
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended March 31, 2005

OR

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

Commission file number 001-15957

CAPSTONE TURBINE CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

95-4180883
(I.R.S. Employer
Identification No.)

21211 Nordhoff Street, Chatsworth, California 91311
(Address of principal executive offices) (Zip code)

818-734-5300
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Title of Class — Common Stock, par value \$.001 per share
Name of Exchange on which Registered — NASDAQ

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 the filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or in any amendment to this Form 10-K.

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

The aggregate market value of the shares of common stock held by non-affiliates, based upon the closing price of the registrant's common stock on June 22, 2005, as reported on the Nasdaq National Market System, was approximately \$104.5 million. Shares of common stock held by each executive officer and director and by each person known to the registrant who owns 5% or more of the outstanding common stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 85,383,691 shares of common stock, \$.001 par value, were outstanding as of June 22, 2005.

DOCUMENTS INCORPORATED BY REFERENCE

Part III: Proxy Statement for Annual Meeting of Stockholders to be held September 16, 2005.

CAPSTONE TURBINE CORPORATION

FORM 10-K

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PART I

Available Information

This annual report on Form 10-K (“Annual Report”), as well as the Capstone Turbine Corporation’s (the “Company” or “Capstone”) quarterly reports on Form 10-Q, and current reports on Form 8-K as well as amendments to those reports, are made available free of charge on the Company’s Internet website (<http://www.microturbine.com>) as soon as reasonably practicable after such materials are electronically filed with or furnished to the Securities and Exchange Commission (“SEC”). Such material may also be read and copied at the SEC’s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet web site (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

Item 1. Business.

Overview

We develop, manufacture, market and service microturbine technology solutions for use in stationary distributed power generation applications, such as cogeneration (combined heat and power (“CHP”) and combined cooling heat and power (“CCHP”)), resource recovery, power reliability and remote power around the world. In addition, our microturbines can be used as generators for hybrid electric vehicle applications. Microturbines allow customers to produce power on-site. There are several technologies which are used to provide “on-site power generation”, also called “distributed generation” such as reciprocating engines, solar power, wind powered systems and fuel cells. For customers who do not have access to the electric utility grid, microturbines can provide clean, on-site power with lower scheduled maintenance intervals and greater fuel flexibility than competing technologies. For customers with access to the electric grid, microturbines can provide an additional source of continuous duty power, thereby providing additional reliability and in some instances, cost savings. With our stand-alone feature, customers can produce their own energy in the event of a power outage and can use the microturbines as their primary source of power for extended periods. Because our microturbines also produce clean, usable heat energy, they can provide economic advantages to customers who can benefit from the use of hot water, air conditioning and direct hot air.

We believe we were the first company to offer a commercially available power source using microturbine technology. Our 30-kilowatt (“Model C30”) and 60-kilowatt (“Model C60”) products are designed to produce electricity for commercial and small industrial users. A 30-kilowatt product can produce enough electricity to power a small convenience store. A 60-kilowatt product can produce enough heat to provide hot water to a 100-room hotel while also providing about one-third of its electrical requirements. Our microturbines combine patented air-bearing technology, advanced combustion technology and sophisticated power electronics to form efficient electricity and heat production systems. Because of our air-bearing technology, our microturbines do not require lubrication. This means they don’t require routine maintenance to change oil or other lubrications, as do the most common competing products. The 30-kilowatt product can be fueled by various sources including natural gas, propane, sour gas, medium British Thermal Unit (“BTU”) gas, kerosene and diesel. The 60-kilowatt product is available with an integrated heat exchanger, making it efficient to install in applications where hot water is used. Our products produce exceptionally clean power. In terms of nitrogen oxides (“NOx”) emissions, our microturbines have been shown to consistently produce less NOx than conventional reciprocating engines including those designed for natural gas.

Stationary applications for our microturbines, either independent of or connected to the electric utility grid, are extremely broad. The primary stationary markets that we have sold products to include:

- *Cogeneration-CHP and CCHP* — These applications use both electricity and heat generated by the microturbines. For example, we have used the heat generated by the microturbines to supply hot water solutions for hotels and schools. When our microturbine exhaust fuels an absorption chiller, the chiller produces chilled water for air conditioning and other uses. Cogeneration maximizes the use of energy produced by the microturbines and enhances the economic advantage for customers.
- *Resource recovery* — Our units can use natural gas, methane or other gasses that are otherwise burned or released directly into the atmosphere to produce electricity and heat. We have supplied microturbine solutions for landfills and waste water treatment facilities.

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- *Power reliability* — These markets require reliable back-up power or have a low tolerance for power interruption. We have sold products to provide backup power to restaurants, television stations and industrial companies. Other applications in this market include peak shaving of electric demand to lower customers' peak demand utility charges.
- *Remote power* — In areas where there are no utilities or where it is expensive for utilities to expand, microturbines can provide on-site power. The ability to run on various fuels; including natural gas, waste gas, kerosene, diesel and propane provides greater flexibility for remote applications. Remote uses of our products have included oil and gas production.

Our technology is also used in vehicular applications. Our customers have applied our products in hybrid electric vehicles such as buses and railcars. While not a focus market at this time, we have continued to explore development of vehicular applications, such as the Spinner vehicle, an advanced military application, and auxiliary power systems for naval vessels. Vehicular applications could become a focused area for development if a significant market demand for a vehicular application emerges.

We sell complete microturbine units, subassemblies, components and various accessories. We also perform engine overhauls and provide parts. Our microturbines are sold primarily through distributors and dealers, although in fiscal 2004, we began our own direct sales effort in portions of the United States. Our distributors purchase our products for sale to end users. The distributors are also required to provide a variety of additional services, including engineering the applications in which the microturbines will be used, installing the products at the end users' sites, commissioning the installed applications and providing post-commissioning services. Our distributors perform like value added resellers. Some distributors, that we call Original Equipment Manufacturers ("OEMs"), integrate Capstone's products into their own engineering solutions. Dealers are like distributors in that they purchase our products for sale to end users and also provide application engineering and installation. However, dealers are different from distributors in that dealers do not perform commissioning or provide post-commissioning services. Capstone has a factory direct service offering for commissioning and post-commissioning services that was started in fiscal 2004 in selected areas of the United States. All of our distributors are Authorized Service Companies ("ASCs"). We also have ASCs who do not sell our products, but only offer services for them. Successful implementation of the microturbine depends upon the quality of the microturbine, the ability of the distributors and dealers to sell into appropriate applications, and the quality installation, commissioning service and support provided by the ASCs.

We began commercial sales of our Model C30 products in 1998, targeting the emerging distributed generation industry that was being driven by fundamental changes in power requirements. In September 2000, we shipped the first commercial unit of our Model C60 microturbine. As of March 31, 2005, we have sold a total of approximately 3,170 units. Approximately 300 of these units, which are owned by our distributors, are currently held in their inventories. There are no rights of return or exchange with respect to these inventories. Our total installed microturbines have logged more than 8 million operating hours. We are still in the early phases of commercializing this technology and, to date, have not been profitable or generated positive cash flow.

Our backlog as of March 31, 2005 was approximately \$8.2 million for 10.8 megawatts. As of March 31, 2004 our backlog was approximately \$4.6 million for 6.5 megawatts of products. The backlog reflects orders that we considered firm, however, cancellations may occur and will be reflected in our backlog when known.

Our Products

Capstone MicroTurbines® are compact, environmentally friendly generators of electricity and heat. They operate on the same principle as a jet engine with the added capability of using a variety of commercially available fuels, such as natural gas, diesel, kerosene and propane, as well as previously unusable or underutilized fuels. For example, our Model C30 can operate on low BTU gas, which is gas with lower energy content, and can also operate on gas with a high amount of sulfur, known in the industry as sour gas. Examples of these fuel sources include methane from facilities such as wastewater treatment plants, landfills or agrodigesters. The compact and light-weight, modular design provides for flexibility in installing our microturbines in applications that are not suitable for other distributed energy devices.

Our microturbines incorporate three major design features:

- advanced combustion technology;
- patented air-bearing technology; and
- digital power electronics.

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Our advanced combustion technology allows the Capstone MicroTurbines to achieve low emissions capability with a design that is simple to manufacture. These low emission levels not only provide an environmentally friendly product, but also eliminate permitting requirements in several municipalities for continuously operated onsite power generation. The air-bearing system allows the microturbine’s single moving assembly to produce power without the need for typical petroleum-based lubrication. Air-bearings use a high-pressure field of air rather than petroleum lubricants. This improves reliability and reduces maintenance, such as oil changes. The electronic controls manage critical functions and monitor operations of the microturbine. For instance, our electronics control the microturbine’s speed, temperature and fuel flow and communicate with external computers and modems. The power electronics coordinate with the demand signals provided by customers, with the grid when the units are operated in a grid-connect mode and with the on-board battery when equipped for stand-alone mode. All control functions are performed digitally. Performance is optimized, resulting in lower emissions, higher reliability and high efficiency over a variable power range.

Our Model C30 and Model C60 products are approximately the size of a large refrigerator. Our Model C30 generates approximately 30 kilowatts of electric power, which is enough to power a typical convenience store, and approximately 300,000 kilojoules per hour of heat, which provides enough energy to heat 20 gallons of water per minute with a 20-degree Fahrenheit temperature rise. Our Model C60 is designed to similar criteria, and generates approximately 60 kilowatts of electric power. Our units can be connected in a multipack configuration to serve larger loads for heat or electrical requirements.

