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

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2008

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-30939

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**ACTIVE POWER, INC.**

(Exact name of registrant as specified in its charter)

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**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)

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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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definitions of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  Smaller Reporting Company

(Do not check if a smaller reporting company)

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

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, par value of \$0.001 per share, outstanding at April 24, 2008 was 60,458,311.**

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[Table of Contents](#)

ACTIVE POWER, INC.  
FORM 10-Q  
INDEX

<a href="#">PART I – FINANCIAL INFORMATION</a>	1
<a href="#">Item 1. Consolidated Financial Statements.</a>	1
<a href="#">Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.</a>	7
<a href="#">Item 3. Quantitative and Qualitative Disclosures about Market Risk</a>	14
<a href="#">Item 4. Controls and Procedures</a>	14
<a href="#">PART II – OTHER INFORMATION</a>	15
<a href="#">Item 1. Legal Proceedings</a>	15
<a href="#">Item 1A. Risk Factors</a>	16
<a href="#">Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.</a>	16
<a href="#">Item 3. Defaults Upon Senior Securities.</a>	16
<a href="#">Item 4. Submission of Matters to a Vote of Security Holders.</a>	16
<a href="#">Item 5. Other Information.</a>	16
<a href="#">Item 6. Exhibits.</a>	17

[Table of Contents](#)**PART I – FINANCIAL INFORMATION**

Item 1. Consolidated Financial Statements.

**Active Power, Inc.**  
**Condensed Consolidated Balance Sheets**  
(in thousands)

	<u>March 31,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
	<u>(unaudited)</u>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,182	\$ 15,504
Short-term investments in marketable securities	2,947	6,581
Accounts receivable, net	5,069	5,177
Inventories	8,670	9,198
Prepaid expenses and other	468	540
Total current assets	30,336	37,000
Property and equipment, net	5,331	5,530
Long-term investments in marketable securities	1,288	407
Other assets	464	389
Total assets	<u>\$ 37,419</u>	<u>\$ 43,326</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,327	\$ 2,342
Accrued expenses	4,786	5,793
Deferred revenue	1,017	1,918
Total current liabilities	8,130	10,053
Long-term liabilities	25	25
Stockholders' equity:		
Common stock	60	60
Treasury stock	(59)	(5)
Additional paid-in capital	258,996	258,630
Accumulated deficit	(229,870)	(225,401)
Other accumulated comprehensive income	137	(36)
Total stockholders' equity	29,264	33,248
Total liabilities and stockholders' equity	<u>\$ 37,419</u>	<u>\$ 43,326</u>

*See accompanying notes.*

**Active Power, Inc.**  
**Condensed Consolidated Statements of Operations and Comprehensive Loss**

(in thousands, except per share amounts)  
(Unaudited)

	Three Months Ended March 31,	
	2008	2007
Product revenue	\$ 6,248	\$ 5,271
Service and spares revenue	1,290	702
Total revenue	7,538	5,973
Cost of product revenue	5,657	4,911
Cost of service and spares revenue	1,098	725
Total cost of revenue	6,755	5,636
Gross profit	783	337
Operating expenses:		
Research and development	1,402	1,584
Selling and marketing	2,950	2,625
General and administrative	1,182	2,751
Total operating expenses	5,534	6,960
Operating loss	(4,751)	(6,623)
Interest income	163	201
Other income (expense)	119	(2)
Net loss	<u>\$ (4,469)</u>	<u>\$ (6,424)</u>
Net loss per share, basic & diluted	\$ (0.07)	\$ (0.13)
Shares used in computing net loss per share, basic & diluted	60,124	50,088
Comprehensive loss:		
Net loss	\$ (4,469)	\$ (6,424)
Translation gain on subsidiaries in foreign currencies	170	(144)
Change in unrealized loss on investments in marketable securities	3	12
Comprehensive loss	<u>\$ (4,296)</u>	<u>\$ (6,556)</u>

See accompanying notes.

**Active Power, Inc.**  
**Condensed Consolidated Statements of Cash Flows**

(in thousands)  
(Unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities</b>		
Net loss	\$ (4,469)	\$(6,424)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	462	518
Change in allowance for doubtful accounts	18	(55)
Accretion of premium/discount on marketable securities	(36)	(12)
Loss on disposal of fixed assets	(20)	200
Stock-based compensation	348	549
Changes in operating assets and liabilities:		
Accounts receivable	90	2,435
Inventories	528	(1,510)
Prepaid expenses and other assets	(2)	93
Accounts payable	(15)	(1,335)
Accrued expenses	(1,009)	2,032
Deferred revenue	(901)	269
Net cash used in operating activities	(5,006)	(3,240)
<b>Investing activities</b>		
Purchases of marketable securities	(1,730)	(259)
Sales/maturities of marketable securities	4,523	4,150
Purchases of property and equipment	(243)	(355)
Net cash provided by investing activities	2,550	3,536
<b>Financing activities</b>		
Net proceeds from issuance of common stock	18	—
Purchases of treasury stock	(54)	—
Net cash provided by financing activities	(36)	—
Translation gain on subsidiaries in foreign currencies	170	(144)
Change in cash and cash equivalents	(2,322)	152
Cash and cash equivalents, beginning of period	15,504	7,652
Cash and cash equivalents, end of period	<u>\$13,182</u>	<u>\$ 7,804</u>

See accompanying notes.

**Active Power, Inc.**  
**Notes to Condensed Consolidated Financial Statements**  
**March 31, 2008**  
(Unaudited)

**1. Significant Accounting Policies**

**Basis of presentation:** Active Power, Inc. and its subsidiaries (hereinafter referred to as “we”, “us”, “Active Power” or the “Company”) design, manufacture and market critical power quality solutions that provide business continuity and protect customers in the event of an electrical power disturbance. Our products are designed to provide power quality to protect customers from voltage fluctuations such as surges and sags, frequency fluctuations, and to also provide ride-through, or temporary power to bridge the gap between a power outage and the restoration of utility power, or the time required to switch to electrical generator power. We target global enterprises with zero tolerance for downtime in their mission critical business operations. The Uninterruptible Power Supply (“UPS”) products we manufacture utilize green technologies to create a renewable energy source. We sell our products globally through direct, manufacturer’s representatives and Original Equipment Manufacturer (“OEM”) channels. Our current principal markets are North America and Europe, Middle East and Africa (“EMEA”).

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and include the accounts of the Company and its consolidated subsidiaries. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company and its consolidated results of operations and cash flows. These interim financial statements should be read in conjunction with the financial statements and accompanying notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2007.

**Recently issued accounting standards:**

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141R (revised 2007), *Business Combinations* (SFAS 141(R)), which establishes the acquisition method to account for business combinations. SFAS 141(R) requires the acquiring entity to recognize all of the assets acquired and liabilities assumed in the transaction, establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. These rules are effective for transactions closing after January 1, 2009.

**2. Supplemental Balance Sheet Information****Receivables**

Accounts receivable consist of the following (in thousands):

	<u>March 31,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
Trade receivables	\$ 5,493	\$ 5,583
Allowance for doubtful accounts	(424)	(406)
	<u>\$ 5,069</u>	<u>\$ 5,177</u>

## Inventory

We state inventories at the lower of cost or market, using the first-in-first-out-method (in thousands):

	March 31, 2008	December 31, 2007
Raw materials	\$ 6,350	\$ 6,340
Work in process and finished goods	4,430	5,054
Allowances for obsolescence	(2,110)	(2,196)
	<u>\$ 8,670</u>	<u>\$ 9,198</u>

Included in inventory at March 31, 2008 and December 31, 2007 were \$2.1 and \$2.2 million respectively, of inventory relating exclusively to our CoolAir family of products. In December 2007 we recorded reserves of \$1.8 million against this inventory as a result of our expectations of future product demand and future product development initiatives that potentially would result in excess quantities of CoolAir inventory. If these expectations are not met during 2008 and we are unable to sell sufficient quantities of our finished CoolAir products, we may need to record an additional impairment charge for some or all of the remaining amount.

## Property and Equipment

Property and equipment consist of the following (in thousands):

	March 31, 2008	December 31, 2007
Equipment	\$ 9,622	\$ 9,409
Computers and software	2,696	2,672
Demonstration units	1,032	1,082
Furniture and fixtures	351	331
Leasehold improvements	7,236	7,232
Construction in progress	31	—
	<u>20,968</u>	<u>20,726</u>
Accumulated depreciation	(15,637)	(15,196)
	<u>\$ 5,331</u>	<u>\$ 5,530</u>

## Accrued Expenses

Accrued expenses consist of the following (in thousands):

	March 31, 2008	December 31, 2007
Compensation and benefits	\$ 1,512	\$ 1,812
Warranty liability	859	819
Federal, state, property and sales taxes	729	1,177
Professional fees	814	1,008
Other	872	977
	<u>\$ 4,786</u>	<u>\$ 5,793</u>



### Warranty Liability

Generally, the warranty period for our power quality products is 12 months from the date of commissioning or 18 months from the date of shipment from Active Power, whichever period is shorter. We provide for the estimated cost of product warranties at the time revenue is recognized and this accrual is contained in accrued expenses on the accompanying balance sheet.

Changes in our warranty liability are presented in the following table (in thousands):

Balance at December 31, 2007	\$ 819
Warranty expense	181
Warranty charges incurred	(141)
Balance at March 31, 2008	<u>\$ 859</u>

### 3. 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 March 31,	
	2008	2007
Net loss	<u>\$ (4,469)</u>	<u>\$ (6,424)</u>
Basic and diluted:		
Weighted-average shares of common stock outstanding	60,124	50,088
Shares used in computing net loss per share, basic and diluted	<u>60,124</u>	<u>50,088</u>
Net loss per share, basic and diluted	<u>\$ (0.07)</u>	<u>\$ (0.13)</u>

Our calculation of diluted loss per share excludes 5,645,007 and 5,861,427 shares of common stock issuable upon exercise of employee stock options as of March 31, 2008 and 2007, respectively, and 238,638 and 260,000 of non-vested shares issuable upon exercise of restricted stock awards of March 31, 2008 and 2007 because their inclusion in the calculation would be anti-dilutive. As of March 31, 2008 and 2007, there was no common stock subject to repurchase.

### 4. Investments in Marketable Securities

Investments in marketable securities consist of money market funds, commercial paper and debt securities with readily determinable fair values. We account for investments that are reasonably expected to be realized in cash, sold or consumed during the year as short-term investments. We classify investments in marketable securities as available-for-sale and all reclassifications made from unrealized gains/losses to realized gains/losses are determined based on the specific identification method.

Included within our short-term investments at December 31, 2007 was \$2.4 million of AAA and AAA1/A1 rated investments in auction rate securities. Auction rate securities held by us are taxable municipal bonds with long-term nominal maturities for which the interest rates are reset through a dutch auction each month. The monthly auctions historically have provided a liquid market for these securities.

