization of deferred stock compensation	83	1,197
Changes in operating assets and liabilities:		
Accounts receivable, net	(722)	(17)
Inventories	2,947	(303)
Prepaid expenses and other assets	(805)	(262)
Accounts payable	651	(3,355)
Accrued expenses	(176)	125
Deferred revenue	368	—
Net cash used in operating activities	(13,112)	(18,952)
Investing activities		
Net maturity (purchase) of investments	5,724	4,094
Purchases of property and equipment	(840)	(548)
Net cash provided by investing activities	4,884	3,546
Financing activities		
Net proceeds from issuance of common stock	453	1,026
Net cash provided by financing activities	453	1,026
Change in cash and cash equivalents	(7,775)	(14,380)
Cash and cash equivalents, beginning of period	62,934	80,401
Cash and cash equivalents, end of period	\$ 55,159	\$ 66,021

See accompanying notes.

Active Power, Inc.
Notes to Financial Statements
September 30, 2003
(unaudited)

1. Organization

Active Power, Inc. was founded in 1992 for the purpose of developing and commercializing advances in the field of electromechanics. Prior to 2000, we devoted our efforts principally to research and development, pursuing patent protection for our innovations, successful production of our initial prototypes, raising capital and pursuing markets for our flywheel-based power quality and energy storage products. In 2000 and 2001, the size and scope of our operations expanded considerably. We raised our level of new product development, increased our manufacturing capabilities and capacity, and added resources in sales and service to strengthen our distribution channels. Since that time, we have concentrated on expanding our core group of products through engineering innovation, reducing the cost of those products, manufacturing them with the quality demanded by our customers and broadening our channels to market.

2. Significant Accounting Policies**Basis of Presentation**

The accompanying unaudited interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the audited financial statements and accompanying notes thereto included in our Form 10-K for the year ended December 31, 2002. In the opinion of management the financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the results for the periods presented. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. Certain reclassifications have been made to the 2002 financial statements to conform to the 2003 presentation.

Inventory

Active Power states inventories at the lower of cost or market. Inventories consist of the following (in thousands):

	September 30, 2003	December 31, 2002
Raw materials	\$ 1,632	\$ 2,643
Processed inventory	1,933	3,868
	<u>\$ 3,565</u>	<u>\$ 6,511</u>

[Table of Contents](#)**Net Loss Per Share**

The following table sets forth the computation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net loss	\$ (5,066)	\$ (6,415)	\$ (17,323)	\$ (19,661)
Basic and diluted:				
Weighted-average shares of common stock outstanding	42,003	41,471	41,885	41,196
Weighted-average shares of common stock subject to repurchase	(8)	(56)	(16)	(64)
Shares used in computing net loss per share, basic and diluted	41,995	41,415	41,869	41,132
Net loss per share, basic and diluted	\$ (0.12)	\$ (0.15)	\$ (0.41)	\$ (0.48)

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), Consolidation Of Variable Interest Entities. FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 must be applied at the end of periods ending after December 15, 2003, and is effective immediately for all new variable interest entities created or acquired after January 31, 2003. We do not believe that the adoption of FIN 46 will have a material impact on our results of operations or financial position, as at this time we are not a party to any variable interest entities.

In May 2003, the FASB issued SFAS No. 150, Accounting For Certain Financial Instruments With Characteristics Of Both Liabilities And Equity. SFAS 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 are effective for financial instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. SFAS 150 did not have a material impact on our results of operations or financial position.

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3. Accounting for Stock-Based Compensation

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of Statement No. 123 (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net loss – as reported	\$ (5,066)	\$ (6,415)	\$ (17,323)	\$ (19,661)
Total stock-based compensation cost, net of related tax effects included in the determination of net loss as reported	17	109	83	1,197
The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards	(1,465)	(2,116)	(4,689)	(6,800)
Pro forma net loss	\$ (6,514)	\$ (8,422)	\$ (21,929)	\$ (25,264)
Earnings per share				
Basic and diluted - as reported	\$ (0.12)	\$ (0.15)	\$ (0.41)	\$ (0.48)
Basic and diluted – pro forma	\$ (0.16)	\$ (0.20)	\$ (0.52)	\$ (0.61)

4. Contingencies

In March 2002 we were named as defendants in a complaint filed in Michigan state court. The plaintiffs are seeking damages for the alleged breach of a joint venture agreement, the breach of fiduciary duties, the misappropriation of trade secrets, and the commission of other torts relating to this joint venture. Further detail is provided later in this document under the Legal Proceedings section (Item 1) of Part II. The parties met for non-binding mediation in Detroit in May 2003, but failed to resolve the dispute. This proceeding is in the discovery phase, and we are therefore unable to determine the ultimate outcome of this claim at this time.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with the financial statements appearing elsewhere in this Form 10-Q and in our Form 10-K for the year ended December 31, 2002. This report contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties. Our expectations with respect to future results of operations that may be embodied in oral and written forward-looking statements, including any forward looking statements that may be included in this report, are subject to risks and uncertainties that must be considered when evaluating the likelihood of our realization of such expectations. Our actual results could differ materially. The words “believe,” “expect,” “intend,” “plan,” “project,” “will” and similar phrases as they relate to us are intended to identify such forward-looking statements.

Among the important factors which could cause actual results to differ materially include: the potential for significant losses to continue; inability to accurately predict revenue and budget for expenses for future periods; fluctuations in revenue and operating results; dealer inventory levels; global economic factors, particularly in the primary markets served by our products, and continued decreases and/or delays in capital spending; limited product offerings; inability to expand and integrate new distribution channels; inability to manage new and existing product distribution relationships; our current dependence on our relationship with Caterpillar; inexperience in manufacturing our products in large quantities; delays in research and development; dependence on sole or limited source suppliers; inability to increase product sales; inventory risks; limited resources; dependence upon key personnel; inability to protect our intellectual property rights, including the possibility of an adverse outcome in the litigation in which we are currently engaged; potential future acquisitions; and the volatility of our stock price regardless of our actual financial performance. The discussion below addresses some of these factors. Additional risks and uncertainties that we are unaware of or that we currently deem immaterial also may become important factors that affect us.

Overview

We design, manufacture and market power quality products that provide the consistent, reliable electric power required by today’s digital economy. We believe that we are the first company to commercialize a flywheel energy storage system that provides a highly reliable, low-cost and non-toxic replacement for the lead-acid batteries used in conventional power quality installations. Our first product offering, the CleanSource® DC can replace lead-acid batteries in a conventional UPS system, or complement the batteries and increase their life span. The CleanSource DC is compatible with all major UPS brands and sold primarily through Powerware, one of the leading global suppliers of UPS systems, and manufacturers’ representatives. Leveraging our expertise in this technology we have developed a battery-free uninterruptible power supply (UPS). We sell our UPS through Caterpillar under the Caterpillar brand name, Cat® UPS, as well as directly to end users through manufacturing representatives under the brand name CleanSource® UPS. We sell and distribute all of our products through a variety of channels including our existing OEMs and an Active Power direct sales channel, including independent power quality manufacturers’ representatives, to maximize market coverage and penetration. Our products are sold for use in the facilities of companies across many different industries that share a critical need for reliable, high-quality power, such as broadcasters, hospitals, plastic manufacturers, semiconductor manufacturers, pharmaceutical manufacturers and data centers. Sales have been spread across many different countries from around the world.

Since 1996, we have focused our efforts and financial resources primarily on the design and development of our CleanSource line of power quality products and on establishing effective distribution channels to market our products. As of September 30, 2003, we had generated an accumulated deficit of \$125.6 million and expect to continue to sustain operating losses for the next several quarters. Prior to our initial public offering, we funded our operations primarily through sales of shares of our preferred stock, which resulted in gross proceeds of \$42.6 million. Based on the current spending levels and expectations in our current business plan, we believe the proceeds from our August 2000 initial public offering, \$138.4 million net of commissions and issuance costs, cash balances on hand prior to August 2000, and cash from product revenue and development contracts will be sufficient to meet our capital requirements through at least the next 24 months. Our cash and investments position at September 30, 2003 was \$76.2 million.

Since our inception, a small number of customers have accounted for the majority of our annual sales. In 2002, 2001 and 2000, Caterpillar and its dealer network accounted for 81%, 87% and 96%, respectively, of our product revenue. In 2002, sales to Powerware constituted 12% of our total revenue. In the first nine months of 2003, sales to Caterpillar and Powerware accounted for 72% and 7%, respectively, of our total revenue. The remainder of our sales revenue for the first nine months of 2003 was derived from our Active Power branded sales channel. We expect to continue to be dependent on Caterpillar for a substantial portion of our sales for the next several quarters.

Critical Accounting Policies and Estimates

The preparation of financial statements and accompanying notes in conformity with generally accepted accounting principles requires that we make estimates and assumptions that affect the amounts reported. Changes in the facts and circumstances could have a significant impact on the resulting financial statements. We believe the following critical accounting policies affect our more complex judgments and estimates. We also have other policies that we consider to be key accounting policies, such as our policies for revenue recognition; however, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

Allowance for Doubtful Accounts

We estimate an allowance for doubtful accounts based on factors related to the credit risk of each customer. Because to date we have sold to a limited number of large customers (e.g., Caterpillar and Powerware), credit losses have been minimal. As we integrate additional distribution channels into our business and begin selling our products to smaller, less established customers, the risk of credit losses may increase. Among other factors, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventories

We state inventories at the lower of cost or market value. If actual future demand or market conditions are less favorable than those projected by management, or if product design changes result in excess or obsolete components beyond current expectations, additional inventory write-downs may be required. We evaluate our inventory values on a quarterly basis.

