

ACTIVE POWER INC (ACPW)

10-Q

Quarterly report pursuant to sections 13 or 15(d)

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

Or

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

For the transition period from _____ to _____

Commission file number: 000-30939

ACTIVE POWER, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

74-2961657

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

2128 W. Braker Lane, BK12, Austin, Texas
(Address of principal executive offices)

78758

(Zip Code)

(512) 836-6464
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (\$232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

(Do not check if a smaller reporting company)

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 November 1, 2011 was 80,168,448.

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PART I – FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements.

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

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 9,455	\$ 15,416
Short-term investments in marketable securities	-	134
Restricted cash	403	-
Accounts receivable, net of allowance for doubtful accounts of \$346 and \$330 at September 30, 2011 and December 31, 2010, respectively	16,725	14,708
Inventories	10,731	6,430
Prepaid expenses and other	501	511
Total current assets	<u>37,815</u>	<u>37,199</u>
Property and equipment, net	3,007	2,005
Deposits and other	404	314
Total assets	<u><u>\$ 41,226</u></u>	<u><u>\$ 39,518</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 6,035	\$ 6,022
Accrued expenses	5,379	7,068
Deferred revenue	4,566	2,492
Revolving line of credit	5,535	2,535
Total current liabilities	<u>21,515</u>	<u>18,117</u>
Long-term liabilities	811	579
Stockholders' equity:		
Common stock	80	80
Treasury stock	(115)	(103)
Additional paid-in capital	276,233	274,807
Accumulated deficit	(257,553)	(253,801)
Other accumulated comprehensive income (loss)	255	(161)
Total stockholders' equity	<u>18,900</u>	<u>20,822</u>
Total liabilities and stockholders' equity	<u><u>\$ 41,226</u></u>	<u><u>\$ 39,518</u></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 September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Product revenue	\$ 16,996	\$ 16,663	\$ 47,890	\$ 39,356
Service and other revenue	<u>3,612</u>	<u>1,793</u>	<u>9,262</u>	<u>6,264</u>
Total revenue	20,608	18,456	57,152	45,620
Cost of goods sold:				
Cost of product revenue	13,112	11,287	35,625	28,323
Cost of service and other revenue	<u>2,649</u>	<u>1,691</u>	<u>7,337</u>	<u>4,606</u>
Total cost of goods sold	15,761	12,978	42,962	32,929
Gross profit	4,847	5,478	14,190	12,691
Operating expenses:				
Research and development	1,272	833	3,279	2,517
Selling and marketing	3,527	3,539	10,397	10,323
General and administrative	<u>1,280</u>	<u>1,075</u>	<u>4,083</u>	<u>3,825</u>
Total operating expenses	6,079	5,447	17,759	16,665
Operating profit (loss)	(1,232)	31	(3,569)	(3,974)
Interest expense, net	(68)	(30)	(149)	(82)
Other income (expense), net	8	13	(34)	(55)
Income (loss) before income taxes	<u>(1,292)</u>	<u>14</u>	<u>(3,752)</u>	<u>(4,111)</u>
Income tax benefit	-	41	-	41
Net income (loss)	\$ (1,292)	\$ 55	\$ (3,752)	\$ (4,070)
Net income (loss) per share, basic	\$ (0.02)	\$ 0.00	\$ (0.05)	\$ (0.05)
Net income (loss) per share, diluted	\$ (0.02)	\$ 0.00	\$ (0.05)	\$ (0.05)
Shares used in computing net income (loss) per share, basic	80,119	79,674	79,990	76,982
Shares used in computing net income (loss) per share, diluted	80,119	80,366	79,990	76,982
Comprehensive income (loss):				
Net income (loss)	\$ (1,292)	\$ 55	\$ (3,752)	\$ (4,070)
Translation gain (loss) on subsidiaries denominated in foreign currencies	<u>(193)</u>	<u>247</u>	<u>416</u>	<u>(12)</u>
Comprehensive income (loss)	\$ (1,485)	\$ 302	\$ (3,336)	\$ (4,082)

Active Power, Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(Unaudited)

	Nine Months Ended September 30, 2011 2010	
Operating activities		
Net loss	\$ (3,752)	\$ (4,070)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	1,093	1,510
Change to allowance for doubtful accounts	16	(42)
(Gain) Loss on disposal of fixed assets	130	8
Stock-based compensation	1,149	716
Changes in operating assets and liabilities:		
Accounts receivable	(2,033)	(1,086)
Inventories	(4,301)	300
Prepaid expenses and other assets	(80)	(253)
Accounts payable	13	(533)
Accrued expenses	(1,689)	809
Deferred revenue	2,074	(10)
Long-term liabilities	232	138
Net cash used in operating activities	(7,148)	(2,513)
Investing activities		
Sales/maturities of marketable securities	134	—
Increase in restricted cash	(403)	—
Purchases of property and equipment	(2,225)	(532)
Net cash used in investing activities	(2,494)	(532)
Financing activities		
Proceeds from private placement of common stock	—	9,923
Issuance costs of private placement	—	(886)
Proceeds from draw on revolving line of credit	3,000	1,008
Payments on revolving line of credit	—	(32)
Proceeds from employee stock purchases	277	24
Purchases of treasury stock	(12)	(30)
Net cash provided by financing activities	3,265	10,007
Translation gain (loss) on subsidiaries in foreign currencies	416	(12)
Change in cash and cash equivalents	(5,961)	6,950
Cash and cash equivalents, beginning of period	15,416	7,489
Cash and cash equivalents, end of period	<u>\$ 9,455</u>	<u>\$ 14,439</u>

See accompanying notes.

Active Power, Inc.
Notes to Condensed Consolidated Financial Statements
September 30, 2011
(Unaudited)

1. Significant Accounting Policies

Organization and Basis of presentation

Active Power, Inc. and its subsidiaries (hereinafter referred to as "we", "us", "Active Power" or the "Company") manufacture and provide critical power quality solutions that provide business continuity and protect customers in the event of an electrical power disturbance. Our products and solutions are designed to deliver continuous clean power, protecting customers from voltage fluctuations, such as surges and sags and frequency fluctuations, and also to provide ride-through, or temporary, power to bridge the gap between a power outage and the restoration of utility power. Our target customers are those global enterprises requiring "power insurance" because they have zero tolerance for downtime in their mission critical operations. The Uninterruptible Power Supply ("UPS") products we manufacture use kinetic energy to provide short-term power as a cleaner alternative to electro-chemical battery-based energy. We sell stand-alone UPS products as well as complete continuous power and infrastructure solutions, including containerized continuous power systems that we brand as PowerHouse. We sell our products globally through direct, manufacturer's representatives, Original Equipment Manufacturer ("OEM") channels and IT partners. Our current principal markets are Europe, Middle East and Africa ("EMEA"), Asia and North America.

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 (consisting only of normal recurring items) 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, 2010.

2. Supplemental Balance Sheet Information

Restricted Cash

Restricted cash balance of \$403 as of September 30, 2011, secured performance guarantees given to a customer. Upon satisfaction of these guarantees, the restriction on these funds will be released.

Receivables

Accounts receivable consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Trade receivables	\$ 17,071	\$ 15,038
Allowance for doubtful accounts	(346)	(330)
	<hr/> \$ 16,725	<hr/> \$ 14,708

Inventory

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

	September 30, 2011	December 31, 2010
Raw materials	\$ 6,859	\$ 5,243
Work in process	3,452	2,382
Finished goods	2,246	1,148
Allowances for obsolescence	(1,826)	(2,343)
	<u><u>\$ 10,731</u></u>	<u><u>\$ 6,430</u></u>

Property and Equipment

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

	September 30, 2011	December 31, 2010
Equipment	\$ 9,991	\$ 9,574
Demonstration units	1,483	1,195
Computers and purchased software	3,932	3,425
Furniture and fixtures	389	362
Leasehold improvements	7,423	7,328
Construction in progress	1,078	389
	<u><u>24,296</u></u>	<u><u>22,273</u></u>
Accumulated depreciation	(21,289)	(20,268)
	<u><u>\$ 3,007</u></u>	<u><u>\$ 2,005</u></u>

Accrued Expenses

Accrued expenses consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Compensation and benefits	\$ 2,331	\$ 3,985
Warranty liability	701	677
Property, income, state, sales and franchise tax	862	1,193
Professional fees	413	360
Other	1,072	853
	<u><u>\$ 5,379</u></u>	<u><u>\$ 7,068</u></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. Occasionally we offer longer warranty periods to certain customers. The warranty period for products sold to our primary OEM customer, Caterpillar, is 12 months from the date of shipment to the end-user, or up to 36 months from shipment. This is dependent upon Caterpillar complying with our storage requirements for our products in order to preserve this warranty period beyond the standard 18-month limit. We provide for the estimated cost of product warranties at the time revenue is recognized and this accrual is included in accrued expenses and long-term liabilities on the accompanying consolidated balance sheet.

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

Balance at December 31, 2010	\$ 734
Warranty expense	695
Warranty charges incurred	(687)
Balance at September 30, 2011	<u><u>\$ 742</u></u>
Warranty liability included in accrued expenses	\$ 701
Long-term warranty liability	41
Balance at September 30, 2011	<u><u>\$ 742</u></u>

Revenue Recognition

In general, we recognize revenue when four criteria are met: (i) persuasive evidence that an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the sales price is fixed or determinable; and (iv) collectability is reasonably assured. In general, revenue is recognized when revenue-generating transactions generally fall into one of the following categories of revenue recognition:

- We recognize product revenue at the time of shipment for substantially all products sold directly to customers and through distributors because title and risk of loss pass on delivery to the common carrier. Our customers and distributors do not have the right to return products. If title and risk of loss pass at some other point in time, we recognize such revenue for our customers when the product is delivered to the customer and title and risk of loss have passed.
- We recognize installation and service and maintenance revenue at the time the service is performed.
- We recognize revenue associated with extended maintenance agreements (“EMAs”) over the life of the contracts using the straight-line method, which approximates the expected timing in which applicable services are performed. Amounts collected in advance of revenue recognition are recorded as a current or long-term liability based on the time from the balance sheet date to the future date of revenue recognition.
- We recognize revenue on certain rental programs over the life of the rental agreement using the straight-line method. Amounts collected in advance of revenue recognition are recorded as a current or long-term liability based on the time from the balance sheet date to the future date of revenue recognition.
- Shipping costs reimbursed by the customer are included in revenue.