## [Table of Contents](#)

During the first quarter we redeemed \$1.5 million of these securities and at March 31, 2008 we held \$875,000 of auction rate securities. The liquidity issues in U.S. and global credit and capital markets during 2008 have resulted in a number of failed dutch auctions in the auction rate securities market. We have experienced failed auctions for our remaining auction rate securities during 2008, meaning that the amount of securities submitted for sale exceeded the amount of purchase orders for these securities. This has resulted in an illiquid asset for us, even though we continue to earn interest on these securities according to their stated terms. Because of this lack of liquidity, the remaining balance of our auction rate securities has been reclassified to a long-term asset at March 31, 2008.

We continue to work with the financial institution that marketed these auction rate securities to us as a liquid money-market asset to enable us to liquidate these securities in an orderly manner. None of the underlying securities have had any credit rating adjustments, but the overall lack of liquidity in the auction rate securities market has resulted in us holding an illiquid asset. Our current liquidity situation is such that we do not have to redeem these securities in the short term. The lack of liquidity also means that we do not have a readily discernable market valuation with which to value these securities. Therefore we continue to carry these securities at par-value as we have historically valued them at par value since that is the value we receive when we trade these securities in an established market. Any differences between par value and the purchase price or settlement have historically been comprised of accrued interest.

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

*The following discussion should be read in conjunction with, and is qualified in its entirety to, the financial statements and notes thereto included in Item 1 of this Form 10-Q and the financial statements and notes thereto and our Management's Discussion and Analysis of Financial Condition and Results of Operation for the year ended December 31, 2007 included in our 2007 Annual Report on Form 10-K. 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. In addition, please see the "Risk Factors" in Part 1, Item 1A in our 2007 Annual Report on Form 10-K and in Part II, Item 1A of this Form 10-Q for a discussion of items that may affect our future results.*

### **Overview**

We design, manufacture and market efficient, reliable and green power quality solutions and Uninterruptible Power Supply (UPS) systems that provide business continuity and protect customers in the event of an electric power disturbance. Our products are designed to provide power quality to protect customers from voltage fluctuations such as surges and sags, frequency fluctuations, and to also provide ride-through, or temporary, power to bridge the gap between a power outage and the restoration of utility power, or the time required to switch to electric generator power. Our products are designed to be environmentally friendly compared to existing solutions without compromising functionality, efficiency or cost. As of March 31, 2008 we have shipped over 1,800 flywheels in UPS system installations, delivering more than 450 megawatts of power to customers in over 40 countries around the world.

## [Table of Contents](#)

Our patented flywheel energy storage systems store kinetic energy by constantly spinning a compact steel wheel (flywheel) driven from utility power in a low friction environment. When the utility power used to spin the flywheel fluctuates or is interrupted, the flywheel's inertia causes it to continue spinning. The resulting kinetic energy of the spinning flywheel generates electricity known as "bridging power" for short periods until utility power is fully restored or a backup electricity generator starts and takes over generating longer term power in the case of an extended electrical outage. We sell our flywheel products to commercial and industrial customers across a variety of vertical markets, including manufacturing, technology, communications, utilities, healthcare, banking and military and in all geographic regions of the world, but particularly in North America, Western Europe and Asia.

We believe that our flywheel products provide many advantages over traditional battery-based systems, including substantial space savings, higher power densities, "green" energy storage and power efficiencies as high as 98% that reduce total operating costs. We offer our flywheel products with load capabilities from 130 kVA to 3,600 kVA, while typically targeting power density applications above 200 kVA since the majority of these customers already have back-up generators. We market our flywheel products under the brand name CleanSource®. CleanSource DC is a non-chemical replacement for lead-acid batteries used for bridging power. Utilizing our flywheel energy storage technology, the CleanSource DC is a stand-alone, direct current (DC) product that is compatible with all major brands of UPS. We built on the technological success of CleanSource DC by creating a battery-free UPS, CleanSource UPS, which integrates the UPS electronics and our flywheel energy storage system into one compact cabinet. CleanSource UPS represent the majority of our current revenue. The CleanSource UPS is also marketed directly by Caterpillar Inc. under an OEM relationship with us. Combining our CleanSource UPS with a generator provides customers with complete short and long-term protection in the event of a power disturbance.

To meet the requirements of customers without backup generators that require protection from utility disturbances, we have also developed a patented extended runtime product that we call CoolAir™ DC. We initially have targeted CoolAir DC at lower power levels than our flywheel products, and it is sold as a minute-for-minute replacement for lead-acid batteries. CoolAir DC can provide backup power for several minutes to hours depending on the customer application. CoolAir DC utilizes mature thermal and compressed air storage (TACAS) technologies combined in a proprietary manner to produce backup power during an electrical disturbance. This product discharges cool air as a by-product of its operation that also can be used by customers during an electrical disturbance as a transitional source of backup cooling.

Our primary sales channels in North America have traditionally been through our OEM partners, Caterpillar, Inc. and Eaton Electrical (formerly known as PowerWare). Since 2005 we have developed additional sales channels in North America including direct sales employees and a network of manufacturer's representatives. Direct sales tend to improve our relationships with clients, improve our gross margins and add service and other revenue opportunities. Our primary sales channels in Europe, Middle East and Asia (EMEA) include selling directly to end users and indirectly through select value added resellers (VARs). We also provide services including engineering, installation, start-up, monitoring, and repair for our products under contracts with our customers.

[Table of Contents](#)

**Results of Operations**

(\$ in thousands)

	Three months ended March 31,				Variance	
	2008	% of	2007	% of	\$	%
		total		total		
	revenue	revenue	revenue	revenue		
Product revenue	\$ 6,248	83%	\$ 5,271	88%	\$ 977	19%
Service and spares revenue	1,290	17%	702	12%	588	84%
Total revenue	7,538	100%	5,973	100%	1,565	26%
Cost of product revenue	5,657	75%	4,911	82%	746	15%
Cost of service and spares revenue	1,098	15%	725	12%	373	51%
Total cost of revenue	6,755	90%	5,636	94%	1,119	20%
Gross profit	783	10%	337	6%	446	132
Operating expenses:						
Research and development	1,402	19%	1,584	27%	(182)	(11%)
Selling and marketing	2,950	39%	2,625	44%	325	12%
General and administrative	1,182	16%	2,751	46%	(1,569)	(57%)
Total operating expenses	5,534	73%	6,960	117%	(1,426)	(20%)
Operating loss	(4,751)	(63%)	(6,623)	(111%)	(1,872)	(28%)
Interest income	163	2%	201	3%	(38)	(19%)
Other income (expense)	119	2%	(2)	—	121	6050%
Net loss	<u>\$(4,469)</u>	<u>(59%)</u>	<u>\$(6,424)</u>	<u>(108%)</u>	<u>\$(1,955)</u>	<u>(30%)</u>

**Product revenue.** Product revenue consists of sales of our CleanSource power quality products, comprised of both UPS and DC product lines, and sales of third-party ancillary equipment, such as engine generators, electrical and switchgear products.

The increase in product revenue from the same period of 2007 was due to higher sales of our 250-900 kVA UPS product line. A single product, depending on its power rating, may be comprised of multiple flywheel units. The average selling price over the first three months of 2008 was \$78,000 per quarter-megawatt flywheel, compared to \$82,000 over the same period in 2007. The increase in product revenue and the corresponding decrease in the average selling price is the result of an increase in transactions in our OEM channels in 2008 compared to 2007, which typically generate lower average selling prices to us than sales made directly to end-users.

During the three-month period ended March 31, 2008 we sold 64 flywheel units compared to 48 flywheel units in the comparable period of 2007. The frequency and timing of our larger system sales, including megawatt class UPS products, made directly by us is more unpredictable than orders received from our OEM partners, and can result in material changes in period-to-period revenue. Such revenues may also occur in periods other than when originally anticipated, which can add to the potential variability in our quarterly financial results and affect our ability to meet forecasted targets.

North American sales were 61% of our total revenue for the three-month period ended March 31, 2008 compared to 60% for the same period of 2007, and 50% in the three-month period ended December 31, 2007.

## [Table of Contents](#)

Since 2005 we have been increasing the size of our direct sales organization in an effort to expand the territories in which we sell our Active Power branded products. Most of this effort initially was focused in the EMEA market where we now have multiple sales offices. In 2007 we also opened our first Asian sales office in Tokyo. Sales of Active Power branded products through our direct and manufacturer's representative channels were 56% of our total revenues for the three-month period ended March 31, 2008 compared to 76% for the same period of 2007. Although our overall direct sales have decreased in the current quarter, direct sales continue to increase in both the EMEA and North American markets. As direct sales typically have higher profit margins than sales through our OEM channels, we will continue to focus on our direct sales channel to increase revenue and improve profit margins. We believe sales of our Active Power branded products to government facilities and industrial customers in regions that were not covered by our OEMs will continue to increase over time and will continue to become a larger percentage of our total revenue.

Caterpillar remains our largest OEM partner and largest overall customer and represented 44% of our revenue for the three-month period ended March 31, 2008, compared to 23% of our revenue for the three-month period ended March 31, 2007. On April 23, 2008, we entered into a new purchase agreement with Caterpillar, effective as of January 1, 2008, governing the sale of products by us to Caterpillar. This purchase agreement has an initial term of three years and provides that Caterpillar will continue to market certain of our flywheel-based uninterruptible power supply products under the Caterpillar brand as a complement to Caterpillar's own product line. We will supply and Caterpillar will purchase all of Caterpillar's Electric Power Division's requirements for our products. We have had recent success with Caterpillar selling our megawatt-class UPS products along with their large engine generators, and expect total revenue from this channel to continue to increase in 2008 in absolute terms.

Our products perform well in harsh environments where power quality is particularly poor, which makes them a good fit for industrial countries with a poor power infrastructure and therefore we have focused our direct sales efforts to these customers. Due to the large size of some of our customer orders relative to our current total revenue levels, our quarterly total revenue trend and the proportion of sales made directly by us can be expected to fluctuate quarterly from the amounts recorded so far in 2008. We have also seen and anticipate a further increase in capital spending in data centers where there is a requirement for higher-density power solutions such as flywheels, and believe that this along with our expanding direct sales strategy will result in higher product revenue levels for us in 2008.

**Service and spares revenue.** Service and spares revenue primarily relates to revenue generated from installation, startup, repairs or reconfigurations of our products, and the sale of spare or replacement parts to our OEM and end-user customers. It also includes revenue associated with the costs of travel of our service personnel. Service and spares revenue increased by 84% for the three-month period ended March 31, 2008 compared to the same prior year period. This increase is primarily due to higher levels of service and contract work from direct product sales made in prior quarters. For some of these customers we provide a full power solution, including site preparation, installation of an entire power solution and provision of all products required to provide a turnkey product to the end user. We anticipate that service and spares revenue will continue to grow with product revenue and as our installed base of product expands, because as more units are sold to customers, more installation, startup and maintenance services will be required. Where we make sales through our OEM channel, it is typical for the OEM to provide these type of services to their end-user customers.