Accrued Warranty Liability

We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability may be required. We evaluate the reasonableness of our warranty accrual levels on a quarterly basis. In 2003 we began reporting warranty expense in Cost of Product Revenue to emphasize the importance of product quality on overall product costs. Prior to 2003, product warranty costs were accounted for in sales, general and administrative expense and have been reclassified to conform to the current year presentation.

Marketing Programs Accrual

We engaged in a marketing program with Caterpillar aimed at increasing the number of dedicated UPS salespeople employed by the Caterpillar dealers. As part of that program, we have agreed, under certain circumstances, to offset some of the first-year expenses of this program. We estimate our liabilities under this program and accrue based on our expected payout. We continually monitor the progress of the program, and based on the success of the dedicated UPS salespeople our actual payments may differ from our estimates.

Results of Operations

Product revenue. Product revenue primarily consists of sales of our CleanSource line of power quality products. Sales increased \$803,000, or 37%, to \$3.0 million for the three months ended September 30, 2003, from \$2.2 million for the three months ended September 30, 2002. For the three months ended September 30, 2003 we sold 49 quarter-megawatt flywheel units compared to 41 units for the same period in 2002. We believe the increase in product revenue and units shipped in the three month period was due to the expansion of our flywheel based product line and sales from our new Active Power direct sales channel. Sales decreased \$933,000, or 13%, to \$6.5 million for the nine months ended September 30, 2003, from \$7.4 million for the nine months ended September 30, 2002. For the nine months ended September 30, 2003 we sold 100 quarter-megawatt flywheel units compared to 130 units for the same period in 2002. We believe the decrease in revenue and units shipped for the nine month period was primarily attributable to a reduction in the market for capital equipment, including power quality equipment, due in large part to the overall economic slowdown that persisted through the first half of 2003 in the United States and globally. The average selling price of our base products has remained relatively flat the last several quarters, but can vary depending on product mix and the level of add-on options purchased by the customer. Our international sales increased to approximately 53% of our product revenue for the three months ended September 30, 2003, compared to approximately 26% in the same period last year, due to an extension of our sales coverage into new regions of Europe and Asia. We anticipate that international sales will continue to account for a substantial portion of our sales revenue for the next several quarters.

We benefited from several large inventory-stocking orders by our OEM customers during 2001. Since that time, the vast majority of our sales have been to our OEM customers for

specifically identified end users. A substantial number of these inventory-stocking units are still being held by OEM customers as of September 30, 2003. We believe the number of units in inventory stock at our OEM customers has begun to decline the last few quarters, including several units that were sold to end customers during the three months ended September 30, 2003. Although we have no obligations to our OEM customers for the inventory that they hold, any reduction in these inventory stocking levels will displace our sales. We are working closely with our OEM's to help place these systems with end users over time.

Development contract revenue. Development contract revenue consists of funding paid to us by Caterpillar. In 1999 we entered into an agreement with Caterpillar to develop the Cat UPS. As part of that agreement Caterpillar provided us with \$5.0 million in funding for the successful completion of several development milestones. In September 2001 we signed an extension to our development agreement with Caterpillar to expand the Cat UPS product line. The extension called for an additional \$5.0 million in funding upon successful completion of certain development milestones. Between December 2001 and December 2002 we completed all five milestones and collected and recognized \$5.0 million of development funding. We had no development contract revenue in the three months ended September 30, 2003 and no development contract revenue in the nine months ended September 30, 2003, compared with \$1.0 million in the three months ended September 30, 2002 and \$3.0 million in the nine months ended September 30, 2002. We currently do not have, nor do we anticipate, any agreements that will provide us with additional development funding.

Cost of product revenue. Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment, product warranty, other costs associated with our assembly and test operations, shipping costs, and the costs of manufacturing support functions such as procurement, logistics and quality assurance. Cost of product revenue decreased approximately \$89,000, or 2%, to \$3.6 million for the three months ended September 30, 2003, from \$3.7 million for the three months ended September 30, 2002. Cost of product revenue decreased approximately \$2.2 million, or 19%, to \$9.8 million for the nine months ended September 30, 2003, from \$12.0 million for the nine months ended September 30, 2002. Product gross margins improved to (21%) for the three months ended September 30, 2003 and to (51%) for the nine months ended September 30, 2003, compared to (70%) and (62%) respectively for the same periods in 2002. This improvement was due to a reduction in our manufacturing and product costs associated with engineering driven product cost savings and reduced manufacturing staffing and spending levels. Product gross margin improvements for the nine month period were reduced by lower sales levels during the first six months of 2003 when compared to the same period of 2002. While our variable product margin (sales less materials, direct labor and warranty expense) was positive in the first nine months of 2003, our overall product margin was negative due, in large part, to the underutilization of our indirect manufacturing costs. Over time, we believe gross margins should improve if we can increase product volume, thereby achieving greater economies of scale in production and in purchasing component parts, and introduce additional engineering design savings. Our product margins can also vary significantly depending on the mix and price of products sold.

Cost of development contract. Cost of development contract primarily consists of engineering expenses incurred related to the joint development process with Caterpillar, through which we have received development funding in the past. Because we do not have a development contract with Caterpillar at this time, we did not have any development contract funding, nor did we have any corresponding cost of development contract expenses during the nine months ended September 30, 2003, compared to \$888,000 in the three months ended September 30, 2002, and \$2.4 million for the nine months ended September 30, 2002.

Research and development. Research and development expense primarily consists of compensation and related costs of employees engaged in research, development and engineering activities, third party consulting and development activities, as well as an allocated portion of our occupancy costs. Research and development expense decreased approximately \$435,000, or 16%, to \$2.2 million for the three months ended September 30, 2003, from \$2.6 million for the three months ended September 30, 2002. Research and development expense decreased \$815,000, or 10%, to \$7.1 million for the nine months ended September 30, 2003, from \$7.9 million for the nine months ended September 30, 2002. The decrease in research and development expense was primarily driven by a reduction in development spending on our new 1200 kVA high power UPS product line extension as we near the completion of its development. We believe research and development costs will remain relatively flat the next several quarters but would decrease as a percentage of sales if future sales growth occurs. Over time we expect a shift in our development efforts from our high power 1200 kVA UPS to lower power, extended runtime products will further reduce our project related cost and, in turn, lower our R&D spending levels.

Selling, general and administrative. Selling, general and administrative expense is primarily comprised of compensation and related costs for sales, service, marketing and administrative personnel, selling and marketing expenses, professional fees, and bad debt costs and reserves. Selling, general and administrative expense decreased \$418,000, or 14%, to \$2.6 million for the three months ended September 30, 2003, from \$3.0 million for the three months ended September 30, 2002. Selling, general and administrative expense decreased \$769,000, or 9%, to \$8.2 million for the nine months ended September 30, 2003, from \$9.0 million for the nine months ended September 30, 2002. The decrease in selling, general and administrative expense was principally due to a reduction in personnel associated with the consolidation of several management and sales positions. We believe that selling, general and administrative expense will increase modestly over the next several quarters, but would decrease as a percentage of sales if future sales growth occurs. Savings realized in the third quarter associated with our second quarter 2003 staffing reductions were offset by increased marketing promotions and advertising, and increases in directors and officers insurance premiums.

Amortization of deferred stock compensation. Deferred stock compensation is a non-cash expense that reflects the difference between the exercise price of option grants to employees and the estimated fair value of our common stock at the date of grant determined subsequently by us. We are amortizing deferred stock compensation as an operating expense over the vesting periods of the applicable options, which resulted in amortization expense of \$17,000 for the three months ended September 30, 2003 and \$109,000 for the three months ended September 30, 2002. Amortization expense was \$83,000 for the nine months ended September 30, 2003 compared to \$1.2 million for the nine months ended September 30, 2002. The amortization expense has been reduced significantly in recent quarters as the options for which we are amortizing this expense become fully vested and as employees to whom these options were granted leave the company and their unvested options are canceled. We expect this amortization expense to continue to decrease in the future until it is eliminated in the second quarter of 2004.

Interest income. Interest income decreased \$363,000, or 46%, to \$423,000 for the three months ended September 30, 2003, from \$786,000 for the three months ended September 30,

2002. Interest income decreased \$1.1 million, or 43%, to \$1.4 million for the nine months ended September 30, 2003, from \$2.5 million for the nine months ended September 30, 2002. This decrease is attributable to two factors. First, there was a decrease in our average cash and investments balance to \$78.4 million for the three-month period ended September 30, 2003, compared to an average cash and investments balance of \$95.8 million for the three-month period ended September 30, 2002. Second, the average rate of return on our investments decreased from 3.3% in the third quarter of 2002 to 2.1% in the third quarter of 2003, as interest rates in the financial markets have declined over the past year, and several higher yield securities purchased in early 2002 matured and were reinvested at current market rates.