Multiple element arrangements (“MEAs”). Arrangements to sell products to customers frequently include multiple deliverables. Our most significant MEAs include the sale of one or more of our CleanSource UPS or PowerHouse products, combined with one or more of the following products: design services, project management, commissioning and installation services, spare parts or consumables, and EMAs. Delivery of the various products or performance of services within the arrangement may or may not coincide. Certain services related to design and consulting may occur prior to delivery of product and commissioning and installation typically takes place within six months of product delivery, depending upon customer requirements. EMAs, consumables, and repair, maintenance or consulting services generally are delivered over a period of one to five years. In certain arrangements revenue recognized is limited to the amount invoiced or received that is not contingent on the delivery of future products and services.

When arrangements include multiple elements, we allocate revenue to each element based on the relative selling price and recognize revenue when the elements have stand-alone value and the four criteria for revenue recognition have been met for each element. We establish the selling price of each element based on Vendor Specific Objective Evidence (“VSOE”) if available, Third Party Evidence (“TPE”) if VSOE is not available, or best estimate of selling price (“BESP”) if neither VSOE nor TPE is available. We generally determine selling price based on amounts charged separately for the delivered and undelivered elements to similar customers in stand-alone sales of the specific elements. When arrangements include an EMA, we recognize revenue related to the EMA at the stated contractual price on a straight-line basis over the life of the agreement.

Any taxes imposed by governmental authorities on our revenue-producing transactions with customers are shown in our consolidated statements of operations on a net-basis; that is, excluded from our reported revenues.

3. Net Income (Loss) Per Share

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

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	2011	2010	2011	2010
Numerator:				
Net income (loss)	\$ (1,292)	\$ 55	\$ (3,752)	\$ (4,070)
Denominator:				
Weighted-average shares of common stock outstanding	80,119	79,674	79,990	76,982
Dilutive effect of employee stock options and restricted stock awards	—	692	—	—
Weighted average shares for diluted net income per share	<u>80,119</u>	<u>80,366</u>	<u>79,990</u>	<u>76,982</u>
Basic net income (loss) per share	\$ (0.02)	\$ 0.00	\$ (0.05)	\$ (0.05)
Diluted income (loss) per share:	\$ (0.02)	\$ 0.00	\$ (0.05)	\$ (0.05)
Common stock equivalents that were not included in the calculation because the option price was greater than the average market price of the common shares or the net loss would cause the effect of the options to be anti-dilutive:				
Employee stock options	10,260	5,363	10,260	7,160
Performance-based options	1,440	2,100	1,440	2,100
Restricted stock awards	—	9	—	19
	<u>11,700</u>	<u>7,472</u>	<u>11,700</u>	<u>9,279</u>

There were no restricted stock awards outstanding at September 30, 2011. As of September 30, 2011 and 2010, respectively, there was no common stock subject to repurchase.

4. Fair Value of Financial Instruments

Investments in marketable securities consist of money-market funds, commercial paper and debt securities with readily determinable fair values. Active Power accounts 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. The carrying amount of investments in marketable securities approximated fair value at December 31, 2010. There were no investments in marketable securities at September 30, 2011.

In accordance with our investment policy and guidelines, our short-term investments are diversified among and limited to high quality securities with a minimum of investment grade ratings. We actively monitor our investment portfolio to ensure compliance with our investment objective to preserve capital, meet liquidity requirements and maximize return on our investments. We do not require collateral or enter into master netting arrangements to mitigate our credit risk.

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Effective October 1, 2008, we adopted an accounting standard that defines fair value, establishes a framework for measuring fair value as well as expands on required disclosures regarding fair value measurements. This standard applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances.

Level 1—uses quoted prices in active markets for identical assets or liabilities we have the ability to access.

Level 2—uses observable inputs other than quoted prices in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3—uses one or more significant inputs that are unobservable and supported by little or no market activity, and that reflect the use of significant management judgment.

Inputs are referred to as assumptions that market participants would use in pricing the asset or liability. The uses of inputs in the valuation process are categorized into a three-level fair value hierarchy.

Our Level 1 assets and liabilities consist of cash equivalents and short-term investments, which are primarily invested in money-market funds. These assets are classified as Level 1 because they are valued using quoted prices in active markets and other relevant information generated by market transactions involving identical assets and liabilities.

The fair value of our cash equivalents, which are primarily invested in money-market funds, was determined using the following inputs as of September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011				
Fair Value Measurements at Reporting Date Using				
	Level 1	Level 2	Level 3	Total
Money-market funds	\$ 3,093	\$ —	\$ —	\$ 3,093
Total	\$ 3,093	\$ —	\$ —	\$ 3,093
Amounts included in:				
Cash and cash equivalents	\$ 3,093	\$ —	\$ —	\$ 3,093
Short-term investments	—	—	—	—
Total	\$ 3,093	\$ —	\$ —	\$ 3,093

December 31, 2010				
Fair Value Measurements at Reporting Date Using				
	Level 1	Level 2	Level 3	Total
Money-market funds	\$ 3,227	\$ —	\$ —	\$ 3,227
Total	\$ 3,227	\$ —	\$ —	\$ 3,227
Amounts included in:				
Cash and cash equivalents	\$ 3,093	\$ —	\$ —	\$ 3,093
Short-term investments	134	—	—	134
Total	\$ 3,227	\$ —	\$ —	\$ 3,227

For cash and cash equivalents, marketable securities, accounts receivable, and accounts payable, the carrying amount approximates fair value because of the relative short maturity of those instruments.

5. Guarantees

In certain geographical regions, particularly Europe and Africa, we are sometimes required to issue performance guarantees to our customers as a condition of sale. These guarantees usually provide financial protection to our customers in the event that we fail to fulfill our warranty obligations. We secure these guarantees with standby letters of credit through our bank. At September 30, 2011 and December 31, 2010, we had \$450 and \$547, respectively, of performance guarantees outstanding to customers that were secured with letters of credit.

6. Subsequent Events

On October 14, 2011 we announced the resignation of our President and Chief Executive Officer and the appointment of Mr. Jan Lindelow, a company director, as interim President and Chief Executive Officer while we undertake a search for a new Chief Executive Officer. In connection with this change in our President and Chief Executive Officer we expect to incur approximately \$940,000 in costs during the fourth quarter of 2011 relating to separation of employment and for costs incurred in hiring a new Chief Executive Officer. This change in President and Chief Executive Officer also resulted in a default of one of the affirmative covenants for our revolving bank lending facility; however our bank has provided us a waiver of this default so that we are in compliance with the terms of our bank lending facility.

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 by reference 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 Operations for the year ended December 31, 2010 included in our 2010 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 I, Item 1A of our 2010 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

Active Power is headquartered in Austin, Texas, where we manufacture our patented flywheel uninterruptible power supply ("UPS") systems and continuous power and infrastructure solutions. These solutions ensure continuity for business and IT operations for enterprises, data center operations and IT service providers in the event of power disturbances.

Our products and solutions are designed to deliver continuous clean power during power disturbances and outages, voltage sags and surges and provide ride-through power in the event of utility failure, supporting operations until utility power is restored or a longer-term alternative power source, such as a diesel generator, is started. We believe that our products offer an advantage over those of our competitors in the areas of space and energy efficiency, total cost of ownership, system reliability, modular design and the economically green benefits of our solutions.

As of September 30, 2011, we have shipped more than 3,200 flywheels in UPS system installations, delivering more than 800 megawatts of critical power to customers in 42 countries around the world. We are headquartered in Austin, Texas, with international offices in the United Kingdom, Germany, China and Japan.

Our patented flywheel-based UPS 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 either utility power is restored or a backup electric generator starts and takes over generating longer-term power in the case of an extended electrical outage. We believe our flywheel products provide many competitive advantages over conventional battery-based UPS systems, including substantial space savings, higher power densities, "green" energy storage, and higher power efficiencies up to 98%. This high energy efficiency reduces operating costs and provides customers a lower total cost of ownership. We offer our flywheel products with load capabilities from 130kVA to 8,400kVA. We typically target higher power applications of 200kVA and above, largely because the majority of customers in this market segment have backup generators. Our flywheel-based UPS systems are marketed under the brand name CleanSource®.

We also sell continuous power systems ("CPS"), which incorporate our UPS products with switchgear and a generator to provide complete short- and long-term protection in the event of a power disturbance. Where the CPS is sold in a containerized package, it is marketed under the brand name PowerHouseTM. PowerHouse can be deployed in either a 20-foot or 40-foot-long container depending upon the customer's power load requirements. These systems are specifically designed to handle the demands of high-tech facilities requiring the highest power integrity available while maximizing up time, useable floor space and operational efficiency. Designed to offer a highly flexible architecture to a customer's constantly changing environment, our PowerHouse systems are offered in four standard modular power configurations, enabling sizing for infrastructure on demand. These systems are highly differentiated as they offer flexibility in placement, space savings, fast deployment time after receipt of order, high energy efficiency, and prompt capital deployment to meet current demands. They also deliver significant value to customers as the entire system is integrated and tested prior to delivery for a repeatable simple solution. We also sell CPS solutions to customers in a non-containerized format, typically deploying such solutions inside buildings.

Leveraging our expertise in containerization and power distribution, in 2010 we began to manufacture continuous infrastructure solutions, designed to specification for select business partners. These solutions serve as the infrastructure for modular data centers, which are self-contained, fully-functional data centers. Modular data centers may be rapidly deployed with other modular infrastructure, such as PowerHouse, as a cost-effective alternative to traditional raised-floor data centers. Active Power designs and delivers the exterior shell and a fully fitted-out interior (including electrical, cooling, monitoring, and other elements) ready for the customer to add its IT racks and servers. After the customer adds its IT equipment to our continuous infrastructure solution, the customer has a functional data center. We expect revenue to grow in coming years from current and future customers as modular data center infrastructure continues to gain acceptance in the market.