**Cost of product revenue.** Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment and other costs associated with our assembly and test operations, including costs from having underutilized facilities, shipping costs, warranty costs, and the costs of manufacturing support functions such as logistics and quality assurance.

## [Table of Contents](#)

The cost of product revenue as a percentage of total product revenue in the three-month period ended March 31, 2008 decreased by 7% compared to the comparable period in 2007 due to the effect of increased flywheel units sold, improved efficiency in our manufacturing operations and material and overhead costs reductions. We have instituted programs to reduce product and component costs where feasible, and this has resulted in a decrease in materials costs as a percentage of product revenue and helped us to mitigate the impact of increased raw commodity pricing on our total product costs. We continue to operate a manufacturing facility that has a capacity level significantly greater than our current product revenue levels. In addition, a large portion of the costs involved in operating our manufacturing facility are fixed in nature and we incur approximately \$1.2 million to \$1.5 million in unabsorbed overhead each quarter. We continue to work on reducing our product costs through design enhancements and modifications, and vendor management programs. The accomplishment of material gross-margin levels is heavily dependent upon our sales channel mix and the effectiveness of our product pricing to our customers. Our ability to maintain and grow positive product gross margin will depend on multiple factors, including our ability to continue to reduce material costs, improve our sales channel mix in favor of direct sales versus OEM, our ability to increase product prices, and to increase our total revenues to a level that will allow us to improve the utilization of our manufacturing operations.

Items that could impact our ability to further improve our gross margin include sales product volume and mix, pricing discounts and customer incentives, currency fluctuations, and variations in our product cost and productivity.

**Cost of service and spares revenue.** Cost of service and spares revenue includes the cost of component parts, as well as labor and overhead of our spare parts, costs associated with travel and labor used in servicing a unit and unabsorbed overhead from the service group. The cost of service and spares revenue decreased to 85% of service and spares revenue in the three-month period ended of March 31, 2008 compared to 103% in the same period of 2007. This decrease reflects better utilization of our service personnel, improved pricing for service, and higher margins on contract work compared to the prior period and the benefits of higher service volume to help meet the fixed costs of our service infrastructure.

**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 product development activities, as well as an allocated portion of our occupancy costs. Overall our research and development expenses were \$182,000 or 11% lower than the first quarter of 2007, and were \$26,000 or 2% lower than the preceding quarter. The decrease from the same period in 2007 was due to headcount reductions and lower project related development costs this year. The prior year expenses included higher prototype and development costs for our CoolAir DC product and costs incurred in paralleling our megawatt-class UPS product. We believe research and development expenses in the second quarter will stay at similar levels to those recorded in the first quarter.

**Selling and marketing.** Selling and marketing expenses primarily consist of compensation, including variable sales compensation, and related costs for sales and marketing personnel, related travel, selling and marketing expenses, as well as an allocated portion of our occupancy costs. Selling and marketing costs were \$325,000 or 12% higher than the amount recorded in the first quarter of 2007, and were \$120,000 or 4% lower than the immediately preceding quarter. The increase from the same period in 2007 is due to increased variable sales compensation associated with the increase in revenue compared to 2007. The decrease in our sales and marketing costs from the three-month period ended December 31, 2007 reflects lower variable sales compensation, particularly in our EMEA market, due to the lower sales volume that we had during that period. Our total headcount in sales and marketing remains at similar levels to last quarter, although we have changed the composition of our sales team over the last year as we expand our direct sales force. We believe that sales and marketing expenses will increase slightly in the second quarter as our revenue levels increase and our variable compensation increases.

## [Table of Contents](#)

**General and administrative.** General and administrative expense is primarily comprised of compensation and related costs for executive and administrative personnel, professional fees, and taxes, including sales, property and franchise taxes. General and administrative expenses decreased by \$1,569,000 or 57% from the levels of the same period in 2007 and decreased by \$227,000, or 16% from the three-month period ended December 31, 2007. This decrease from the same period in the prior year was primarily attributable to \$1.5 million of professional fees incurred last year with a review of our historical stock option granting procedures that covered the period from 2000 through 2006. During the last quarter of 2007, we incurred legal fees in connection with a tender offer with respect to certain of the Company's employees as a result of the stock option review to correct errors in option pricing. We are currently in the process of negotiating to settle the outstanding tax matters resulting from the option investigation with the Internal Revenue Service, and may still record additional expense to cover tax obligations for innocent employees who were affected by the option review. We would record any further expenses at the time we legally finalize those obligations for our employees. Absent the impact of such expenses from the option review, we anticipate that the level of general and administrative expenses should stay at similar levels in the second quarter of 2008.

**Interest income.** Interest income has decreased from \$201,000 in the three-month period ended March 31, 2007 to \$163,000 in the three-month period ended March 31, 2008. This reflects the decrease in our average cash and investments balance compared to the prior year as we have used our investments to fund operations and from decreasing interest rates available in credit markets. Our average cash and investments balance over the three month period ending March 31, 2008 has decreased by approximately \$1.1 million or 6% compared to the average balance over the comparable period ending March 31, 2007.

**Other income (expense).** Other income in the current quarter increased over the preceding quarter due to sale of previous expensed equipment and foreign exchange gains on a bank account held in foreign currency.

### Liquidity and Capital Resources

Our principal sources of liquidity as of March 31, 2008 consisted of \$17.4 million of cash and investments and the funds available to us under our \$5 million revolving credit facility with our bank. We have primarily funded our operations through public and private placements of our common stock as well as \$10.0 million in development funding received from Caterpillar since 1999, and from our product, service and spares revenue. We believe that our cash and investments on hand will be sufficient to fund our operations through the next twelve months based upon our historical and projected cash burn.

The following table summarizes the quarterly changes in cash used in operating activities:

(\$ in thousands)	Three months ended March 31,		Variance 2008 vs. 2007	
	2008	2007	\$	%
Cash used in operating activities	\$(5,006)	\$(3,240)	\$1,766	55%

Cash used in operating activities increased by 55% compared to the same period of 2007. This is primarily attributable to changes in our working capital compared to the prior period. We were able to secure advance payments of \$1 million from certain foreign customers in the prior quarter in advance of

## [Table of Contents](#)

recognizing revenues that benefited our cash used in operating activities in the prior quarter. This resulted in a decrease in our deferred revenues in the current period as this benefit reversed. We also had a further \$1 million decrease in our accrued liabilities in the current period as we paid property and sales and VAT taxes, professional fees and year end compensation. We anticipate that the level of cash used in operating activities will decrease in the second quarter as we continue to increase our revenue and have fewer fluctuations in our working capital.

Investing activities primarily consist of sales and purchases of investments and purchases of property and equipment. Fluctuations in the sale and purchase of investments generally reflect our use of these funds to finance our ongoing operations. Capital expenditures were \$243,000 in the three-month period ending March 31, 2008 compared to \$355,000 in the same period of 2007.

Funds provided by financing activities during the three months ended March 31, 2008 reflect proceeds from employee share purchases. The increase in funds from financing activities compared to the comparable period of 2007 is due higher levels of stock option exercises by the Company's employees.

As noted above, we believe our existing cash and investments balances at March 31, 2008 will be sufficient to meet our cash requirements through at least the next 12 months, although we may elect to seek additional funding prior to that time. Beyond the next 12 months, our cash requirements will depend on many factors, including the rate of sales growth, the success of our direct selling strategy, the market acceptance of our products, including the CoolAir DC product family, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the efficiency of our manufacturing processes, and the timing and extent of research and development projects.

As of March 31, 2008, we held \$875,000 in auction rate securities. Due to difficulties in US credit and capital markets, there have been a number of failed auctions in the US auction rate securities market in 2008. We have experienced failed auctions for the municipal bond instruments that we hold, resulting in a lack of liquidity for these securities. We continue to earn interest on these securities but are, in the short term at least, unable to liquidate these investments in an orderly manner. As a result we have reclassified these securities as a long-term investment at March 31, 2008.

We continue to work with the financial institution that marketed these auction rate securities to us as a liquid money-market asset to enable us to liquidate these securities in an orderly manner. None of the underlying securities have had any credit rating adjustments, but the overall lack of liquidity in the auction rate securities market has resulted in us holding an illiquid asset. Our current liquidity situation is such that we do not have to redeem these securities in the short term. The lack of liquidity also means that we do not have a readily discernable market valuation with which to value these securities. Therefore we continue to carry these securities at par value consistent with our historical practice since that is the value we receive when we trade these securities in an established market. Any differences between par value and the purchase price or settlement have historically been comprised of accrued interest.

### **Recent Accounting Pronouncements**

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141R (revised 2007), *Business Combinations* (SFAS 141(R)), which establishes the acquisition method to account for business combinations. SFAS 141(R) requires the acquiring entity to recognize all of the assets acquired and liabilities assumed in the transaction, establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. These rules are effective for transactions closing after January 1, 2009.



## [Table of Contents](#)

### Item 3. 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 \$116,000.

Our international sales have historically been made in U.S. dollars. As we increase sales in foreign markets, particularly those markets where we have a physical presence, we are making more sales that are denominated on other currencies, primarily euros and British pounds. Those sales in currencies other than U.S. dollars can result in transaction gains and losses which have not been material to date. Currently, we do not engage in hedging activities for our international operations other than an increasing amount of sales and support expenses being incurred in foreign currencies. However, we may engage in hedging activities in the future.

Our international business is subject to the typical risks of any international business, including, but not limited to, the risks described in Item 1A – “Risk Factors” in our 2007 Annual Report on Form 10-K. Accordingly, our future results could be materially harmed by the actual occurrence of any of these or other risks.

### Item 4. Controls and Procedures

#### **Evaluation of disclosure controls and procedures.**

We performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(f) under the Securities Exchange Act of 1934. Based on their evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of March 31, 2008 (the end of the period covered by this Quarterly Report on Form 10-Q) to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.

#### **Changes in internal control over financial reporting.**

During the three months ended March 31, 2008 there was no change in our internal control over financial reporting that occurred that has materially affected, or that we believe is reasonably likely to materially affect, our internal control over financial reporting.