Our products can operate:

- connected to the electric utility grid as a current source;
- on a stand-alone basis as a voltage source;
- multipacked to support larger loads as a “virtual single” unit;
- in dual mode, where the microturbine operates connected to the grid or, when the grid is unavailable, the microturbine automatically disconnects itself from the grid and operates on a stand-alone basis.

We also offer Model C60 Integrated CHP systems. These systems combine the standard C60 microturbine unit with a Heat Recovery Module that provides electricity and heats water in a single package.

Our family of products is currently available (“X”) in the following configurations:

Product Configurations

Fuel:	Model C30		Model C60		
	Grid Connect	Stand-Alone	Grid Connect	Stand-Alone	Integrated CHP
Low pressure natural gas	X	X	X	X	X
High pressure natural gas.	X	X	X	X	X
Low BTU gas.	X				
Sour gas.	X	X			
Gaseous propane.	X	X	X	X	X
Compressed natural gas.	X	X	X	X	X
Diesel.	X	X			
Kerosene.	X	X			

We offer various accessories for our products including rotary gas compressors with digital controls, heat recovery modules for CHP applications, dual mode controllers that allow automatic transition between grid connect and stand-alone modes, batteries with digital controls for stand-alone or dual-mode operations, power servers for large multipacked installations, protocol converters for Internet access, packaging options and miscellaneous parts such as frames, exhaust ducting and installation hardware. We also sell microturbine components and subassemblies to OEMs.

The Capstone MicroTurbine consists of a turbogenerator and our patented electronic controls, combined with ancillary systems such as a fuel system. The turbogenerator includes a mechanical combustor system and a single moving assembly rotating on our patented air-bearings at up to 96,000 revolutions per minute. The combustor system operates on a variety of fuels and, at full power, achieves NOx emissions levels in the exhaust of less than nine parts per million per volume with natural gas and less than 35 parts per million per volume when operating with diesel. The emissions from the diesel turbogenerator combustion system are up to 10 times lower than emissions standard for a reciprocating diesel fuel generator set. As a result of our patented air-bearings, our microturbines do not require liquid lubrication. In addition, our

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microturbines do not utilize liquid cooling, keeping scheduled maintenance costs extremely low throughout their useful life.

Our electronic controls include an air cooled, insulated gate bipolar transistor (commonly known as IGBT) based inverter with advanced digital signal processor based microelectronics. These electronics control and manage the microturbine using proprietary software and advanced algorithms. The controls:

- start the turbogenerator and manage its load;
- coordinate the functioning of the microturbine with the grid;
- manage the speed, fuel flow, and exhaust temperature of the microturbine;
- convert the variable frequency, up to a maximum of 1,600 Hertz, and variable voltage power produced by the generator into a usable output of either 50/60 Hertz AC or optionally DC for HEV applications; and
- provide digital communications to externally maintain and control the equipment.

In addition, our Capstone Remote Monitoring Software (“CRMS”) provides an advantage to end-users by allowing them to remotely operate and manage the microturbine. Unlike the technology of other power sources that require manual monitoring and maintenance, the microturbine allows end-users to remotely and efficiently monitor performance, fuel input, power generation and time of operation using our proprietary communications software, which can interface with standard personal computers using CRMS. This remote capability can provide end-users with power generation flexibility and cost savings.

The Model C30 was initially designed to operate connected to an electric utility grid and using a high pressure, natural gas fuel source. We have expanded its functionality to operate with different fuels including a variety of carbon-based fuels such as propane, sour gas, kerosene and diesel. The combustor system remains the same for all fuels, except for the fuel injectors, which currently vary between liquid and gaseous fuels. The Capstone MicroTurbine’s multi-fuel capability provides significant competitive advantages with respect to some of our selected vertical markets.

Our Model C30 and Model C60 grid-connect and stand-alone microturbine power systems meet the Underwriters’ Laboratories certification for the UL2200 stationary engine generator standards and the UL1741 utility interactive requirements. Our products are manufactured by processes that are ISO9001 certified.

In January 2002, the California Energy Commission certified our 30-kilowatt and 60-kilowatt microturbine power systems as the first products to comply with the requirements of its “Rule 21” grid interconnection standard. This standard streamlines the process for connecting distributed generation systems to the grid in California. The benefits of this standard include avoiding both costly external equipment procurement requirements and extensive site-by-site and utility-by-utility analysis. Our protective relay functionality has been recognized by the State of New York which has pre-cleared our microturbines for connection to New York’s electric utility grid.

Our Model C60 was the first mechanical power generation product to be certified by the State of California as meeting its stringent distributed generation emissions standards that went into effect January 1, 2003.

Applications

Worldwide, stationary power generation applications vary from huge central stationary generating facilities, above 1,000 megawatts, down to back-up uses below ten kilowatts. Historically, power generation in most developed countries, such as the United States (“U.S.”), has been part of a regulated system. A number of developments related primarily to the deregulation of the industry, as well as significant technology advances, have broadened the range of power supply choices available to customers. We believe that our microturbines will be used in a variety of innovative electric power applications requiring less than two megawatts and, more immediately, in those requiring less than 300 kilowatts. Capstone has identified several markets with characteristics that we believe will value our inherently flexible, distributed electricity generating system.

Cogeneration / CHP / CCHP

Cogeneration is a market that seeks to use both the heat energy and electric energy produced in the power generation process. Using the heat and electricity created from a single combustion process increases the efficiency of the system from approximately 30% to 70% or more. The increased operating efficiency often reduces overall emissions and, through displacement of other separate systems,

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can reduce variable production costs. The most prominent uses of heat energy include space heating and air conditioning, heating and cooling water, as well as drying and other applications.

There are potential markets for CHP and CCHP applications in North America, Europe, Japan and parts of Asia. Many governments have encouraged more efficient use of the power generation process to reduce pollution and the cost of locally produced goods. Japan, which has some of the highest electric power costs in the world, has been particularly active in exploring innovative ways to improve the efficiency of generating electricity. To access this market, we have entered into agreements with distributors, which have engineered combined heat and power packages that utilize the hot exhaust air of the microturbine for heating water and also use the hot exhaust to run an absorption chiller for air conditioning. Further, we have developed our own integrated CHP product where the heat exchanger is placed on top of the Model C60. This provides a pre-engineered solution for hot water applications.

Resource Recovery

On a worldwide basis, there are thousands of locations where the production of fossil fuels and other extraction and production processes creates fuel byproducts, which traditionally have been released or burned into the atmosphere. Our Model C30 microturbine can burn these waste gases with minimal emissions, thereby, in some cases, avoiding the imposition of penalties incurred for pollution, while simultaneously producing electricity for use at the site or in the surrounding community. Our Model C30 has demonstrated effectiveness in this application and outperforms conventional combustion engines in a number of situations, including when the gas contains a high amount of sulfur. We have sold systems that were installed in the resource recovery market to be used at oil and gas exploration and production sites. We have also sold systems to be used to burn gases released from landfills and wastewater treatment facilities. These gases are considered renewable resources.

Power Reliability, Including Back-up and Standby Power / Peak Shaving

Because of the potentially catastrophic consequences of even momentary system failure, certain power users, such as high technology and information systems companies, require particularly high levels of reliability in their power service. Our microturbines can follow levels of demand, providing power when other sources fail. Our products can be configured in multiple unit arrays and used in combination to provide a highly reliable electricity generating system. We believe that customers with particularly low tolerances for power service interruptions, such as high technology and information systems companies, represent a growing and long-term potential market for our microturbine products.

With opportunities created by deregulation in the electric utility industry and increased reliance on sensitive digital electronics in day-to-day life, industrialized societies are increasingly demanding high quality, highly reliable power. End customers with greater freedom of choice are investigating alternative power sources to protect their business operations and equipment from costly interruptions. Customers who are charged peak rates by utilities can use microturbines to “peak shave” or self-generate electricity to manage their electric consumption to avoid costly “peak demand” charges.

Utilities also can take advantage of Capstone MicroTurbines to avoid costly transmission and distribution system expansion or upgrades in uncertain growth or “weak” areas in the electric utility grid. These companies can place our microturbines where the electrical power is needed. The microturbines can supply power in conjunction with the power provided by the utility’s standard generation and transmission equipment. In the alternative, the utility can use the microturbines to provide power during times when demand for power is at its highest, potentially reducing the need for expensive expansions to the central power plant. Rural electric cooperatives and electric utilities may use our microturbines as a stand-alone system to provide temporary or back-up power for specific applications or to provide primary power for remote needs.

Remote Power

The ability of our microturbines to use a location’s fuel of choice, including for example kerosene, diesel or propane, allows customers to use their available fuel source infrastructure more efficiently. We also have designed our microturbines to be a competitive primary power source alternative compared to diesel generators and other technologies that currently provide power to remote areas or areas with unreliable central generation. This is due to our microturbines’ “load following” characteristic, which means that our microturbines are able to match power output to the served facility’s need for power. Remote commercial and industrial applications, including oil and gas, can also benefit from use of our microturbines. The less frequent scheduled maintenance intervals mean fewer trips are required to provide routine maintenance to remotely located units, and the remote management and monitoring functions provide greater ease of interface with the units.

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MicroTurbine Benefits

Multi-Fuel Capability

The Capstone MicroTurbine design provides flexibility for use with a variety of possible fuels, including both gaseous and liquid fuels. This multi-fuel capability increases the number of applications and geographic locations in which our microturbines may be used. The Model C30 is currently capable of being configured for low pressure natural gas, high pressure natural gas, low BTU gas such as methane, high sulfur content (sour) gas, gaseous propane and compressed natural gas, as well as liquid fuels such as diesel and kerosene. Our Model C60 currently uses natural gas.