We sell our products to a wide array of commercial and industrial customers across a variety of vertical markets, including data centers, manufacturing, technology, broadcast and communications, financial, utilities, healthcare, government and airports. We have expanded our global sales channels and direct sales force, selling in most all major geographic regions of the world, but particularly in North America, Europe and Asia. We sell our products through the following distribution methods:

- Sales made directly by Active Power;
- Manufacturer's representatives;
- Distributors;
- OEM partners; and
- Strategic IT Partners.

We believe a number of underlying macroeconomic trends place Active Power in a strong position to be one of the leading providers of critical power protection. These trends include:

- Ever-increasing demands placed on the public utility infrastructure;
- An inadequate investment in global utility infrastructure;
- Rising costs of energy worldwide;
- Increasing business costs of downtime;
- A rapidly expanding need for data centers that provide reliable, efficient power; and
- An increasing demand for economically green solutions.

We believe that our total revenue will continue to grow from all of our products and as we continue to focus on selling more complete systems rather than just products. In particular, we expect continuing market acceptance of containerized solutions to drive higher sales of our PowerHouse and containerized infrastructure solution products globally. We also believe that the global growth in data center demand will lead to higher sales of our UPS products. We are specifically targeting those customers with large IT and power needs who have the ability to make frequent and large UPS purchases as their global operations expand.

Our commercialization strategy remains focused on the following:

- Building the Active Power brand globally;
- Expanding our distribution channels;
- Creating innovative solutions; and
- Focusing on operating and product cost reduction.

As a result of this strategy, we have been successful in improving our operating and financial performance, broadening our global footprint, diversifying our customer base, broadening our sales channels and partners, and moving higher up the customer value chain with innovative developments of our core underlying product technology.

Results of Operations

(\$ in thousands)	Three Months ended September 30,				Variance 2011 vs. 2010	
	2011	% of total revenue	2010	% of total revenue	\$	%
Product revenue	\$ 16,996	82%	\$ 16,663	90%	\$ 333	2%
Service and other revenue	3,612	18%	1,793	10%	1,819	101%
Total revenue	20,608	100%	18,456	100%	2,152	12%
Cost of product revenue	13,112	64%	11,287	61%	1,825	16%
Cost of service and other revenue	2,649	13%	1,691	9%	958	57%
Total cost of revenue	15,761	76%	12,978	70%	2,783	21%
Gross profit	4,847	24%	5,478	30%	(631)	(12)%
Operating expenses:						
Research and development	1,272	6%	833	5%	439	53%
Selling and marketing	3,527	17%	3,539	19%	(12)	—%
General and administrative	1,280	6%	1,075	6%	205	19 %
Total operating expenses	6,079	29%	5,447	30%	632	12%
Operating profit (loss)	(1,232)	(6)%	31	—%	(1,263)	(4,074)%
Interest expense, net	(68)	—	(30)	—	(38)	(127)%
Other income (expense), net	8	—	13	—	(5)	(38)%
Income (loss) before income taxes	(1,292)	(6)%	14	—%	(1,306)	(9,329)%
Income tax benefit	—	—	41	—	(41)	(100)%
Net income (loss)	\$ (1,292)	(6)%	\$ 55	—%	\$ (1,347)	(2,449)%
(\$ in thousands)	Nine months ended September 30,				Variance 2011 vs. 2010	
	2011	% of total revenue	2010	% of total revenue	\$	%
Product revenue	\$ 47,890	84%	\$ 39,356	86%	\$ 8,534	22%
Service and other revenue	9,262	16%	6,264	14%	2,998	48%
Total revenue	57,152	100%	45,620	100%	11,532	25%
Cost of product revenue	35,625	62%	28,323	62%	7,302	26%
Cost of service and other revenue	7,337	13%	4,606	10%	2,731	59%
Total cost of revenue	42,962	75%	32,929	72%	10,033	30%
Gross profit	14,190	25%	12,691	28%	1,499	12%
Operating expenses:						
Research and development	3,279	6%	2,517	6%	762	30%
Selling and marketing	10,397	18%	10,323	23%	74	1%
General and administrative	4,083	7%	3,825	8%	258	7%
Total operating expenses	17,759	31%	16,665	37%	1,094	7%
Operating loss	(3,569)	(6)%	(3,974)	(9)%	405	(10)%
Interest expense, net	(149)	—	(82)	—	(67)	82%
Other income (expense), net	(34)	—	(55)	—	21	(38)%
Loss before income taxes	(3,752)	(6)%	(4,111)	(9)%	359	9 %
Income tax benefit	—	—	41	—	(41)	(100)%
Net loss	\$ (3,752)	(6)%	\$ (4,070)	(9)%	\$ 318	8%

Product revenue. Product revenue primarily consists of sales of our CleanSource power quality products, CPS and other data center infrastructure solutions. Our CleanSource power quality products are comprised of both UPS and DC product lines and our CPS are comprised of our UPS systems and some combination of third party ancillary equipment, such as engine generators and switchgear. The CPS products may be sold in a containerized solution that we call PowerHouse, or as separate equipment. Our data center infrastructure solutions provide power distribution, cooling capabilities, security systems, fire suppression and monitoring capabilities for our IT channel partners. Our product revenue was derived from the following sources:

(\$ in thousands)	Three Months Ended September 30,		Variance	
	2011	2010	\$	%
Product revenue:				
UPS product revenue	\$ 5,991	\$ 8,358	\$ (2,367)	(28)%
Continuous Power Systems	7,034	1,210	5,824	481%
Data center infrastructure solutions	3,971	7,095	(3,124)	(44)%
Total product revenue	<u>\$ 16,996</u>	<u>\$ 16,663</u>	<u>\$ 333</u>	<u>2%</u>

(\$ in thousands)	Nine Months Ended September 30,		Variance	
	2011	2010	\$	%
Product revenue:				
UPS product revenue	\$ 20,764	\$ 23,210	\$ (2,446)	(11)%
Continuous Power Systems	20,105	6,298	13,807	219%
Data center infrastructure solutions	7,021	9,848	(2,827)	(29)%
Total product revenue	<u>\$ 47,890</u>	<u>\$ 39,356</u>	<u>\$ 8,534</u>	<u>22%</u>

Product revenue for the three-month period ended September 30, 2011 increased approximately \$333,000, or 2%, compared to the same period of 2010. This increase is primarily attributable to an increase in sales of continuous power systems, including Powerhouse, of \$5.8 million, as our solutions have gained market acceptance. Sales related to our CPS products, which are generally larger in value and are purchased by fewer customers relative to our UPS products, comprised 41% of product revenue in the third quarter of 2011, compared to 7% of product revenue in the third quarter of 2010. In addition, sales of our megawatt class UPS products increased by \$2.3 million compared to the third quarter of 2010 and sales of our 65-150kVA CleanSource UPS product line increased by approximately \$340,000 compared to the third quarter of 2010. These increases were offset by a \$4.8 million decrease in sales of our 250-900kVA CleanSource UPS product line compared to the same period of 2010. This change in product mix and revenue source was driven by the particular customer orders at any point in time and can vary based upon customer load and space requirements.

Product revenue for the nine-month period ended September 30, 2011 increased by \$8.5 million, or 22%, compared to the same period in 2010. This increase was driven primarily by an increase of \$13.8 million in sales of our CPS products, particularly in Europe and Asia. Sales related to our CPS products comprised 42% of product revenue in the first nine months of 2011, compared to 16% of product revenue in the same period of 2010. The \$2.4 million decrease in UPS product revenue for the first nine months of 2011 was primarily a result of an increase of \$5.1 million in our megawatt class UPS products and an increase of approximately \$670,000 in our 65-150kVA CleanSource UPS product line, offset by a larger decrease in our 250-900 kVA CleanSource product line megawatt class UPS products of \$8.2 million. This reflects a trend towards higher-power system sales in our end markets and the absence of large UPS only orders from the US technology industry this year compared to 2010.

Product revenue for the third quarter of 2011 increased by approximately \$840,000, or 5%, compared to the second quarter of 2011, primarily due to higher continuous power system and data center infrastructure solutions revenues, offset by lower UPS product revenues.

Product sales from our OEM channels for the three-month period ended September 30, 2011 increased by approximately \$560,000, or 38%, compared to the same period in 2010 and for the nine-month period ended September 30, 2011 increased by \$1.4 million, or 18%, as compared to the same period in 2010. Product sales from our OEM channels for the three-month period ended September 30, 2011 increased by approximately \$245,000, or 14%, compared to the second quarter of 2011. The size and volume of orders from our OEM channels can fluctuate significantly on a quarterly basis and in 2011 we have seen fewer, but larger value transactions from our OEM channel. We have supported our OEM partners' efforts to sell total solutions to their customers that include generators and switchgear that they manufacture along with our UPS systems as a total solution. If our OEM partners are successful with this strategy, we believe that it will help drive an increase in our UPS product revenue. However, as our OEM partners sell more solutions, the quarterly volume of revenue become more variable. Sales to Caterpillar, our primary OEM channel, represented 12% and 19% of our product revenue for the three-month and nine-month periods ended September 30, 2011, respectively, as compared to 9% and 20%, respectively, of our product revenue in both the comparable periods of 2010. Caterpillar remains one of our largest customers as well as our largest OEM customer.

During the third quarter of 2011, we delivered 22.2 megawatts of critical power systems, which generated approximately \$585,000 in revenue per megawatt. This compares to 23.9 megawatts of critical power systems delivered in the third quarter of 2010, which generated approximately \$420,000 in revenue per megawatt. The increase in revenue generated per megawatt of critical power delivered was largely driven by an increase in sales of complete power systems, which generate more revenue per megawatt of critical power delivered compared to UPS systems only.

Our CPS and PowerHouse contracts tend to be larger in value and from a smaller number of customers compared to sales of our UPS products. This smaller number of customers with greater transaction value can contribute to large quarterly fluctuations in revenue from each product family, due to the timing of orders or shipments in any particular accounting period. The size of these transactions has been increasing and individual CPS transactions have been as high as \$6 million in 2011. A small number of transactions can therefore lead to significant revenue, but cause greater volatility in our quarterly results and increase liquidity risk for us as we continue to refine and improve the payment terms of these opportunities as part of our working capital management.