**PART II – OTHER INFORMATION**

Item 1. Legal Proceedings

On January 22, 2008, we initiated legal proceedings in the U.S. District Court for the District of Puerto Rico against Antilles Power Depot, Inc. (Antilles), our distributor in Puerto Rico, seeking payment of outstanding balances from Antilles, our costs of litigation, and a declaratory judgment establishing that we have “just cause” to terminate our distribution agreement due to Antilles non-performance of its contractual obligations, including non-payment of outstanding amounts. Antilles has formally responded to our complaint and has filed counterclaims against us seeking (i) approximately \$100,000 in finance charges, (ii) a declaratory judgment establishing we do not have “just cause” to terminate the distribution agreement, and (iii) damages of no less than \$560,000 in the event that we terminate the distribution agreement without “just cause”. We have filed a motion to dismiss these counterclaims and are currently waiting for Antilles opposition to the same.

We have previously reserved fully for the amounts due from Antilles. We have initiated the declaratory judgment action to obtain a judicial determination that we are not subject to potential payments or penalties that would be otherwise payable to Antilles under the Puerto Rico Act No. 75 which is designed to compensate local distributors whose distribution rights are terminated without “just cause” (as that term is defined under Puerto Rico law). Until this matter is resolved we are unable to sell our products in Puerto Rico directly or to engage a new distributor in that market. We do not anticipate the costs of this litigation to be material to our financial results. We anticipate potential discovery of this case to continue into the second quarter of 2008.

## [Table of Contents](#)

### Item 1A. Risk Factors

*You should carefully consider the risks described in Item 1A of our 2007 Annual Report on Form 10-K before making a decision to invest in our common stock or in evaluating Active Power and our business. The risks and uncertainties described in our 2007 Annual Report on Form 10-K 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 risks described in our 2007 Annual Report on Form 10-K could materially harm our business, financial condition and results of operations. In that case, the trading price of our common stock could decline.*

### **Our increased emphasis on a direct sales model and our transaction and customer concentration may affect our ability to accurately predict the timing of revenues and to meet short-term expectations of operating results.**

Our increased emphasis on a direct sales model has increased the effort and time required by us to complete sales to customers. Further, a larger portion of our quarterly revenue is derived from relatively few large transactions with relatively few customers. For example, in the first quarter of 2008, our five largest customers contributed 74% of our revenue. Our shift to the direct sales model, or any delay in completing these large sales transactions or reduction in the number of customers or large transactions, may result in significant fluctuations in our quarterly revenue. Further, we use anticipated revenues to establish our operating budgets and a large portion of our expenses, particularly rent and salaries, are fixed in the short term. As a result, any shortfall or delay in revenue could result in increased losses and would likely cause our operating results to be below public expectations. The occurrence of any of these events would likely cause the market price of our common stock to decline.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

### Item 3. Defaults Upon Senior Securities.

None.

### Item 4. Submission of Matters to a Vote of Security Holders.

None.

### Item 5. Other Information.

None.

## Table of Contents

### Item 6. Exhibits.

The following documents are filed as exhibits to this report:

- 3.1\* Amended and Restated Certificate of Incorporation (filed as Exhibit 3.1 to Active Power's IPO Registration Statement on Form S-1 (SEC File No. 333-36946) (the "IPO Registration Statement"))
- 3.2.\* Second Amended and Restated Bylaws (filed as Exhibit 3.2 to Active Power's Current Report on Form 8-K filed on February 2, 2007)
- 3.3\* Amendment to Second Amended and Restated Bylaws (filed as Exhibit 3.01 to Active Power's Current Report on Form 8-K filed December 7, 2007)
- 4.1\* Specimen certificate for shares of Common Stock (filed as Exhibit 4.1 to the IPO Registration Statement)
- 4.2\* Rights Agreement, dated as of December 13, 2001, between the Active Power and Equiserve Trust N.A., which includes the form of Certificate of Designation for the Series A Junior Participating Preferred Stock as Exhibit A, the form of Rights Certificate as Exhibit B and the Summary of Rights to Purchase Series A Preferred Stock as Exhibit C (filed as Exhibit 4.1 to Active Power's Current Report on Form 8-K dated December 13, 2001)
- 4.3\* See Exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and Bylaws of the registrant defining the rights of holders of common stock
- 4.4\* Registration Rights Agreement dated August 14, 2007 (filed as Exhibit 10.2 to Registrant's Current Report on Form 8-K filed August 14, 2007)
- 10.1† Purchase Agreement effective as of January 1, 2008 between Active Power and Caterpillar, Inc.
- 31.1 Rule 13a-15(e)/15d-15(e) Certification of Principal Executive Officer
- 31.2 Rule 13a-15(e)/15d-15(e) Certification of Principal Financial Officer
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer

\* Incorporated by reference to the indicated filing.

† Confidential treatment has been requested for certain portions of this exhibit.

**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)

April 28, 2008  
(Date)

/s/ James A. Clishem  
James A. Clishem  
President and Chief Executive Officer  
(Principal Executive Officer)

April 28, 2008  
(Date)

/s/ John K. Penver  
John K. Penver  
Vice President of Finance, Chief Financial Officer and Secretary  
(Principal Financial and Accounting Officer)

**PURCHASE AGREEMENT**

This Agreement is made effective as of the 1<sup>st</sup> day of January 2008 (the “**Effective Date**”), by and between Caterpillar Inc., a Delaware corporation with principal offices in Peoria, Illinois (“**Buyer**”) and Active Power, Inc., a Delaware corporation with principal offices in Austin, Texas (“**Seller**”). This Agreement hereby supersedes and replaces that certain Phase II & Phase III Purchase Agreement entered into by and between Buyer and Seller having an effective date as of January, 1 2000, and any subsequent Amendments. Buyer and Seller hereby agree as follows:

1. **Products Covered by Agreement.** This Agreement concerns the purchase and sale of the parts or products listed in **Exhibit A** (“**Products**”). Each Product will be manufactured by Seller to the specifications that are set forth in the relevant Caterpillar drawings for that Product (for each Product, the “**Specifications**”). Buyer and Seller may agree in writing to modify the list of Products in **Exhibit A** or any of the Specifications for any Product from time to time, and the modified Specifications will apply to all of that Product that is ordered by Buyer after the modification; the modification will only apply to previously ordered but unshipped Product if mutually agreed by the parties in writing. As set forth on **Exhibit A**, some Products are designated as “**Production Products**,” and others are designated as “**Spare Part Products**.”
2. **Purchase and Sale of Product.**
  - a. **Buyer’s Requirements.** Subject to Section 10, Seller will supply and Buyer will purchase one hundred percent (100%) of its Electric Power Division’s requirements for each Product. Seller will provide Buyer an approved PPAP (Production Part Approval Process) for every Product and every change to Product prior to shipment of Product. Seller understands that Buyer makes no guarantee as to the quantity of Product it will require.
  - b. **Forecasts and Firm Orders.**
    - i. Buyer’s forecasted requirements will be made available to Seller on a quarterly basis. Any forecasts or estimates of such requirements provided to Seller by Buyer shall be non-binding, and Seller acknowledges that it shall not be entitled to and shall not rely on such forecasts or estimates as binding commitments unless they are expressly stated as such by Buyer in writing.
    - ii. Buyer will place orders with Seller by sending the order consist file (each, a “**Firm Order**”) specifying the Product, quantity, requested and/or restricted shipping dates, and delivery location.
  - c. **Seller’s Acceptance or Rejection of Firm Orders.**
    - i. Each Firm Order shall be subject to acceptance by Seller. Seller’s acceptance shall be indicated in writing and confirm the ship date. If Seller has not rejected such Firm Order within five (5) days from the date Buyer places Firm Order, such Firm Order shall be deemed accepted by Seller. Once a Firm Order has been accepted by Seller, it cannot be modified or canceled except by the parties’ mutual written consent, or as set forth in Section 2(f) below.

d. Lead Times.

- i. Seller has designated “**Standard Lead Times**” for each Product on **Exhibit A**. The term “**Standard Lead Time**” means the minimum period of time between when Seller receives a Firm Order from Buyer for a particular Product, and when Seller makes that Product available for shipment at Seller’s dock.
- ii. If Buyer requests a ship date sooner than the Standard Lead Time after the Firm Order is placed (each, an “**Expedited Ship Date**”), and if Seller can provide that Product on required ship date without incurring additional costs, Seller will do so at Buyer’s request for no fee; otherwise, Seller will quote Buyer the additional charges to meet such ship date that will be required, and the ship date that Seller can offer for that Product, and Buyer can accept or reject those charges. If Buyer rejects those charges, then the ship date will be deemed to be the Standard Lead Time for that Product after the date that Firm Order was received by Seller.
- iii. If a Firm Order does not specify a ship date, then the ship date will be deemed to be the Standard Lead Time for that Product after the date that Firm Order was received by Seller.
- iv. Seller can modify the Standard Lead Times on **Exhibit A** from time to time on sixty (60) days written notice to Buyer, subject to Buyer’s consent which shall not be unreasonably withheld.
- v. Seller agrees that the Standard Lead Times on **Exhibit A** for each Product will not be longer than the shortest average lead times provided by Seller for that Product to any other customer of Seller that purchases the same Product at similar volume levels.

e. Shipping.

- i. Each Firm Order shall specify Buyer’s dealers’ freight carrier and Buyer’s dealers’ account number with that carrier, or Buyer will provide a Bill of Lading to Seller within seventy-two (72) hours of the scheduled ship date, so that all freight charges can be paid directly by Buyer’s dealers to the carrier. Seller will provide Buyer a signed Buyer Bill of Lading for Product within seventy-two (72) hours of shipment of Product. Otherwise Seller will specify its own freight carrier and invoice delivery charges to Buyer. In that event, unless otherwise directed by Buyer in writing, Seller shall obtain insurance at Buyer’s expense from the carrier for losses incurred during shipment.
- ii. All Products shall be shipped F.C.A. Seller’s facility (Incoterms 2000). Title to each Product shall pass to Buyer upon Seller’s tender of the Product to the freight carrier at Seller’s loading dock.
- iii. If a Firm Order does not specify an Expedited Ship Date, and if the quantity of that Product to be shipped in that month as indicated by Buyer’s forecast does not exceed one-hundred fifty percent (150%) of the expected quarterly quantity, for that Product and month, and if Seller tenders the Product to the freight carrier later than the specified ship date, then as Buyer’s exclusive remedy, Seller will be responsible for any special freight charges that are reasonably incurred to try to hasten the delivery date for that Product in light of Seller’s late tender to the freight carrier.

f. Change Orders.