Liquidity and Capital Resources

Our principal source of liquidity as of September 30, 2003 consisted of approximately \$76.2 million of cash, cash equivalents and investments in marketable securities. We have primarily funded our operations from the proceeds of our initial public offering in August 2000 of \$138.4 million net of underwriting discounts and issuance costs, \$42.6 million in proceeds from preferred stock financings, as well as \$10 million in development funding we received from Caterpillar since 1999, and our product revenue. Cash used in operating activities in the three months ended September 30, 2003 was \$4.4 million, a \$1.7 million decrease from the \$6.1 million used in the same period of 2002. Cash used in operating activities in the first nine months of 2003 was \$13.1 million, a \$5.9 million decrease from the \$19.0 million used in the first nine months of 2002. The cash usage in 2002 and 2003 was principally focused on product development of our higher power product platform, the expansion and product cost reductions of our existing UPS product line, and the funding of manufacturing operations and sales and marketing activities to support current revenue and position us for future sales growth. The decrease in cash usage for both the three and nine months ended September 30, 2003 compared to the same period the prior year was primarily attributable to reductions in our net loss and inventory levels.

Capital expenditures in the first nine months of 2003 were \$840,000, a \$292,000 increase from the \$548,000 used in the first nine months of 2002. In the first nine months of 2003 our expenditures were principally for the completion of the leasehold improvements to adapt a portion of our manufacturing facility to support the consolidation of our manufacturing, sales, service, marketing, information technology and administrative functions into one facility. Our expenditures in the first nine months of 2002 were limited to leasehold improvements to our engineering testing facilities and other general computer equipment and software for administrative purposes. We expect to spend \$100,000 to \$200,000 during the remainder of 2003 for additional engineering lab equipment, and computer equipment and software for general corporate purposes.

We believe our existing cash and investments balance at September 30, 2003 will be sufficient to meet our capital requirements through at least the next 24 months, although we might elect to seek additional funding prior to that time. Beyond the next 24 months, our capital requirements will depend on many factors, including the rate of sales growth, the market acceptance of our products, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the rate of expansion of our manufacturing processes, and the timing and extent of research and development projects. Although we are not a party to any agreement or letter of intent with respect to a potential acquisition or merger, we may enter into acquisitions or strategic arrangements in the future, which could also require us to seek additional equity or debt financing.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), Consolidation Of Variable Interest Entities. FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 must be applied at the end of periods ending after December 15, 2003, and is effective immediately for all new variable interest entities created or acquired after January 31, 2003. We do not believe that the adoption of FIN 46 will have a material impact on our results of operations or financial position, as at this time we are not a party to any variable interest entities.

In May 2003, the FASB issued SFAS No. 150, Accounting For Certain Financial Instruments With Characteristics Of Both Liabilities And Equity. SFAS 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 are effective for financial instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. SFAS 150 did not have a material impact on our results of operations or financial position.

Quantitative and Qualitative Disclosures About Market Risk

We invest our cash in a variety of financial instruments, including bank time deposits, and taxable variable rate and fixed rate obligations of corporations, municipalities, and local, state and national government entities and agencies. These investments are denominated in U.S. dollars.

Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We believe that our investment policy is conservative, both in terms of the average maturity of investments that we allow and in terms of the credit quality of the investments we hold. We estimate that a 1% decrease in market interest rates would decrease our annual interest income by \$760,000. Because of the nature of the majority of our investments, we do not believe a 1% decline in interest rates would have a material effect on their fair value.

Risk Factors That May Affect Future Results

You should carefully consider the risks described below before making a decision to invest in our common stock or in evaluating Active Power and our business. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we do not presently know, or that we currently view as immaterial, may also impair our business operations. This report is qualified in its entirety by these risk factors.

The actual occurrence of any of the following risks could materially harm our business, financial condition and results of operations. In that case, the trading price of our common stock could decline.

We have incurred significant losses and anticipate losses for the next several quarters.

We have incurred operating losses since our inception and expect to continue to incur losses for the next several quarters. As of September 30, 2003, we had an accumulated deficit of \$125.6 million. To date, we have funded our operations principally through the sale of our stock, our product revenue and \$10.0 million in development funding payments from Caterpillar. We will need to generate significant additional revenue to achieve profitability, and we cannot assure you that we will ever realize additional revenue at such levels. We also expect to incur product development, sales and marketing and administrative expenses significantly in excess of our product revenue after costs, and, as a result, we expect to continue to incur losses for the next several quarters.

Due to our limited operating history and the uncertain market acceptance of our products, we may never achieve significant revenue and may have difficulty accurately predicting revenue for future periods and appropriately budgeting for expenses.

We have generated a total of \$44.4 million in product revenue since January 1, 1998, with approximately \$3.0 million generated in the three months ended September 30, 2003. We are uncertain whether our products will achieve market acceptance such that our revenue will increase or whether we will be able to achieve significant revenue. Therefore, we have a very limited ability to predict future revenue. Our limited operating experience, the uncertain market acceptance for our products, and other factors that are beyond our control make it difficult for us to accurately forecast our quarterly and annual revenue. However, we use our forecasted revenue to establish our expense budget. Most of our expenses are fixed in the short term or incurred in advance of anticipated revenue. As a result, we may not be able to decrease our expenses, if desired, in a timely manner to offset any revenue shortfall. If our revenue does not increase as anticipated, we will continue to incur significant losses.

Our business is subject to fluctuations in operating results, which could negatively impact the price of our stock.

Our product revenue, expense and operating results have varied in the past and may fluctuate significantly in the future due to a variety of factors, many of which are outside of our control. These factors include, among others:

- the timing of orders from our customers and the possibility that these customers may change their order requirements with little or no advance notice to us;
- the rate of adoption of our flywheel-based energy storage system as an alternative to lead-acid batteries;

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- the deferral of customer orders in anticipation of new products from us or other providers of power quality systems;
- the ongoing need for short-term power outage protection in traditional UPS systems;
- the uncertainty regarding the adoption of our current and future products, including the CleanSource UPS and CleanSource2 DC products, as well as our other products which are currently under development; and
- the rate of growth of the markets for our products.

There is a substantial amount of product held as inventory by several of our OEM customers. If these OEMs fill their orders from existing stock instead of our factory, our revenue will suffer.

Several OEMs purchased a substantial number of our Cleansource DC and UPS systems during 2001, of which many have remained in those OEMs inventories rather than being sold to end user customers. As our OEMs fill some of their Cleansource DC and Cat UPS orders with existing inventory stock, as opposed to placing orders with Active Power, our revenue will suffer for the next several fiscal quarters as this inventory held by these OEMs is reduced.

Our business is dependent on the market for power quality products and the health of the overall economy, and if this market does not expand as we anticipate, if alternatives to our products are successful, or if the downturn in the economy continues to limit capital spending, our business will continue to suffer.

The market for power quality products is evolving and it is difficult to predict its potential size or future growth rate. Most of the organizations that may purchase our products have invested substantial resources in their existing power systems and, as a result, have been reluctant or slow to adopt a new approach, particularly during a period of reduced capital expenditures. Moreover, our current products are alternatives to existing UPS and battery-based systems and may never be accepted by our customers or may be made obsolete by other advances in power quality technologies. Improvements may also be made to the existing alternatives to our products that could render them less desirable or obsolete. Furthermore, our business depends on capital expenditures by organizations, which tend to decrease when the U.S. or global economy slows. Our business suffered significantly as a result of the economic slowdown that continued through the first six months of 2003. Our business may continue to suffer until the economy recovers and capital expenditures by our customers increase and stabilize.

The impact of global economic conditions on our customers may cause us to fail to meet analyst and investors' expectations, which would negatively impact the price of our stock.

Our operating results can vary significantly based upon the impact of global economic conditions on our customers. More specifically, the macroeconomic environment and capital spending has declined in recent years. While the economic environment is showing signs of improvement, we have yet to notice a significant increase in capital expenditures by our customers or potential customers. Our operating results depend on the overall demand for power quality products. Because our sales are primarily to major corporate customers whose businesses fluctuate with general economic and business conditions, a softening of demand for power quality products caused by a weakening economy resulted in decreased revenues. We may be especially prone to this as a result of the relatively high percentage of revenue we have historically derived from the high-tech industry, which was more significantly adversely impacted by the economic decline than other industries. Customers may defer or reconsider purchasing our products if they continue to experience a lack of growth in their business or if the general economy fails to significantly improve and stabilize.

We have limited product offerings and our success depends on our ability to develop in a timely manner new and enhanced products that achieve market acceptance.

To grow our revenue, we must develop and introduce to the market new products and product enhancements in a timely manner. Specifically, our ability to capture significant market share depends on our ability to develop and market extensions to our existing UPS product line at higher and lower power range offerings, and on our ability to develop and market extended runtime products. Even if we are able to develop and commercially introduce new products and enhancements, they may not achieve market acceptance, which would substantially impair our revenue, profitability and overall financial prospects.

Failure to expand our distribution channels and manage our existing and new product distribution relationships could impede our future growth.

The future growth of our business will depend in part on our ability to expand our existing relationships with distributors, to identify and develop additional channels for the distribution and sale of our products and to manage these relationships. As part of our growth strategy, we may expand our relationships with distributors and develop relationships with new distributors. We will also look to identify and develop new relationships with additional parties that could serve as an outlet for our products. For example, we recently broadened our sales and distribution channel by offering our products through manufacturers' representatives throughout North America and internationally. Our inability to successfully execute this strategy, and to integrate and manage our existing OEM channel partners, Caterpillar and Powerware, and our new manufacturers' representatives could impede our future growth.

We are heavily dependent on our relationship with Caterpillar, our primary OEM customer. If our relationship is unsuccessful, for whatever reason, our business and financial prospects could suffer.