North America product sales were 82% of our product revenue for the three-month period ended September 30, 2011, compared to 84% for the same period in 2010, and 52% of product revenue in the three-month period ended June 30, 2011. For the nine-month period ended September 30, 2011, our North America product sales were 61% of our product revenue, which compared to 73% for the same period in 2010.

We also sell products directly to customers in Asia and Western Europe and we have a network of international distributors in other territories that sell products for us. In these markets, customers are more likely to purchase a total power solution from us rather than a stand-alone UPS system. This usually results in a longer selling cycle and makes quarterly results from these regions more volatile. Thus the amount of revenue from our international markets can fluctuate significantly on a quarterly basis. Product sales to customers in Asia represented 5% of our product revenue in the three-month period ended September 30, 2011, compared to 4% for the same period in 2010 and 25% of product revenue in the second quarter of 2011. Product sales in EMEA represented 10% of product revenue in the three-month period ended September 30, 2011, compared to 11% for the same period in 2010 and 23% of product revenue in the second quarter of 2011. These fluctuations are primarily attributable to variations in sales of our CPS products in each region in the relevant periods and illustrate the impact of larger orders from fewer customers on quarterly revenue for each of these regions.

Product sales of Active Power branded products through our direct and manufacturer's representative channels were 30% of our product revenue for the three-month period ended September 30, 2011, compared to 49% for the same period of 2010, and 61% of our product revenue for the three-month period ended June 31, 2011. For the nine-month period ended September 30, 2011, product sales of Active Power branded products through our direct and manufacturer's representative channels were 47% of our product revenue, compared to 55% for the same period of 2010. 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 and to decrease our dependency upon our OEM channel. We believe sales of our Active Power branded products in markets that are not covered by our OEMs will continue to increase over time and will continue to become a larger percentage of our total revenue.

Our products perform well in harsh environments where power quality or reliability is particularly poor, which makes them a good fit for countries with a poor power infrastructure or in harsh manufacturing or process environments, or situations where reliability is paramount, such as mission-critical business applications. Therefore, we have traditionally focused our direct sales efforts on these types of customer situations.

Service and other revenue. Service and other revenue primarily relates to revenue generated from both traditional (after-market) service work and from customer-specific system engineering. This includes revenue from design, 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 and revenues or fees received upon contract deferment or cancellation. Revenue from extended maintenance contracts with our customers is also included in this revenue category.

Service and other revenue increased by approximately \$1.8 million, or 101%, for the three-month period ended September 30, 2011, compared to the same period in 2010, and increased by \$3.0 million, or 48%, for the nine-month period ended September 30, 2011 as compared to the same period in 2010. These increases reflect higher levels of service and contract work from direct product sales and from professional fees associated with PowerHouse and other CPS sales. For these CPS customers, we provide a full power solution, including design services, site preparation, installation of an entire power solution and provision of all products required to provide a turnkey product to the end user often including maintenance services. We also had increased service revenues from maintenance contracts and repair-related activities as our increasing installed base of UPS customers provides greater opportunities to generate such revenues. Where we make sales through our OEM channel, it is typical for the OEM to provide these types of services to their end-user customers so these revenue opportunities do not typically exist for us on our OEM sales. We anticipate that service and other revenue will continue to grow with product revenue, particularly as our PowerHouse system revenue grows and as our installed base of UPS product expands, because as more units are sold to customers, more installation, startup and maintenance services will be required.

Cost of product revenue. Cost of product revenue includes the cost of component parts of our products, ancillary equipment that is sourced from external suppliers, personnel, equipment and other costs associated with our assembly and test operations, including costs from having underutilized facilities, depreciation of our manufacturing property and equipment, shipping costs, warranty costs, and the costs of manufacturing support functions such as logistics and quality assurance. The cost of product revenue as a percentage of total product revenue was 77% for the three-month period ended September 30, 2011, compared to 68% for the same period in 2010, and 74% for the nine-month period ended September 30, 2011, as compared to 72% for the same period of 2010. These increases in costs as a percentage of revenue reflect higher levels of unabsorbed overhead costs attributable to a lower level of UPS system production. We continue to operate a manufacturing facility that has a manufacturing and testing capacity significantly greater than our current product revenue levels. A large portion of the costs involved in operating this manufacturing facility are fixed in nature and we can incur up to \$600,000 in unabsorbed overhead each quarter depending on the level of UPS system production. We continue to work on reducing our product costs through design enhancements and modifications, vendor management programs and increasing our sales volume to absorb these expenses.

Cost of service and other revenue. Cost of service and other revenue includes the cost of component parts that we use in service or sell as spare parts, as well as labor and overhead costs of our service organization, including travel and related costs incurred in fulfilling our service obligations to our customers. Costs paid to third parties in fulfillment of service and design or installation services are also included in costs of service and other revenue. The cost of service and other revenue decreased to 73% of service and other revenue in the three-month period ended September 30, 2011, compared to 94% for the same period of 2010, and increased to 79% in the nine-month period ended September 30, 2011 as compared to 74% in the same period of 2010. This increase in the cost of service and other revenue for the year-to-date was primarily due to lower margins realized in Europe for design, installation and project management on a number of large CPS system sales in 2011 that resulted in costs being a higher proportion of revenue. The decrease in the current quarter reflects higher utilization of our service personnel and improved margins on the professional service work we perform for CPS systems installation. We have also had higher costs relative to the increase in service and other revenues as we have continued to expand our service team as we broaden the geographic regions where we have service capability as our total business grows. Operationally, we are challenged to manage the growth of our service organization congruent with the growth in total revenues so that we can meet customer requirements without growing our service organization cost structure too rapidly. The utilization of our service personnel will also be affected by the number of PowerHouse and infrastructure solution products implemented in a particular period and in periods where we have a low number of installation projects we would expect our costs as a percentage of revenue to increase. A large portion of the costs involved in operating our service organization are fixed in nature and we incur approximately \$300,000 to \$600,000 in unabsorbed overhead each quarter. We continue to work on reducing our service overhead through better utilization of our service employees and cost control measures. This infrastructure also means that we can leverage this investment and grow our service capabilities substantially by adding direct technical labor only as required.

Gross profit. For the three-month period ended September 30, 2011 our gross profit margin was 24% of revenue, compared to a 30% gross margin for the same period in 2010. For the nine-month period ended September 30, 2011, our gross profit margin was 25% of revenue, compared to 28% for the same period of 2010. The decrease in gross profit margin from 2010 reflects the impact of an increase in the sales of our CPS and infrastructure products as a percentage of our total revenue. These products generally earn lower margins for us than sales of our UPS product because they include a higher proportion of third party ancillary equipment. A change in sales mix driven by an increase in revenues from these lower margin products as a percentage of total revenues will result in a lower gross profit for our business. Our margins were also negatively impacted by lower margins on professional services in Europe related to CPS system installation and management, and from higher unabsorbed overhead costs from our manufacturing operations due to lower UPS product revenue. Our ability to improve our gross profit will depend, in part, on our ability to continue to reduce material costs, improve our sales channel mix in favor of direct sales versus OEM sales, increase sales of higher margin products such as our UPS products, increase product prices, improve our professional service margins through pricing and operating efficiency, and increase our total revenues to a level that will allow us to improve the utilization of our manufacturing and service operations.

Research and development. Research and development expense primarily consists of compensation and related costs for 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 approximately \$439,000, or 53%, higher in the third quarter of 2011 compared to the third quarter of 2010 and \$186,000, or 17%, higher than the second quarter of 2011. For the nine months ended September 30, 2011, our research and development expenses were \$762,000, or 30%, higher than the same period in 2010. We are currently developing a new generation of UPS product that we believe will offer greater power modularity and space efficiencies especially as we target the larger power market segments. We have increased headcount to support this new product development and to support new infrastructure and UPS products that we believe will contribute to future revenue growth for us. It is anticipated that the new UPS product line will allow improved profit margins for our UPS systems business. Our research and development efforts in 2010 were largely focused on new configurations of our existing flywheel technology, as well as refinements and enhancements to the standardization of our PowerHouse and containerized infrastructure solution products. We believe research and development expenses in the fourth quarter of 2011 will remain at similar levels to those recorded in the third quarter of 2011.

Selling and marketing. Selling and marketing expense primarily consists of compensation, including variable sales compensation, and related costs for sales and marketing personnel, and related travel, selling and marketing expenses, as well as an allocated portion of our occupancy costs and the cost of our foreign sales operations. Selling and marketing costs were approximately \$12,000, or 0%, lower in the third quarter of 2011 compared to the third quarter of 2010 and increased approximately \$127,000, or 4%, from the second quarter of 2011. For the nine-month period ended September 30, 2011, our selling and marketing expenses were approximately \$74,000, or 1%, higher than for the same period in 2010. The decrease in quarterly expense in 2011 compared to the prior year and prior quarter reflects lower variable sales compensation due to our lower gross margins, offset by higher salary costs as a result of an increase in headcount for our direct sales organization in the U.S. We believe that sales and marketing expenses will remain at similar levels to those recorded in the third quarter of 2011, except for changes in variable selling expenses that are based on fluctuations in total revenue and gross profit margins.

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 for the third quarter of 2011 increased approximately \$205,000, or 19%, compared to the same period in 2010 due to higher headcount and professional services fees, and decreased approximately \$155,000, or 11%, as compared to the second quarter of 2011 due to lower recruiting and professional costs. For the nine-month period ended September 30, 2011, our general and administrative costs were \$258,000, or 7%, higher than the same period of 2010 due to higher headcount. We expect to incur approximately \$940,000 in costs during the fourth quarter of 2011 relating to separation of employment and for costs incurred in hiring a new Chief Executive Officer.

Interest expense, net. Net interest expense has increased from approximately \$30,000 in the third quarter of 2010 to approximately \$68,000 in the third quarter of 2011, or by 127%. We incurred higher interest expense as we had a larger average outstanding balance on our revolving credit facility. Our average cash and investments balance over the three-month period ending September 30, 2011 has decreased by \$4.8 million, or 32%, compared to the average balance over the same period ending September 30, 2010 and has decreased by \$3.3 million, or 21%, for the nine-month period ended September 30, 2011, compared to the average balance over the same period of 2010. The lower cash balances and lower interest rate environment resulted in a decrease in interest income.