- i. Buyer can cancel or modify a Firm Order without liability to Seller by notifying Seller in writing *before* Seller has accepted that Firm Order. Seller or Buyer may not cancel or modify a Firm Order after acceptance without the other party's written consent.
- ii. *After* Seller has accepted a Firm Order, if Buyer notifies Seller in writing that Buyer wishes to cancel, modify the configuration of, increase or reduce the quantity of, or delay the ship date for one or more Products ordered in a Firm Order (each, a "**Change Order**"), then in each case, Seller shall respond to the Change Order within forty-eight (48) hours. If Seller can accept the Change Order without incurring additional costs, Seller will do so for no fee; otherwise, Seller will requote the new price and availability of Product to Buyer, and Buyer can accept or reject the Change Order. If Seller does not respond to the Change Order within forty-eight (48) hours then it will be assumed that Seller can provide the Change Order without additional costs. If Buyer rejects the Change Order, the original terms of the accepted Firm Order will apply.
- iii. No change orders will be accepted within two (2) weeks of the expected ship date, unless mutually agreed by both Seller and Buyer.

g. Software. Seller agrees to allow Buyer the right to provide Seller's monitoring and service software known as UPS View, to Buyer's dealers through a password protected website with no restriction on licensing and at no additional cost. Seller acknowledges Buyer will take no additional action to monitor usage or distribution of UPS View which is downloaded from the password protected website.

3. **Price Containment.** Both Seller and Buyer are committed to controlling and reducing costs, and both recognize that effective cost control as set forth in this Section 3 is of the essence to this Agreement. While this Agreement is in effect, Seller will maintain a cost control and reduction program with respect to Product, and will review costs on a regular basis for progress toward the objective of maintaining or reducing Seller's prices to Buyer. Interaction between Buyer's and Seller's engineering and purchasing personnel regarding costs will be encouraged. All cost savings generated by Buyer and Seller working together will be shared on a 50/50 basis by reducing the Prices set forth on Exhibit A, taking into consideration expenses of both Buyer and Seller to implement the cost reduction. All cost savings generated solely by Seller which still allow Seller to strictly comply with all drawings and Specifications, and does not change form, fit or function of Product, will not change Prices. If Seller requests a Price increase, the Price Increase Process set forth in Exhibit B will be followed.

4. **Product Prices.** Prices will be as shown in Exhibit A. Exhibit A may be modified from time to time by the signed written agreement of both parties, or as provided in Section 3 above. The prices shown on Exhibit A do not include installation charges, freight and handling charges, applicable taxes, and Buyer shall be responsible for all such charges and



taxes. (Unless Buyer furnishes a proper exemption certificate, Buyer shall be charged for all sales taxes, however designated, levied or based on the sales of Products specifically excluding any income taxes related to the sale of Products.)

5. **Payment Terms.** Seller shall invoice Buyer for each Product after that Product ships from Seller's facility. [ \* ].
6. **Term.** The initial term of this Agreement shall be three (3) years, commencing on the Effective Date. This Agreement shall automatically be extended for additional terms of one (1) year each unless either party gives written notice to terminate at least three (3) months prior to the end of the initial term or any additional term or unless otherwise terminated pursuant to the provisions hereof.
7. **Warranty.**
  - a. **Warranty as to Products.** Seller warrants that each Product shall be free from defects and in full conformity with the Specifications for the warranty term. The term of Seller's warranty to Buyer is twelve (12) months from the date Product is placed in service with the end-user (provided that in no event shall this period exceed thirty-six (36) months after the date Seller shipped that Product). The thirty-six (36) month warranty period set forth above, will not apply for a particular Product if Seller establishes and provides reasonable evidence to Buyer that Buyer or Buyer's dealer has not complied with the Storage Guidelines in Caterpillar document TIBU4855, which is attached hereto as **Exhibit D**, with respect to that Product, and such failure to comply was the primary cause for the Product failure.
  - b. **Modification of Storage Guidelines.** The Storage Guidelines can be modified upon mutual agreement with Buyer and Seller, not to be unreasonably withheld.
  - c. **Remedy With Respect to Parts.** Buyer stocks some Spare Part Products through its Morton, Illinois distribution facility ("**Stocked Spare Parts**"). When a Stocked Spare Part is required to repair a defective or non-conforming Product during the applicable warranty period (each, a "**Required Replacement Part**"), Buyer will use that Stocked Spare Part as the Required Replacement Part, and will submit a reimbursement claim to Seller. When a warranty repair to a defective or non-conforming Product requires a Required Replacement Part that is not a Stocked Spare Part, Buyer will order that Required Replacement Part from Seller in accordance with this Agreement, and then will submit a reimbursement claim to Seller. Subject to Section 7(c) and Section 7(f), Seller will reimburse Buyer the Price of that Required Replacement Part that was (i) necessary to complete the repair of the Product that was under warranty and (ii) purchased by Buyer from Seller and paid for by Buyer in accordance with this Agreement.
    - i. If a part on the Warranty Recall Parts List attached hereto as **Exhibit E** is reasonably believed by Buyer to be defective or non-conforming to Specification, and is replaced with a Required Replacement Part, Buyer must return that defective or non-conforming part to Seller (or require its dealers to return it to Seller), along with the

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

warranty claim, within one-hundred eighty (180) days of the repair date. Seller shall reimburse all shipping costs for the return of the defective or non-conforming part, provided the requirements as set forth in **Exhibit F** are followed. The Warranty Recall Parts List may only be modified by mutual agreement of both Buyer and Seller, such agreement not to be unreasonably withheld.

- ii. Buyer shall be responsible for informing its dealers of the Warranty Recall Parts List, and requiring its dealers to return failed parts on this Warranty Recall Parts List to Seller with the claim history documentation.
- iii. If a warranty reimbursement claim is paid by Seller and the Required Replacement Part was a Stocked Spare Part, then, in addition to reimbursing Buyer the Price of the Required Replacement Part, Seller will pay Buyer an additional [ \* ] of the Price of the Required Replacement Part to account for Buyer's cost of logistics. This additional amount will not be paid if the Required Replacement Part is not a Stocked Spare Part.
- d. Remedy With Respect to Labor. When a repair to a defective or non-conforming Product that is under warranty requires labor, then, in addition to any parts reimbursement pursuant to Section 7(c) above, and subject to the limitations set forth in this Section 7(d) and in Section 7(f) Seller will reimburse Buyer for the labor charges that are actually incurred by Buyer and that are reasonably necessary to complete the repair of the Product. Seller's obligation is limited to the labor rates (in dollars per hour) not to exceed [ \* ] per hour, and the labor hours set forth on Seller's "Time Required Guide" or "TRG" Schedule that is attached hereto as **Exhibit G**. If a warranty labor reimbursement claim is submitted by Buyer to Seller and it exceeds the labor hours in Seller's TRG Schedule, then Seller shall adjust the claim and reimburse only the adjusted amount. Seller's TRG Schedule can only be modified if mutually agreed to by both Seller and Buyer and will be reviewed annually, such agreement not to be unreasonably withheld.
- e. Remedy With Respect to Travel Charges. If Buyer or Buyer's dealer performs warranty labor that is reimbursable by Seller under Section 7(d) above at the site of an end user of the Product, then Seller shall also reimburse Buyer for the documented, customary and reasonable travel expenses incurred by Buyer, for travel by automobile of up to four (4) hours of driving time (round trip), so long as (i) the warranty labor is performed by Buyer's dealers and the technician performing the warranty service is currently trained by the Buyer, as described below in Section 8, with respect to that particular Product, and (ii) the travel expenses are not required to be paid by the end-user customer under **Exhibit C** or another agreement with that end-user customer.
- f. Conditions on Warranty. Seller may reject all or a portion of any warranty claim, including a claim under Section 7(c), all associated warranty labor claims under Section 7(d), and all associated travel charge claims under Section 7(e), if the defective or non-conforming part is found on the Warranty Recall Part List and is not returned to Seller for that particular warranty reimbursement claim within the one-hundred eighty (180) day

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

period required by Section 7(c), or if the part is returned but is found not to be defective or non-conforming, or if warranty labor has been provided on that Product by a technician who was not at that time certified by Seller with regard to that particular Product as provided below in Section 8.

- g. Monthly Statement. A monthly statement of Buyer warranty claims, including notice of specific Product failures, and summary information on the causes of such failure, comments from the service technician, serial number, model number and installation date will be sent by Buyer to Seller. This statement, currently called the "Field Incident Report," shall be used by Seller in its process of determining the validity of the warranty claims submitted in that month. Seller shall respond to each warranty claim listed in the Field Incident Report with amount of warranty to be recovered by Buyer from Seller with justification as to the amount. This response shall occur within fourteen (14) days from Seller's receipt of Field Incident Report and/or receipt of the returned part if applicable, whichever comes last.
- h. Special Buyer Programs. Seller's participation in Buyer's "Product Improvement Programs" (PIP), "Product Support Programs" (PSP), "Extended Warranty" terms, and other policy actions are to be negotiated on a case-by-case basis by both parties, documented in writing and signed by both parties. Participation in these programs will be based on an amount mutually agreed to by Seller and Buyer.
- i. Disclaimer. EXCEPT FOR THE EXPRESS WARRANTY MADE IN THIS SECTION 7, SELLER DISCLAIMS ALL OTHER WARRANTIES ON ANY GOODS OR SERVICES PROVIDED BY SELLER, WHETHER EXPRESS OR IMPLIED, INCLUDING WITHOUT LIMITATION ANY WARRANTY OF MERCHANTABILITY, OF NON-INFRINGEMENT, OR OF FITNESS FOR A PARTICULAR PURPOSE. THE SOLE REMEDY FOR ANY BREACH OF SELLER'S EXPRESS LIMITED WARRANTY SHALL BE THE REMEDIES THAT ARE EXPRESSLY SET FORTH IN THIS SECTION 7.

## 8. **Product Training.**

- a. In order for Seller's warranty to be valid with respect to a particular Product, all work performed on that Product by Buyer or Buyer's dealers' personnel must be performed by personnel who have completed training on that Product as offered by Buyer. If Buyer permits any service personnel to work on a Product without having proper training from Buyer, then Seller's warranty with regard to that Product will be invalidated and Seller will not reimburse any labor or travel charges.
- b. Buyer's dealers' service personnel must successfully complete Buyer's training course. Seller will provide certified training for Buyer's trainers of Product at a mutually agreed upon price and time. Training courses are specific to particular Products. If any new Product is added to this Agreement, or if the Specification of a Product is modified to an extent that Seller reasonably believes re-training is necessary, then previously certified training personnel will be given an updated course with regard to those new or modified Products to be certified on those new or modified Products, and subsequently, Buyer's dealers will be trained on these updates by Buyer's trainers. In addition, certified trainers

will be given an update course at least once every three (3) years to remain certified, even if no new or modified Product has been released. Buyer will keep records of all persons trained on Product and will make those records available to Seller at Seller's reasonable request in connection with warranty claims, such request not to be unreasonably withheld.

- c. Seller may provide sales and marketing support to Buyer's key dealers, only if requested by Buyer, and as agreed to by Seller.