If our relationship with Caterpillar is not successful, or if Caterpillar's distribution of the Cat UPS product is not successful, our business and financial prospects could suffer. During 2002, 2001 and 2000, Caterpillar and its dealer network accounted for 81%, 87% and 96% of our product revenue, respectively. During the first nine months of 2003, Caterpillar and its dealer network accounted for 72% of our product revenue. Pursuant to our distribution agreement with Caterpillar, they are the exclusive OEM distributor, subject to limited exceptions, of our CleanSource UPS product. Caterpillar is not obligated to purchase any CleanSource UPS units. Through December 31, 2002, pursuant to our development agreements Caterpillar has provided us with \$10.0 million in funding to support the development of the Cat UPS product line and other development efforts. In exchange for these payments, Caterpillar received co-ownership of the proprietary rights in this product. Either Caterpillar or we may license to other entities the intellectual property that we jointly own without seeking the consent of the other and the licensing party will solely retain all licensing revenue generated by licensing this intellectual property. However, we may not license the joint intellectual property to specifically identified competitors of Caterpillar until January 1, 2007. Caterpillar may terminate this agreement at any time by giving us 90 days advance written notice.

We have no experience manufacturing our products in large quantities.

To be financially successful, we will have to manufacture our products in commercial quantities at acceptable costs while also preserving the quality levels we achieved when manufacturing these products in more limited quantities. This presents a number of technological and engineering challenges for us. We have not previously manufactured our products in high volume. We do not know whether or when we will be able to develop efficient, low-cost manufacturing capability and processes that will enable us to meet the quality, price, engineering, design and product standards or production volumes required to successfully manufacture large quantities of our products. Even if we are successful in developing our manufacturing capability and processes, we do not know whether we will do so in time to meet our product commercialization schedule or to satisfy the requirements of our customers.

In 2001 we expanded our manufacturing facility based on anticipated sales volume increases. If we do not achieve these forecasted sales volumes, we will underutilize our manufacturing capacity and our business will suffer.

In May 2001 we completed a 127,000 square foot facility used for manufacturing and testing our three-phase product line, including our DC and UPS products. In order for us to fully utilize the capacity of the facility and spread out its associated overhead, we must achieve significantly higher sales volumes. We have not been successful at increasing our sales volume following the facility expansion and we may never increase our sales volume to necessary levels. If we do not reach these sales volume levels, or if we cannot sell our products at our suggested prices, our ability to reach profitability will be materially limited.

Quality problems relating to one or more of our new or existing products could negatively impact the market's acceptance of our products and cause us to miss our revenue goals and/or to incur significant liability.

Because of the nature of the power quality and reliability market, quality problems attributable to the CleanSource DC and CleanSource UPS product lines could significantly affect the market's perception of our technology and slow or limit their acceptance. This would substantially impair our revenue prospects. Moreover, quality problems for our product lines could cause us to delay or cease shipments of products, or recall products, thus impairing our revenue or cost targets. In addition, while we seek to limit our liability as a result of product failures or defects through warranty and other limitations, if one of our products fails then a customer could suffer a significant loss and seek to hold us responsible for that loss.

We are subject to increased inventory risks and costs because we outsource the manufacturing of components of our products in advance of binding commitments from our customers to purchase our products.

To assure the availability of our products to our customers, we outsource the manufacturing of components prior to the receipt of purchase orders from customers based on their forecasts of their product needs and internal product sales revenue forecasts. However, these forecasts do not represent binding purchase commitments and we do not recognize revenue for such products until the product is shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated revenue. As demand for our products may not materialize, this product delivery method subjects us to increased risks of high inventory carrying costs, obsolescence and excess, and may increase our operating costs. In addition, we may from time to time make design changes to our products, which could lead to obsolescence of inventory.

We depend on sole source and limited source suppliers for certain key components, and if we are unable to buy these components on a timely basis, our inability to deliver our products to our customers in a timely manner may result in reduced revenue and lost sales.

At current sales levels we purchase several component parts from sole source and limited source suppliers. As a result, if our suppliers receive excess demand for their products, we may receive a low priority for order fulfillment as large volume customers will receive priority. If we are delayed in acquiring components for our products, the manufacture and shipment of our products also will be delayed. We are, however, continuing to enter into long-term agreements with our sole suppliers and other key suppliers, when available, using a rolling sales volume forecast to stabilize component availability. Lead times for ordering materials and components vary significantly and depend on factors such as specific supplier requirements, contract terms, the extensive production time required and current market demand for such components. Some of these delays may be substantial. As a result, we purchase several components in large quantities to protect our ability to deliver finished products. If we overestimate our component requirements, we may have excess inventory, which will increase our costs. If we underestimate our component requirements, we will have inadequate inventory, which will delay our manufacturing and render us unable to deliver products to customers on scheduled delivery dates. If we are unable to obtain a component from a supplier or if the price of a component has increased substantially, we may be required to manufacture the component internally, which will also result in delays. Manufacturing delays could negatively impact our ability to sell our products and could damage our customer relationships.

We depend on key personnel to manage our business and develop new products in a rapidly changing market, and if we are unable to retain our current personnel and hire additional personnel, our ability to develop and sell our products could be impaired.

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. There is a limited supply of skilled employees in the power quality marketplace. The decline in our stock price has resulted in a substantial number of “underwater” stock options, which may cause certain of our employees to seek employment elsewhere as a result of this decreased financial incentive. In April 2003, we reduced our workforce throughout all departments of the Company. If we experience significant demand for our products in the near term, we may have difficulty hiring and training qualified new employees to meet this demand. If we are unable to retain the personnel we currently employ, or if we are unable to quickly replace departing employees, our operations and new product development may suffer.

We are a relatively small company with limited resources compared to some of our current and potential competitors, and competition within our markets may limit our sales growth.

The markets for power quality and power reliability are intensely competitive. There are many companies engaged in all areas of traditional and alternative UPS and backup systems in the United States and abroad, including, among others, major electric and specialized electronics firms, as well as universities, research institutions and foreign government-sponsored companies. There are many companies that are developing flywheel-based energy storage systems and flywheel-based power quality systems. We also compete indirectly with companies that are developing other types of power technologies, such as superconducting magnetic energy storage, ultra-capacitors and dynamic voltage restorers.

Many of our current and potential competitors have longer operating histories, significantly greater resources, broader name recognition and a larger customer base than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours, which would allow them to respond more quickly than us to new or emerging technologies or changes in customer requirements. In addition, some of our current and potential competitors have established supplier or joint development relationships with our current or potential customers. These competitors may be able to leverage their existing relationships to discourage these customers from purchasing products from us or to persuade them to replace our products with their products. Increased competition could decrease our prices, reduce our sales, lower our margins, or decrease our market share. These and other competitive pressures could prevent us from competing successfully against current or future competitors and could materially harm our business.

If we are unable to protect our intellectual property, we may be unable to compete.

Our products rely on our proprietary technology, and we expect that future technological advancements made by us will be critical to sustain market acceptance of our products. Therefore, we believe that the protection of our intellectual property rights is, and will continue to be, important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and business partners and control access to and distribution of our software, documentation and other proprietary information. Despite these efforts, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where applicable laws may not protect our proprietary rights as fully as in the United States. In addition, the measures we undertake may not be sufficient to adequately protect our proprietary technology and may not preclude competitors from independently developing products with functionality or features similar to those of our products.

Our efforts to protect our intellectual property may cause us to become involved in costly and lengthy litigation, which could seriously harm our business.

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights. For example, we were named in a lawsuit, along with Joe Pinkerton, our chairman and chief executive officer, alleging the misappropriation of trade secrets that we describe in further detail in “Legal Proceedings” in Item 1 of Part II below. We may become involved in additional litigation in the future to protect our intellectual property or defend allegations of infringement asserted by others. Legal proceedings, including the current lawsuit in which we are named as a defendant, could subject us to significant liability for damages or invalidate our intellectual property rights. Any litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert management’s time and attention. Any potential intellectual property litigation also could force us to take specific actions, including:

- cease selling our products that use the challenged intellectual property;

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- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology or trademark, which license may not be available on reasonable terms, or at all; or
- redesign those products that use infringing intellectual property or cease to use an infringing trademark.

Any acquisitions we make could disrupt our business and harm our financial condition.

Although we are not currently negotiating any material business or technology acquisitions, as part of our growth strategy, we may review opportunities to acquire other businesses or technologies that would complement our current products, expand the breadth of our markets or enhance our technical capabilities. We have no experience in making acquisitions. Acquisitions entail a number of risks that could materially and adversely affect our business and operating results, including:

- problems integrating the acquired operations, technologies or products with our existing business and products;
- potential disruption of our ongoing business and distraction of our management;
- difficulties in retaining business relationships with suppliers and customers of the acquired companies;
- difficulties in coordinating and integrating overall business strategies, sales and marketing, and research and development efforts;
- the maintenance of corporate cultures, controls, procedures and policies;
- risks associated with entering markets in which we lack prior experience; and
- potential loss of key employees.

We may require substantial additional funds in the future to finance our product development and commercialization plans.

