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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 March 31, 2006

Or

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

For the transition period from ______ to ______

Commission file number:__________

ACTIVE POWER, INC.
(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer ☐ Accelerated Filer ☒ Non-Accelerated Filer ☐

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

The number of shares of common stock, par value of $0.001 per share, outstanding at April 24, 2006 was 49,488,584.

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PART I - FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements.

Active Power, Inc.
Condensed Consolidated Balance Sheets

(in thousands)

	March 31, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,243	$ 7,590
Restricted cash	116	116
Short-term investments in marketable securities	24,751	31,364
Accounts receivable, net	6,207	5,769
Inventories	4,969	4,242
Prepaid expenses and other	494	596
Total current assets	45,780	49,677
Property and equipment, net	7,359	7,530
Long-term investments in marketable securities	2,959	2,970
Deposits and other	188	188
Total assets	$ 56,286	$ 60,365
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$ 1,907	$ 2,264
Accrued expenses	3,508	3,780
Deferred revenue	395	205
Total current liabilities	5,810	6,249
Stockholders’ equity:		
Common stock	49	49
Treasury stock	(5)	(5)
Deferred stock compensation	—	(293)
Additional paid-in capital	237,254	235,147
Accumulated deficit	(186,738)	(180,689)
Other accumulated comprehensive income	(84)	(93)
Total stockholders’ equity	50,476	54,116
Total liabilities and stockholders’ equity	$ 56,286	$ 60,365

See accompanying notes.

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

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

	Three Months Ended March 31,	
	2006	2005
Product revenue	$ 5,044	$ 2,931
Service and spares revenue	525	507
Total revenue	5,569	3,438
Cost of product revenue	5,137	3,245
Cost of service and spares revenue	576	544
Total cost of revenue	5,713	3,789
Gross margin	(144)	(351)
Operating expenses:		
Research and development	2,225	2,231
Selling and marketing	2,659	1,437
General and administrative	1,494	2,137
Total operating expenses	6,378	5,805
Operating loss	(6,522)	(6,156)
Interest income	394	378
Gain due to change in market value of investment rights	—	493
Other income (expense)	79	(42)
Net loss	$ (6,049)	$ (5,327)
Net loss per share, basic & diluted	$ (0.12)	$ (0.12)
Shares used in computing net loss per share, basic & diluted	49,183	46,085
Comprehensive loss:		
Net loss	$ (6,049)	$ (5,327)
Change in unrealized loss on investments in marketable securities	(84)	(101)
Comprehensive loss	$ (6,133)	$ (5,428)

See accompanying notes.

Active Power, Inc.
Condensed Consolidated Statements of Cash Flows

(in thousands)
(*Unaudited*)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Operating activities		
Net loss	$(6,049)	$ (5,327)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	516	462
Amortization of intangible assets	—	28
Accretion of premium/discount on marketable securities	(30)	65
Stock-based compensation	857	174
Change in market value of investments rights	—	(493)
Changes in operating assets and liabilities:		
Accounts receivable, net	(438)	1,803
Inventories	(723)	(1,498)
Prepaid expenses and other assets	102	192
Accounts payable	(357)	(459)
Accrued expenses	(272)	186
Deferred revenue	190	104
Net cash used in operating activities	(6,204)	(4,763)
Investing activities		
Purchases of marketable securities	(2,132)	(8,140)
Sales/maturities of marketable securities	8,795	12,610
Change in restricted cash	—	625
Purchases of property and equipment	(345)	(212)
Net cash provided by investing activities	6,318	4,883
Financing activities		
Net proceeds from issuance of common stock	1,539	19,168
Net cash provided by financing activities	1,539	19,168
Change in cash and cash equivalents	1,653	19,288
Cash and cash equivalents, beginning of period	7,590	17,625
Cash and cash equivalents, end of period	$ 9,243	$36,913

See accompanying notes.

Active Power, Inc.
Notes to Condensed Consolidated Financial Statements
March 31, 2006
(Unaudited)

1. Significant Accounting Policies

Basis of presentation: Active Power, Inc. and its subsidiaries (hereinafter referred to as "we", "Active Power" or the "Company") design manufacture and market power quality products to provide the consistent, reliable electric power required by customers during electric utility outages. We offer a range of flywheel energy storage systems that provide highly reliable, low-cost and non-toxic replacement for lead-acid batteries used in conventional power quality installations. We have recently broadened our product offerings by developing a battery-free extended runtime technology that utilizes thermal and compressed air storage to provide backup power for minutes to hours depending on the application and that will come to market in 2006. We sell our products globally through direct and Original Equipment Manufacturer ("OEM") channels. Our current principal markets are North America and Europe, Middle East and Africa ("EMEA").

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and include the accounts of the Company and its consolidated subsidiaries. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary to present fairly the consolidated financial position of the Company and its consolidated results of operations and cash flows. These interim financial statements should be read in conjunction with the financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Recently issued accounting standards: In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 154, *Accounting Changes and Error Corrections.* SFAS No.154 changes the requirements for the accounting for and reporting of a change in accounting principle. We are required to adopt SFAS No.154 for accounting changes and error corrections that occur after the beginning of 2006. Our results of operations and financial condition will only be impacted following the adoption of SFAS No.154 if it implements changes in accounting principles that are addressed by the standards or corrects accounting errors in future periods.

In March 2005 the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47"). FIN 47 requires a company to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably recognized. A conditional asset retirement obligation refers to a legal obligation to perform an asset retirement activity, such as restoring a facility to its original condition, and where the timing and method of settlement are contingent upon a future event, that may or may not be beyond the company's control. This liability should be recognized when incurred; typically upon acquisition or entering into a lease. FIN 47 provides guidance as to when suitable information exists to enable a company to determine its liability for a contingent asset retirement obligation. If insufficient information exists to enable a company to measure the liability when incurred, it shall recognize a liability in the period when sufficient information becomes available to estimate its fair value. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently assessing the financial impact of adopting FIN 47 and is obtaining the information necessary to make a determination of the financial impact of adoption.

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Stock-based compensation: Effective the beginning of 2006, we adopted SFAS No.123(R), *Share-Based Payment,* and elected to adopt the modified prospective application method. Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. For stock awards granted in 2006, expenses are amortized under the straight-line attribution method. For stock awards granted prior to 2006, expenses are amortized under the single option method prescribed by FASB Interpretation No.28. Previously reported amounts have not been restated. See note 2.