9. **Indemnification.**

- a. Seller agrees to indemnify, defend, and hold Buyer, its subsidiaries, affiliates, directors, officers, employees and agents harmless from and against all claims, demands, liabilities, loss, damage, cost, and expense, of whatsoever nature, including attorneys' fees, arising from or in any way connected with the injury or death of any person or loss or damage to property as a consequence of, or attributable to, any defect of design, material, or workmanship of Product or failure of Product to conform with Seller's and Buyer's Specifications, drawings, and data.
- b. Buyer agrees to indemnify, defend, and hold Seller harmless against and from all claims, demands, liabilities, loss, damage, cost, and expense, of whatsoever nature paid to a third party or incurred in the defense of a claim arising on account of Buyer's (i) misrepresentation of the Product or providing unauthorized representations or warranties to its customers, (ii) modifications to the Product, or (iii) negligence or other fault of products or services of Buyer.

10. **Termination.**

- a. Notice. Either party may give the other party notice of default of this Agreement if (i) the other party materially breaches this Agreement; (ii) the other party anticipatorily repudiates any material provision of this Agreement and fails to provide adequate assurance of future performance; or (3) the other party becomes insolvent, files a petition for relief under any bankruptcy, insolvency or similar law, or makes an assignment for the benefit of its creditors.
- b. Notices of Default and Cure Period. Any notice of default shall be in writing in accordance with Section 11, reference this Section 10, and specify the default that is the basis for the notice. The defaulting party shall have sixty (60) days in which to cure the default, and the Agreement shall not terminate if the defaulting party cures the default within the cure period. (However, if the default cannot be cured within the cure period, no cure period will be available.) During any cure period, the parties shall continue to perform this Agreement except that Seller may stop delivering goods and services under this Agreement during the cure period if the default is the Buyer's failure to pay amounts that are due.
- c. In addition to the rights provided in Section 10a, Buyer may terminate this Agreement at any time, either totally or partially, in the event:
- i. Quality - Products consistently and materially fail to meet the Specifications as they exist today and are communicated to Seller from time to time, or Seller fails to maintain its status as a Caterpillar certified supplier (including maintaining a current quality plan).

- ii. Delivery - Seller is substantially and consistently failing to meet Buyer's Firm Orders with respect to mutually agreed shipment dates. Buyer should not have to expedite normal deliveries. It is the obligation of the Seller to maintain an up to schedule condition after a reasonable time period. That time period will be agreed upon by Seller and Buyer for each part number listed in **Exhibit A**.
- iii. Competitiveness - Seller fails to be responsive to the market place or fails to remain competitive on a worldwide basis with other manufacturers of comparable parts or products in terms of price.
- iv. Default Generally - Default by Seller in any obligation owed by Seller to Buyer.

Buyer's decision on termination shall be final. Buyer will be reasonable in making the final decision.

- 11. **Notices.** When written notice is required by this Agreement, it shall be sent by certified mail, by courier that provides confirmation of delivery, by email with an email message being sent in return by the recipient confirming delivery, or by such other written or electronic method as will permit the sender and recipient to verify delivery, to the addresses set forth below:

For Caterpillar:

560 Rehoboth Road  
Griffin, Georgia 30252  
Attn: Eric Musick, Global Purchasing Category Manager  
Fax: (770) 233-5868  
Email: musicem@cat.com

With copies to:

Caterpillar Inc.  
100 N.E. Adams Street  
Peoria, Illinois 61629-7310  
Attn: General Counsel  
Fax: (309) 675-6620

To Seller:

Active Power, Inc.  
2128 West Braker Lane, BK12  
Austin, Texas 78758  
Attn: John Penver, CFO  
Fax: (512) 836-4511  
Email: jpenver@activepower.com

Written notice may also be sent by facsimile to the numbers listed above, but such notice shall not be effective unless the sender receives a return facsimile acknowledging receipt of the notice. Notice shall be deemed received when actually delivered to the recipient (as demonstrated by postal records, in the case of notice sent by mail. Facsimile and emailed notice shall be deemed received upon receipt by the recipient, as reflected in the reply message received by the sender as described. Notice of delivery by courier shall be deemed received on the date of confirmation of delivery. The addresses and transmittal numbers set forth above can be changed only by written notice that complies with the requirements of this Section.

12. **Use of Other Supply Sources.** Nothing in this Agreement shall prevent Buyer from seeking other sources for alternatives to Product if Seller's production capacity is insufficient to meet Buyer's needs.
13. **Change in Ownership and Control.** During this Agreement, if there is a change in the ownership and control of either party, the other party shall have the option of terminating this Agreement immediately by giving written notice thereof within sixty (60) days of being notified of the occurrence of such change of control; provided that if a party provides advance notice of a bona fide proposed change of control (including the identity of the principal owners after such change of control occurs) the other party will within sixty (60) days provide written notification to the first party as to whether it will exercise such termination right if the change of control occurs. For purposes of this Section 13, a change in the ownership and control of either Buyer or Seller or a parent company of either party, if appropriate shall be deemed to have occurred if and only if and when any one or more persons (excluding existing owners) acting individually or jointly is or becomes a beneficial owner, directly or indirectly, of securities representing more than thirty-three percent (33%) of the combined voting power of the then outstanding securities of Seller or Buyer or the parent company of either party.
14. **Force Majeure.** Neither Buyer nor Seller shall be liable to the other for any delay in or failure of performance of their respective obligations hereunder if such performance is rendered impossible or impracticable by reason of fire, explosion, earthquake, drought, embargo, war, riot, act of God or of public enemy, an act of governmental authority, agency or entity, or any other similar contingency, delay, failure or cause, beyond the reasonable control of the party whose performance is affected, irrespective of whether such contingency is specified herein or is presently occurring or anticipated by either party. In the event either party is prevented from fulfilling its obligations under this Agreement because of such a force majeure as described herein, both the Seller and Buyer shall make every reasonable effort to continue to maintain as much as reasonably possible the supplier-customer relationship

established under this Agreement. However, if Buyer or Seller is unable to meet its obligations hereunder because of the conditions described above and such inability continues for a period of sixty (60) days, the other party shall have the right to terminate this Agreement upon thirty (30) days prior written notice (which will not be effective if the force majeure ceases prior to the expiration of this 30-day period).

15. **Assignment; Applicable Law.** This Agreement is not assignable by either party without the written consent of the other party. This Agreement and any matter related in any way to this Agreement will be governed by and construed in accordance with the laws of the State of New York without regard to the conflict of laws provisions thereof.
16. **Entire Agreement.** This Agreement and the terms and conditions referenced in any purchase order issued by Buyer in connection with this Agreement (to the extent not inconsistent with this Agreement) constitutes the entire agreement and understanding between the parties with respect to the subject matters herein and therein, and supersedes and replaces any and all prior agreements, understandings, representations, and promises, whether oral or written, between them with respect to such matters. Both parties agree that the terms and conditions of any Seller quotation, offer, acknowledgment or similar document, however designated, shall not apply.
17. **Waiver.** The provisions of this Agreement may be waived, altered, amended, or repealed in whole or in part only upon the written consent of Buyer and Seller. The waiver by either party of any breach of this Agreement shall not be deemed or construed as a waiver of any other breach, whether prior, subsequent or contemporaneous, of this Agreement.
18. **Severability.** Invalidation of any of the provisions contained herein, or the application of such invalidation thereof to any person, by legislation, judgment or court order shall in no way affect any of the other provisions hereof or the application thereof to any other person, and the same shall remain in full force and effect, unless enforcement as so modified would be unreasonable or inequitable under all the circumstances or would frustrate the purposes hereof.
19. **Construction.** The parties have participated jointly in the negotiation and drafting of this Agreement. In the event an ambiguity or question of intent or interpretation arises, this Agreement shall be construed as if drafted jointly by the Parties and no presumption or burden of proof shall arise favoring or disfavoring any Party by virtue of the authorship of any of the provisions of this Agreement.
20. **Counterparts.** Section headings contained herein are for ease of reference only and shall not be given substantive effect. This Agreement may be signed in one or more counterparts, each to be effective as an original.
21. **Testing and Test Reports.** Seller shall test each Production Product prior to shipment. Seller will maintain all test reports for Production Products for a period of thirty-six (36) months after shipment, and will promptly provide them to Buyer upon Buyer's request. Seller's testing process and test report contents will be subject to Buyer's approval, which will not be unreasonably withheld, conditioned, or delayed.

22. **Limitation of Liability.** NOTWITHSTANDING ANYTHING ELSE IN THIS AGREEMENT, IN NO EVENT SHALL EITHER PARTY BE LIABLE TO THE OTHER PARTY, UNDER ANY EQUITY, COMMON LAW, TORT, CONTRACT, ESTOPPEL, NEGLIGENCE, STRICT LIABILITY OR OTHER THEORY, FOR ANY INCIDENTAL, SPECIAL, PUNITIVE, CONSEQUENTIAL OR INDIRECT DAMAGES, OR BUYER'S COST OF PROCUREMENT OF SUBSTITUTE GOODS OR SERVICES. THIS LIMITATION OF LIABILITY SHALL NOT APPLY, HOWEVER, TO (a) ANY AMOUNT THAT IS EXPRESSLY PAYABLE UNDER ANOTHER PROVISION OF THIS AGREEMENT; (b) ANY OBLIGATION UNDER THIS AGREEMENT, AT LAW, OR OTHERWISE, TO INDEMNIFY OR HOLD A PARTY OR OTHER PERSON HARMLESS AGAINST A THIRD PARTY CLAIM; (c) ANY PARTY'S OR PERSON'S CLAIM OF INFRINGEMENT OR MISAPPROPRIATION OF ANY PARTY'S OR PERSON'S INTELLECTUAL PROPERTY RIGHTS; (d) ANY VIOLATION OF AN EXPRESS CONFIDENTIALITY COVENANT; OR (e) PERSONAL INJURY OR PROPERTY DAMAGE.
23. **Compliance with Laws.** Both parties will comply with the provisions of all applicable laws and regulations from which liability may accrue to the other party for any violation thereof.
24. **Confidentiality of Agreement.** When a party has disclosed this Agreement to potential investors and/or inquirers, that party will notify the other party of the identity of the investor and/or inquirer to whom this Agreement has been disclosed. Except with respect to potential investors and/or acquirers that have agreed in writing to maintain the terms of this Agreement in confidence, the terms of this Agreement as well as its existence shall be kept confidential and not disclosed by either party without the express written consent of the other party, or unless required by law or governmental or judicial order, in which case the party will give the other party prompt notice of any such requirement or order (if permitted by law) and each party will cooperate in good faith with the other party's efforts if any to obtain confidential treatment, a protective order, or other reasonable means to maintain the confidentiality of this Agreement.
25. **Branding, Trademarks, and Copyright.** Except as required under law, nothing in this Agreement authorizes Buyer to use any name, trademark, trade dress, or other designation or mark that belongs to, or to a reasonable person in the relevant market for the Products would identify, Seller. Buyer is not licensed to use any marketing collateral or other works of authorship that belong to Seller, regardless whether related to the Products. Unless otherwise agreed by Seller in writing, Buyer shall resell the Products under Buyer's brand, product names, and marks, and shall generate and use its own marketing collateral, developed independently of Seller and Seller's materials.
26. **Licenses.**
- a. As between the parties, Seller shall own all rights, title and interest in and to the Products except as otherwise provided in the "Phase II Development and Phase III Feasibility Study Agreement" dated January 22, 1999 and the "Phase III Product Development Agreement" dated September 1, 2001. If this Agreement is terminated by Buyer pursuant to Section 10 Seller hereby grants to Buyer, effective as of such termination date, a non-exclusive,



worldwide, royalty-bearing license (including the right to sublicense only to Buyer's wholly owned subsidiaries) to make, have made, use and/or sell the Products. The license granted by the preceding sentence shall only be effective for eighteen (18) months beginning on the effective date of the termination, and Buyer shall pay a royalty to Seller of (A) [ \* ] per delivered megajoule per published rating by Seller for each Product designated by Seller as a "Phase II Product," and (B) [ \* ] per kVA for each Product designated by Seller as a "Phase III Product."