Cost Competitive

We believe our microturbines have the potential to be cost competitive in our target markets. In the exploration and production markets, environmental penalties incurred for flaring or venting gas can be avoided by using our microturbines. Our microturbines can burn wellhead gas directly off the casing head, avoiding any intermediary sulfur scrubbing devices, while competing devices require extra maintenance and additional intermediary devices. In the landfill gas digestion market, the microturbine can burn low BTU and sour gas while requiring minimal routine maintenance relative to competing technologies such as reciprocating engines. The ability of the microturbine to operate on a stand-alone basis allows for less capital expenditures compared to the electric utility grid, which requires up-front capital expenditures for additional distribution and transmission lines. In combined heat and power applications, the microturbine's efficiency is 70% or more making for enhanced economic results.

Because the applications for our microturbines are broad and the number of features, which can influence capital cost, is also large, estimates of energy generation costs per kilowatt-hour vary substantially depending on the solution. Other applications including standby and peak shaving depend greatly on the specific set of circumstances for each potential end-user.

Environmentally Friendly

In stationary power generation configurations, our digital power controlled combustion system produces less than nine parts per million per volume of emissions of NOx and unburned hydrocarbons at full power when burning natural gas or propane, and less than 35 parts per million per volume of emissions of NOx when using diesel fuel. We believe that these emissions levels are among the lowest emissions of any fossil fuel combustor without catalytic combustion or other emissions reduction equipment, which results in a high quality exhaust. Because of our patented air-bearing technology, our microturbines require no petroleum-based lubricants, and avoid potential ground contamination caused by petroleum-based lubricants used by conventional reciprocating engines, turbines and other microturbines. Because our system is air cooled, we avoid the use of toxic liquid coolants, such as glycol.

Availability and Reliability

Our microturbines can provide both high availability and reliability when compared to other power generation alternatives. We designed the microturbine for a minimum target availability of 98%. Certain of our microturbines have achieved this availability target when using high-pressure natural gas, and we are working to achieve this availability target across all of our units and for other fuel sources.

Minimal Scheduled Maintenance

Our patented air-bearing system, solid state electronic controls and air-cooled design reduce the scheduled maintenance cost of our microturbines as compared to alternative products. The air bearings eliminate the need for lubrication, avoiding the need to change oil and individually lubricate ball bearings or other similar devices. Our product's ability to continuously and remotely monitor our microturbine performance avoids regularly scheduled diagnostic maintenance costs. The air-cooled design eliminates all of the maintenance related to liquid cooling systems utilized with conventional power electronics technology and generator cooling. Currently, the scheduled maintenance interval for both the Model C30 and C60 is periodic cleaning or changing of the intake air filter, fuel filters and other consumable items every 8,000 hours of operation, with maintenance intervals dependent upon operation, environment, duty cycle and other operational variables.

Remote Monitoring and Operating

Our electronic controls allow users to efficiently monitor our microturbines' performance, fuel input, power generation and time of operation in the field from off-site locations. In addition, the operator can remotely turn the microturbine on and off, control the fuel flow and vary the power output.

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Flexible Configuration

Our microturbines can be customized to serve a wide variety of operating requirements. They can be connected to the electric utility grid or operate on a stand-alone or dual mode basis. They can use a variety of fuel sources and can be readily integrated into combined heating and power applications. The microturbine can be sold either as a ready-to-use unit or in component and subassembly form for repackaging to the ultimate end-user. The microturbine can be operated as a single unit or several units can be installed together and operated in parallel.

Scalable Power System

Our microturbines are designed to allow multiple units to run together to meet each customer's specific needs. This feature enables users to meet more precisely their growing demand requirements and thereby manage their capital costs more efficiently.

Relative Ease of Transportation and Minimal Site Requirements

Our microturbines are easy to transport and relocate. Their small size allows great flexibility in siting. Our stationary systems in enclosures are approximately six feet tall and weigh between 900 and 3,000 pounds, depending upon model and optional equipment. Our microturbines require a fuel source connection, a connection for the power generated, and proper venting or utilization of exhaust. Larger multipack microturbine configurations may require concrete pads to support the additional weight, but the connections are similar.

Protection Relay Functionality

Our microturbines have protective relay functions built into them such that in grid-connect or dual mode, the microturbine will not send power out over the electric utility grid if the utility is not supplying voltage over its grid. This protection relay functionality minimizes the potential damage to the local electric grid, which is one of the electric utilities' major concerns regarding the interconnection of distributed generation technologies.

Sales, Marketing and Distribution

We sell microturbines in the worldwide stationary markets. We anticipate that our microturbines will be used in a variety of stationary power applications requiring less than two megawatts and more immediately in those requiring less than 300 kilowatts.

We sell our products through distributors and dealers and, in some areas of the United States, we sell directly. Our parts are sold to distributors, ASCs and to end users. Our typical terms of sale include shipments of the products with title, care, custody and control transferring at our dock, payment due anywhere from in advance of shipment to 60-days from shipment and warranty periods of approximately 15 to 18 months from shipment. We have not had customer acceptance provisions in our agreements.

Sales by Geographical Location

The Americas

We have distribution agreements with a number of companies throughout the Americas for the resale of our products. Many of these distributors serve multiple markets in their select geographic regions. The primary markets served in this region have been CHP and resource recovery.

In addition to our distributors, we are initiating actions to expand our presence in our targeted markets by utilizing dealers, manufacturer's representatives and packagers as well as direct sales in selected markets in North America. Manufacturer's representatives act as sales agents and earn commissions.

In developing our direct sales opportunities we have identified the need to address various requirements present in our target localities. These requirements include electric grid interconnection standards, gas utility connection requirements, building and fire safety codes and various inspections and approvals. The costs and schedule ramifications of these various approvals can be significant to the completion of an installation. Our goal is to work with the applicable regulating entities to establish standards for the installation of our microturbines so that the costs and schedule impacts of compliance are minimized. To date, we have received pre-approval by the New York State Public Services Commission for installation and interconnection to the electric utilities in New York. Our microturbines are the only distributed generation products to have such a pre-approval. We believe that we can create market advantages for our products through enhancing the ease of deploying our distributed generation solutions.

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Asia

Our sales and marketing strategy in Asia has been to develop several distributor relationships in Japan and subsequently enter other selected markets along the Pacific Rim.

Our primary market focus in Japan is CHP applications. Within Japan, there is great demand for economic energy solutions that will lower both the existing high cost of electricity and meet the greenhouse gas emissions guidelines of the Kyoto accords. Our Japanese distributors recognize the quickest and most practical way to accomplish this is through CHP applications, which raise efficiencies from approximately 30% for pure electrical generation to approximately 70% or more. Our Japanese distributors mainly act as packagers. They seek to design applications using our microturbines and/or subassemblies and components for their particular target CHP market, as well as the “free fuel” biogas market. The Japanese market tends to prefer systems that burn liquid fuels because of the lower costs and greater availability of the fuel.

Other areas in Asia offer attractive opportunities as well. South Korea, China and Australia are areas where resource recovery applications and CHP and CCHP solutions are expected to experience market growth.

In order to meet the service needs in Japan, we established a parts warehouse and a customer support office in Tokyo.

Europe, Africa and the Middle East

To address the European market, we are strengthening our relationship with existing distributors and supporting them, expanding our distribution base by placing direct sales and service resources in the region. We have located a sales manager in Italy to work with our distributors in Europe on a daily basis to realize growth opportunities. Our plans also call for establishing a spare parts distribution center in Europe to make parts readily available to our distributors. In the past, we have had limited direct presence in Europe, Africa and the Middle East and few sales and service channels. However, resource recovery applications have been growing in Europe based on attractive incentives established in several countries. Further, Europe has a history of extensive use of distributed generation technologies.

Revenues

For geographic and segment revenue information, please see “Notes to Consolidated Financial Statements – Segment Reporting.”

Customers

Sales to United Technologies Corporation (“UTC”) accounted for 15% of the Company’s net revenues for the year ended March 31, 2005. No customer accounted for 10% or more of the Company’s net revenues for the year ended March 31, 2004. Two customers accounted for 12% and 10% of the Company’s net revenues for the year ended December 31, 2002. To date, we have sold to a relatively few number of customers and have limited repeat business.

Competition

The market for our products is highly competitive and is changing rapidly. Our microturbines compete with existing technologies such as reciprocating engines and may also compete with emerging distributed generation technologies, including solar power, wind powered systems, fuel cells and other microturbines. Many companies who could be our customers today rely on the utility grid for their electrical power. As many of our distributed generation competitors are well-established companies, they derive advantages from production economies of scale, worldwide presence and greater resources, which they can devote to product development or promotion.

Generally, power purchased from the electric utility grid is less costly than power produced by distributed generation technologies, such as fuel cells or microturbines. Utilities may also charge fees to interconnect to their power grids. However, we can provide economic benefits to end users in instances where the costs of connecting to the grid from locations are high, where reliability and power quality are of critical importance, or in situations where peak shaving could be economically advantageous because of highly variable electricity prices. Because the Capstone MicroTurbine can provide a reliable source of power and can operate on multiple fuel sources, we believe it offers a level of flexibility not currently offered by other current technologies such as reciprocating engines.

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Our competitors that produce reciprocating engines have products and markets that are well developed and technologies that have been proven for some time. A reciprocating engine is similar in design to an internal combustion engine used in automobiles. Reciprocating engines are popular for back-up power applications but are not typically intended for primary power use because of high levels of emissions, noise and maintenance. These technologies which typically have a lower up-front cost than microturbines are currently produced by, among others, Caterpillar, Cummins, Waukesha, Jenbacher, Yanmar and Kohler.