Other income (expense), net. Other income (expense) in the third quarter of 2011 and 2010 reflects foreign exchange gains (losses) on a bank account held in foreign currencies by our subsidiary company.

Liquidity and Capital Resources

Our primary sources of liquidity at September 30, 2011 are our cash and investments on hand, our bank credit facilities and projected cash flows from operating activities. If we meet our cash flow projections in our current business plan, we expect that we have adequate capital resources in order to continue operating our business for at least the next 12 months. Our business plan and our assumptions around the adequacy of our liquidity are based on estimates regarding expected revenues and future costs. However, there are scenarios in which our revenues may not meet our projections, our costs may exceed our estimates or our working capital needs may be greater than anticipated. Further, our estimates may change and future events or developments may also affect our estimates. Any of these factors may change our expectation of cash usage in 2011 and beyond or significantly affect our level of liquidity, which may limit our opportunity to pursue certain opportunities to grow our business.

A substantial increase in sales of our PowerHouse or our infrastructure solutions products or a substantial increase in UPS sales may materially impact the amount of liquidity required to fund our operations. The amount of time between the receipt of payment from our customers and our expenditures for raw materials, manufacturing and shipment of products (the cash cycle) for sales of our CleanSource UPS product can be as short as 45 days, and is typically 60 days. However, the cash cycle on a PowerHouse sale can be as much as 210 days, depending upon customer payment terms. We intend to mitigate the financial impact of this longer cash cycle by requiring customer deposits and periodic payments where possible from our customers. This is not always commercially feasible, and in order to increase our PowerHouse sales, we may be required to make larger investments in inventory and receivables. These larger investments may require us to obtain additional sources of working capital, debt or equity financing in order to fund this business.

Should additional funding be required, we would expect to raise the required funds through borrowings or public or private sales of debt or equity securities. If we raise additional funds through the issuance of debt or equity securities, the ownership of our stockholders could be significantly diluted. If we obtain additional debt financing, a substantial portion of our operating cash flow may be dedicated to the payment of principal and interest on such indebtedness, and the terms of the debt securities issued could impose significant restrictions on our operations. We do not know whether we will be able to secure additional funding, or funding on terms acceptable to us, to continue our operations as planned. If financing is not available, we may be required to reduce, delay or eliminate certain activities or to license or sell to others some of our proprietary technology.

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

(\$ in thousands)	Nine months ended September 30,		Variance 2011 vs. 2010	
	2011	2010	\$	%
Cash used in operating activities	\$ (7,148)	\$ (2,513)	\$ (4,635)	(184)%

Cash used in operating activities increased by \$4.6 million in the nine-month period ended September 30, 2011 compared to the same period of 2010. This was primarily due to changes in our working capital requirements caused by the timing of product shipments to our customers and by our operating loss of \$3.6 million. This timing of large orders can cause large fluctuations in the amount of cash required for operations on a quarterly basis. For example, during the quarter ended September 30, 2011 the net cash used in operating activities was approximately \$114,000 compared to net cash used of \$4.3 million in the second quarter of 2011.

Inventories have increased by \$4.3 million since December 31, 2010 but decreased by \$1.3 million in the current quarter. The increase since December 2010 is attributable to higher levels of raw materials and work-in-progress inventory of \$2.7 million to support our CPS and infrastructure projects, and from higher levels of UPS inventory. Accounts receivable increased by \$2.0 million since December 31, 2010, but decreased \$1.1 million since June 30, 2011. These changes reflecting the higher revenue levels in the first nine months of 2011 compared to the same period in 2010 and the improvement since June reflects a higher proportion of CPS revenues that were completed near the end of the second quarter for which we had not yet been paid. Our accounts payable is approximately the same level as at December 31, 2010, but we have seen large fluctuations in the balance of accounts payable as we receive large power and infrastructure orders. The level of accounts payable decreased by \$5.0 million during the third quarter, due to timing of vendor payments and inventory flow on these large orders. Accrued expenses decreased by \$1.7 million since December 31, 2010, reflecting payments of annual incentive compensation. These uses of funds were offset by an increase in deferred revenue of \$2.1 million since December 31, 2010, that primarily reflects the receipt of customer deposits and advance payments related to the timing of our large CPS and infrastructure projects. We anticipate that cash provided by (used in) operations will fluctuate significantly based upon the volume and size of our CPS and infrastructure solutions, and by the timing of product delivery relative to our reporting periods, and that such volatility in sources and uses of funds will continue as our CPS and infrastructure solutions businesses continue to grow.

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

(\$ in thousands)	Nine months ended September 30,		Variance 2011 vs. 2010	
	2011	2010	\$	%
Cash used in investing activities	\$ (2,494)	\$ (532)	\$ (1,962)	(369)%

Investing activities primarily consist of purchases of property and equipment. Capital expenditures were \$2.2 million in the nine-month period ending September 30, 2011, compared to approximately \$532,000 in the same period of 2010, as we invested in multiple demonstration CPS systems in Asia and Europe and the U.S., for rental equipment to support our sales activities and commenced tooling for our next generation UPS product.

The following table summarizes the quarterly changes in cash provided by financing activities:

(\$ in thousands)	Nine months ended September 30,		Variance 2011 vs. 2010	
	2011	2010	\$	%
Cash provided by financing activities	\$ 3,265	\$ 10,007	\$ (6,742)	(67)%

Funds provided by financing activities during the nine months ended September 30, 2011 reflect a draw of \$3.0 million on our revolving bank line of credit and proceeds from the exercise of employee stock options. An additional \$6.0 million was available to draw upon under our current banking relationship. Funds provided by financing activities during the nine-months ended September 30, 2010 primarily reflect the sale of common stock in a firm-commitment underwritten offering pursuant to which we sold approximately 13.25 million shares of common stock at a purchase price of \$0.75 per share, for proceeds, net of fees and expenses, of approximately \$9.0 million.

We believe that our cash and investments and our sources of available liquidity will be sufficient to fund our operations for at least the next 12 months. Our sales cycle is such that we generally have visibility 2-3 quarters in advance for future orders that allows us to predict revenues over this period of time with some degree of confidence. However, a sudden change in business volume or product mix, positive or negative, from any of our business or channel partners or in our direct business could significantly impact our expected revenues. The recent global economic downturn has reduced our confidence at predicting future revenues, and even with improving economic conditions, there is still uncertainty and risk in our forecasting. This 2-3 quarter window of sales visibility does provide us with some opportunity to adjust expenditures or take other measures to reduce our cash consumption if we can see and anticipate a shortfall in revenue or give us time to identify additional sources of funding if we anticipate an increase in our working capital requirements due to increased revenues or changes in our revenue mix. A significant increase in sales, especially in our PowerHouse or our infrastructure solutions business, would likely increase our working capital requirements, due to the longer production time and cash cycle of sales of these products. We established a revolving bank credit facility to help finance a growth in PowerHouse and infrastructure solutions and believe that this will be adequate to sustain further growth in these products.

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. Because of the nature of the majority of our investments, we do not believe a 1% decline in interest rates would have a material effect on interest income or their fair value.

Our international sales were historically made in U.S. dollars. As we have increased sales in foreign markets and opened operations in multiple foreign countries, we have executed more transactions that are denominated in other currencies, primarily Euro and British pounds. Those sales and expenses in currencies other than U.S. dollars can result in translation gains and losses which have not been significant 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 as a natural hedge. However, recent volatility in currencies, particularly with the pound and Euro, is increasing the amount of potential translation gains and losses and we may engage in hedging activities in the future to mitigate the risks caused by such currency volatility.

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." 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.

Our Chief Executive Officer and our Chief Financial Officer, based on the evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) required by paragraph (b) of Rule 13a-15 or Rule 15d-15, have concluded that, as of September 30, 2011, our disclosure controls and procedures were effective to ensure that the information we are required to disclose in reports that we file or submit under the Exchange Act, (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

During the three months ended September 30, 2011, there were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and Rule 15d-15(d) under the Exchange Act that have materially affected, or that we believe are reasonably likely to materially affect, our internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

We are, from time to time, subject to various legal proceedings, claims and litigation arising in the ordinary course of business. We do not believe we are party to any currently pending legal proceedings the outcome of which may have a material effect on our operations or consolidated financial position. There can be no assurance that existing or future legal proceedings arising in the ordinary course of business or otherwise will not have a material adverse effect on our financial position, results of operations or cash flows.

Item 1A. Risk Factors.

You should carefully consider the risks described below and in Item 1A of our 2010 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 below and in our 2010 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.

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The actual occurrence of any of the risks described below and in our 2010 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 Chief Executive Officer and President has resigned, we have appointed an Interim Chief Executive Officer and we are searching for a permanent replacement, and the uncertainty of this transition could adversely affect our customer, vendor, and employee relationships and result in adverse effects on our business and operating results.

Our Chief Executive Officer and President resigned in October 2011, and an Interim Chief Executive Officer from our Board of Directors was appointed pending appointment of a permanent successor. Although our Interim Chief Executive Officer is a seasoned chief executive officer, he may need some time to familiarize himself with the operations of our company and thus may not be fully effective during this transition. Further, the resignation of our Chief Executive Officer and President and/or the presence of an interim Chief Executive Officer may destabilize our relationships with customers, vendors, and employees, resulting in loss of business, loss of vendor relationships, and the loss of key employees or declines in the productivity of existing employees. The search for a permanent Chief Executive Officer may take many months or more, further exacerbating these factors. Any or all of these risks could adversely affect our business and operating results.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Reserved.

Item 5. Other Information.

None.

Item 6. Exhibits.