2. Supplemental Balance Sheet Information

Receivables

Accounts receivables consist of the following (in thousands):

	March 31, 2006	December 31, 2005
Trade receivables	$ 7,316	$ 7,111
Allowance for doubtful accounts	(1,109)	(1,342)
	$ 6,207	$ 5,769

Inventory

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

	March 31, 2006	December 31, 2005
Raw materials	$ 3,657	$ 2,687
Work in process and finished goods	1,624	1,966
Allowances for obsolescence	(312)	(411)
	$ 4,969	$ 4,242

Property and Equipment

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

	March 31, 2006	December 31, 2005
Equipment	$ 8,488	$ 8,265
Computers and software	2,432	2,381
Demonstration units	568	480
Furniture and fixtures	345	327
Leasehold improvements	7,043	7,043
Construction in progress	267	307
	19,143	18,803
Accumulated depreciation	(11,784)	(11,273)
	$ 7,359	$ 7,530

Accrued Expenses

Accrued expenses consist of the following (in thousands):

	March 31, 2006	December 31, 2006
Compensation and benefits	$ 1,496	$ 1,594
Warranty liability	613	644
State, property and sales taxes	87	309
Professional fees	448	419
Other	864	814
	$ 3,508	$ 3,780

Warranty Liability

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

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

Balance at December 31, 2005	$ 644
Warranty expense	131
Warranty charges incurred	(162)
Balance at March 31, 2006	$ 613

Contingencies

Between March 2002 and October 2004, Active Power and Joseph Pinkerton, our Chairman and Chief Executive Officer, were parties to a lawsuit with Magnex Corporation and other plaintiffs alleging breach of a joint venture agreement, misappropriation of trade secrets and other torts. As disclosed in our 2004 Annual Report on Form 10-K, this litigation was settled in October 2004 with the Company paying $5.08 million in settlement expense in 2004. The plaintiffs dismissed their claims and provided a covenant not to sue the defendants in the future. The plaintiffs further agreed to transfer, assign and otherwise release to the defendants all rights to certain technology involved in the lawsuit,

On July 16, 2004 we filed a lawsuit against Greenwich Insurance Company seeking coverage under an insurance policy providing for management liability and company reimbursement coverage for certain of our and our CEO, Joe Pinkerton’s, expenses and damages related to the Magnex litigation described above.

This case seeks a declaratory judgment that we are entitled to coverage under our policy with Greenwich Insurance Company and also alleges breach of contract for Greenwich’s failure to fulfill its contractual obligations under the policy. This case was filed in the Travis County District Court, in Texas state court. An amended petition was filed on September 14, 2004. In the event of any recovery in this action, we would retain an amount equal to our legal expenses related to this Greenwich Insurance litigation. Any additional recovery up to $1.22 million shall next be paid to Mr. Pinkerton as reimbursement for his settlement expense and other costs related to the Magnex lawsuit. Any recovery beyond this amount would be retained by us.

On April 11, 2006 the Court denied Greenwich's motion for summary judgment in part, and we anticipate a trial date in November 2006. Discovery in the case is ongoing.

Stock Plans

As of March 31, 2006, we had 7,591,080 shares of common stock reserved for issuance under our 2000 stock plan, of which 6,703,408 were subject to outstanding options and 887,672 were available for future grants of stock awards. Options are subject to terms and conditions as determined by our Board of Directors. In February 2006, we cancelled our Stock Purchase Plan.

Stock Options: Our stock options are generally immediately exercisable and vest quarterly over four years beginning from the date of grant. Board of directors' options typically cliff vest one year from the grant date. The exercise price, term and other conditions applicable to each stock option granted are generally determined by the Compensation Committee of our Board of Directors. The exercise price of each award is set on the grant date and is typically set at the fair market value per share of our stock on that date. All options expire after 10 years. Unexercised options are cancelled 90 days after termination and unvested options are cancelled on the date of employee termination and become available under the Plan for future grants.

Option activity for the first three months of 2006 is summarized as follows:

	Number of Shares	Weighted average exercise price per share	Weighted average remaining contractual life (in years)
Outstanding and exercisable – Dec. 31, 2005	6,277,316	$ 4.55	7.59
Granted	1,138,500	4.11	9.93
Exercised	(508,950)	2.50	6.89
Cancelled or expired	(203,458)	8.66	6.60
Outstanding and exercisable – March 31, 2006	6,703,408	$ 4.51	7.85

The weighted average fair value of options granted during the three-month period ending March 31, 2006 was $2.60. The total intrinsic value of options (which is the amount by which the stock price exceeded the exercise price of the options at the date of exercise) exercised during the three months ended March 31, 2006 was $914,000. The aggregate intrinsic value of outstanding and exercisable options at March 31, 2006 was $10.7 million. During the three months ended March 31, 2006, the amount of cash received from the exercise of options was $1.2 million.

Changes in our non-vested options for the three months ended March 31, 2006 are summarized as follows:

	Number of Shares	Weighted average fair value per share
Non-vested – December 31, 2005	3,126,099	$ 1.65
Granted	1,138,500	2.60
Vested	(472,323)	1.96
Cancelled	(82,377)	1.92
Non-vested – March 31, 2006	3,709,899	$ 2.00

As of March 31, 2006 there was $7.1 million of total unrecognized compensation cost, related to non-vested stock options, that is expected to be recognized over a weighted-average vesting period of 1.71 years. The total fair value of options vested during the three months ended March 31, 2006 was $926,000.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on implied and historical volatilities. The expected life of options granted is based on historical experience and on the terms and conditions of the options. The risk-free rates are based on the U.S. Treasury yield in effect at the time of grant. Assumptions used in the Black-Scholes model are presented below:

Three Months Ended	March 31, 2006
Stock Plans:	
Average expected life in years	6.0
Expected volatility	65.01%
Weighted average risk-free interest rate	4.75%
Expected forfeitures	5.00%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable and requires the input of subjective assumptions, including the expected stock price volatility and estimated option life. For purposes of this valuation model, no dividends have been assumed.

Restricted Stock: As of March 31, 2006 there were 100,000 shares of restricted stock outstanding, of which 50,000 were performance-based stock awards. For service-based restricted stock awards, restrictions lapse on the one-year anniversary of the grant date. For the performance-based restricted stock awards, vesting is contingent upon meeting certain performance goals during 2006.

There were no grants or cancellation of restricted stock during the three-months ended March 31, 2006. The fair value and compensation expense for restricted stock was determined before implementation of SFAS No. 123(R). Compensation expense for the three months ended March 31, 2006 for restricted stock was $85,000 and is included in general and administrative expense. As of March 31, 2006 there was $208,000 of total unrecognized compensation cost, related to non-vested restricted stock awards, that is expected to be recognized over the remainder of 2006.

Stock-Based Compensation Expense: Total compensation costs relating to our stock plans in the three-months ended March 31, 2006 was $857,000 and included the following:

	Three months ended March 31, 2006
Stock-based compensation expense by caption:	
Cost of product revenue	$ 111,000
Cost of service and spares revenue	13,000
Research and development	222,000
Selling and marketing	190,000
General and administrative	321,000
	$ 857,000
Stock-based compensation expense by type of award:	
Stock options	$ 595,000
Stock purchase plan	177,000
Restricted stock awards	85,000
	$ 857,000

Stock-based compensation expense of $4,000 was capitalized and remained in inventory at the end of March 2006. As of March 31, 2006, $7.3 million of total unrecognized compensation costs related to non-vested awards that is expected to be recognized over a weighted average period of 1.67 years.