Our microturbines may also compete with other distributed generation technologies, including solar power and wind-powered systems. Solar powered and wind powered systems produce no emissions. The main drawbacks to solar powered and wind powered systems are their dependence on weather conditions and high capital costs.

Although the market for fuel cells is still developing, a number of companies are focused on the residential and vehicle fuel cell markets, including Plug Power, Avista Labs and Ballard Power Systems. Fuel cells have lower levels of NO_x atmospheric emissions than our microturbines. We believe that none of these fuel cell technologies will compete directly with our microturbines in the short-term. However, over the medium-to-long term, fuel cell technologies that compete directly with our products may be introduced.

We also compete with several companies who have microturbine products, many of which have significantly greater resources and market presence than us, including Ingersoll-Rand, Elliott Energy Systems, Bowman Power, Toyota and Turbec.

Overall, we compete with end users' other options for electrical power and heat generation on the basis of the ability of our microturbines to provide power when utility grid power is not available or goes out of service, total cost of ownership, power quality, the ability to run certain of our microturbines on multiple fuel types and ease of maintenance.

Governmental and Regulatory Impact

Our market can be positively or negatively impacted by the effects of governmental and regulatory matters. We are affected not only by energy policy, laws, regulations and incentives of governments in the areas into which we sell, but also by rules, regulations and costs imposed by utilities. Utility companies or governmental entities could place barriers on the installation of our product or the interconnection of the product with the electric grid. Further, they may charge additional fees to customers who install on-site power generation, thereby reducing the electricity they take from the utility, or for having the capacity to use power from the grid for back-up or standby purposes. These types of restrictions, fees or charges could hamper the ability to install or effectively use our product or increase the cost to our potential customers for using our systems. This could make our systems less desirable, thereby adversely affecting our revenue and profitability potential. In addition, utility rate reductions can make our products less competitive which would have a material adverse effect on our operations. These costs, incentives and rules are not always the same as those faced by technologies with which we compete. However, rules, regulations, laws and incentives could also provide an advantage to our distributed generation solutions as compared with competing technologies if we are able to achieve required compliance in a lower cost, more efficient manner.

Government funding can impact the rate of development of new technologies. While we have, and continue to receive some development funding, committed amounts remaining are relatively low. See "Research and Development." Competing new technologies generally receive larger incentives and development funding than do microturbines.

Sourcing and Manufacturing

Our microturbines are designed to achieve high volume, low-cost production objectives. Our manufacturing designs include the use of conventional technology which has been proven in high volume automotive and turbocharger production for many years. The microturbines are designed for simple assembly and testing and to facilitate automated production techniques using less-skilled labor.

Our strategy of out-sourcing the manufacturing and assembly of our nonproprietary product components allows for more attractive pricing, quick ramp-up and the use of just-in-time inventory management techniques. While the current variability in our demand volumes and resulting imprecise demand forecasting affect our ability to leverage these capabilities, we believe that we can realize economies of scale related to our product manufacturing costs as unit volume increases. We manufacture the air-bearings and certain combustion system components at our facility in Chatsworth, California. We also assemble and test the units at that location. We manufacture recuperator cores at our facility in Van Nuys, California. We have primary and secondary sources for other critical components. As part of our strategic plan, we evaluated our core competencies and identified additional outsourcing opportunities which we are now actively pursuing.

Solar Turbines Incorporated, a wholly owned subsidiary of Caterpillar Inc., had been our sole supplier of recuperator cores prior to 2001. In 2000, we exercised an option to license Solar's technology, which allows us to manufacture cores ourselves. In June 2001, we

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started to manufacture recuperator cores. Recuperator cores using the Solar technology, which we make and sell, are subject to a per-unit royalty fee. As of March 31, 2005, royalties of \$23,000 were earned under the terms of the agreement.

Research and Development (“R&D”)

Our R&D activities enabled us to become one of the first companies to develop a commercially available microturbine that operates in parallel with the grid. We were the first company to successfully demonstrate a commercially available microturbine that operates on a stand-alone basis.

Our most recent significant R&D activity has been the C200 microturbine — a 200-kilowatt, higher efficiency product. We have worked with the U.S. Department of Energy (“DOE”) on the “Advanced Microturbine System” concept behind the C200 product and have received funding for some of the associated development efforts. To date, the C200 beta testing has demonstrated performance to design objectives without significant failure incidents. The commercial launch for this product will be determined following the results of that testing. Because of the timing for beta testing and commercialization, the C200 is not critical to generating sales or margins in our current strategic plan. Our R&D costs are disclosed in our Consolidated Statements of Operations.

As a result of our strategic planning efforts, we have developed a prioritized list of new and enhanced products to be developed and released over the next three years. These products will directly support our strategic plan by providing new solutions to customers in selected markets and by introducing new technologies that we believe will maintain Capstone’s leadership role in the industry.

R&D activities have historically also focused on development of related products and applications, including gas compressors that enhance the microturbines’ multi-fuel capability and integration with energy storage devices like battery packs for stand-alone applications. Current and future development activities will be in support of our focused target markets.

Protecting our Intellectual Property Rights and Patents

We rely on a combination of patent, trade secret, copyright and trademark law and nondisclosure agreements to establish and protect our intellectual property rights in our products. In this regard, we have obtained 86 U.S. and 26 international patents (in certain cases covering the same technology in multiple jurisdictions). The patents we have obtained will expire between 2014 and 2021.

We believe that a policy of protecting intellectual property is an important component of our strategy of being the leader in microturbine system technology and will provide us with a long-term competitive advantage. In addition, we implement tight security procedures at our plants and facilities and have confidentiality agreements with our suppliers, distributors, employees and visitors to our facilities.

Organization and Employees

We were organized in 1988. On June 22, 2000, we reincorporated as a Delaware corporation.

As of March 31, 2005, we employed 225 employees. No employees are covered by collective bargaining arrangements.

Business Risks

This document contains certain forward-looking statements (as such term is defined in Section 27A of the Securities Act of 1933, as amended (the “Securities Act”) and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) pertaining to, among other things, our future results of operations, R&D activities, sales expectations, our ability to develop markets for our products, sources for parts, federal, state and local regulations, and general business, industry and economic conditions applicable to us. These statements are based largely on our current expectations, estimates and forecasts and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. Factors that can cause actual results to differ materially include, but are not limited to, those discussed below. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The following factors should be considered in addition to the other information contained herein in evaluating Capstone and its business. We assume no obligation to update any of the forward-looking statements after the filing of this Form 10-K to conform such statements to actual results or to changes in our expectations except as required by law.

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Investors should carefully consider the risks described below before making an investment decision. In addition, these risks are not the only ones facing our Company. Additional risks of which we may not be aware or that we currently believe are immaterial may also impair our business operations or our stock price. Our business could be harmed by any of these risks. The trading price of our common stock has and could continue to vary as a result of any of these risks, and investors may lose all or part of their investment. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Annual Report on Form 10-K, or in our Quarterly Reports on Form 10-Q and other documents filed by us from time to time.

Our operating history is characterized by net losses. We anticipate further losses and we may never become profitable.

Since inception, we have incurred annual operating losses. We expect this trend to continue until such time that we can sell a sufficient number of units and achieve a cost structure to become profitable. Our business is such that we have relatively few customers and limited repeat business; therefore, we may not maintain or increase net revenues. We may not have adequate cash resources to reach the point of profitability, and we may never become profitable. Even if we do achieve profitability, we may be unable to increase our sales and sustain or increase our profitability in the future.

A sustainable market for microturbines may never develop or may take longer to develop than we anticipate, which would adversely affect our revenues and profitability.

Our products represent an emerging market, and we do not know whether our targeted customers will accept our technology or will purchase our products in sufficient quantities to allow our business to grow. If a sustainable market fails to develop or develops more slowly than we anticipate, we may be unable to recover the losses we have incurred to develop our products, we may have further impairment of assets, and we may be unable to meet our operational expenses. The development of a sustainable market for our systems may be hindered by many factors, including some that are out of our control. Examples include:

- consumer reluctance to try a new product;
- regulatory requirements;
- the cost competitiveness of our microturbines;
- costs associated with the installation and commissioning of our microturbines;
- maintenance and repair costs associated with our microturbines;
- the future costs and availability of fuels used by our microturbines;
- economic downturns and reduction in capital spending;
- consumer perceptions of our microturbines' safety and quality; and
- the emergence of newer, more competitive technologies and products.

We operate in a highly competitive market among competitors who have significantly greater resources than we have and we may not be able to compete effectively.

Capstone MicroTurbines compete with several technologies, including reciprocating engines, fuel cells and solar power. Competing technologies may receive certain benefits, like governmental subsidies or promotion, that we do not enjoy or do not benefit from to the same extent. This could enhance our competitors' abilities to fund research or penetrate markets.

Our competitors include several well-known companies with histories of providing power solutions. They have substantially greater resources than we have and have established worldwide presence. Because of greater resources, some of our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements, to devote greater resources to the promotion and sale of their products than we can or they may introduce governmental regulations and policies to create competitive advantage vis-à-vis our products. We believe that developing and maintaining a competitive advantage will require continued investment by us in product development and quality, as well as attention to product performance, our product prices, our conformance to industry standards, manufacturing capability and sales and marketing. In addition, current and potential competitors have established or may in the future establish collaborative relationships among themselves or with third parties, including third parties with whom we have business relationships. Accordingly, new competitors or alliances may emerge and rapidly acquire significant market share.