The following documents are filed as exhibits to this report:

- 3.1* Restated Certificate of Incorporation (filed as Exhibit 3.1 to Active Power's Quarterly Report on Form 10-Q filed on July 28, 2006)
- 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 on December 7, 2007)
- 4.1* Specimen certificate for shares of Common Stock (filed as Exhibit 4.1 to Active Power's IPO Registration Statement on Form S-1 (SEC File No. 333-36946) (the "IPO Registration Statement"))
- 4.2* Rights Agreement, dated as of December 13, 2001, between 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 filed on December 14, 2001)
- 4.3* See Exhibits 3.1, 3.2 and 3.3 for provisions of the Certificate of Incorporation and Bylaws of the registrant defining the rights of holders of common stock
- 10.1** Separation Agreement and Release, dated October 15, 2011, between Active Power and James A. Clishem.
- 10.2** Offer Letter, dated October 16, 2011, between Active Power and Jan Lindelow.
- 31.1** Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
- 31.2** Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15(d)-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
- 32.1** Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003
- 32.2** Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003
- 101 The following financial statements from the Active Power's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, formatted in XBRL: (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations and Comprehensive Loss, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.

* Incorporated by reference to the indicated filing.

SIGNATURES

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

ACTIVE POWER, INC.
(Registrant)

November 1, 2011
(Date)

/s/ JAN H. LINDELOW

Jan H. Lindelow
President and Chief Executive Officer
(Principal Executive Officer)

November 1, 2011
(Date)

/s/ JOHN K. PENVER

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

SEPARATION AGREEMENT AND RELEASE

This Separation Agreement and Release (“Agreement”) is made by and between James A. Clishem (“Employee”) and Active Power, Inc. (the “Company”) (collectively referred to as the “Parties” or individually referred to as a “Party”).

RECITALS

WHEREAS, Employee was employed by the Company;

WHEREAS, Employee signed an Proprietary Information and Nondisclosure Agreement with the Company on May 5, 2005 (the “Confidentiality Agreement”);

WHEREAS, Employee signed a Severance Benefits Agreement with the Company on April 14, 2010, which amended and restated that a Severance Benefits Agreement dated October 29, 2008 (collectively, the “Severance Agreement”);

WHEREAS, the Company and Employee have entered into (i) Stock Option Agreements, dated June 7, 2005, November 10, 2005, May 16, 2006, February 7, 2007, February 28, 2008, February 4, 2009, February 25, 2010 and February 25, 2010 granting Employee the option to purchase shares of the Company’s common stock subject to the terms and conditions of the Company’s 2000 Stock Incentive Plan and the Stock Option Agreements and (ii) a Stock Option Agreement, dated February 28, 2011 granting Employee the option to purchase shares of the Company’s common stock subject to the terms and conditions of the Company’s 2010 Equity Incentive Plan and the Stock Option Agreement (all such agreements referred to in (i) and (ii), collectively the “Stock Agreements”);

WHEREAS, Employee and the Company have agreed that Employee’s employment with the Company will terminate effective October 14, 2011 (the “Termination Date”), and that such separation will be considered an involuntary termination without cause as described in the Severance Agreement; and

WHEREAS, the Parties wish to resolve any and all disputes, claims, complaints, grievances, charges, actions, petitions, and demands that the Employee may have against the Company and any of the Releasees as defined below, including, but not limited to, any and all claims arising out of or in any way related to Employee’s employment with or separation from the Company;

NOW, THEREFORE, in consideration of the mutual promises made herein, the Company and Employee hereby agree as follows:

AGREEMENT

1. **Consideration.** In consideration of Employee’s execution of this Agreement and Employee’s fulfillment of all of its terms and conditions, the Company agrees as follows:

a. Separation Payment. The Company agrees to pay Employee a total of Three Hundred and Forty-Four Thousand and no/100 Dollars (\$344,000.00), at the rate of Twenty Eight Thousand, Six Hundred Sixty-Six and 67/100 Dollars (\$28,666.67) per month, less applicable withholding, for twelve (12) months from the first regular payroll date following the Effective Date, in accordance with the Company's regular payroll practices.

b. COBRA. The Company shall reimburse Employee for the payments Employee makes for COBRA coverage for a period of twelve (12) months, or until Employee has secured other employment, whichever occurs first, provided Employee timely elects and pays for continuation coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("COBRA"), within the time period prescribed pursuant to COBRA. COBRA reimbursements shall be made by the Company to Employee consistent with the Company's normal expense reimbursement policy, provided that Employee submits documentation to the Company substantiating his payments for COBRA coverage. The Company's obligation to pay COBRA reimbursements shall cease immediately upon the date that Employee secures other employment.

c. Bonus. The Company agrees to pay Employee a lump sum of One Hundred Thousand Dollars (\$100,000), less applicable withholding, to compensate Employee for his 2011 bonus in accordance with Section 2(d) of the Severance Agreement. This payment will be made to Employee within ten (10) days following the Effective Date of this Agreement.

d. General. Employee acknowledges that without this Agreement, he is otherwise not entitled to the consideration listed in this paragraph 1.

2. Stock. In consideration for this Agreement, the Parties have agreed that, for the purposes of determining the number of shares of the Company's common stock that Employee is entitled to purchase from the Company pursuant to the exercise of outstanding options, the Company will accelerate the vesting of 435,475 shares (equivalent to an additional one (1) year of vesting) under the Stock Agreements that would have otherwise remained unvested at the Termination Date, such that Employee will be vested in a total of 1,890,675 shares under the Stock Agreements, effective as of the Effective Date. The exercise of Employee's vested options shall continue to be governed by the terms and conditions of the Company's Stock Agreements. Employee hereby acknowledges and agrees that he is not entitled to any additional vesting under the Stock Agreements.

3. Benefits. Employee's health insurance benefits shall cease on October 14, 2011, subject to Employee's right to continue his health insurance under COBRA. Employee's participation in all benefits and incidents of employment, including, but not limited to, vesting in stock options, and the accrual of bonuses, vacation, and paid time off, ceased as of the Termination Date.

4. Payment of Salary and Receipt of All Benefits. Employee acknowledges and represents that, other than (i) the consideration set forth in this Agreement, (ii) accrued vacation/PTO in the amount reflected in the Company's records, and (iii) outstanding business expenses in an amount not to exceed Three Thousand Two Hundred Fifteen and 62/100 (\$3,215.62), the Company has paid or provided all salary, wages, bonuses, accrued vacation/paid time off, premiums, leaves, housing allowances, relocation costs, interest, severance, outplacement costs, fees, reimbursable expenses, commissions, stock, stock options, vesting, and any and all other benefits and compensation due to Employee. Items set forth in Section 4(ii) and (iii) will be paid in accordance with Company policy and schedule.

5. **Resignation and Release of Claims.** Employee hereby resigns all executive positions with the Company and with all subsidiaries of the Company and hereby resigns as a member of the Board of Directors of the Company and from the Board of Directors of all subsidiaries of the Company. Employee agrees that the foregoing consideration represents settlement in full of all outstanding obligations owed to Employee by the Company and its current and former officers, directors, employees, agents, investors, attorneys, shareholders, administrators, affiliates, benefit plans, plan administrators, insurers, trustees, parents, divisions, and subsidiaries, and predecessor and successor corporations and assigns (collectively, the "Releasees"). Employee, on his own behalf and on behalf of his respective heirs, family members, executors, agents, and assigns, hereby and forever releases the Releasees from, and agrees not to sue concerning, or in any manner to institute, prosecute, or pursue, any claim, complaint, charge, duty, obligation, or cause of action relating to any matters of any kind, whether presently known or unknown, suspected or unsuspected, that Employee may possess against any of the Releasees arising from any omissions, acts, facts, or damages that have occurred up until and including the Effective Date of this Agreement, including, without limitation:

- a. any and all claims relating to or arising from Employee's employment relationship with the Company and the termination of that relationship;
- b. any and all claims relating to, or arising from, Employee's right to purchase, or actual purchase of shares of stock of the Company, including, without limitation, any claims for fraud, misrepresentation, breach of fiduciary duty, breach of duty under applicable state corporate law, and securities fraud under any state or federal law;
- c. any and all claims for wrongful discharge of employment; constructive discharge; termination in violation of public policy; discrimination; harassment; retaliation; breach of contract, both express and implied; breach of covenant of good faith and fair dealing, both express and implied; promissory estoppel; negligent or intentional infliction of emotional distress; fraud; negligent or intentional misrepresentation; negligent or intentional interference with contract or prospective economic advantage; unfair business practices; defamation; libel; slander; negligence; personal injury; assault; battery; invasion of privacy; false imprisonment; conversion; and disability benefits;
- d. any and all claims for violation of any federal, state, or municipal statute, including, but not limited to, Title VII of the Civil Rights Act of 1964; the Civil Rights Act of 1991; the Rehabilitation Act of 1973; the Americans with Disabilities Act of 1990; the Equal Pay Act; the Fair Labor Standards Act; the Fair Credit Reporting Act; the Employee Retirement Income Security Act of 1974; the Worker Adjustment and Retraining Notification Act; the Family and Medical Leave Act; the Sarbanes-Oxley Act of 2002; the Texas Payday Act; Texas Workers' Compensation Act; and Chapter 21 of the Texas Labor Code (also known as the Texas Commission on Human Rights Act);
- e. any and all claims for violation of the federal or any state constitution;

- f. any and all claims arising out of any other laws and regulations relating to employment or employment discrimination;
- g. any claim for any loss, cost, damage, or expense arising out of any dispute over the non-withholding or other tax treatment of any of the proceeds received by Employee as a result of this Agreement; and
- h. any and all claims for attorneys' fees and costs.

Employee agrees that the release set forth in this section shall be and remain in effect in all respects as a complete general release as to the matters released. This release does not extend to any obligations incurred under this Agreement. This release does not release claims that cannot be released as a matter of law, including, but not limited to, Employee's right to file a charge with or participate in a charge by the Equal Employment Opportunity Commission, or any other local, state, or federal administrative body or government agency that is authorized to enforce or administer laws related to employment, against the Company (with the understanding that any such filing or participation does not give Employee the right to recover any monetary damages against the Company; Employee's release of claims herein bars Employee from recovering such monetary relief from the Company).