- b. Each of Buyer and Seller grants to the other party an irrevocable, perpetual, non-exclusive, worldwide, royalty-free license (including the right to sublicense only to that party's wholly owned subsidiaries) to make, have made, use, sell and otherwise exploit, during and after the term of this Agreement, any modifications, improvements, inventions, know-how, ideas, or suggestions made with respect to the other party's Proprietary Information by that party's employees or contractors who have had access to such Proprietary Information. If something ceases to be Proprietary Information pursuant to Section 25 above, any license granted with respect thereto while such information was Proprietary Information will be unaffected.

27. **Parts Support.** During this Agreement or following any termination hereof, other than termination by Seller due to a breach by Buyer, Seller shall provide, or at its option shall cause to be provided, such quantities of Spare Part Products to Buyer as Buyer may request from time to time for a period of five (5) years after the last shipment made by Seller under this Agreement of a Production Product that uses the requested Spare Part Product. Seller shall provide such Spare Part Products at a price not to exceed Seller's then-current prices provided to other customer under similar terms and conditions, provided that such Spare Part Products are reasonably and commercially available to Seller. If for any reason Seller is unable to provide Spare Part Products to Buyer pursuant to its obligation under Section 27, then Seller grants to Buyer a non-exclusive, perpetual, worldwide, royalty-bearing license to make, have made, use, and sell those particular Spare Part Products using Seller's proprietary designs. The foregoing license is subject to a royalty of [ \* ] of the applicable price set forth in Seller's most current catalog or price list for those Spare Part Products.

28. This Agreement hereby supersedes and replaces that certain Phase II and Phase III Purchase Agreement entered into by and between Buyer and Seller having an effective date as of January 1, 2000, and any subsequent Amendments.

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed by their duly authorized representatives as of the date first set forth above.

CATERPILLAR INC.  
**(“Buyer”)**

ACTIVE POWER, INC.  
**(“Seller”)**

By: /s/ Dan Murphy  
Name: Dan Murphy  
Title: Vice President Global Purchasing

By: /s/ Jim Clishem  
Name: Jim Clishem  
Title: President & Chief Executive Officer

**EXHIBIT A**

[ \* ]

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

B-1

**EXHIBIT B: PRICE INCREASE PROCESS**

This process will be used whenever Seller requests a price increase for a Product listed in **Exhibit A**, including changes to these Products that do not require a new part number to be released.

1. On the date Seller requests a price increase, Seller will submit to Buyer the proposed price increase, the Effective Date of the price increase, and data related to the material or component cost drivers that are prompting Seller to propose the price increase (The price increase Effective Date shall not be less than 60 days from the date this data is received by Buyer). Seller is not obligated to share any data that it or a third party may consider confidential, and may instead provide a non-confidential summary of that data; however, Buyer must be able to correlate the data using industry standard material cost indexes. This data may include, for example,
  - a. 3<sup>rd</sup> party supplier invoices illustrating the increase in material costs, labor or service charges.
  - b. Increased material content (bill of material) or labor requirements, and the costs of the added requirements.
  - c. Commodity prices at the time of the previous quote, and the content within Product.
  - d. Commodity prices at the current time, and the content within Product.
2. Buyer will review and validate the information submitted by Seller. For component cost increases that can not be correlated to industry standard material cost indexes, both Buyer and Seller will work together to try and offset the component increase by:
  - a. Jointly meeting with the supplier(s) causing the component cost increase to investigate cost reduction/avoidance ideas
  - b. Investigating other components with the Product for possible cost reduction ideas
3. If an agreement is reached on the price increase, then Exhibit A will be amended in writing and such new prices will be implemented on the Effective Date, or as otherwise mutually agreed to by Buyer and Seller. No retroactive price increases will be allowed.
4. If no agreement is reached on the proposed price increase prior to the Effective Date, then,
  - a. Seller will have the option for ten (10) days to notify Buyer in writing that Seller has withdrawn its proposal for a price increase;
  - b. If Seller does not exercise its option to withdraw its price increase proposal, then the price increase as proposed by Seller will take effect on the Effective Date. If the price increase takes effect without Buyer's written consent, then Buyer will have the option during the period of ten (10) days after the Effective Date: (i) terminate this Agreement in its entirety by giving Seller ninety (90) days written notice; or (ii) cancel the part numbers and all orders for Product affected by this price increase.

EXHIBIT C: CATERPILLAR STANDARD LIMITED WARRANTY

Effective with sales to the first user on or after January 1, 2006

CATERPILLAR LIMITED WARRANTY
Industrial Engine Products and Electric Power Generation Products
Worldwide

Caterpillar Inc. or any of its subsidiaries ("Caterpillar") warrants new and remanufactured engines and electric power generation products sold by Caterpillar, its dealers, or other authorized distributors of Caterpillar, to be free from defects in material and workmanship.

This warranty does not apply to Caterpillar Motors (CM) products, engines sold in California, or remanufactured engines, in marine applications, by or for Caterpillar, 3500 and 3600 Family engines used in locomotive applications, 3100 Family engines, C0.5 through C4.4 and ACERT (C6.6, C7, C9, C11, C13, C15, C18, C27, and C32) engines used in industrial applications, or Caterpillar brand batteries. These products are covered by other Caterpillar warranties. This warranty is subject to the following:

- Warranty Period
- For Uninterruptible Power Supply (UPS) systems, the warranty period is 12 months after date of delivery to the first user.
- For new industrial engines, electric power generation products (excluding UPS systems), the warranty period is 12 months (24 months for Automatic Transfer Switch (ATS) product, mobile agricultural and standby electric power generation applications) after date of delivery to the first user.
- For Selective Catalytic Reduction (SCR) and Oxidation Catalyst products, the warranty period is 12 months (24 months for standby electric power generation applications) after date of delivery to the first end user.
- For Diesel Particulate Filter (DPF) products, the warranty period is 24 months\* for standby electric power generation applications after date of delivery to the first user.

\*If the product is operating in California, USA the warranty period is 60 months or 4200 hours, whichever occurs first after date of delivery to the first user.

- For all remanufactured engines, the warranty period is 6 months (12 months for mobile agricultural and standby electric power generation applications) after date of delivery to the first user.

Caterpillar Responsibilities

If a defect in material or workmanship is found during the warranty period, Caterpillar will, during normal working hours and through a place of business of a Caterpillar dealer or other source approved by Caterpillar:

- Provide at Caterpillar's choice new, remanufactured or Caterpillar-approved repaired parts or assembled components needed to correct the defect.

Note: Items replaced under this warranty become the property of Caterpillar.

- Replace lubricating oil, filters, coolant and other service items made unusable by the defect.
- Provide reasonable or customary labor needed to correct the defect, including labor to disconnect the product from and reconnect the product to its attached equipment, mounting, and support systems, if required.
For new 3114, 3116 and 3126 engines and electric power generation products (including any new products of the other manufacturers packaged and sold by Caterpillar):
- Provide travel labor, up to four hours round trip if, in the opinion of Caterpillar, the product cannot reasonably be transported to a place of business of a Caterpillar dealer or other source approved by Caterpillar (travel labor in excess of four hours round trip, and any meals, mileage, lodging, etc. is the user's responsibility).

For all other products:

- Provide reasonable travel expenses for authorized mechanics, including meals, mileage, and lodging, when Caterpillar chooses to make the repair on-site.

User Responsibilities

The user is responsible for:

- Providing proof of the delivery date to the first user.
- Labor costs, except as stated under "Caterpillar Responsibilities", including costs beyond those required to disconnect the product from and reconnect the product to its attached equipment, mounting and support systems.
- Travel expenses not covered under "Caterpillar Responsibilities".
- All costs associated with transporting the product to and from the place of business of a Caterpillar dealer or other source approved by Caterpillar.
- Premium or overtime labor costs.
- Parts shipping charges in excess of those which are usual and customary.
- Local taxes, if applicable.
- Costs to investigate complaints, unless the problem is caused by a defect in Caterpillar material or workmanship.
- Giving timely notice of a warrantable failure and promptly making the product available for repair.
- Performance of the required maintenance (including use of proper fuel, oil, lubricants and coolant) and items replaced due to normal wear and tear.
- Allowing Caterpillar access to all electronically stored data.

SEU5405

EXHIBIT C (continued)

**Limitations**  
 Caterpillar is not responsible for:

- Failures resulting from any use or installation which Caterpillar judges improper.
- Failures resulting from attachments, accessory items and parts not sold or approved by Caterpillar.
- Failures resulting from abuse, neglect and/or improper repair.

• Failures resulting from user's delay in making the product available after being notified of a potential product problem.

- Failures resulting from unauthorized repair or adjustments, and unauthorized fuel-setting changes.
- Damage to parts, fixtures, housings, attachments, and accessory items that are not part of the engine or electric power generation product (including any

products of other manufacturers packaged and sold by Caterpillar).

- Repair of components sold by Caterpillar that is warranted directly to the user by their respective manufacturer. Depending on type of application, certain exclusions may apply. Consult your Caterpillar dealer for more information.

*For products operating outside of Australia, Fiji, Niuru, New Caledonia, New Zealand, Papua New Guinea, the Solomon Islands and Taiti, the following is applicable:*

NEITHER THE FOREGOING EXPRESS WARRANTY NOR ANY OTHER WARRANTY BY CATERPILLAR, EXPRESS OR IMPLIED, IS APPLICABLE TO ANY ITEM CATERPILLAR SELLS WHICH IS WARRANTED DIRECTLY TO THE USER BY ITS MANUFACTURER.