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Overall, the market for our products is highly competitive and is changing rapidly. We believe that the primary competitive factors affecting the market for our products, including some that are outside of our control, include:

- name recognition, historical performance and market power of our competitors;
- product quality and performance;
- operating efficiency;
- product price;
- availability and price of fuel;
- development of new products and features; and
- emissions levels.

There is no assurance that we will be able to successfully compete against either current or potential competitors or that competition will not have a material adverse effect on our business, operating results and financial condition.

If we do not effectively implement our sales, marketing and service plans, our sales will not grow and our profitability will suffer.

Our sales and marketing efforts may not achieve intended results and therefore may not generate the net revenues we anticipate. As a result of our strategic plan, we have decided to focus our resources on selected vertical markets. We may change our focus to other markets or applications in the future. There can be no assurance that our focus or our near term plans will be successful. If we are not able to successfully address markets for our products, we may not be able to grow our business, compete effectively or achieve profitability.

Also, as we expand in international markets, customers may have difficulty or be unable to integrate our products into their existing systems or may have difficulty complying with foreign regulatory and commercial requirements. As a result, our products may require redesign. Any redesign of the product may delay sales or cause quality issues. In addition, we may be subject to a variety of other risks associated with international business, including import/export restrictions, fluctuations in currency exchange rates and global political and economic instability.

As a result of our strategic planning process, we have begun offering direct sales and service in selected markets. We do not have extensive experience in providing direct sales and service and may not be successful in executing this strategy. In addition, we may lose existing distributors or service providers or we may have more difficulty attracting new distributors and service providers as a result of this strategy. Further we may incur new types of obligations, such as extended service obligations, that could result in costs that exceed the related revenues. We may encounter new transaction types through providing direct sales and service and these transactions may require changes to our historic business practices. For example, an arrangement with a third party leasing company may require us to provide a residual value guarantee, which is not consistent with our past operating practice.

We may not be able to retain or develop distributors in our targeted markets, in which case our sales would not increase as expected.

In order to serve certain of our targeted markets, we believe that we must ally ourselves with companies that have particular expertise in or more extensive access to those markets. We believe that retaining or developing strong distributors in these targeted markets can improve the rate of adoption as well as reduce the direct financial burden of introducing a new technology and creating a new market. Because of distributors' relationships in their respective markets, the loss of a distributor could adversely impact the ability to penetrate its target market. At the present time, we offer our distributors a stated discount from list price for the products they purchase. In the future, to attract and retain distributors, we may provide volume price discounts or otherwise incur significant costs that may reduce the potential profitability of these relationships. We may not be able to retain or develop appropriate distributors on a timely basis, and we cannot assure you that the distributors will focus adequate resources on selling our products or will be successful in selling them. In addition, some of the relationships may require that we grant exclusive distribution rights in defined territories. These exclusive distribution arrangements could result in our being unable to enter into other arrangements at a time when the distributor with whom we form a relationship is not successful in selling our products or has reduced its commitment to market our products. We cannot assure you that we will be able to negotiate collaborative relationships on favorable terms or at all. The inability of the Company to have appropriate distribution in our target markets may adversely affect our financial condition and results of operations.

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We may not be able to develop sufficiently trained applications engineering, installation and service support to serve our targeted markets.

Our ability to identify and develop business relationships with companies who can provide quality, cost-effective application engineering, installations and service can significantly affect our success. The application engineering and proper installation of our microturbines, as well as proper maintenance and service, are critical to the performance of the units. Additionally, we need to reduce the total installed cost of our microturbines to enhance market opportunities. Our inability to improve the quality of applications, installation and services while reducing associated costs could affect the marketability of our products.

Changes in our product components may require us to replace parts held at Distributors and Authorized Service Companies (“ASCs”).

We have entered into agreements with some of our Distributors and ASCs which require that if we render obsolete parts inventories they own and hold in support of their obligations to serve fielded microturbines, then we are required to replace the affected stock at no cost to the Distributors or ASCs. While we have never incurred costs or obligations for these types of replacements, it is possible that future changes in our product technology could result and yield costs that have a material effect on our results or operations or financial position.

We operate in a highly regulated business environment, and changes in regulation could impose costs on us or make our products less economical, thereby affecting demand for our microturbines.

Our products are subject to federal, state, local and foreign laws and regulations, governing, among other things, emissions to air and occupational health and safety. Regulatory agencies may impose special requirements for implementation and operation of our products (*e.g.*, connection with the electric grid) or may significantly affect or even eliminate some of our target markets. We may incur material costs or liabilities in complying with government regulations. In addition, potentially significant expenditures could be required in order to comply with evolving environmental and health and safety laws, regulations and requirements that may be adopted or imposed in the future. For example, our current products do not comply with the 2007 proposed emission standards of the California Air Resources Board. Furthermore, our potential utility customers must comply with numerous laws and regulations. The deregulation of the utility industry may also create challenges for our marketing efforts. For example, as part of electric utility deregulation, federal, state and local governmental authorities may impose transitional charges or exit fees, which would make it less economical for some potential customers to switch to our products. We can provide no assurances that we will be able to obtain these approvals and changes in a timely manner, or at all.

The market for electricity and generation products is heavily influenced by federal and state government regulations and policies. The deregulation and restructuring of the electric industry in the United States and elsewhere may aid the desirability of alternative power sources. However, problems associated with such deregulation and restructuring may cause rule changes that may reduce or eliminate advantages of such deregulation and restructuring. We cannot predict how the deregulation and the restructuring of the electric utility industry will ultimately affect the market for our microturbines. Changes in regulatory standards or policies could reduce the level of investment in the research and development of alternative power sources, including microturbines. Any reduction or termination of such programs can increase the cost to our potential customers, making our systems less desirable, and thereby adversely affect our revenue and potential profitability.

Utility companies or governmental entities could place barriers to our entry into the marketplace and we may not be able to effectively sell our product.

Utility companies or governmental entities could place barriers on the installation of our product or the interconnection of the product with the electric grid. Further, they may charge additional fees to customers who install on-site generation, thereby reducing the electricity they take from the utility, or for having the capacity to use power from the grid for back-up or standby purposes. These types of restrictions, fees or charges could hamper the ability to install or effectively use our product or increase the cost to our potential customers for using our systems. This could make our systems less desirable, thereby adversely affecting our revenue and profitability potential. In addition, utility rate reductions can make our products less competitive which would have a material adverse effect on our operations.

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Product quality expectations may not be met causing slower market acceptance or warranty cost exposure.

As we continue to improve the quality and lower the total costs of ownership of our products, we may require engineering changes. Such improvement initiatives may render existing inventories obsolete or excessive. Despite our continuous quality improvement initiatives, we may not meet customer expectations. Any significant quality issues with our products could have a material adverse effect on our rate of product adoption, results of operations and financial position. Moreover, as we develop new configurations for our microturbines or as our customers place existing configurations in commercial use, our products may perform below expectations. Any significant performance below expectations could adversely affect our operating results and financial position and affect the marketability of our products.

We sell our products with warranties. While management believes that the provision for estimated product warranty expenses is reasonable, there can be no assurance that the provision will be sufficient to cover our warranty expenses in the future. Although we attempt to reduce our risk of warranty claims through warranty disclaimers, we cannot ensure that our efforts will effectively limit our liability. Any significant incurrence of warranty expense in excess of estimates could have a material adverse effect on our operating results and financial position. Further, we have at times undertaken programs to enhance the performance of units previously sold. These enhancements have at times been provided at no cost or below our cost. While we believe we have no obligations to offer such programs, we may choose to do so again in the future and such actions could result in significant costs.

We depend upon the development of new products and enhancements of existing products.

Our operating results may depend on our ability to develop and introduce new products, or enhance existing products and to reduce the costs to produce our products. The success of our products is dependent on several factors, including proper product definition, product cost, timely completion and introduction of the products, differentiation of products from those of our competitors, meeting changing customer requirements, emerging industry standards and market acceptance of these products. The development of new, technologically advanced products and enhancements is a complex and uncertain process requiring high levels of innovation, as well as the accurate anticipation of technological and market trends. There can be no assurance that we will successfully identify new product opportunities, develop and bring new or enhanced products to market in a timely manner, successfully lower costs and achieve market acceptance of our products, or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive.

Operational restructuring may result in asset impairment or other unanticipated charges.

As a result of our strategic plan, we have identified opportunities to outsource to third party suppliers certain functions which we currently perform. We believe outsourcing can reduce product costs, improve product quality or increase operating efficiency. These actions may not yield the expected results. Transitioning to outsourcing may cause certain affected employees to leave the company before the outsourcing is complete. This could result in a lack of the experienced in-house talent necessary to successfully implement the outsourcing. Further, depending on the nature of operations outsourced and the structure of agreements we reach with suppliers to perform these functions, we may experience impairment in the value of manufacturing assets related to the outsourced functions or other unanticipated charges, which could have a material adverse effect on our operating results.

We may not achieve production cost reductions necessary to competitively price our product, which would impair our sales.

We believe that we will need to reduce the unit production cost of our products over time to maintain our ability to offer competitively priced products. Our ability to achieve cost reductions will depend on our ability to develop low cost design enhancements, to obtain necessary tooling and favorable supplier contracts and to increase sales volumes so we can achieve economies of scale. We cannot assure you that we will be able to achieve any such production cost reductions. Our failure to achieve such cost reductions could have a material adverse effect on our business and results of operations.

Commodity market factors impact our costs and availability of materials.