Through 2005, we accounted for our stock plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations and provided the required pro forma income and per share data as if a fair value method had been used to account for stock-based compensation for the three months ended March 31, 2005 (in thousands, except per share amounts):

	Three months ended March 31, 2005
Net loss – as reported	$ (5,327)
Total stock-based compensation cost, net of related tax effects included in the determination of net income as reported	174
The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards	(1,609)
Pro forma net loss	$ (6,762)
Earnings per share	
Basic and diluted – as reported	$ (0.12)
Basic and diluted – pro forma	$ (0.15)

Change in Market Value of Investment Rights

In February 2005 in connection with a private placement of common stock to certain investors, we granted the investors certain Additional Investment Rights that entitled the investors to acquire additional shares on the same terms and condition as the private placement. In accordance with the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the fair value of the Additional Investment Rights was determined at the time of issuance based on the proceeds of the offering and the relative fair values of the securities and the Additional Investment Rights. We used the Black-Scholes valuation model to determine the fair value of the Additional Investment Rights, and accordingly attributed a value of $964,000 to the Additional Investment Rights, which was recorded as additional paid-in capital. Changes in the fair value of the Additional Investment Rights since the date of issuance were required to be reflected in our earnings. The rights were revalued to their market value of $471,000 at March 31, 2005, with the resultant gain of $493,000 recorded as other income during the three-month period ended March 31, 2005.

Net Loss Per Share

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

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Net loss	$ (6,049)	$ (5,327)
Basic and diluted:		
Weighted-average shares of common stock Outstanding	49,183	46,085
Shares used in computing net loss per share, basic and diluted	49,183	46,085
Net loss per share, basic and diluted	$ (0.12)	$ (0.12)

Our calculation of diluted loss per share excludes 6,703,408 and 5,725,105 shares of common stock issuable upon exercise of employee stock options as of March 31, 2006 and 2005, respectively, because their inclusion in the calculation would be anti-dilutive. As of March 31, 2006 and 2005, there was no common stock subject to repurchase.

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

The following discussion should be read in conjunction with, and is qualified in its entirety to, the financial statements and notes thereto included in Item 1 of this Form 10-Q and the financial statements and notes thereto and our Management's Discussion and Analysis of Financial Condition and Results of Operation for the year ended December 31, 2005 included in our 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 II, Item 1A for a discussion of items that may affect our future results.

Overview

We design, manufacture and market power quality products that provide the consistent, reliable electric power required by customers during electric utility outages. We believe that we are the first company to commercialize a flywheel energy storage system that provides a highly reliable, low-cost and non-toxic replacement for the lead-acid batteries used in conventional power quality installations. Our first commercial product was a battery-free DC system (CleanSource® DC) that is used as a bridging energy source in typical power quality installations and is compatible with all major uninterruptible power supply (UPS) brands. Leveraging our expertise in this technology, we have also developed a battery-free UPS system that incorporates our flywheel technology with a UPS system (CleanSource UPS). The CleanSource UPS is also marketed by Caterpillar Inc. under the brand name "Cat® UPS". Between 2003 and 2005, we broadened our product offerings and expanded our available markets by developing additional battery-free UPS systems to address customer needs at both higher and lower power levels. Our family of battery-free UPS products currently ranges from 65 kVA – 1200 kVA. By paralleling our megawatt-class UPS systems together, we currently provide 2400 kVA UPS systems and are able to provide up to 3600 kVA battery-free UPS systems to customers. In addition, we also provide customers with continuous power systems (CPS), which are comprised of our UPS systems, third party ancillary equipment such as engine generators and transfer switches, and installation and start-up services.

During 2004 and 2005 we developed a battery-free extended runtime technology (one that provides backup power for minutes to hours depending on the application) that utilizes thermal and compressed air storage (TACAS). This TACAS technology typically operates at lower power levels than our flywheel products, and is sold as a minute-for-minute DC replacement for lead-acid batteries. This product is being marketed as the CoolAir™ DC. We shipped the first evaluation unit of this extended runtime product in December 2004, and shipped additional evaluation units throughout 2005 before formally launching this product for commercial sale in the fourth quarter of 2005. We recorded our first sale of CoolAir DC in December 2005 and will begin commercial production of CoolAir DC in the first half of 2006. In addition, where customers desire a complete backup solution with an extended runtime, we have introduced the CoolAir UPS that couples our CoolAir DC product with a third-party double-conversion UPS. We entered into a supply arrangement with General Electric in 2005 to provide us with the UPS component of this product.

We distribute our products through a variety of channels, including OEMs, independent power quality representatives, manufacturer's representatives, and through direct sales personnel to maximize market coverage and penetration. Our products are sold for use in the facilities of companies across many different industries that all share a critical need for reliable, high-quality power, such as broadcasters, hospitals, credit card processing centers, semiconductor manufacturers, pharmaceutical manufacturers, plastics manufacturers, data centers and electric utilities. Sales have been spread across many different countries from many regions of the world. Our primary markets are currently North America and Europe, Middle East and Africa (EMEA).

Critical Accounting Policies and Estimates

We consider an accounting policy to be critical if:

- The accounting estimate requires us to make assumptions about matters that are highly uncertain or require the use of judgment at the time we make that estimate; and
- Changes in the estimate that are reasonably likely to occur from period to period, or use of different estimates that we could have reasonably used instead in the current period, would have a material impact on our financial condition or results of operations.

Management has reviewed the development and selection of these critical accounting estimates with the Audit Committee of our Board of Directors, and the Audit Committee has reviewed these disclosures. In addition, there are other items within our financial statements that require estimation, but are not deemed critical as defined above. Changes in these and other items could still have a material impact upon our financial statements.

Allowance for Doubtful Accounts

Trade receivables are recorded at the stated amount, less an allowance for doubtful accounts. The allowance represents estimated uncollectible receivables associated with potential customer defaults on contractual obligations, usually due to the customer's potential insolvency. The allowance includes amounts for certain customers where a risk of default has been specifically identified. In addition, the allowance includes a provision for customer defaults on a general formula basis when it is determined the risk of some default is probable and estimable, but cannot yet be associated with certain customers. The assessment of the likelihood of customer defaults is based on various factors, including the length of time the receivables are past due, risks unique to particular geographic regions, historical experience and existing economic conditions. Historically, a large portion of our sales were made through OEM channels to a few large customers, and so our credit losses have been minimal. As we integrate additional distribution channels into our business and increase our direct sales to more, and smaller customers, the risk of credit loss may increase. In accordance with this policy, our allowance for doubtful accounts was $1.1 million and $1.3 million at March 31, 2006 and December 31, 2005, respectively.

Inventory Reserve

Inventories are priced at the lower of cost (using the first-in-first-out method) or market. We estimate inventory reserves on a quarterly basis and record reserves for obsolescence or slow-moving inventory based on assumptions about future demand and marketability of products, the impact of new product introductions, inventory turns and specific identification of items, such as product discontinuance, damaged goods or engineering/material changes.