Our product development and commercialization schedule could be delayed if we are unable to fund our research and development activities or the development of our manufacturing capabilities with our revenue and our cash on hand. We expect that our current cash and investments, together with our other available sources of working capital, will be sufficient to fund development activities for at least 24 months. However, unforeseen delays or difficulties in these activities could increase costs and exhaust our resources prior to the full commercialization of our products under development. We do not know whether we will be able to secure additional funding, or funding on terms acceptable to us, to continue our operations as planned. If financing is not available, we may be required to reduce, delay or eliminate certain activities or to license or sell to others some of our proprietary technology.

Provisions in our charter documents and of Delaware law, and provisions in our agreements with Caterpillar, could prevent, delay or impede a change in control of our company and may depress the market price of our common stock.

Provisions of our certificate of incorporation and bylaws could have the effect of discouraging, delaying or preventing a merger or acquisition that a stockholder may consider favorable. Additionally, in December of 2001 our board of directors approved a stockholder

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rights plan, which would require a potential acquiror to negotiate directly with our board of directors regarding any planned acquisition. We also are subject to the anti-takeover laws of the State of Delaware, which may further discourage, delay or prevent someone from acquiring or merging with us. In addition, our agreement with Caterpillar for the distribution of CleanSource UPS provides that Caterpillar may terminate the agreement in the event we are acquired or undergo a change in control. The possible loss of our most significant customer could be a significant deterrent to possible acquirers and may substantially limit the number of possible acquirers. All of these factors may decrease the likelihood that we would be acquired, which may depress the market price of our common stock.

Our stock price may be volatile.

Historically the market price of our common stock has fluctuated significantly. The market price of our common stock can be expected to fluctuate significantly in response to numerous factors, some of which are beyond our control, including the following:

- actual or anticipated fluctuations in our operating results;
- changes in financial estimates by securities analysts or our failure to perform in line with such estimates;
- changes in market valuations of other technology companies, particularly those that sell products used in power quality systems;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- introduction of technologies or product enhancements that reduce the need for flywheel energy storage systems;
- the loss of one or more key OEM customers;
- inability to expand our distribution channels;
- departures of key personnel; and
- changing external capital market conditions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

This information is included in the section captioned “Quantitative and Qualitative Disclosures About Market Risk” in Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Item 4. Controls and Procedures

- (a) Evaluation of Disclosure Controls and Procedures. We maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in the periodic reports we file with the SEC is recorded, processed, summarized and reported within the time periods specified in the rules of the SEC. We carried out an evaluation as of September 30, 2003, under the supervision and the participation of our management, including our chief executive officer and chief financial officer, of the design and operation of these disclosure controls and procedures pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the company required to be included in our periodic SEC filings.

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- (b) Changes in internal controls over financial reporting. There was no change in internal control over financial reporting that occurred during the three months ended September 30, 2003 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ACTIVE POWER, INC.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

On March 25, 2002, we, along with Joseph F. Pinkerton, III, our chairman and chief executive officer, Pinkerton Generator, Inc. (a corporation in which Mr. Pinkerton was an officer, director and the primary shareholder), and Caterpillar Inc. were named as defendants in a complaint filed in Michigan state court in the Circuit Court for the County of Wayne. The plaintiffs, Magnex Corporation, Enigma Corporation and Bergeron Corporation, and their individual principals, are seeking damages for: alleged breach of a joint venture agreement dated June 23, 1989, which was entered into by and among Pinkerton Generator, Inc., Magnex Corp. and Enigma Corp.; breach of fiduciary duties; misappropriation of trade secrets; and the commission of other torts relating to this joint venture. Neither Active Power nor any of its predecessors in interest was a party to the joint venture agreement. We were served with the Original Complaint and Amended Complaint on April 19, 2002. The parties met for non-binding mediation in Detroit in May 2003, but failed to resolve the dispute. This proceeding is in the discovery phase, and we are therefore unable to determine the ultimate outcome of this claim at this time.

Item 2. Changes in Securities and Use of Proceeds.

The Securities and Exchange Commission on August 7, 2000 declared effective our registration statement on Form S-1 (File No. 333-36946) relating to the initial public offering of our common stock. As of September 30, 2003, we have used all of the net offering proceeds for the purchase of temporary investments, consisting of cash, cash equivalents, and short-term investments. We currently intend to use the net proceeds of the offering for working capital and general corporate purposes, including financing accounts receivable and capital expenditures made in the ordinary course of business. We also may apply a portion of the proceeds of the offering to acquire businesses, products and technologies, or enter into joint venture arrangements, that are complementary to our business and product offerings; however, at this time we have not identified a specific acquisition or joint venture or allocated a specific amount for this purpose. We also may apply a portion of the proceeds to the payment of cash dividends or for additional stock repurchases or other similar transactions.

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

- 10.1* Purchase and Sale Agreement between Active Power, Inc. and Fuji Electric Co., Ltd. dated July 23, 2003.
- 31.1 Certification of Joseph F. Pinkerton, III, President and Chief Executive Officer of the Company, as adopted pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
- 31.2 Certification of David S. Gino, Vice President and Chief Financial Officer of the Company, as adopted pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Joseph F. Pinkerton, III, President and Chief Executive Officer, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
- 32.2 Certification of David S. Gino, Vice President and Chief Financial Officer of the Company, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

* A request for confidential treatment has been made with the Securities and Exchange Commission as to certain portions of this exhibit

(b) During the fiscal quarter ended September 30, 2003, Active Power filed the following current report on Form 8-K:

- We filed a Form 8-K dated July 24, 2003, which included information reported on Item 7 – Financial Statements, Pro Forma Financial Information and Exhibits and Item 12 – Results of Operations and Financial Condition.

SIGNATURES

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

ACTIVE POWER, INC.
(Registrant)

October 23, 2003

(Date)

/s/ Joseph F. Pinkerton, III

Joseph F. Pinkerton, III
Chairman of the Board, President and
Chief Executive Officer

October 23, 2003

(Date)

/s/ David S. Gino

David S. Gino
Chief Operating Officer, Vice President of Finance,
Chief Financial Officer and Secretary
(Principal Accounting Officer)

PURCHASE AND SALE AGREEMENT

This Purchase and Sale Agreement (this "Agreement") is made and entered into as of July 23rd, 2003, by and between ACTIVE POWER, INC., a corporation organized and existing under the laws of the State of Delaware, United States of America ("USA"), having its principal place of business at 2128 W. Braker Lane, B12, Austin, Texas 78758, USA ("Seller"), and FUJI ELECTRIC CO., LTD., a corporation organized and existing under the laws of Japan, having its principle place of business at 11-2, Osaki 1-chome, Shinagawa-ku, Tokyo 141-0032, Japan ("Purchaser").

RECITALS

A. The Purchaser desires to continuously purchase the Products as defined in Section 1.2 below from the Seller on the terms and conditions set forth herein so that the Purchaser will be able to use the Products for the Purchaser's products marketed in Japan, the People's Republic of China, the Republic of Korea and any other country other than USA agreed upon by the parties.

B. The Seller is willing to continuously sell the Products in Japan only to the Purchaser and grant to the Purchaser the exclusive right to sell and distribute the Products in Japan on the terms and conditions set forth herein. Exclusive selling rights is granted on the basis that the attached Exhibit A - Sales and Marketing Activities are completed as stated. Failure to complete the listed activities in the sales and marketing plan may result in loss of exclusive selling rights at Seller's discretion.

NOW, THEREFORE, in consideration of the premises and the mutual covenants hereinafter set forth, the parties hereto hereby agree as follows:

**ARTICLE I
CERTAIN DEFINITIONS**

1.1 "Agreement" shall mean this Agreement, together with all exhibits attached hereto, as amended from time to time pursuant to the terms hereof.

1.2 "Products" shall mean the products and parts therefor listed in Exhibit B, as amended from time to time. Notwithstanding the forgoing, any new models introduced in the product range described in Exhibit B after the date of this Agreement shall only be deemed to be the Products upon the mutual written agreement of both parties hereto.

1.3 "Purchase Order" shall mean a written order for the purchase of the Products specifying the date of the Purchase Order, part number, quantity, requested delivery date and destination.

1.4 "Purchase Prices" shall mean the prices of the Products, in US dollars, as described in Article 5.

1.5 "Specifications" shall mean the specifications for the Products as set forth in Exhibit C, as amended from time to time in accordance with Article 7.

ARTICLE II
PURCHASE AND SALES OF PRODUCTS

2.1 The Seller shall sell, and the Purchaser shall purchase, the Products in accordance with the terms and conditions of this Agreement.

2.2 The Seller shall engage in the sales, and the Purchaser shall engage in the purchase, of the Products as a principal for its own account and at its own expense and risk. This Agreement does not in any way create the relationship of principal and agent, or any similar relationship, between the Seller and the Purchaser. The Seller shall sell the Products in Japan only to the Purchaser and grant to the Purchaser the exclusive right to sell and distribute the Products in Japan under the Purchaser's own terms and conditions. If the Seller receives an inquiry on the Products from a third party in Japan, the Seller shall immediately transmit such inquiry to the Purchaser for its transaction.

2.3 The Seller shall grant to the Purchaser a royalty-free license to use the trademark and/or trade name of the Seller including the words "Active Power" and "CleanSource", in connection with the Products.

2.4 The Seller shall use its reasonable efforts to supply the Products in accordance with the Purchase Order accepted by the Seller.

ARTICLE III
ORDERS

3.1 All purchases of the Products by the Purchaser shall be in accordance with the Purchase Order submitted to and accepted by the Seller.