Our products contain a number of commodity materials, from metals to computer components. The availability of these commodities could impact our ability to acquire the materials necessary to meet our requirements. The pricing could impact the costs to manufacture our product. Either of these factors could have a material adverse effect on our operating results.

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Our suppliers may not supply us with a sufficient amount of components or components of adequate quality, and we may not be able to produce our product.

Although we generally attempt to use standard parts and components for our products, some of our components are currently available only from a single source or limited sources. We may experience delays in production if we fail to identify alternative suppliers, or if any parts supply is interrupted, each of which could materially adversely affect our business and operations. In order to reduce manufacturing lead times and ensure adequate component supply, we enter into agreements with certain suppliers that allow them to procure inventory based upon criteria defined by us. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete inventories, which could adversely affect our business. Our inability to meet volume commitments with suppliers could affect the availability or pricing of our parts and components. A reduction or interruption in supply, a significant increase in price of one or more components or a decrease in demand of products could materially adversely affect our business and operations and could materially damage our customer relationships. Financial problems of suppliers on whom we rely could limit our supply or increase our costs. Also, we cannot guarantee that any of the parts or components that we purchase will be of adequate quality or that the prices we pay for the parts or components will not increase. Inadequate quality of products from suppliers could interrupt our ability to supply quality products to our customers in a timely manner. Additionally, defects in materials or products supplied by our suppliers that are not identified before our products are placed in service by our customers could result in higher warranty costs and damage to our reputation.

Our products involve a lengthy sales cycle and we may not anticipate sales levels appropriately, which could impair our potential profitability.

The sale of our products typically involves a significant commitment of capital by customers, with the attendant delays frequently associated with large capital expenditures. For these and other reasons, the sales cycle associated with our products is typically lengthy and subject to a number of significant risks over which we have little or no control. We expect to plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. If sales in any period fall significantly below anticipated levels, our financial condition and results of operations could suffer. If demand in any period increases well above anticipated levels, we may have difficulties in responding, incur greater costs to respond, or be unable to fulfill the demand in sufficient time to retain the order, which would negatively impact our operations. In addition, our operating expenses are based on anticipated sales levels, and a high percentage of our expenses are generally fixed in the short term. As a result of these factors, a small fluctuation in timing of sales can cause operating results to vary from period to period.

Potential intellectual property, shareholder or other litigation may adversely impact our business.

Because of the nature of our business, we may face litigation relating to intellectual property matters, labor matters, product liability, or other matters. An adverse judgment could negatively impact our financial position and results of operations, the price of our common stock and our ability to obtain future financing on favorable terms or at all. Any litigation could be costly, divert management attention or result in increased costs of doing business.

We may be unable to fund our future operating requirements, which could force us to curtail our operations.

While we do not currently foresee a need, at some time we may need additional financing to fund our operations. Our future capital requirements will depend on many factors, including our ability to successfully market and sell our products. To the extent that the funds we now have on hand are insufficient to fund our future operating requirements, we would need to raise additional funds, through further public or private equity or debt financings. These financings may not be available or, if available, may be on terms that are not favorable to us and could result in dilution to our stockholders. Downturns in worldwide capital markets could also impede our ability to raise additional capital on favorable terms or at all. If adequate capital were not available to us, we would likely be required to significantly curtail or possibly even cease our operations.

We may not be able to effectively manage our growth, expand our production capabilities or improve our operational, financial and management information systems, which would impair our sales and profitability.

If we are successful in executing our business plan, we will experience growth in our business that could place a significant strain on our business operations, management and other resources. Our ability to manage our growth will require us to expand our production capabilities, continue to improve our operational, financial and management information systems, and to motivate and effectively manage our employees. We cannot assure you that our management will be able to manage this growth effectively.

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Our success depends in significant part upon the continuing service of management and key employees.

Our success depends in significant part upon the continuing service of our executive officers, senior management and sales and technical personnel. The failure of our personnel to execute our strategy, or our failure to retain management and personnel, could have a material adverse effect on our business. Our success will be dependent on our continued ability to attract, retain and motivate highly skilled employees. There can be no assurance that we can do so.

Our internal control systems rely on people trained in the execution of the controls. Loss of these people or our inability to replace them with similarly skilled and trained individuals or new processes in a timely manner could adversely impact our internal control mechanisms.

We cannot be certain of the future effectiveness of our internal controls over financial reporting or the impact thereof on our operations or the market price of our common stock.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to include in our Annual Report on Form 10-K our assessment of the effectiveness of our internal controls over financial reporting. Furthermore, our independent registered public accounting firm is required to audit our assessment of the effectiveness of our internal controls over financial reporting and separately report on whether it believes we maintain, in all material respects, effective internal controls over financial reporting. We identified three material weaknesses in our system of internal controls. The first related to setting up the calculation of depreciation and leasehold amortization in our accounting software when we changed from a calendar to a fiscal reporting year in the first calendar quarter of 2004. The second related to accounts payable and accruals, primarily for legal bills. The third related to the compilation and manual input of inventory count tags and the supervisory review of this process. We believe that we have adequately addressed these deficiencies following fiscal 2005 year-end and since then have adequate internal controls procedures in place. We cannot be certain that future changes will maintain the effectiveness of the overall system of internal controls. If we cannot adequately maintain the effectiveness of our internal controls over financial reporting, the accuracy of some component of our financial reporting could be at risk. If reporting errors actually occurred, we might be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. These results could adversely affect our financial results or the market price of our common stock.

Our business is especially subject to the risk of earthquake.

Our Company and our manufacturing facilities are located in Southern California, a region known for seismic activity. A significant natural disaster, such as an earthquake, could have a material adverse impact on our business, operating results and financial condition.

We face potentially significant fluctuations in operating results, and the market price of our common stock is highly volatile and may change regardless of our operating performance.

As a result of variety of factors discussed herein, operating results for a particular quarter are difficult to predict. Given the continued uncertainty surrounding many variables that may affect the industry in which we operate, our visibility into future periods is limited. This variability could affect our operating results and thereby adversely affect our stock price.

The market price of our common stock is highly volatile. Many factors of this volatility are beyond our control. These factors may cause the market price of our common stock to change, regardless of our operating performance. Factors that could cause fluctuation in our stock price may include, among other things:

- actual or anticipated variations in quarterly operating results;
- market sentiment toward alternate energy stocks in general or toward Capstone;
- changes in financial estimates or recommendations by securities analysts;
- conditions or trends in our industry or the overall economy;
- changes in the market valuations of other technology companies;
- the trading of options on our common stock;

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- announcements by us or our competitors of significant acquisitions, strategic partnerships, divestitures, joint ventures or other strategic initiatives;
- announcements of significant market events, such as power outages, regulatory changes or technology changes;
- capital commitments;
- additions or departures of key personnel;
- sales or purchases of the company's stock; and
- the failure of our common stock to continue to meet Nasdaq listing requirements.

Item 2. *Properties.*

Our principal corporate offices, administrative, sales and marketing, R&D and support facilities consist of approximately 98,000 square feet of office space, warehouse space and assembly and test space at 21211 Nordhoff Street in Chatsworth, California. Our lease for those premises expires in May 2010. We also lease an approximately 79,000 square foot facility at 16640 Stagg Street in nearby Van Nuys, California as an engineering test and manufacturing facility for our recuperator cores. This lease will expire in May 2010. We also lease space for sales and/or service offices. These leased facilities are not significant properties to us. We believe our facilities are adequate for our current needs.

Item 3. *Legal Proceedings.*

In December 2001, a purported shareholder class action lawsuit was filed against the Company, two of its then officers, and the underwriters of the Company's initial public offering. The suit purports to be a class action filed on behalf of purchasers of the Company's common stock during the period from June 28, 2000 to December 6, 2000. An amended complaint was filed on April 19, 2002. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company's June 28, 2000 initial public offering and November 16, 2000 secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. Plaintiffs allege that the prospectuses for these two public offerings were false and misleading in violation of the securities laws because they did not disclose these arrangements. A committee of the Company's Board of Directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the Amended Complaint. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers. The proposed settlement is pending final approval by parties to the action and the United States District Court Southern District of New York.

A demand for arbitration has been filed by a party in March 2004 that conducts business with the Company, claiming damages for breach of contract in excess of \$10 million. The arbitration is currently scheduled for January 2006. The Company intends to vigorously defend against this action. As with any such action, the ultimate outcome is uncertain.

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

We did not submit any matters to a vote of our stockholders during the fourth quarter of fiscal 2005.

PART II**Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***Price Range of Common Stock*

Our common stock is publicly traded on the Nasdaq National Market under the symbol "CPST". The following table sets forth the low and high sales prices for each period indicated.

	<u>High</u>	<u>Low</u>
Three Months Ended March 31, 2003	\$ 1.20	\$ 0.71
Year Ended March 31, 2004:		
First Quarter	\$ 1.60	\$ 0.72
Second Quarter	\$ 2.57	\$ 1.01
Third Quarter	\$ 2.21	\$ 1.40
Fourth Quarter	\$ 3.23	\$ 1.78
Year Ended March 31, 2005:		
First Quarter	\$ 3.52	\$ 1.34
Second Quarter	\$ 2.25	\$ 1.42
Third Quarter	\$ 2.10	\$ 1.49
Fourth Quarter	\$ 1.90	\$ 1.49

As of June 22, 2005, the last reported sale price of our common stock on the Nasdaq National Market was \$1.35 per share. As of June 22, 2005 there were 1,015 stockholders of record of our common stock. This does not include the number of persons whose stock is held in nominee or "street name" accounts through brokers.