Accrued Warranty Liability

The estimated warranty liability costs are accrued for each of our products at the time of sale. Our estimates are principally based on assumptions regarding the lifetime warranty costs of each product, including where little or no claims experience may exist. Due to the uncertainty and potential volatility of these estimates, changes in our assumptions could have a material effect on our reported operating results. Our estimate of warranty liability is reevaluated on a quarterly basis. Experience has shown that initial data for a new product can be very volatile due to factors such as product failure rates, material usage and service delivery costs in correcting product failures; therefore our process relies upon long-term historical averages until sufficient data is available. As actual experience becomes available, it is used to modify the historical averages to ensure that the forecast is within the range of likely outcomes. The resulting balances are then compared to current spending rates to ensure that the accruals are adequate to meet expected future obligations.

Revenue Recognition

In general, revenue for product sales is recognized when title has transferred to the customer as stipulated by the delivery terms in a sales contract. In addition, prior to revenue recognition we require persuasive written evidence of the arrangement, a fixed or determinable price, and a determination that collectibility is reasonably assured.

We also offer various services to customers depending on the type of product the customer has purchased, which may include on-site services or installation and integration services. Such services are not essential to the functionality of the delivered product. Revenue for services is recognized at the time services are provided. When products and services are contracted under a single arrangement, we allocate the total sales price to the multiple deliverables based on their relative fair values. The fair value of our equipment is based on our average historical selling prices, while the fair value of services is based upon the rates that we charge customers in separately negotiated transactions or based on the market price an independent third party would charge to provide these services. Revenue associated with the sale of extended warranties is recognized ratably over the contract period.

Stock-based Compensation

Beginning in 2006, we adopted SFAS No. 123(R) using the modified prospective application method and began accounting for our stock-based compensation using a fair-value based recognition method. Under the provisions of SFAS No. 123(R), stock-based compensation cost is estimated at the grant date based on the fair-value of the award and is recognized as expense ratably over the requisite service period of the award. Determining the appropriate fair-value model and calculating the fair value of stock-based awards at the grant date requires considerable judgment, including estimating stock price volatility, expected option life and forfeiture rates. We develop our estimates based on historical data and market information that can change significantly over time. A small change in the estimates used can have a relatively large change in the estimated valuation.

We use the Black-Scholes option valuation model to value employee stock awards. We estimate stock price volatility based upon our historical volatility. Estimated option life and forfeiture rate assumptions are derived from historical data. For stock-based compensation awards with graded vesting that were granted after 2005, we recognize compensation expense using the straight-line amortization method.

Results of Operations

($ in thousands)	Three months ended March 31, 2006	% of total revenue	2005	% of total revenue	Variance 2006 vs. 2005 $	%	Three months ended Dec. 31, 2005	Variance to Q4 $
Product revenue	$ 5,044	91%	$ 2,931	85%	$2,113	72%	$ 4,786	$ 258
Service and spares revenue	525	9	507	15	18	4	374	151
Total revenue	5,569	100	3,438	100	2,131	62	5,160	409
Cost of product revenue	5,137	92	3,245	94	1,892	58	4,811	326
Cost of service and spares revenue	576	10	544	16	32	6	327	249
Total cost of revenue	5,713	103	3,789	110	1,924	51	5,138	575
Gross margin	(144)	(3)	(351)	(10)	207	59	22	(166)
Operating expenses:								
Research and development	2,225	40	2,231	65	(6)	(0)	3,341	(1,116)
Selling and marketing	2,659	48	1,437	42	1,222	85	1,949	710
General and administrative	1,494	27	2,137	62	(643)	(30)	1,898	(404)
Total operating expenses	6,378	115	5,805	169	573	10	7,188	(810)
Operating loss	(6,522)	(117)	(6,156)	(179)	(366)	(6)	(7,166)	644
Interest income	394	7	378	11	16	4	420	(26)
Gain due to change in market value of investment rights	—	0	493	14	(493)	(100)	—	—
Other income (expense)	79	1	(42)	(1)	121	288	(26)	105
Net loss	$(6,049)	(109)%	$(5,327)	(155)%	$ (722)	(14)%	$(6,772)	$ 723

Product revenue. Product revenue consists of sales of our CleanSource power quality products, comprising both UPS and DC product lines, and sales of Continuous Power Systems (CPS) which are comprised of our UPS systems, some combination of third-party ancillary equipment, such as engine generators and switchgear, and installation and start-up services.

The increase in product revenue from the same period of 2005 was due to higher sales of our DC and megawatt-class UPS product lines and continued growth from our direct sales channel. When we sell product directly, as compared to through our OEM channels, we typically generate higher prices and better contribution margins as we do not have to offer channel discounts. The average selling price over the first three months of 2006 was $54,000 per quarter-megawatt flywheel, compared to $59,000 over the same period in 2005 due to higher DC sales and OEM deals at lower average prices than our direct sales. A single product, depending on its power rating, may be comprised of multiple flywheel units.

During the quarter ended March 31, 2006 we sold 91 flywheel units compared to 43 in the comparable period of 2005. This includes a significantly higher number of DC wheels compared to 2005 that typically sell at lower average selling prices than our UPS wheels. Our CPS revenues were 8% of product revenue compared to 14% of product revenue in the comparable period of 2005. CPS revenue is typically tied to higher power system sales and tend to be larger in amount and more infrequent, with longer sales cycles. The frequency and timing of such revenue is more volatile and can result in material changes in period- to-period revenue. The current quarter included $428,000 of CPS revenues from previously announced large transactions.

North American sales were 74% of our total revenue for the three-month period ended March 31, 2006 compared to 62% for the same period of 2005, and 64% in the immediately preceding quarter. This increase is due to several large megawatt-class and DC system sales made in this region during Q1.

During 2005 in an effort to expand the territories in which we sell our Active Power branded products, we began to increase our direct sales organization, particularly in EMEA. We anticipate higher sales from these regions in 2006 as a result of these efforts. Sales of Active Power branded products through our direct and manufacturer's representative channels were 36% of our total revenues for the three-month period ended March 31, 2006 compared to 38% for the same period of 2005. Direct sales typically have higher profit margins than sales through our OEM channels; therefore, increasing our direct sales channel is expected to result in increased revenue and improved profit margins. We believe sales of our Active Power branded products to government facilities and industrial customers in regions that were not covered by our OEMs will continue to increase over time and will become a larger percentage of our total revenue.

Our products perform well in harsh environments where power quality is particularly poor, which makes them a good fit for industrial countries with a poor power infrastructure and therefore we have focused our direct sales efforts to these customers. Due to the large size of some of our customer orders relative to our current total revenue levels, our quarterly total revenue trend and the proportion of sales made directly by us can be expected to fluctuate quarterly from the amounts recorded so far in 2006. Caterpillar remains our largest OEM partner and largest customer, and represented 46% of our product revenue for both the three-month periods ended March 31, 2006 and March 31, 2005. We have had recent success with Caterpillar selling our megawatt-class UPS products along with their large engine generators, and expect total revenue from this channel to increase in 2006. We have also seen and anticipate a further increase in capital spending in data centers where there is a requirement for higher-density power solutions such as flywheels, and believe that this will result in higher product revenue levels for us in 2006.