3.2 The Seller reserves the right to accept or reject all or any part of any Purchase Order, and no Purchase Order shall be effective until accepted in writing by the Seller, provided that the Purchase Order shall be deemed to have been accepted by the Seller unless the Seller gives written notice of acceptance or rejection thereof within ten (10) days of receipt of such Purchase Order.

3.3 The Purchaser shall not change any Purchase Order accepted by the Seller without the Seller's prior written consent.

3.4 In the event of any conflict between the terms of a Purchase Order and the provisions of this Agreement, the terms of the Purchase Order shall control.

ARTICLE IV
PURCHASE PRICES

4.1 The Purchase Prices shall be EXW the Seller's factory in USA, and the details of the Purchase Prices shall be agreed upon by the parties hereto separately.

4.2 If there should be a severe change in market price including the cost of materials or labor, both parties shall discuss revision of the Purchase Prices.

4.3 Trade terms used in this Agreement shall be construed in accordance with the International Rules for the Interpretation of Trade Terms ("INCOTERMS") published by the International Chamber of Commerce, in the version current as of the date of this Agreement.

ARTICLE V
TERMS OF PAYMENT

Payment by the Purchaser to the Seller under this Agreement shall be made in US dollars by telegraphic transfer remittance within [****] days after receipt of Seller's invoices to be issued after delivery of the Products pursuant to Section 6.2.

ARTICLE VI
DELIVERY AND INSPECTION

6.1 The Seller shall, at its own cost, pack, mark and protect the Products in accordance with its standard for export shipping unless otherwise agreed upon by the parties hereto.

6.2 The Seller shall deliver the Products to the Purchaser by the date and at the place specified in the Purchase Order. Delivery of the Products shall be EXW the Seller's factory in USA, unless otherwise agreed upon by the parties hereto.

6.3 If the Seller discovers that a delay in the delivery of the Products will occur, then the Seller shall immediately notify the Purchaser of the expected delay. In such case, the parties shall discuss necessary measures to catch up on the delivery in good faith.

6.4 Title to the Products shall pass from the Seller to the Purchaser when such Products are delivered to the common carrier.

6.5 Upon arrival of the Products at the place where the Products are installed or stored, the Purchaser shall inspect the Products in accordance with the inspection criteria and method to be agreed upon by the parties hereto. Within ten (10) days after arrival of the Products at the said place the Purchaser shall submit to the Seller the results of such inspection, unless otherwise agreed upon by the parties hereto.

Confidential treatment has been requested for the portions of this agreement marked by asterisks. Omitted material for which confidential treatment has been requested has been filed separately with the Securities and Exchange Commission.

6.6 In the event that the Products are found to be nonconforming to the inspection criteria, the Seller's sole liability shall be to provide the Products necessary to correct such nonconformity as soon as reasonably practical.

6.7 The Seller may take back nonconforming Products including excessive Products within thirty (30) days after the date of receipt of the inspection results, unless otherwise agreed upon by the parties hereto. During such period the Purchaser shall store such Products with reasonable care at the Seller's cost.

ARTICLE VII
SPECIFICATIONS AND DESIGN

7.1 If the Seller desires to change the Specifications, the Seller shall give the Purchaser at least ninety (90) days' prior written notice of any proposed changes in the Specifications.

7.2 The Seller reserves the right at any time and from time to time to discontinue the manufacture or sale of any Products. In such case, the Seller shall use its reasonable efforts to give the Purchaser at least one (1) year prior written notice, and the Seller shall be responsible for the continuous supply of any parts for such discontinued Products for eight (8) years after such prior written notice.

ARTICLE VIII
SELLER'S RESPONSIBILITIES

8.1 The Seller shall support the Purchaser to the reasonable extent in the Products-related technical matters and, upon the Purchaser's request, provide the Purchaser with operation manuals, drawings, etc. of the Products free of charge so that the Purchaser will be able to maximize the sale of its products in combination with the Products. All literature shall be in English.

8.2 If the Products should need to be recalled, the Seller shall take necessary action as promptly as possible to minimize the impacts of such recall on the Purchaser's customers, the Purchaser and the Seller itself, and be fully responsible for settling such recall and for all claims from the Purchaser's customers relating to said recall as well as its indemnity obligation toward the Purchaser for such recall related claims.

ARTICLE IX
WARRANTY

9.1 The Seller warrants that the Products will conform to the Specifications and will be free from defects in material and workmanship for a period of twelve (12) months from the date of installation of the Products or eighteen (18) months from the date of delivery set forth in Section 6.2 ("Warranty Period"), PROVIDED THAT THE SOLE AND EXCLUSIVE REMEDY FOR BREACH OF THIS LIMITED WARRANTY, WHETHER BASED ON CONTRACT, TORT (INCLUDING, BUT NOT LIMITED TO, NEGLIGENCE AND STRICT LIABILITY) OR OTHERWISE, SHALL BE (I) SUPPLY OF THE REPLACEMENT OR (II) REPAIR OF NON-CONFORMING OR DEFECTIVE PRODUCTS AT THE SELLER'S COST. Warranty services shall be made in accordance with Exhibit D.

9.2 Any part of Products replaced and/or repaired under this Article 9 shall carry a new 12 months Warranty Period from the date of such replacement and/or repair.

9.3 If the Seller supplies the replacement in accordance with this Article 9, the Purchaser shall return such defective Products to the Seller at Purchaser's cost, and the Seller shall send the replacement to the Purchaser at the Seller's cost, unless otherwise requested by the Seller.

9.4 The Seller shall not be responsible for the replacement or making good of any defect or of any damage to the Products arising out of or resulting from any of the following causes:

- (a) modification of the Products by the Purchaser without the Seller's approval;
- (b) use of the Products not in accordance with the operating manual;
- (c) use of the Products other than for its intended purpose.

9.5 Upon the Purchaser's Request, The Seller shall promptly investigate the cause of defects that may occur on the Products even after expiration of the Warranty Period.

ARTICLE X INDEMNIFICATIONS

10.1 Each party will indemnify, defend and hold harmless the other party and its successors, assigns, agents, officers, directors and employees, against all claims, damages, costs (including but not limited to reasonable attorneys' fees and court costs), charges, losses or liabilities to the extent caused by the negligence or willful misconduct of the indemnifying party, its employees or contractors.

10.2 Notwithstanding anything to the contrary in this Agreement, the Seller shall, at its own expense, indemnify and hold harmless the Purchaser, as well as its directors, officers, employees and agents, from and against any and all losses, damages (actual, consequential or indirect), liabilities, penalties, claims, demands, suits or actions, and related costs and expenses of any kind (including, without limitation, expenses of investigation and recall, legal fees, judgments and settlements) for injury to or death of any person or property damage or any other loss suffered or allegedly suffered by any person or entity and arising out of or otherwise in connection with any defect or alleged defect of the Products.

10.3 NOTWITHSTANDING ANYTHING IN THIS AGREEMENT OR OTHERWISE, AND TO THE EXTENT ALLOWED BY APPLICABLE LAW, UNDER NO CIRCUMSTANCES WILL EITHER PARTY BE LIABLE WITH RESPECT TO ANY SUBJECT MATTER OF THIS AGREEMENT UNDER ANY CONTRACT, NEGLIGENCE, STRICT LIABILITY OR OTHER LEGAL OR EQUITABLE THEORY FOR ANY INCIDENTAL OR CONSEQUENTIAL DAMAGES, LOST PROFITS OR LOST DATA.

ARTICLE XI
PATENT INDEMNIFICATION

11.1 If either party receives any claim by any third party that the Products violate, infringe or misappropriate any patent, utility model, design, trademark, trade secret, copyright or other intellectual property rights of any type (“Intellectual Property Right”) of a third party, such party gives written notice to the other party without delay.

11.2 Except as provided in Section 11.3, the Seller shall defend any suit brought against the Purchaser and pay any damages finally awarded against the Purchaser based on a claim that the Products, as delivered to the Purchaser, infringe the Intellectual Property Right of a third party, provided that the Purchaser (a) gives the Seller immediate written notice of any such claim of infringement, (b) the Seller has sole control of the defense of any such claim and all negotiations for any settlement or compromise and (c) the Purchaser provides the Seller with such information and assistance as the Seller deems necessary. In the event that the Products are held to infringe the Intellectual Property Right of a third party, the Seller shall, at its discretion, (a) procure for the Purchaser, or reimburse the Purchaser for procuring, the right to continue using the infringing Products, (b) modify the infringing Products so that they become non-infringing, (c) replace the infringing Products with non-infringing Products or (d) provide a refund of any amounts paid for the infringing Products.

11.3 The Seller shall have no liability or obligation to the Purchaser with respect to any claim of infringement based on or arising from any (a) specifications, plans, designs or components furnished by the Purchaser, (b) use of the Products in combination with devices or products not supplied by the Seller, (c) use of the Products in an application or environment for which they were not designed or (d) modification of the Products.

ARTICLE XII
CONFIDENTIAL INFORMATION

12.1 The term “Confidential Information” shall mean information related to the Products or the business and affairs of a party disclosed during the term of this Agreement. Any Confidential Information shall be, if provided in tangible form, clearly marked “Confidential”, or if orally disclosed, reduced to a written summary similarly marked and delivered to the receiving party within thirty (30) days after its disclosure. All Confidential Information disclosed by either party shall remain the property of the disclosing party. The Confidential Information shall not include information that:

(a) is or becomes publicly available without default hereunder by the receiving party;

(b) is lawfully acquired by the receiving party from a third party not under any obligation of confidentiality to the disclosing party with respect to such information;

- (c) is in the possession of the receiving party in written or other recorded form at the time of its disclosure hereunder;
- (d) is disclosed to any third party by or with the permission of the disclosing party without restriction on further disclosure; or
- (e) is independently developed by the receiving party and such development can be demonstrated by tangible evidence.