Dividend Policy

We currently intend to retain any earnings for use in our business and, therefore, we do not anticipate paying any cash dividends in the foreseeable future. We have never declared or paid any cash dividends on our capital stock. In the future, the decision to pay any cash dividends will depend upon our results of operations, financial condition and capital expenditure plans, as well as such other factors as our Board of Directors, in its sole discretion, may consider relevant.

Recent Sales of Unregistered Securities

On October 28, 2002, we sold 3,994,817 shares of common stock for an aggregate price of approximately \$4.0 million to United Technologies Corporation ("UTC") in connection with a strategic alliance entered into with UTC. No underwriters were involved and, as such, no underwriting commissions or discounts were paid. This transaction was exempt from registration under the Securities Act pursuant to Rule 506 of Regulation D based, in part, on UTC's investment representations to the Company.

Item 6. Selected Financial Data.

The selected financial data shown below have been derived from the audited financial statements of Capstone. The historical results are not necessarily indicative of the operating results to be expected in the future. The selected financial data should be read in conjunction with "Business Risks", "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes included elsewhere in this Form 10-K.

On December 12, 2003, the Company changed its fiscal year end from December 31 to March 31. As such, selected financial data appears below for the Company's three months transition period of January 1, 2003 to March 31, 2003. The period from April 1, 2003 to March 31, 2004 is referred to herein as fiscal 2004 and thereafter, the fiscal year designation refers to the twelve-month period ending in March of the stated fiscal year.

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Amounts in thousands, except per share data.

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Years Ended December 31,		
				2002	2001	2000
Statement of Operations:						
Total revenues	\$ 16,968	\$ 12,607	\$ 2,782	\$ 19,529	\$ 35,956	\$ 23,163
Cost of goods sold	23,908	29,385	4,956	41,530	39,602	27,815
Gross loss	(6,940)	(16,778)	(2,174)	(22,001)	(3,646)	(4,652)
Operating costs and expenses:						
Research and development	11,761	11,221	1,006	6,966	10,658	11,319
Selling, general and administrative	22,419	20,840	4,821	31,846	40,780	24,067
Impairment loss on marketing rights	—	—	—	15,999	—	—
Loss from operations	(41,120)	(48,839)	(8,001)	(76,812)	(55,084)	(40,038)
Net loss	\$ (39,449)	\$ (47,739)	\$ (7,635)	\$(74,355)	\$(46,859)	\$(31,424)
Net loss per share of common stock						
— basic and diluted	\$ (0.47)	\$ (0.58)	\$ (0.09)	\$ (0.95)	\$ (0.61)	\$ (12.82)

Refer to Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for a description of significant charges in calendar year 2002 that affect the comparability of the reported results.

	As of March 31,			As of December 31,		
	2005	2004	2003	2002	2001	2000
Balance Sheet Data:						
Cash and cash equivalents	\$63,593	\$102,380	\$132,584	\$140,310	\$170,868	\$236,947
Working capital	61,562	95,602	135,590	139,948	189,162	238,128
Total assets	95,190	136,545	176,801	187,191	254,254	302,018
Capital lease/note payable obligations	83	595	2,009	2,496	3,833	5,496
Long-term liabilities	1,002	1,149	1,277	1,325	1,158	342
Stockholders’ equity	76,678	115,443	160,568	168,182	237,454	279,382
Total liabilities and stockholders’ equity	\$95,190	\$136,545	\$176,801	\$187,191	\$254,254	\$302,018

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with the financial statements and related notes included in Item 8 of this Form 10-K. When used in this Annual Report on Form 10-K, and in the following discussion, the words “believes”, “anticipates”, “intends”, “expects” and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. These risks include those identified under “Business Risks” in Item 1 of this Form 10-K. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof.

Executive Overview

Capstone is, and has been, the market leader in microturbines based on the number of microturbines sold. However, the adoption rate for our products has been slower than originally anticipated. We believe that the following key factors contributed to this result: inadequate technology robustness and solution-specific engineering, installation, commissioning and service work; market approach; new technology adoption barriers; Capstone’s R&D culture and constrained capital spending due to the general economic conditions. The performance of our early-generation microturbines was inconsistent. While some units performed as expected, others did not. These performance inconsistencies have been identified as coming from the product itself and from inappropriate application and inadequate installation and service work. Contributing to these challenges, our historical market approach was to emphasize sales volume primarily rather than sales with higher contribution margins. This historical focus on volume introduced high variability in the configurations sold, types of applications, system installations and customer requirements. In addition, new technologies traditionally encounter adoption barriers. An important means to overcome adoption barriers is to fully meet customers’ needs and develop groups of customers who provide good references for potential new customers in their specific markets. Capstone’s widespread approach to marketing did not provide for depth of referencing in any given market. While these types of challenges are not unusual for new companies, we believe Capstone’s historically R&D-focused business structure and culture prohibited us from adequately addressing necessary changes. Capstone is undergoing a period of transition.

Creating the New Capstone

Fiscal 2004 marked a year of transition for us. During the second and third quarters of fiscal 2004, we completely overhauled our leadership team and strengthened the entire organization. We heightened our focus on customers, learning from them what we needed to do to improve our delivery of products and services. As a result, we evaluated key aspects of our business and implemented changes to address short-term needs. We also put in place a new strategic plan, which addressed fiscal 2005, 2006 and 2007. In fiscal 2005, we continued implementing the necessary changes to transition from an R&D-focused company and culture to a business that is focused on customers and operational excellence. As with any R&D-focused company, engineering generally dominates the business process. We changed our focus to be driven by market and customer requirements. With this new direction, engineering projects are approved based on market requirements and decisions to move forward on projects are tied to our financial goals. Our focus is on products and solutions that provide near-term opportunities to drive repeatable business rather than discrete projects for niche markets. In order to increase volume and reduce cost, we are focusing our efforts in vertical markets that we expect to generate repeat business for the Company. To support our opportunities to grow in these target markets, we enhanced the reliability of our products' performance through a multi-faceted approach. We developed new processes and enhanced training to assist those who apply, install and use our products, and we improved the products themselves. We believe these changes are critical to our efforts to become cash flow positive by fiscal year 2007. Fiscal 2005 was a year of change within the Company as we improved internal processes, rationalized manufacturing and engineering and restructured sales and service to improve customer satisfaction.

At the end of fiscal 2005, we revisited our strategic plan. With the first year of the initial plan behind us, we reassessed our view of fiscal years 2006 and 2007 and added on our expectations for fiscal year 2008. While some aspects of the initial plan were modified, the overall direction, targets and key initiatives remained in tact. An overview of our strategic plan progress and its current status follows:

- 1) *Focus on vertical markets* – Within the distributed generation markets that we serve, we are focusing on vertical markets that we identified as having the greatest near-term potential. The markets we are focusing on: CHP, CCHP, resource recovery, power reliability and remote power, are consistent with those identified a year ago. Within each of these select markets, we have identified specific targeted vertical market segments. Our specific targets have been modified based on the results of our market development efforts in fiscal 2005. We are continuing to address the critical factors to penetrating these markets and have built our plans around these actions.
- 2) *Sales and Distribution Channel* – A year ago, we identified the need to hone our channels of distribution. While some distributors and representatives had business capabilities to support our growth plans in our targeted markets, others did not. Additionally, we identified the need to add new distributors and representatives who were experienced in our target markets. We made significant progress in tailoring our distribution channels to our needs in fiscal 2005. In the Americas, we went from 48 distributors to 9 distributors and 3 dealers. Internationally, we added distribution in a number of countries where we were previously under-represented. In fiscal 2006, we intend to continue to refine the distribution channels to address our specific targeted markets.
- 3) *Geographies* – The Americas have been, and will continue to be, our largest market. Within the United States, our focus will be on California and the Northeast. In fiscal 2005, we opened a sales and service office in New York. We intend to use this presence to expand our penetration in the Northeastern market. Based on our belief that Europe will offer significant opportunities, we opened a European headquarters office in Milan, Italy in fiscal 2005. Since establishing that office, we have seen an improvement in our sales in Europe. In fiscal 2006, we expect to continue to develop our distribution base and market presence in Europe. In Japan, we are focused on developing niche opportunities we believe offer the potential for relatively significant sales volumes over the next three years.
- 4) *Service* – During fiscal 2005, we entered the direct service business. Previously, the service strategy was to serve all customers through our distributors and ASCs. Distributors were expected to sell the products, provide engineering solutions, and perform as ASCs by providing installation, commissioning and service. Several of our distributors did not provide the level of service desired and a number of end users requested to work directly with us. As a result, we are pursuing a strategy to serve customers directly, as well as through qualified distributors and ASCs, all of whom will perform their service work using technicians specifically trained by Capstone. In fiscal 2005, we put the resources in place to initiate our direct service offering in North America. While we had less than \$0.5 million of service revenues in fiscal 2005, we expect to leverage the investments we have made by entering into a larger number of service agreements in fiscal

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2006. To support our distributors throughout the world, we added field service engineers in the U.S., Europe and Japan. We also intend to establish a spare parts distribution center in strategic locations to ensure timely delivery of parts.

- 5) *Product Robustness and Life Cycle Maintenance Costs* – Customers expect high performance and competitive total cost of ownership. To address those needs, we must continually ensure a high level of performance. Performance is affected not only by the microturbine, but also by the proper application design and installation, and the quality of ongoing service. We established a team to enhance the robustness of both our Model C30 and Model C60 products. The objective of this team was to meet, and then exceed, an average of 8,000 hours mean-time-between-failures for our microturbines. Based on our expected performance of units being manufactured and shipped, the team met this goal early in fiscal 2005. These product robustness enhancements also resulted in lowering our per unit warranty costs and other support costs.