6. **Unknown Claims.** Employee acknowledges that he has been advised to consult with legal counsel and that he is familiar with the principle that a general release does not extend to claims that the releaser does not know or suspect to exist in his favor at the time of executing the release, which, if known by him, must have materially affected his settlement with the releasee. Employee, being aware of said principle, agrees to expressly waive any rights he may have to that effect, as well as under any other statute or common law principles of similar effect.

7. **No Pending or Future Lawsuits.** Employee represents that he has no lawsuits, claims, or actions pending in his name, or on behalf of any other person or entity, against the Company or any of the other Releasees. Employee also represents that he does not intend to bring any claims on his own behalf or on behalf of any other person or entity against the Company or any of the other Releasees.

8. **Application for Employment.** Employee understands and agrees that, as a condition of this Agreement, Employee shall not be entitled to any employment with the Company, and Employee hereby waives any right, or alleged right, of employment or re-employment with the Company. Employee further agrees not to apply for employment with the Company and not otherwise pursue an independent contractor or vendor relationship with the Company.

9. **Confidentiality.** Employee agrees to maintain in complete confidence the existence of this Agreement, the contents and terms of this Agreement, and the consideration for this Agreement (hereinafter collectively referred to as "Separation Information"). Except as required by law, Employee may disclose Separation Information only to his immediate family members, the Court in any proceedings to enforce the terms of this Agreement, Employee's counsel, and Employee's accountant and any professional tax advisor to the extent that they need to know the Separation Information in order to provide advice on tax treatment or to prepare tax returns, and must prevent disclosure of any Separation Information to all other third parties. Employee agrees that he will not publicize, directly or indirectly, any Separation Information.

Employee acknowledges and agrees that the confidentiality of the Separation Information is of the essence and a material term of this Agreement. The Parties agree that if the Company proves that Employee breached this Confidentiality provision, the Company shall be entitled to an award of its costs spent enforcing this provision, including all reasonable attorneys' fees associated with the enforcement action, without regard to whether the Company can establish actual damages from Employee's breach. Any such individual breach or disclosure shall not excuse Employee from his obligations hereunder, nor permit him to make additional disclosures. Employee warrants that he has not disclosed, orally or in writing, directly or indirectly, any of the Separation Information to any unauthorized party.

10. **Trade Secrets and Confidential Information/Company Property.** Employee reaffirms and agrees to observe and abide by the terms of the Confidentiality Agreement, specifically including the provisions regarding nondisclosure of the Company's trade secrets and confidential and proprietary information, and any restrictive covenants contained therein. Employee also reaffirms and agrees to observe and abide by the terms of the surviving terms of the Severance Agreement, including the non-competition and non-solicitation provisions contained in Section 4 of such agreement. Employee's signature below constitutes his certification under penalty of perjury that he has returned all documents and other items provided to Employee by the Company, developed or obtained by Employee in connection with his employment with the Company, or otherwise belonging to the Company.

11. **No Cooperation.** Employee agrees that he will not knowingly encourage, counsel, or assist any attorneys or their clients in the presentation or prosecution of any disputes, differences, grievances, claims, charges, or complaints by any third party against any of the Releasees, unless under a subpoena or other court order to do so. Employee agrees both to immediately notify the Company upon receipt of any such subpoena or court order, and to furnish, within three (3) business days of its receipt, a copy of such subpoena or other court order. If approached by anyone for counsel or assistance in the presentation or prosecution of any disputes, differences, grievances, claims, charges, or complaints against any of the Releasees, Employee shall state no more than that he cannot provide counsel or assistance.

12. **Non-Disparagement.** Employee agrees to refrain from any disparagement, defamation, libel, or slander of any of the Releasees, and agrees to refrain from any tortious interference with the contracts and relationships of any of the Releasees. Employee shall direct any inquiries by potential future employers to the Company's human resources department, which shall use its best efforts to provide only the Employee's last position and dates of employment.

13. **Breach.** In addition to the rights provided under paragraph **22** below (the "Attorneys' Fees" section), Employee acknowledges and agrees that any material breach of this Agreement, or of any provision of the Confidentiality Agreement shall entitle the Company immediately to recover and/or cease providing the consideration provided to Employee under this Agreement and to obtain damages, except as provided by law.

14. **No Admission of Liability.** Employee understands and acknowledges that this Agreement constitutes a compromise and settlement of any and all actual or potential disputed claims by Employee. No action taken by the Company hereto, either previously or in connection with this Agreement, shall be deemed or construed to be (a) an admission of the truth or falsity of any actual or potential claims or (b) an acknowledgment or admission by the Company of any fault or liability whatsoever to Employee or to any third party.

15. Costs. The Parties shall each bear their own costs, attorneys' fees, and other fees incurred in connection with the preparation of this Agreement.

16. ARBITRATION. THE PARTIES AGREE THAT ANY AND ALL DISPUTES ARISING OUT OF THE TERMS OF THIS AGREEMENT, THEIR INTERPRETATION, AND ANY OF THE MATTERS HEREIN RELEASED, SHALL BE SUBJECT TO ARBITRATION IN TRAVIS COUNTY, TEXAS BEFORE THE JUDICIAL ARBITRATION & MEDIATION SERVICES, INC. ("JAMS"), PURSUANT TO ITS EMPLOYMENT ARBITRATION RULES & PROCEDURES ("JAMS RULES"). THE ARBITRATOR MAY GRANT INJUNCTIONS AND OTHER RELIEF IN SUCH DISPUTES. THE ARBITRATOR SHALL ADMINISTER AND CONDUCT ANY ARBITRATION IN ACCORDANCE WITH TEXAS LAW, AND THE ARBITRATOR SHALL APPLY SUBSTANTIVE AND PROCEDURAL TEXAS LAW TO ANY DISPUTE OR CLAIM, WITHOUT REFERENCE TO ANY CONFLICT-OF-LAW PROVISIONS OF ANY JURISDICTION. TO THE EXTENT THAT THE JAMS RULES CONFLICT WITH TEXAS LAW, TEXAS LAW SHALL TAKE PRECEDENCE. THE DECISION OF THE ARBITRATOR SHALL BE FINAL, CONCLUSIVE, AND BINDING ON THE PARTIES TO THE ARBITRATION. THE PARTIES AGREE THAT THE PREVAILING PARTY IN ANY ARBITRATION SHALL BE ENTITLED TO INJUNCTIVE RELIEF IN ANY COURT OF COMPETENT JURISDICTION TO ENFORCE THE ARBITRATION AWARD. THE PARTIES TO THE ARBITRATION SHALL EACH PAY AN EQUAL SHARE OF THE COSTS AND EXPENSES OF SUCH ARBITRATION, AND EACH PARTY SHALL SEPARATELY PAY FOR ITS RESPECTIVE COUNSEL FEES AND EXPENSES; PROVIDED, HOWEVER, THAT THE ARBITRATOR SHALL AWARD ATTORNEYS' FEES AND COSTS TO THE PREVAILING PARTY, EXCEPT AS PROHIBITED BY LAW. THE PARTIES HEREBY AGREE TO WAIVE THEIR RIGHT TO HAVE ANY DISPUTE BETWEEN THEM RESOLVED IN A COURT OF LAW BY A JUDGE OR JURY. NOTWITHSTANDING THE FOREGOING, THIS SECTION WILL NOT PREVENT EITHER PARTY FROM SEEKING INJUNCTIVE RELIEF (OR ANY OTHER PROVISIONAL REMEDY) FROM ANY COURT HAVING JURISDICTION OVER THE PARTIES AND THE SUBJECT MATTER OF THEIR DISPUTE RELATING TO THIS AGREEMENT AND THE AGREEMENTS INCORPORATED HEREIN BY REFERENCE. SHOULD ANY PART OF THE ARBITRATION AGREEMENT CONTAINED IN THIS PARAGRAPH CONFLICT WITH ANY OTHER ARBITRATION AGREEMENT BETWEEN THE PARTIES, THE PARTIES AGREE THAT THIS ARBITRATION AGREEMENT SHALL GOVERN.

17. Tax Consequences. The Company makes no representations or warranties with respect to the tax consequences of the payments and any other consideration provided to Employee or made on his behalf under the terms of this Agreement. Employee agrees and understands that he is responsible for payment, if any, of local, state, and/or federal taxes on the payments and any other consideration provided hereunder by the Company and any penalties or assessments thereon. Employee further agrees to indemnify and hold the Company harmless from any claims, demands, deficiencies, penalties, interest, assessments, executions, judgments, or recoveries by any government agency against the Company for any amounts claimed due on account of (a) Employee's failure to pay or the Company's failure to withhold, or delayed payment of, federal or state taxes, or (b) damages sustained by the Company by reason of any such claims, including attorneys' fees and costs.

18. Authority. The Company represents and warrants that the undersigned has the authority to act on behalf of the Company and to bind the Company and all who may claim through it to the terms and conditions of this Agreement. Employee represents and warrants that he has the capacity to act on his own behalf and on behalf of all who might claim through him to bind them to the terms and conditions of this Agreement. Each Party warrants and represents that there are no liens or claims of lien or assignments in law or equity or otherwise of or against any of the claims or causes of action released herein.

19. No Representations. Employee represents that he has had an opportunity to consult with an attorney, and has carefully read and understands the scope and effect of the provisions of this Agreement. Employee has not relied upon any representations or statements made by the Company that are not specifically set forth in this Agreement.

20. No Waiver. The failure of the Company to insist upon the performance of any of the terms and conditions in this Agreement, or the failure to prosecute any breach of any of the terms or conditions of this Agreement, shall not be construed thereafter as a waiver of any such terms or conditions. This entire Agreement shall remain in full force and effect as if no such forbearance or failure of performance had occurred.

21. Severability. In the event that any provision or any portion of any provision hereof or any surviving agreement made a part hereof becomes or is declared by a court of competent jurisdiction or arbitrator to be illegal, unenforceable, or void, this Agreement shall continue in full force and effect without said provision or portion of provision.

22. Attorneys' Fees. In the event that either Party brings an action to enforce or effect its rights under this Agreement, the prevailing Party shall be entitled to recover its costs and expenses, including the costs of mediation, arbitration, litigation, court fees, and reasonable attorneys' fees incurred in connection with such an action.