Service and spares revenue. Service and spares revenue primarily relates to revenue generated from installation, startup, repairs or reconfigurations of our products, and the sale of spare or replacement parts to our OEM and end-user customers. It also includes revenue associated with the costs of travel of our service personnel. Service and spares revenue increased by 4% for the three month period ended March 31, 2006 compared to the same prior year period. We anticipate that service and spares revenue will continue to grow with product revenue and as our installed base of product expands, because as more units are sold to customers, more installation, startup and maintenance services will be required. As sales through our Active Power branded channels increase, these revenues will increase further because our OEM's would typically provide these services to their end-user customers.

Cost of product revenue. Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment and other costs associated with our assembly and test operations, including costs from having underutilized facilities, shipping costs, warranty costs, and the costs of manufacturing support functions such as logistics and quality assurance. Cost of product revenue in the quarter ended March 31, 2006 also included $111,000 of stock-based compensation expense following the adoption of Financial Accounting Standard No. 123(R). This had the effect of decreasing our reported gross margin by 2% for the quarter ended March 31, 2006. The cost of product revenue as a percentage of total revenue in the three-month period ended March 31, 2006 decreased compared to the comparable period in 2005 due to improved efficiency in our manufacturing operations and material and overhead costs reductions. We have instituted programs to reduce product and component costs where feasible and this has resulted in a decrease in materials costs as a percentage of product revenue. We continue to operate a manufacturing facility that has a capacity level significantly greater than our current product revenue levels. A large portion of the costs involved in operating our manufacturing facility are fixed in nature and we incur approximately $1.2 million to $1.5 million in unabsorbed overhead each quarter. We reduced our manufacturing staff levels in 2003 and have continued to reduce our overhead levels where feasible. We also continue to work on reducing our product costs. We have achieved gross-margin break-even in three of the last four quarters at revenue levels of between $4.5 million and $5.5 million, however, our accomplishment of gross-margin break even is heavily dependent upon the sales channel mix at this revenue level. Our ability to maintain positive product gross margin will depend on multiple factors, including our ability to continue to reduce material costs, improve our sales channel mix in favor of direct sales versus OEM, and to increase our total revenues to a level that will allow us to improve the utilization of our manufacturing operations.

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

Cost of service and spares revenue. Cost of service and spares revenue includes the cost of component parts, as well as labor and overhead of our spare parts, costs associated with travel and labor used in servicing a unit and unabsorbed overhead from the service group. The cost of service and spares revenue increased slightly in the three-month period ended of March 31, 2006 compared to the same period of 2005. This increase is consistent with the increase in service and spares revenue, however compared to the three-month periods ended March 31, 2005 and December 31, 2005, cost of service and spares revenue gross margin has decreased as we have added more service personnel to support our growing installed base of products.

Research and development. Research and development expense primarily consists of compensation and related costs of employees engaged in research, development and engineering activities, third party consulting and product development activities, as well as an allocated portion of our occupancy costs. Included in research and development expenses is $222,000 of stock-based compensation expense. This expense offset a slight decrease in research and development expenses in the three-month period ended March 31, 2006 compared to the same period in 2005 that was primarily driven by lower headcount. Overall our research and development expenses were approximately the same as in the first quarter of 2005. They decreased by $1.1 million or 33% compared to the immediately preceding quarter due to the absence of impairment charges that were recorded last quarter and from moderation of development and prototyping costs related to the development of our CoolAir™ DC product and from costs incurred in paralleling our CPS products. We believe research and development expenses in the second quarter will stay at similar levels to those recorded in the first quarter.

Selling and marketing. Selling and marketing expenses primarily comprise 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. Included in the selling and marketing expenses this quarter was $190,000 for stock-based compensation expense. Sales and marketing costs increased by $1.2 million or 85% in the quarter ended March 31, 2006 compared to the same period of 2005. The increase in our sales and marketing costs reflect increased headcount to 41 people from 30 a year earlier, as we have expanded our direct sales and support team in EMEA, and increased variable compensation relating to higher sales levels. We have expanded our marketing team since the beginning of 2005 and increased expenditures on marketing and direct sales-support activities as part of an effort to facilitate more direct sales.

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. Included in general and administrative expenses this quarter was $321,000 of stock-based compensation expense. General and administrative expenses decreased by 30% or $643,000 compared to the same period of 2005. This decrease was due to the absence of sales tax expenses and higher auditing and professional fees recorded in 2005, and the recovery of $236,000 of previously-reserved doubtful accounts during the current quarter. These savings were offset by stock-based compensation expense and higher legal fees in connection with the Greenwich litigation. General and administrative expenses were 21% lower from the immediately prior quarter when we made a $1.2 million allowance for doubtful accounts. We expect general and administrative expenses to be slightly higher in the next quarter.

Interest income. Interest income has increased slightly from $394,000 to $378,000 in the three-month periods ended March 31, 2006 and 2005, respectively. Higher interest rates have offset the fact that our average cash and investments balance over the three month period ending March 31, 2006 has decreased by approximately $13.1 million or 25% compared to the average balance over the comparable period ending March 31, 2005.

Gain from change in Market Value of Additional Investment Rights. On February 4, 2005, we completed the private placement of 5,454,510 shares of our common stock at a price of $3.64 per share, for an aggregate offering of approximately $19.8 million, to certain purchasers. We also issued Additional Investment Rights to purchase 1,636,353 shares of Common Stock to the Purchasers, at an exercise price per share of $3.64. The Additional Investment Rights were not exercised and expired on August 18, 2005.

In accordance with the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the fair value of the Additional Investment Rights was determined at the time of issuance based on the proceeds of the offering and the relative fair values of the securities and the Additional Investment Rights. We used the Black-Scholes valuation model to determine the fair value of the Additional Investment Right, and accordingly attributed a value of $964,000 to the Additional Investment Rights, which was recorded as additional paid in capital. Changes in the fair value of the Additional Investment Rights since the date of issuance due to fluctuations in the value of our stock were required to be reflected in our earnings. The rights were revalued to their market value of $471,000 at March 31, 2005, with the resultant gain of $493,000 recorded as other income during the three-months ended March 31, 2005. As these investment rights expired in the third quarter of 2005, there was no impact related to the Additional Investment Rights in the three-month period ended March 31, 2006.

Other income (expense). Other income in this quarter included cost recoveries from annual audits of our real estate leases. The 2005 amount included $84,000 of realized losses on marketable securities.