THIS WARRANTY IS EXPRESSLY IN LIEU OF ANY OTHER WARRANTIES, EXPRESS OR IMPLIED, INCLUDING ANY WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE, EXCEPT CATERPILLAR EMISSION-RELATED COMPONENTS WARRANTIES FOR NEW ENGINES, WHERE APPLICABLE. REMEDIES UNDER THIS WARRANTY ARE LIMITED TO THE PROVISION OF MATERIAL AND SERVICES, AS SPECIFIED HEREIN.

CATERPILLAR IS NOT RESPONSIBLE FOR INCIDENTAL OR CONSEQUENTIAL DAMAGES.

CATERPILLAR EXCLUDES ALL LIABILITY FOR OR ARISING FROM ANY NEGLIGENCE ON ITS PART OR ON THE PART OF ANY OF ITS EMPLOYEES, AGENTS OR REPRESENTATIVES IN RESPECT OF THE MANUFACTURE OR SUPPLY OF GOODS OR THE PROVISION OF SERVICES RELATING TO THE GOODS.

IF OTHERWISE APPLICABLE, THE VIENNA CONVENTION (CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS) IS EXCLUDED IN ITS ENTIRETY.

For personal or family use engines or electric power generation products, operating in the USA, its territories and possessions, some states do not allow limitations on how long an implied warranty may last nor allow the exclusion or limitation of incidental or consequential damages. Therefore, the previously expressed exclusion may not apply to you. This warranty gives you specific legal rights and you may also have other rights, which vary by jurisdiction. To find the location of the nearest Caterpillar dealer or other authorized repair facility, call (800) 447-4996. If you have questions concerning this warranty or its applications, call or write:

In USA and Canada: Caterpillar Inc., Engine Division, P.O. Box 610, Moline, IL 61552-0610, Attention: Customer Service Manager, Telephone (800) 447-4996. Outside the USA and Canada: Contact your Caterpillar dealer.

SELF405

**EXHIBIT D: UPS STORAGE GUIDELINES – TIBU4855-00****Introduction**

The problem that is identified below does not have a known permanent solution. Until a permanent solution is known, use the solution that is provided below.

**Problem**

The vacuum pump has incurred an early hour failure due to one or more of the following results:

- z improper procedure for storage
- z improper setup procedure
- z improper troubleshooting procedure

**Solution**

The following procedures will provide enhanced information regarding the vacuum pump:

- z procedure for storage
- z setup procedure
- z troubleshooting procedure

**Procedure for Storage**

Normal Operating Range

Minimum temperature ... 0 °C (32 °F)

Maximum temperature ... 40 °C (104 °F)

Range of Humidity Minimum Humidity “Non-condensing”... 5% Maximum Humidity “Non-condensing” ... 95%

The vacuum pump has the following specifications for short term storage:

Short Term Temperature Range Minimum temperature ... -25 °C (-13 °F) Maximum temperature ... 70 °C (158 °F)

Short Term Range of Humidity Minimum Humidity “Non-condensing” ... 65% Maximum Humidity “Non-condensing”... 95%

**Short Term Storage** - Short Term defines the storage period of two months or less.

Short Term conditions cover the time when the equipment is in transit from the factory to the dealer or from the dealer to the customer site. The system should be stored under short term conditions for only two months or less.

The vacuum pump has the following specifications for long term storage:

Long Term Temperature Range Minimum temperature ... 0 °C (32 °F) Maximum temperature ... 40 °C (104 °F)

Long Term Range of Humidity Minimum Humidity “Non-condensing” ... 5% Maximum Humidity “Non-condensing” ... 95%

**Long Term Storage** - Long Term defines the storage period of three to twelve months.

The system can be stored under long term conditions without any additional concerns. If the UPS is stored longer than one year, you will need to change the oil for the vacuum pump. Thereafter, change the oil in the vacuum pump annually. After completing the oil change for the vacuum pump, you will need to energize the vacuum pump. Operate the vacuum pump for four hours. Operation of the pump will ensure proper lubrication of the seals for the vacuum pump.

The vacuum pump is shipped from Service Parts without oil. Therefore, you are not required to change the oil for the vacuum pump for any inventory from service parts.

Do not utilize a vacuum pump that has exceeded specifications for storage of the vacuum pump. Do not utilize a vacuum pump that has exceeded the operational environmental specifications of the vacuum pump. The vacuum pump must be replaced. The replacement cost of the vacuum pump is not a warrantable repair.

**Setup Procedure**

The vacuum pump has a tamperproof label. This prohibits the service technician from utilizing a 120 VAC source to begin the process for vacuum draw on the flywheel during the commissioning procedure. A tamperproof label that is corrupted will void any warranty claim that is associated with the vacuum pump.

To operate the vacuum pump prior to commissioning the system, temporarily disconnect the 240 VAC internal wiring to the receptacle on the right side of the pump. Connect a 240 VAC line cord from an external source. Ensure that you have removed the external 240 VAC source prior to energizing the input terminals.

Refer to the appropriate Operation and Maintenance Manual when you perform the following procedures:

- z commissioning of the UPS
  - z replacement (field service) of the vacuum pump
  - z installation of bearings for the flywheel

In addition, perform the following operations:

- z When you change the bearing retainers in order to install bearings, complete the procedure in a timely manner. Installation of the bearings in place of the bearing retainers should be completed prior to energizing the vacuum pump. Efficient installation will minimize any possible contamination of the chamber for the flywheel. Efficient installation should decrease the time that is required to create an acceptable vacuum level within the chamber for the flywheel.

- z Do not use a 120 VAC source to begin the vacuum draw on the flywheel.
- z Remove any externally connected 240 VAC source from the vacuum pump.
- z Perform a thorough inspection of the vacuum lines and connection points. Look for any possible discrepancies that could result in a vacuum leak.
- z Verify that the vacuum pump has clean, fresh oil. Verify that the oil for the vacuum pump is filled to the appropriate level. Use **190-8487** Vacuum Pump Oil for the vacuum pump. The pump capacity is 0.7 liters. The capacity of the container for the oil (service parts) is 1.0 liter.
- z Do not overfill the reservoir for the vacuum pump. Overfilling the reservoir will cause the following results: misting oil from the vacuum pump, contamination of the interior of the UPS and the appearance of a leaking vacuum pump.
- z The vacuum pump is equipped with two control switches. One switch controls the gas ballast. The other switch controls the operation mode of the vacuum pump. For normal operation of the vacuum pump, turn the gas ballast switch to the Closed position (“O”). The switch for the mode selector is in the Full Clockwise position.
- z Remove the air bubbles from the vacuum system by turning the switch for the ballast from the 0 position to the II position. The switch for the ballast is located on the top middle of the pump behind the exhaust port. Run the pump for 1 hour. Return the switch for the ballast to the 0 position and allow the pump to pull a vacuum.
- z For systems that have been in dealer storage with an age equal to or exceeding 12 months, lubricate the O-ring seal of the polymer elbow. The O-ring is located on the suction side of the vacuum pump. Utilize **6V-2055** Grease for the O-ring.

## NOTICE

**Use rubber gloves when handling the o-ring. Do not use bare hands.**

### Troubleshooting Procedure

A properly sealed flywheel with a properly operating vacuum pump will yield a minimum reading for the vacuum of 35 millitorr within three hours of operation.

If the results of your troubleshooting indicate that the fault actually resides with the vacuum pump, perform a “Dead Head” test on the vacuum pump. To perform the “Dead Head” test, you will require the following service tool:

- z **295-5408** Sensor Kit (“Dead Head”)
  1. Verify that the system is in bypass mode. Verify that the flywheel is disengaged. Refer to the appropriate Systems Operation, Testing and Adjusting.
  2. De-energize the vacuum pump.
  3. Disconnect the input vacuum hose and the 90 degree elbow assembly between the flywheel and the right side of the vacuum pump.
  4. Connect the **295-5409** Adapter Plate into the fitting for the vacuum pump. See Step 3.
  5. Connect the **200-8452** Vacuum Sensor to the **295-5409** Adapter Plate .
  6. Disconnect the wiring harness for the flywheel installed vacuum sending unit at the flywheel.
  7. Connect the wiring harness from Step 6 to the test **200-8452** Vacuum Sensor .
  8. For a single module unit, connect your laptop computer to the RS-232 connector that is located on the “I/O” board. For a multiple module unit, connect your laptop computer to the RS-232 connector that is located on the “PCI” board.
  9. Start the UPSView program. Establish communications.
  10. Select the appropriate telemetry tile in order to view the “Vacuum Gauge”.
  11. Energize the vacuum pump.
  12. Monitor the reading of vacuum pressure via UPSView.
  13. An acceptable reading for the vacuum pump is 10 millitorr or less. If the vacuum pump produces a reading greater than 10 millitorr, replace the pump.
  14. Upon completion of the “Dead Head” test, return the system back to the original configuration.
  15. Return the system to on-line status. Refer to the appropriate Systems Operation, Testing and Adjusting.



**EXHIBIT E**

[ \* ]

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

**EXHIBIT F: SHIPPING REQUIREMENTS FOR WARRANTY RECALL PARTS**

Packaging Rules: Return parts must be properly packaged to prevent any shipment damage. The use of original shipping containers is preferred. All PWAs and semiconductor parts must be placed in an ESDS bag when packaged for return shipment.

Shipping Rules: Domestic\* Standard Ground Freight  
No Overnight Shipments\*\*\*  
No Collect Shipments

International\*\* Standard Air Freight  
No Overnight Shipments\*\*\*  
No Collect Shipments

Notes:

\* All domestic parts returns must be accompanied by a Parts Return Tag.

\*\* International parts returns must be accompanied by a copy of the warranty order. All international parts shipments must be claimed as a warranty replacement part to avoid importation fees.

\*\*\* Overnight shipping will not be accepted without prior written approval from Active Power’s Service Manager, Director of Service, or VP of Service.

**EXHIBIT G**

[ \* ]

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\* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portion.

G-1

## CERTIFICATIONS

I, James A. Clishem, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;
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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (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 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.

Date: April 28, 2008

/s/ James A. Clishem

James A. Clishem  
President and Chief Executive Officer  
(Principal Executive Officer)

## CERTIFICATIONS

I, John K. Penver, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;
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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (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 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.

Date: April 28, 2008

/s/ John K. Penver

John K. Penver

Vice President of Finance, Chief Financial Officer and Secretary  
(Principal Financial and Accounting Officer)

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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending March 31, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James A. Clishem, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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), as applicable, 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.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

*/s/ James A. Clishem*

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James A. Clishem  
President and Chief Executive Officer  
April 28, 2008

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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending March 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John K. Penver, Vice President of Finance, Chief Financial Officer and Secretary of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 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), as applicable, 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.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

/s/ John K. Penver

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John K. Penver

Vice President of Finance, Chief Financial Officer and Secretary

April 28, 2008