12.2 During the term of this Agreement and for a period of ten (10) years thereafter, each party agrees to use the Confidential Information of the other party only for the purposes contemplated herein and to safeguard the Confidential Information against unauthorized disclosure.

12.3 In the event that a receiving party or any of its representatives is requested or required (by the disclosure requirements of any rule, regulation or form of any court or other governmental authority, or by oral questions, interrogatories, requests for information or documents or by any court or other governmental authority or other person in legal proceedings, subpoenas, civil investigative demands or other similar processes) to disclose any of the Confidential Information received from the other party, the receiving party so requested or required, or whose representative has been so requested or required, shall provide the other party with prompt written notice of any such request or requirement so that the other party may object to production, seek a protective order or other appropriate remedy and/or waive compliance with the provisions of this Agreement. The receiving party or representative shall exercise its reasonable efforts (at the sole expense of the other party) to preserve the confidentiality of such Confidential Information, including, without limitation, by cooperating with the other party to obtain an appropriate protective order or other reliable assurance that confidential treatment will be accorded such Confidential Information. If, in the absence of a protective order or other remedy or the receipt of a waiver of the other party, such receiving party or any of its representatives is nonetheless legally compelled to disclose such Confidential Information to any tribunal or else stand liable for contempt or suffer other censure or significant penalty, such receiving party or representative may, without liability hereunder, disclose to such tribunal only that portion of the Confidential Information which is legally required to be disclosed.

12.4 After the expiration or termination of this Agreement for any reason or upon written request of the disclosing party, the receiving party shall return all the Confidential Information including all copies, or shall certify in writing that all such Confidential Information and copies have been destroyed.

ARTICLE XIII TERM AND TERMINATION

13.1 This Agreement is effective as of the first date written above and shall have an initial term of one (1) year unless earlier terminated as provided herein. Thereafter, this Agreement shall be automatically renewed for successive terms of one year each, unless either party gives the other party written notice of its intention to terminate this Agreement upon the expiration of its then current term not less than ninety (90) days prior to the expiration of such term.

13.2 Either party may terminate this Agreement and any Purchase Order by giving a written notice of termination to the other party if such other party fails to perform any of its material obligations under this Agreement and fails to cure such default within sixty (60) days after written notice thereof from the terminating party.

13.3 Either party may terminate this Agreement and any Purchase Order with immediate effect by written notice to the other party upon the occurrence of any of the following events:

(a) the other party becomes insolvent or bankrupt, or an application shall be made to have such other party declared insolvent or bankrupt, or a receiver or trustee is appointed, or such other party makes an assignment for the benefit of its creditors;

(b) the acquisition or the merger of the other party with or into any other corporation, the sale by the other party of all or substantially all of its property or assets or a change in control of the other party; or

(c) one party reasonably deems that any of the events provided in Subsections 13.3(a) and (b) above may occur.

13.4 If any of the events provided in Subsections 13.3(a), (b) and (c) occurs, then all debts owed by the defaulting party shall become immediately due and payable.

ARTICLE XIV EFFECT OF TERMINATION

14.1 Termination of this Agreement shall not affect any right of the Seller to payment for the Products ordered by the Purchaser hereunder prior to such termination and delivered by the Seller before or after such termination.

14.2 In case of termination of this Agreement for the reason not attributable to the Seller, the Seller shall have the option, at its discretion and upon notice to Purchaser, either to cancel or to perform any Purchase Order previously accepted and not performed.

14.3 Any Purchase Order to be performed by the Seller after expiration or termination of this Agreement shall be governed by the provisions of this Agreement.

14.4 The provisions of Articles 8, 9, 10, 11, 12, 14 and 16 and Section 17.1 shall survive the expiration or termination of this Agreement.

ARTICLE XV FORCE MAJEURE

Neither party shall be liable for failure or delay in performing its obligations hereunder if such failure or delay is due to circumstances beyond its reasonable control, including, without

limitation, acts of any governmental body, war, insurrection, sabotage, embargo, fire, flood, acts of God, strike or other labor disturbances, interruption of or delay in transportation or inability to obtain raw materials, supplies, power or equipment used in or needed for the production or transportation of the Products, provided, however, that lack of credit, funds, or financing shall not be considered a matter beyond the reasonable control of a party. A party subject to or anticipating any event of force majeure shall (a) promptly notify the other party in writing of the nature of such actual or anticipated event of force majeure, the expected duration thereof, and its anticipated effect on the party expected to perform, (b) use its best efforts to remedy such delay (except that neither party shall be under any obligation to settle a labor dispute) and (c) keep the other party informed of the effect of the event of force majeure and the anticipated date of its resumption of performance. Notwithstanding the foregoing, either party shall have the right to terminate this Agreement if the excused failure or delay continues for six (6) months from the date that performance was first delayed.

ARTICLE XVI
ARBITRATION

In the event of any dispute, controversy or claim arising out of or relating to this Agreement or to a breach hereof, including its interpretation, performance or termination, the parties shall attempt in the first instance to resolve such dispute through friendly consultations. If formal discussions are not commenced within thirty (30) days from the initial request for friendly consultations, then the matter shall be finally resolved by binding arbitration in accordance with the Commercial Arbitration Rules of the Japan Commercial Arbitration Association (“JCAA”) then in effect. Such arbitration shall be held before the JCAA. The arbitration panel shall consist of three (3) arbitrators. Each party shall appoint one (1) arbitrator within thirty (30) days after giving or receiving the demand for arbitration and a third arbitrator shall be appointed through consultation of the parties hereto within twenty (2) days thereafter. If both parties do not reach an agreement on appointment of the third arbitrator or either party fails to appoint an arbitrator within the foregoing durations, such arbitrator(s) shall be appointed by the JCAA. The arbitrators appointed must have extensive knowledge or experience, or both, regarding the manufacture and distribution of power systems similar to the Products, and must be fluent in English. The arbitration will be conducted (i) within 30 days of the appointment of the arbitrators, (ii) in the English language and (iii) in the Tokyo metropolitan area at a place and a time agreed by the parties or, if the parties cannot agree, as designated by the arbitration panel. The arbitrator panel’s final decision or award shall be final and binding upon the parties, and the expense of the arbitration (including without limitation the award of attorneys’ fees to the prevailing party) shall be paid as the arbitrator panel determines. Judgment upon that decision or award may be entered in any court having jurisdiction over either or both of the parties or their respective assets, and the enforcement of that decision or award will be in accordance with and governed by the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

ARTICLE XVII
MISCELLANEOUS PROVISIONS

17.1 This Agreement, which is written in English, shall be interpreted in accordance with the commonly understood meaning of the words and phrases hereof in the United States of

America, and it and performance of the parties hereunder shall be construed and governed according to the laws of the State of New York and the United States applicable to contracts made and to be fully performed therein, without reference to conflicts of laws provisions or the provisions of the United Nations Convention on Contracts for the International Sale of Goods.

17.2 All notices required or permitted hereunder shall be made in English and in writing, delivered by hand, by registered or certified mail, or by fax, and shall be deemed to have been duly given and received when delivered by hand or, if mailed, five (5) business days after deposit in the mail, with postage prepaid for registered or certified mail, return receipt requested, or, in the case of fax notice, when sent, if confirmation is received, and addressed to the Seller at:

2128 W. Braker Lane, B12
Austin, Texas 78758
USA
Fax No.: _____
Attn: _____

and to the Purchaser at:

Gate City Ohsaki, East Tower,
11-2, Osaki 1-chome,
Shinagawa-ku, Tokyo 141-0032, Japan
Fax No.: _____
Attn: _____

or at such other address as a party shall have furnished the other party in accordance with this Section 17.2.

17.3 The parties intend that the terms of this Agreement, including the attached exhibits, shall be the final expression of their agreement with respect to the subject matter hereof and may not be contradicted by evidence of any prior or contemporaneous agreement. The parties further intend that this Agreement shall constitute the complete and exclusive statement of its terms and that no extrinsic evidence whatsoever may be introduced in any judicial, administrative, or other legal proceeding involving this Agreement.

17.4 This Agreement may not be amended except by an instrument in writing signed by the party against whom enforcement of the amendment is sought. No failure to exercise and no delay in exercising any right, remedy or power hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any right, remedy or power hereunder preclude any other or further exercise thereof or the exercise of any other right, remedy or power provided herein or by law or in equity.

17.5 Neither party may assign, transfer, delegate, or otherwise dispose of, whether voluntarily, involuntarily or by operation of law, any right or obligation under this Agreement without prior written consent of the other party hereto. The acquisition of a party or the merger of any party with or into any other corporation, the sale by any party of all or substantially all of its property or assets or a change in control of a party shall constitute an assignment for purposes of this Section 17.5. Subject to the foregoing limits on assignment and delegation, this Agreement shall be binding upon and shall inure to the benefit of the parties and their respective heirs, executors, administrators, successors and assigns.

17.6 The Seller shall not subcontract all or any part of manufacture of the Products to any third parties including the Seller's subsidiaries or affiliates without the Purchaser's prior written consent, which shall not be unreasonably withheld.