Liquidity and Capital Resources

Our principal sources of liquidity as of March 31, 2006 consisted of $37.0 million of cash and investments. We have primarily funded our operations through a private placement of our common stock in February 2005 that resulted in net proceeds of $18.7 million, our initial public offering in August 2000, that resulted in net proceeds of $138.4 million, sales of shares of our preferred stock from 1992 to 1999, which have resulted in gross proceeds of approximately $42.6 million, as well as $10.0 million in development funding received from Caterpillar since 1999, and our product revenue.

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

($ in thousands)	Three months ended March 31,		Variance 2006 vs. 2005	
	2006	2005	$	%
Cash used in operating activities	$(6,204)	$(4,763)	$(1,441)	30%

Cash used in operating activities increased by 30% compared to the same period of 2005. This is primarily attributable to an increase in our receivables balance resulting from higher revenues. Our revenues are approximately $2.1 million higher at March 2006 compared to March 2005, and a large portion of these revenues were uncollected at the end of the period. Offsetting this use of funds, we were more efficient with our working capital and compared to the prior year invested less funds into inventory and paid down less payables and accrued expenses. Our higher net loss was largely attributable to the $857,000 stock-based compensation charge which is non-cash in nature and did not affect our liquidity. We anticipate cash used in operating activities to increase in the second quarter as we position the Company for future growth by increasing inventories of our CoolAir product as its production and sales volumes increase.

Investing activities primarily consist of sales and purchases of investments, use of restricted cash and purchases of property and equipment. Fluctuations in the sale and purchase of investments generally reflect our use of these funds to finance our ongoing operations. Capital expenditures were $345,000 in the three-month period ending March 31, 2006 compared to $212,000 in the same period of 2005.

Funds provided by financing activities during the three-months ended March 31, 2006 reflect proceeds from employee share purchases, including stock option exercises and from the Employee Stock Purchase Plan that we discontinued in February. The significant decrease in funds from financing activities compared to the comparable period of 2005 is due to the fact that during the first quarter of 2005 we completed a private placement of 5,454,510 shares of our common stock that resulted in net proceeds to us of $18.7 million.

We believe our existing cash and investments balances at March 31, 2006 will be sufficient to meet our cash requirements through the next 12 months, although we may elect to seek additional funding prior to that time. Beyond the next 12 months, our cash requirements will depend on many factors, including the rate of sales growth, the market acceptance of our products including the CoolAir DC product family, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the rate of expansion of our manufacturing processes, and the timing and extent of research and development projects. Although we are not a party to any agreement or letter of intent with respect to a potential acquisition or merger, we may enter into acquisitions or strategic arrangements in the future, which could also require us to seek additional equity or debt financing.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 154, *Accounting Changes and Error Corrections.* SFAS No.154 changes the requirements for the accounting for and reporting of a change in accounting principle. We are required to adopt SFAS No.154 for accounting changes and error corrections that occur after the beginning of 2006. Our results of operations and financial condition will only be impacted following the adoption of SFAS No.154 if it implements changes in accounting principles that are addressed by the standards or corrects accounting errors in future periods.

In March 2005 the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47"). FIN 47 requires a company to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably recognized. A conditional asset retirement obligation refers to a legal obligation to perform an asset retirement activity, such as restoring a facility to its original condition, and where the timing and method of settlement are contingent upon a future event, that may or may not be beyond the company's control. This liability should be recognized when incurred; typically upon acquisition or entering into a lease. FIN 47 provides guidance as to when suitable information exists to enable a company to determine its liability for a contingent asset retirement obligation. If insufficient information exists to enable a company to measure the liability when incurred, it shall recognize a liability in the period when sufficient information becomes available to estimate its fair value. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently assessing the financial impact of adopting FIN 47 and is obtaining the information necessary to make a determination of the financial impact of adoption.

Stock-based compensation: Effective the beginning of 2006, we adopted SFAS No.123(R), *Share-Based Payment*, and elected to adopt the modified prospective application method. Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. For stock awards granted in 2006, expenses are amortized under the straight-line attribution method. For stock awards granted prior to 2006, expenses are amortized under the single option method prescribed by FASB Interpretation No.28. Previously reported amounts have not been restated. As of March 31, 2006 there was $7.3 million of total unrecognized compensation cost related to nonvested awards that is expected to be recognized over a weighted average period of 1.67 years.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We believe that our investment policy is conservative, both in terms of the average maturity of investments that we allow and in terms of the credit quality of the investments we hold. We estimate that a 1% decrease in market interest rates would decrease our annual interest income by $320,000.

Our international sales are made primarily in U.S. dollars. Those sales in currencies other than U.S. dollars can result in translation gains and losses. As we increase sales in foreign markets, we anticipate making more sales denominated in foreign currencies, primarily euros and pounds. Currently, we do not engage in hedging activities for our international operations. However, we may engage in hedging activities in the future.

Our international business is subject to the typical risks of any international business, including, but not limited to, the risks described in Item 2 – “Risk Factors that May Affect Future Results” above. Accordingly, our future results could be materially harmed by the actual occurrence of any of these or other risks.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. We performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (“CFO”), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d -15(f) under the Securities Exchange Act of 1934. Based on their evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of March 31, 2006, (the end of the period covered by this Quarterly Report on Form 10-Q) to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.

(b) Changes in internal control over financial reporting. During the three months ended March 31, 2006 there was no change in our internal control over financial reporting that occurred that has materially affected, or that we believe is reasonably likely to materially affect, our internal control over financial reporting.

ACTIVE POWER, INC.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

Active Power, Inc., et al. v. Greenwich Insurance Company

Between March 2002 and October 2004, Active Power and Joseph Pinkerton, our Chairman and Chief Executive Officer, were parties to a lawsuit with Magnex Corporation and other plaintiffs alleging breach of a joint venture agreement, misappropriation of trade secrets and other torts. As disclosed in our 2004 Annual Report on Form 10-K, this litigation was settled in October 2004 with the Company paying $5.08 million in settlement expense in 2004. The plaintiffs dismissed their claims and provided a covenant not to sue the defendants in the future. The plaintiffs further agreed to transfer, assign and otherwise release to the defendants all rights to certain technology involved in the lawsuit,

On July 16, 2004 we filed a lawsuit against Greenwich Insurance Company seeking coverage under an insurance policy providing for management liability and company reimbursement coverage for certain of our and our CEO, Joe Pinkerton's, expenses and damages related to the Magnex litigation described above.

This case seeks a declaratory judgment that we are entitled to coverage under our policy with Greenwich Insurance Company and also alleges breach of contract for Greenwich's failure to fulfill its contractual obligations under the policy. This case was filed in the Travis County District Court, in Texas state court. An amended petition was filed on September 14, 2004. In the event of any recovery in this action, we would retain an amount equal to our legal expenses related to this Greenwich Insurance litigation. Any additional recovery up to $1.22 million shall next be paid to Mr. Pinkerton as reimbursement for his settlement expense and other costs related to the Magnex lawsuit. Any recovery beyond this amount would be retained by us.

On April 11, 2006 the Court denied Greenwich's motion for summary judgment in part, and we anticipate a trial date in November 2006. Discovery in the case is ongoing.