23. Entire Agreement. This Agreement represents the entire agreement and understanding between the Company and Employee concerning the subject matter of this Agreement and Employee's employment with and separation from the Company and the events leading thereto and associated therewith, and supersedes and replaces any and all prior agreements and understandings concerning the subject matter of this Agreement and Employee's relationship with the Company, with the exception of the Confidentiality Agreement, the surviving terms of the Severance Agreement, and the Stock Agreements.

24. No Oral Modification. This Agreement may only be amended in a writing signed by Employee and the Company's Chief Executive Officer.

25. **Governing Law.** This Agreement shall be governed by the laws of the State of Texas, without regard for choice-of-law provisions. Employee consents to personal and exclusive jurisdiction and venue in the State of Texas.

26. **Section 409A.**

a. Notwithstanding anything to the contrary in this Agreement, if Employee is a “specified employee” within the meaning of Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”) and the final Treasury Regulations and any guidance promulgated thereunder (“Section 409A”) at the time of Employee’s termination of employment (other than due to death), and the severance payable to Employee, if any, pursuant to this Agreement, when considered together with any other severance payments or separation benefits that are considered deferred compensation under Section 409A (together, the “Deferred Compensation Separation Benefits”) that are payable within the first six (6) months following Employee’s termination of employment, will become payable on the first payroll date that occurs on or after the date six (6) months and one (1) day following the date of Employee’s termination of employment. All subsequent Deferred Compensation Separation Benefits, if any, will be payable in accordance with the payment schedule applicable to each payment or benefit. Notwithstanding anything herein to the contrary, if Employee dies following Employee’s termination of employment but prior to the six (6) month anniversary of Employee’s termination of employment, then any payments delayed in accordance with this paragraph will be payable in a lump sum as soon as administratively practicable after the date of Employee’s death and all other Deferred Compensation Separation Benefits will be payable in accordance with the payment schedule applicable to each payment or benefit. Each payment and benefit payable under this Agreement is intended to constitute separate payments for purposes of Section 1.409A-2(b)(2) of the Treasury Regulations.

b. Any amount paid under the Agreement that satisfies the requirements of the “short-term deferral” rule set forth in Section 1.409A-1(b)(4) of the Treasury Regulations will not constitute Deferred Compensation Separation Benefits for purposes of this Agreement. Any amount paid under the Agreement that qualifies as a payment made as a result of an involuntary separation from service pursuant to Section 1.409A-1(b)(9)(iii) of the Treasury Regulations that does not exceed the Section 409A Limit will not constitute Deferred Compensation Separation Benefits for purposes of this Agreement. For this purpose, “Section 409A Limit” means the lesser of two (2) times: (i) Employee’s annualized compensation based upon the annual rate of pay paid to Employee during the Company’s taxable year preceding the Company’s taxable year of Employee’s termination of employment as determined under Treasury Regulation 1.409A-1(b)(9)(iii)(A)(1) and any Internal Revenue Service guidance issued with respect thereto; or (ii) the maximum amount that may be taken into account under a qualified plan pursuant to Section 401(a)(17) of the Code for the year in which Employee’s employment is terminated.

c. The foregoing provisions are intended to comply with the requirements of Section 409A so that none of the severance payments and benefits to be provided hereunder will be subject to the additional tax imposed under Section 409A, and any ambiguities herein will be interpreted to so comply. Employee and the Company agree to work together in good faith to consider amendments to this Agreement and to take such reasonable actions which are necessary, appropriate or desirable to avoid imposition of any additional tax or income recognition prior to actual payment to Employee under Section 409A.

27. **Effective Date.** This Agreement will become null and void if not signed by Employee on or before 3:00 pm (CST) on October 16, 2011. This Agreement will become effective on the day both Parties have signed it (the "Effective Date").

28. **Counterparts.** This Agreement may be executed in counterparts and by facsimile, and each counterpart and facsimile shall have the same force and effect as an original and shall constitute an effective, binding agreement on the part of each of the undersigned.

29. **Voluntary Execution of Agreement.** Employee understands and agrees that he executed this Agreement voluntarily, without any duress or undue influence on the part or behalf of the Company or any third party, with the full intent of releasing all of his claims against the Company and any of the other Releasees. Employee acknowledges that:

- a. he has read this Agreement;
- b. he has been represented in the preparation, negotiation, and execution of this Agreement by legal counsel of his own choice or has elected not to retain legal counsel;
- c. he understands the terms and consequences of this Agreement and of the releases it contains; and
- d. he is fully aware of the legal and binding effect of this Agreement.

[Remainder of Page Blank; Signature Page Follows]

IN WITNESS WHEREOF, the Parties have executed this Agreement on the respective dates set forth below.

JAMES A. CLISHEM, an individual

Dated: October 15, 2011

/s/ James A. Clishem
James A. Clishem

ACTIVE POWER, INC.

Dated: October 15, 2011

By/s/ Benjamin L. Scott
Benjamin L. Scott
Chairman

[Active Power Letterhead]

October 16, 2011

Jan Lindelow
2502 Bridle Path
Austin, Texas 78703

Re: Offer of Employment with Active Power, Inc.

Dear Jan:

On behalf of Active Power, Inc. (“Active Power” or the “Company”), I am pleased to invite you to join the Company as its Interim Chief Executive Officer. In this position, you will report directly to the Company’s Board of Directors.

You will be expected to devote your full business time, attention and energies to the performance of your duties with the Company. The effective date of your employment will be October 17, 2011, or such other date as you and the Company mutually agree in writing.

The terms of this offer of employment are as follows:

1. At-Will Employment. You should be aware that your employment with the Company is for no specified period and constitutes “at-will” employment. As a result, you are free to terminate your employment at any time, for any reason or for no reason. Similarly, the Company is free to terminate your employment at any time, for any reason or for no reason. We request that you give the Company at least two weeks’ notice in the event of a resignation.

2. Board Service/Short-Term Appointment. As reflected by your job title, you are being hired as the “Interim” CEO. The nature of this role is, naturally, intended to be of short duration. You agree and acknowledge that your employment is at-will as discussed above, and further, you acknowledge your understanding of the fact that when the Company hires a non-interim CEO, your position will no longer be required. It is expected that your term of service as Interim CEO will last no longer than six (6) months. During your term as Interim CEO, you agree to continue to serve on the Company’s Board of Directors.

3. Salary. The Company will pay you a salary at the rate of \$35,000 per month (the “Base Salary”) payable in accordance with the Company’s standard payroll policies, including compliance with applicable withholding. Any increase or decrease in Base Salary (together with the then existing Base Salary) shall serve as the “Base Salary” for future employment under this offer letter. The first and last payment by the Company to you will be adjusted, if necessary, to reflect a commencement or termination date other than the first or last working day of a pay period. Notwithstanding the foregoing, if you service as “Interim” CEO is terminated as the result of the hiring of a new CEO on or before the 90th day after the date of this Offer Letter, you will be entitled to receive a lump sum payment equal to the amount of Base Salary that would have been paid to you from the date of such termination until the 90th day after the date of this Offer Letter.

4. **Bonus.** At or around the time of the conclusion of your term of service as Interim CEO, the Board, in its sole discretion, will perform an assessment of your individual performance and the Company's achievement of corporate goals. Depending on the results of such assessment and the length of your service as Interim CEO you will be eligible for consideration for a performance bonus.

5. **Benefits.** During the term of your employment, you will be entitled to the Company's standard vacation and benefits (including expense reimbursement) covering employees at your level, as such may be in effect from time to time.

6. **Immigration Laws.** For purposes of federal immigration laws, you will be required to provide to the Company documentary evidence of your identity and eligibility for employment in the United States. Such documentation must be provided within 3 business days of the effective date of your employment, or your employment relationship with the Company may be terminated.

7. **Employee Proprietary Information Agreement.** As a condition of this offer of employment, you will be required to complete, sign and return the Company's standard form of employee proprietary information agreement, with the following modifications: (i) the time period set out in the second paragraph of Section 2 of the EPIA will be changed from 5 years to 2 years; (ii) Section 5 of the EPIA, which deals with non-solicitation of employees, will be deleted; and (iii) Section 7 of the EPIA, which deals with noncompetition, will be deleted (the "EPIA"). None of the foregoing modifications will be deemed to modify any common-law fiduciary obligations that you may have as a director of the Company.

8. **D&O Insurance.** The Company has in effect and will maintain in effect during your tenure as Interim CEO (and thereafter, until the expiration of applicable statutes of limitation) a D&O insurance policy, or tail or extended reporting period coverage with respect thereto, with standard terms and conditions.

9. **Indemnification.** The Company confirms that you and the Company are parties to an Indemnification Agreement dated August 2, 2000, which has not been amended or revised and which continues in effect as of the date hereof, and that such Indemnification Agreement indemnifies you both in your capacity as a director and in your capacity as an officer of the Company, subject to the terms and conditions thereof.

10. **General.** This offer letter and the EPIA, when signed by you, set forth the terms of your employment with the Company and supersede any and all prior representations and agreements, whether written or oral. In the event of a conflict between the terms and provisions of this offer letter and the EPIA, the terms and provisions of the EPIA will control. Any amendment of this offer letter or any waiver of a right under this offer letter must be in a writing signed by you and an officer of the Company. **Texas law will govern this offer letter.**

We look forward to you joining the Company. If the foregoing terms are agreeable, please indicate your acceptance by signing this offer letter in the space provided below and returning it to me, along with your completed and signed EPIA.

Sincerely,

ACTIVE POWER, INC.

By/s/ Benjamin L. Scott

Benjamin L. Scott, Chairman of the Board

AGREED TO AND ACCEPTED:

“Employee”

/s/ Jan Lindelow
Jan Lindelow

CERTIFICATIONS

I, Jan H. Lindelow, 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 the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 1, 2011

/s/ Jan H. Lindelow

Jan H. Lindelow
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 the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 1, 2011

/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 September 30, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jan H. Lindelow, 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/ Jan H. Lindelow

Jan H. Lindelow
President and Chief Executive Officer
November 1, 2011

**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 September 30, 2011 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, 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/ John K. Penver

John K. Penver
Vice President of Finance, Chief Financial Officer and Secretary
November 1, 2011