17.7 If any provision of this Agreement, or the application thereof to any person, place, or circumstance; shall be held by a court of competent jurisdiction to be invalid, unenforceable or void, the remainder of this Agreement and such provisions as applied to other persons, places and circumstances shall remain in full force and effect.

17.8 This Agreement may be executed in counterparts, each of which shall be deemed an original, but all of which taken together shall constitute one and the same instrument.

IN WITNESS WHEREOF, each party has executed this Agreement as of the date first above written.

ACTIVE POWER, INC.

FUJI ELECTRIC CO., LTD.

By: /s/ _____

By: /s/ _____

Name: _____

Name: Toshiharu, Sasamoto

Title: _____

Title: Executive Officer, General Manager Public & Social Systems
Division Energy and Electrical Systems Company

Exhibit A

Sales and Marketing Activities

[****]

Confidential treatment has been requested for the portions of this agreement marked by asterisks. Omitted material for which confidential treatment has been requested has been filed separately with the Securities and Exchange Commission.

Exhibit B

Products

CleanSource 2 Flywheel Energy Storage Systems

B-1

Exhibit C
Specifications

Configuration:

2 terminal DC energy storage

System Dimensions:

(42"+9.69")W x 34"D x 78"H

Input:

Float voltage range: 400 to 600 volts DC

Minimum charging current required:

15 ADC (CS2-250)

30 ADC (CS2-500)

Average standby current:

2-3 ADC (CS2-250)

4-6 ADC (CS2-500)

Output:

Adjustable nominal discharge voltage range: 360 to 550 volts DC.

Maximum rated power between 480 and 550 VDC.

DC voltage regulation $\pm 1\%$ steady state.

DC nipple <2%

Recharge time [current dependent]

From complete discharge: <2.5 minutes

Upon initial start-up: <7.5 minutes

Environmental:

Operating temperature range: -25°C to 40°C

Non-operating temperature range: 0°C to 70°C

Humidity: <95% without condensation

Operating altitude: Up to 4,000 ft with no derating

Operating noise level: 72 dBA at 1 meter

Typical heat dissipation:

<3 kW or 10250 BTU (CS2-250)

<5kW or 17050 BTU (CS2-500)

Standard

LCD monitor/control panel

RS232/485 communication interface

Self diagnostics

Alarm status contacts

Parallel capabilities

Soft-start precharge from DC bus

Push-button shutdown

UL listed

CE Mark

DC disconnect

Side-car for top cable entry

Options

CSView-real-time monitoring software

Remote notification and monitoring

- pager and/or e-mail
- modem and/or Ethernet

Modbus interface

SNMP

Exhibit D

Warranty and Post-Warranty Service

Purchaser's service personnel must successfully complete Seller's certified training course (administered by either Seller or Purchaser's Trainer that has been certified for the CleanSource) in order to provide warranty support for the Product.

Warranty Parts - Seller will provide warranty replacement Spare Parts at no charge to Purchaser during the warranty period. These Spare Parts will replace the spare parts inventory purchased by Purchaser per the attached Spare Parts list. Purchaser will purchase the initial stock of spare parts inventory at Seller's published list price less 35%. These Spare Parts should cover 95% of expected repairs to all CleanSource models. Upon receiving a Spare Part covered under warranty and accompanied by the supporting documentation, (See attachment 1), Seller will provide either a new, repaired, remanufactured Spare Part to replace the Purchaser's inventoried Spare Part. Purchaser will be responsible for the shipping of the affected Spare Part to the approved Seller Parts Center. Seller will be responsible for the freight cost of the returning the failed Spare Part to the Purchaser logistic support center designated by Purchaser. In warranty cases requiring express shipping, Seller will be responsible for the express freight charges.

Return Material Authorization Procedures - See Attachment 2

Warranty Service Escalation Plan - For any system down more than 48 hours and being covered by the Seller's Service Escalation Plan, Seller technical support coverage will be expanded to 24 hours per day 7 days per week for the specific event. (See Attachment 3)

Supporting Warranty Documentation - summary of Field Activity Reports (attached hereto as Exhibit D – Attachment 4) will be provided by Purchaser to Seller for providing Seller warranty services to Purchaser Customers. This must include documentation of specific failures and summary information on the causes of such failures.

At any time during the warranty period with respect to each Product, Seller reserves the right to meet and confer, upon ten (10) days prior written notice regarding the Purchaser provided warranty service on each such Product if: in any three (3) month period an uncorrected (i) repetitive problem occurs, (ii) Purchaser repair has been repeatedly done incorrectly and/or (iii) the Spare Parts used by Purchaser to resolve or correct problems has been materially higher than the average for the applicable problem. If, after meeting and conferring, the parties are unable to reach a mutually acceptable resolution of the foregoing issues, then, upon ten (10) days prior written notice, Seller may assume future warranty obligations. The cost associated with such meeting shall be paid by the party whose initiates the cause of such meeting.

EXHIBIT D-Attachment 1

Spare Parts Seller's List Price

Effective 4/01/03

[****]

Confidential treatment has been requested for the portions of this agreement marked by asterisks. Omitted material for which confidential treatment has been requested has been filed separately with the Securities and Exchange Commission.

EXHIBIT D - Attachment 2

Seller's Warranty and Post Warranty Return Material Authorization Procedures

Before returning a Spare Part for repair or replacement, Purchaser must first contact Seller and obtain a Return Material Authorization (RMA) number. The following information must be supplied in order to obtain an RMA number:

- Name of the Purchaser's Customer
- Serial number of the original Product
- Shipment or delivery date
- Description of the problem
- Offsetting Order for replacement Spare Part (if the Spare Part is approved for replacement)

Upon receipt of the RMA number, which will be supplied by Seller before the end of the next business day, Purchaser or Purchaser's Customer will return the Spare Part to Seller at Seller's expense. The RMA and Spare Part serial number must be referenced on all correspondence regarding the returned Product, as well as on the shipping container or package and all shipping documents. Spare Parts returned without RMA numbers or actual RMA authorization will not be accepted. All returned Spare Parts must be properly and commercially reasonably packed. Seller is not responsible for damage to Spare Parts incurred in shipment or due to inadequate or improper packaging. Seller will promptly repair or replace any defective Spare Part and return the replacement or repaired Spare Part to Purchaser at Purchaser's expense for Spare Parts under warranty (if non-warranty then the return will be at Seller's expense) or issue credit if replacement of Spare Part had already been filled by Seller's Spare Part purchase order under warranty.

EXHIBIT D - Attachment 3

Typical Service Escalation Chart

The escalation chart below is to be used as the maximum allowable time from identification of warranty issue before the next responsible party is notified and has an obligation to provide service response. These times are not to be considered the minimum time allowed prior to notifying a responsible party. Purchaser may contact Seller anytime for technical assistance after showing a responsible effort on Purchaser's party to resolve the related issue.

Chart: C-1
Typical Service Escalation

Elapsed Time	Purchaser Field Service	Purchaser Technical Support	Active Power Service	Active Power Engineering	Active Power On-Site Service
T + 24 Hrs.	X	X			
T + 48 Hrs.	X	X	X	X	
T + 72 Hrs.	X	X	X	X	
T + 96 Hrs.	X	X	X	X	X

EXHIBIT D - Attachment 4

FUJI ELECTRIC CO. Field Activity Report

Place Name:

Place Address:

Phone:

Contact:

Technician:

P.O.:

Arrival Date/Time:

Completion Date/Time:

Problem Description:

Service Notes:

Code:

Text:

Products Serviced:

Model ID:

Revision:

Serial ID:

Contract ID / Version:

Services:

Model ID:

Service Description

Quantity

Non-Product Part and Non-Part Usage

Part Need Details

Certification

I, Joseph F. Pinkerton III, President and Chief Executive Officer of Active Power, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Active Power, Inc. (the "Registrant");
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
 - (b) Reserved.
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: October 23, 2003

/s/ Joseph F. Pinkerton, III

Joseph F. Pinkerton, III
Chairman of the Board, President and Chief Executive Officer
(Principal Executive Officer)

Certification

I, David S. Gino, Vice President, Chief Operating Officer and Chief Financial Officer of Active Power, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Active Power, Inc. (the "Registrant");
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) [and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f))] for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
 - (b) Reserved.
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: October 23, 2003

/s/ David S. Gino

David S. Gino
Vice President, Chief Operating Officer and Chief Accounting Officer
(Principal Financial and Accounting Officer)

**CERTIFICATION PURSUANT TO
18 U.S.C. § 1350,
AS ADOPTED PURSUANT TO § 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10Q of Active Power, Inc. (the "Company") for the period ending September 30, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Joseph F. Pinkerton, III, Chairman of the Board, President and Chief Executive Officer of the Company, hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods expressed in the Report.

/s/ Joseph F. Pinkerton, III

Joseph F. Pinkerton, III
Chairman of the Board, President and Chief Executive Officer
(Principal Executive Officer)
October 23, 2003

**CERTIFICATION PURSUANT TO
18 U.S.C. § 1350,
AS ADOPTED PURSUANT TO § 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Active Power, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, David S. Gino, Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods expressed in the Report.

/s/ David S. Gino

David S. Gino
Vice President, Chief Operating Officer and Chief Accounting Officer
(Principal Financial and Accounting Officer)
October 23, 2003