Item 1A. Risk Factors

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

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

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

We have incurred operating losses since our inception and expect to continue to incur losses for at least the next several quarters. As of March 31, 2006, we had an accumulated deficit of $186.7 million. To date, we have funded our operations principally through the sale of our stock, product revenue and development funding payments from Caterpillar. We will need to generate significant additional revenue to achieve profitability, and we cannot assure you that we will ever realize sufficient additional revenue to achieve profitability. We also expect to incur product development, sales and marketing and administrative expenses in excess of our revenue after costs, and, as a result, we expect to continue to incur losses for the next several quarters.

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

We have generated a total of $86.0 million in product revenue since January 1, 1998, with $5.6 million generated in the three months ended March 31, 2006. We are uncertain whether our products will achieve market acceptance such that our revenue will increase or whether we will be able to achieve significant revenue. Therefore, we have a very limited ability to predict future revenue. Our limited operating experience, the uncertain market acceptance for our products, and other factors that are beyond our control make it difficult for us to accurately forecast our quarterly and annual revenue. However, we use our forecasted revenue to establish our expense budget. Most of our expenses, particularly rent and salaries, are fixed in the short term or incurred in advance of anticipated revenue. As a result, we may not be able to decrease our expenses, if desired, in a timely manner to offset any revenue shortfall. If our revenue does not increase as anticipated, we will continue to incur significant losses. As a result of the foregoing, we cannot assure you that our revenues will grow or remain stable in future periods or that we will become profitable. In addition, in some future quarters, our financial results may be below the expectations of public market analysts or investors. In such event, the market price of our common stock would likely fall.

Our financial results may vary significantly from quarter to quarter.

Our product revenue, operating expenses and quarterly operating results have varied in the past and may fluctuate significantly from quarter to quarter in the future due to a variety of factors, many of which are outside of our control. As a result you should not rely on our operating results during any particular quarter as an indication of our future performance in any quarterly period or fiscal year. These factors include, among others:

- timing of orders from our customers and the possibility that customers may change their order requirements with little or no notice to us;

- rate of adoption of our flywheel-based energy storage system or our thermal and compressed air system as alternatives to lead-acid batteries;
- ongoing need for short-term power outage protection in traditional UPS systems;
- deferral of customer orders in anticipation of new products from us or other providers of power quality systems;
- timing of deferred revenue components associated with large orders;
- new product releases, licensing or pricing decisions by our competitors;
- commodity and raw material component prices;
- lack of order backlog;
- loss of a significant customer or distributor;
- impact of changes to our product distribution strategy and pricing policies;
- changes in the mix of domestic and international sales;
- rate of growth of the markets for our products; and
- other risks described below.

We derive a significant portion of our revenue from relatively few large transactions. The sales cycle for these large transactions tend to be longer than the sales cycle on smaller orders. The longer sales cycle for large transactions makes it difficult to predict the quarter in which these sales will occur. Accordingly, our operating results may fluctuate from quarter to quarter based on the existence and timing of larger transactions. A reduction in the number of large transactions, or a delay in closing of such a sales transaction could materially impact our revenue in a particular period.

The market for power quality products is evolving and difficult to predict its potential size or future growth rate. Most of the organizations that may purchase our products have invested substantial resources in their existing power systems and, as a result, have been reluctant or slow to adopt a new approach, particularly during a period of reduced capital expenditures. Moreover, our current products are alternatives to existing UPS and battery-based systems and may never be accepted by our customers or may be made obsolete by other advances in power quality technologies.

Significant portions of our expenses are not variable in the short term and cannot be quickly reduced to respond to decreases in revenue. Therefore, if our revenue is below our expectations, our operating results are likely to be adversely and disproportionately affected. In addition, we may change our prices, modify our distribution strategy and policies, accelerate our investment in research and development, sales or marketing efforts in response to competitive pressures or to pursue new market opportunities. Any one of these activities may further limit our ability to adjust spending in response to revenue fluctuations. We use forecasted revenue to establish our expense budget. Because most of our expenses are fixed in the short term or incurred in advance of anticipated revenue, any shortfall in revenue may result in significant losses.

We have increased our international activities significantly and plan to continue such efforts, which subjects us to additional business risks including increased logistical and financial complexity, political instability and currency fluctuations.

The percentage of our product revenue derived from customers located outside of the United States was 45%, 50% and 48% in 2005, 2004 and 2003, respectively. In the three-month period ended March 31, 2006 we derived 26% of our total revenues from sales to international customers. Our international operations are subject to a number of risks, including:

- foreign laws and business practices that favor local competition;
- dependence on local channel partners;
- compliance with multiple, conflicting and changing government laws and regulations;
- longer sales cycles;
- difficulties in managing and staffing foreign operations;
- foreign currency exchange rate fluctuations and the associated effects on product demand and timing of payment;
- political and economic stability, particularly in the Middle East and North Africa;
- greater difficulty in the contracting and shipping process and in accounts receivable collection and longer collection periods;
- greater difficulty in hiring qualified technical sales and application engineers; and
- difficulties with financial reporting in foreign countries.

To date, the majority of our sales to international customers and purchases of components from international suppliers have been denominated in U.S. dollars. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive for our international customers to purchase, thus rendering our products less competitive. As we increase direct sales in foreign markets, we are making more sales that are denominated in other currencies, primarily Euros. Those sales in currencies other than U.S. dollars can result in translation gains and losses. Currently, we do not engage in hedging activities for our international operations. However, we may engage in hedging activities in the future.

We are subject to risks relating to product concentration and lack of revenue diversification.

We derive a substantial portion of our revenue from a limited number of products, and we expect these products to continue to account for a large percentage of our revenues in the near term. Continued market acceptance of these products, is therefore, critical to our future success. Our future success will also depend on our ability to reduce our dependence on these few products by developing and introducing to the market new products and product enhancements in a timely manner. Specifically, our ability to capture significant market share depends on our ability to develop and market extensions to our existing UPS product line at higher and lower power range offerings, and on our ability to develop and market our extended runtime products, such as the CoolAir DC. Even if we are able to develop and commercially introduce new products and enhancements, they may not achieve market acceptance, which would substantially impair our revenue, profitability and overall financial prospects. Successful product development and market acceptance of our existing and future products depend on a number of factors including:

- changing requirements of customers;
- accurate prediction of market and technical requirements;

- timely completion and introduction of new designs;
- quality, price and performance of our products;
- availability, quality, price and performance of competing products and technologies;
- our customer service and support capabilities and responsiveness;
- successful development of our relationships with existing and potential customers; and
- changes in technology, industry standards or end-user preferences.

We must expand our distribution channels and manage our existing and new product distribution relationships to continue to grow our business.

The future growth of our business will depend in part on our ability to expand our existing relationships with distributors, to identify and develop additional channels for the distribution and sale of our products and to manage these relationships. As part of our growth strategy, we may expand our relationships with distributors and develop relationships with new distributors. We will also look to identify and develop new relationships with additional parties that could serve as an outlet for our products, including CoolAir DC. As of March 31, 2006 we have broadened our sales and distribution channel by offering our products through 30 manufacturer's representatives throughout North America. In 2005 we also entered into a long-term supply agreement with GE Zenith Controls to source UPS systems from them that we intend to sell along side our CoolAir DC product. Our inability to successfully execute this strategy, and to integrate and manage our existing OEM channel partners, Caterpillar and Eaton Powerware, and our new manufacturer's representatives could impede our future growth.

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

Caterpillar and its dealer network are our primary OEM customer for our flywheel based products. Caterpillar and its dealer network accounted for 42%, 54% and 60% of our revenue, during 2005, 2004 and 2003, respectively. In the three-month period ended March 31, 2006 Caterpillar and its dealer network accounted for 46% of our revenue. If our relationship with Caterpillar is not successful, or if Caterpillar's distribution of the Cat UPS product is not successful or suffers a material change, our business and financial prospects would likely suffer. Pursuant to our distribution agreement with Caterpillar, they are the exclusive OEM distributor, subject to limited exceptions, of our CleanSource UPS product. Caterpillar is not obligated to purchase any CleanSource UPS units. Pursuant to our development agreements Caterpillar has provided us with $10.0 million in funding to support the development of the Cat UPS product line and other development efforts. In exchange for these payments, Caterpillar received co-ownership of the proprietary rights in this product. Either Caterpillar or Active Power may license to others the intellectual property that we jointly own without seeking the consent of the other, and the licensing party will solely retain all licensing revenue generated by licensing this intellectual property. However, we may not license the joint intellectual property to specifically identified competitors of Caterpillar until January 1, 2007. Caterpillar may terminate this agreement at any time by giving us 90 days advance written notice.

We have underutilized manufacturing capacity and have no experience manufacturing our products in large quantities.

In 2001, we completed and equipped a 127,000 square foot facility used for manufacturing and testing of our three-phase product line, including our DC and UPS products. To be financially successful, and to fully utilize the capacity of this facility and allocate its associated overhead, we must achieve significantly higher sales volumes. We must accomplish this while also preserving the quality levels we achieved when manufacturing these products in more limited quantities. To date, we have not been successful at increasing our sales volume to a level that fully utilizes the capacity of the facility and we may never increase our sales volume to necessary levels. We intend to manufacture and test our CoolAir DC product in this facility, which will help increase the utilization of our facility. If we do not reach these necessary sales volume levels, or if we cannot sell our products at our suggested prices, our ability to reach profitability will be materially limited.

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

We currently operate without a significant backlog.

We generally operate our business without any significant backlog of orders from customers. Normally our products are shipped and revenue is recognized shortly after the order is received. This lack of backlog makes revenue in any quarter substantially dependent on orders booked and shipped throughout that quarter.

We depend on sole and limited source suppliers, and outsource selected component manufacturing.

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

To assure the availability of our products to our customers, we outsource the manufacturing of selected components prior to the receipt of purchase orders from customers based on their forecasts of their product needs and internal product sales revenue forecasts.

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

We face significant competition from other companies.

The markets for power quality and power reliability are intensely competitive. There are many companies engaged in all areas of traditional and alternative UPS and backup systems in the United States and abroad, including, among others, major electric and specialized electronics firms, as well as universities, research institutions and foreign government-sponsored companies. There are many companies that are developing flywheel-based energy storage systems and flywheel-based power quality systems. We may face future competition from companies that are developing other types of emerging power technologies, such as high-speed composite flywheels, ultra capacitors and superconducting magnetic energy storage.

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

We may be unable to protect our intellectual property and proprietary rights.

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

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights. We may become involved in litigation in the future to protect our intellectual property or defend allegations of infringement asserted by others. Legal proceedings could subject us to significant liability for damages or invalidate our intellectual property rights. Any litigation, regardless of its merits or its outcome, would likely be time consuming and expensive to resolve and would divert management's time and attention. Any potential intellectual property litigation also could force us to take specific actions, including:

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

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

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

We have anti-takeover provisions that could discourage, delay or prevent our acquisition.

Provisions of our certificate of incorporation and bylaws could have the effect of discouraging, delaying or preventing a merger or acquisition that a stockholder may consider favorable. Additionally, in December 2001 our board of directors approved a stockholder rights plan, which would require a potential acquiror to negotiate directly with our board of directors regarding any planned acquisition. We also are subject to the anti-takeover laws of the State of Delaware, which may further discourage, delay or prevent someone from acquiring or merging with us. In addition, our agreement with Caterpillar for the distribution of CleanSource UPS provides that Caterpillar may terminate the agreement in the event we are acquired or undergo a change in control. The possible loss of our most significant customer could be a significant deterrent to possible acquirers and may substantially limit the number of possible acquirers. All of these factors may decrease the likelihood that we would be acquired, which may depress the market price of our common stock.

Volatility in our stock price could result in claims against us.

Historically the market price of our common stock has fluctuated significantly. In 2005 the sales price of our common stock ranged from \$2.39 to \$4.66. During the three-month period ending March 31, 2006 the sales price of our common stock ranged from \$3.83 to \$5.01. In addition to those risks described earlier in this section, the market price of our common stock can be expected to fluctuate significantly in response to numerous other factors, many of which are beyond our control, including the following:

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

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

The Securities and Exchange Commission on August 7, 2000 declared effective our registration statement on Form S-1 (File No. 333-36946) relating to the initial public offering of our common stock.

We did not repurchase any common stock in the first quarter of 2006.

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits.

The following documents are filed as exhibits to this report:

31.1	Rule 13a-15(e)/15d-15(e) Certification of Principal Executive Officer
31.2	Rule 13a-15(e)/15d-15(e) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer

SIGNATURES*

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

ACTIVE POWER, INC.
(Registrant)

April 27, 2006 (Date)	/s/ Joseph F. Pinkerton, III Joseph F. Pinkerton, III Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
April 27, 2006 (Date)	/s/ John K. Penver John K. Penver Vice President of Finance, Chief Financial Officer and Secretary (Principal Accounting Officer)

Exhibit 31.1

CERTIFICATIONS

I, Joseph F. Pinkerton, III, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;

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

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

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

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

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 27, 2006

/s/ Joseph F. Pinkerton, III

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

CERTIFICATIONS

I, John K. Penver, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 27, 2006

/s/ John K. Penver

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

Exhibit 32.1

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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the “Company”) for the period ending March 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Joseph F. Pinkerton, III, 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 13a or 15d, 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/ Joseph F. Pinkerton, III
Joseph F. Pinkerton, III
Chairman of the Board and Chief Executive Officer
April 27, 2006

Exhibit 32.2

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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John K. Penver, Chief Financial 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 13a or 15d, as applicable, of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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

/s/ John K. Penver

John K. Penver
Vice President of Finance and Chief Financial Officer
April 27, 2006