To further provide us with the ability to evaluate microturbine performance in the field, we developed a “real-time” remote monitoring and diagnostic feature. This feature allows us to monitor installed units instantaneously and collect operating data on a continual basis. We intend to use this information to anticipate and quickly respond to field performance issues, evaluate component robustness and identify areas for continuous improvement. We expect this feature to be very important to allowing us to better serve our customers.

- 6) *New product development* – Our new product development is targeted specifically to meet the needs of our selected vertical markets. We expect that our existing product platforms — the Model C30 and Model C60, will be our foundational product lines throughout the strategic planning period. Our product development efforts are centered on enhancing the features of these base products.
- 7) *Cost and Core Competencies* – Improving overall product cost is an important element of the strategic plan. The planning process identified opportunities for improvement through focusing on core competencies. We believe that we can achieve overall cost improvements by outsourcing areas not consistent with our core competencies. We have identified design, assembly, test and installation support as areas where we have capabilities to add value. In conjunction with these changes, we have identified a number of supply chain driven component cost reduction actions. While we are driving to reduce costs, commodity price increases in mid-to-late fiscal 2005 have increased our costs of goods sold. In response to this, near year-end, we increased prices an average of 7%.

We believe that execution in each of these key areas of our strategic plan will be important in continuing Capstone’s transition from an R&D focused company with a promising technology and early market leadership to a cash flow positive company by fiscal 2007 with growing market presence and improving financial performance. We expect fiscal 2006 to be an important year in our transformation. While we expect to continue to invest in the business, we expect to begin seeing the results of our efforts. We expect revenues in fiscal 2006 to be at least twice those of fiscal 2005. We believe we will move from gross losses to positive gross margin in fiscal 2006. Further, our goal is to use less cash for operating and investing activities in fiscal 2006 than in any prior annual period in our history as a public company.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent liabilities. On an on-going basis, we evaluate our estimates, including but not limited to those related to intangible assets, fixed assets, bad debts, inventories, warranty obligations, income taxes, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe that the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the consolidated financial statements.

- We review long-lived assets, including intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Our intangible assets consist of a license granted to the Company to use a former supplier’s intellectual property and marketing rights repurchased by the Company from a former shareholder. Long-lived assets are being depreciated or amortized over their estimated useful lives. Intangible assets are being amortized over their estimated useful lives. Future write-downs may be required if the value of these assets becomes impaired, and depreciation and amortization may be

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accelerated if estimated useful lives are shortened. We recorded a \$0.6 million loss in fiscal 2005 on assets held for sale as of March 31, 2005. The Company recognized a full impairment loss on marketing rights of \$16.0 million in the second quarter of the year ended December 31, 2002 (“Calendar 2002”) and in the fourth quarter of Calendar 2002 recorded a partial impairment loss of \$5.0 million on fixed assets and the manufacturing license related to our recuperator core facility. We identify asset groups in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets” and compare the expected future cash flows to be generated from asset groups to the carrying value of the assets. In the event that the future cash flows are insufficient to recover the value of the assets, we write-down the asset group to their estimated fair value. While we currently have no indications of events or circumstances that indicate additional impairments are warranted, future changes in our forecast expectations or changes in our utilization of these or other assets may result in further impairment of our long-lived assets.

- Our inventories are valued at lower of cost or market. We routinely evaluate the composition of our inventory and identify slow-moving, excess, obsolete or otherwise impaired inventories. Inventories identified as impaired are evaluated to determine if write-downs are required. Included in this assessment is a review for obsolescence as a result of engineering changes in our product. Future product enhancement and development may render certain inventories obsolete, resulting in additional write-downs of inventory. In addition, inventories are classified as current or long-term based on our sales forecast. A change in forecast could impact the classification of inventory and may also result in further write-downs of inventory which could be material to our financial condition and results of operations.
- We provide for the estimated cost of warranties at the time revenue from sales is recognized. We also accrue the estimated costs to address reliability repairs on products no longer under warranty when, in the Company’s judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. We estimate warranty expenses based upon historical and projected product failure rates, estimated costs of parts and labor to repair or replace a unit and the number of units covered under the warranty period. While we engage in extensive quality programs and processes, our warranty obligation is affected by failure rates and service costs in correcting failures. As the Company has more units commissioned and longer periods of actual performance, additional data becomes available to assess expected warranty costs. When we have statistically valid evidence that product changes are altering the historical failure occurrence rates, the impact of such changes is then taken into account in estimating future warranty liabilities. Changes in estimate are recorded in the period that new information becomes available. Should actual failure rates or service costs differ from our estimates, revisions to the warranty liability would be required and could be material to our financial condition and results of operations.
- Our revenues consist of sales of products, parts, accessories and services, net of discounts and allowances for sales returns. Our distributors purchase products and parts for sale to end users and are also required to provide a variety of additional services, including application engineering, installation, commissioning and post-commissioning services. Our standard terms of sales to distributors and direct end users include transfer of title, care, custody and control at the point of shipment, payment terms ranging from full payment in advance of shipment to payment in 60 days, no right of return or exchange, and no post-shipment performance obligations by us except for warranties provided on the products and parts sold. We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, selling price is fixed or determinable and collectibility is reasonably assured. While there are no rights or return privileges on product sales, we have made some limited exceptions to the no-right-of-return policy. We have provided an allowance for future sales returns based on historical information. Our operating policy may change in the future.
- We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers was to deteriorate or if other conditions arise that result in an impairment of their ability or intention to make payments, additional allowances may be required.
- We have a history of unprofitable operations. These losses generated significant federal and state net operating loss (“NOL”) carryforwards. GAAP requires that we record a valuation allowance against the deferred income tax assets associated with these NOLs if it is “more likely than not” that we will not be able to utilize them to offset future income taxes. Due to the uncertainty surrounding the timing of realizing the benefits of our favorable tax attributes in future income tax returns, a valuation allowance has been provided against all of our deferred income tax assets. We currently provide for income taxes only to the extent that we expect to pay cash taxes, primarily state taxes. It is possible, however, that we could be profitable in the future at levels which could cause management to determine that it is more likely than not that we will realize all or a portion of the NOL carryforward. Upon reaching such a conclusion, we would record the estimated net realizable value of the deferred income tax asset at that time. Such adjustment would increase income in the period that the determination was made.

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- We account for contingencies in accordance with SFAS No. 5, "Accounting for Contingencies." SFAS No. 5 requires that we record an estimated loss from a loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. Accounting for contingencies, such as legal matters, requires us to use our judgment. Any unfavorable outcome of litigation or other contingencies could have an adverse impact on our financial condition and results of operations.

Results of Operations

Change in Fiscal Year

On December 12, 2003, we changed our fiscal year end from December 31 to March 31. We filed a report for the three-month transition period from January 1, 2003 through March 31, 2003 with the Securities and Exchange Commission on January 26, 2004. The results of operations and cash flows for the transition period January 1, 2003 to March 31, 2003 are included in this Annual Report on Form 10-K. Our fiscal year commences on April 1 and ends on March 31.

Year Ended March 31, 2005 Compared to Year Ended March 31, 2004

Revenues

Revenues increased \$4.4 million to \$17.0 million for the year ended March 31, 2005 from \$12.6 million for the year ended March 31, 2004. Revenues are reported net of sales returns and allowances. Shipments during the current period were 16.5 megawatts compared with 11.5 megawatts in the prior period. Approximately 85% of the increased revenue between periods came from higher sales volumes of Model C60 products. Growth in CHP and CCHP applications is driving the higher demand for the Model C60 product.

One customer accounted for 15% of the Company's net revenues for the year ended March 31, 2005. No customer accounted for 10% or more of the Company's net revenues for the year ended March 31, 2004. In each year, our top ten customers generated approximately 60% of the total revenues for the year. Only three companies were in the top ten customers by revenue in both fiscal 2005 and fiscal 2004. This demonstrates that we are building strength in our distribution channel. The top ten customers as a group produced results approximately 45% higher than they did in the prior year. Since seven of these ten customers were not in the top ten last year, this reflects that they are either continuing distributors who are gaining traction in their marketplaces, or they are new distributors or dealers who are already among the top in producing results. These changes in the performance of our distribution base reflects the strategy we undertook at the beginning of fiscal 2005. This strategy included focusing on target markets we believed held greater prospects for improved sales and improving the distribution channel. The change in the distribution channel entailed terminating some of the previously existing agreements and entering into new agreements with distributors and dealers we believed would be capable of growing sales in our targeted markets. Our efforts to develop our target markets in concert with a more productive base of distributors and dealers yielded the improved sales between years.

Late in fiscal 2005, we increased our product sales prices an average of approximately 7% in response to our increasing costs for commodity metals. While this price increase will increase the per-unit revenues in the future, it is not expected to have a material effect on contribution margin because of the offsetting increase in product costs. We expect to roughly double our sales in fiscal 2006 from the levels reported in fiscal 2005.

Gross Loss

Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. We had a gross loss of \$6.9 million for the year ended March 31, 2005, compared with \$16.8 million for the year ended March 31, 2004, an improvement of \$9.9 million. The improvement in cost of goods sold came from warranty cost changes between the years.

In fiscal 2004, we recorded warranty charges of \$9.8 million. We record a per-unit warranty at the time the product is shipped. In fiscal 2004, we recorded a liability for several reliability repair programs based on a decision we made to voluntarily undertake

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programs to provide some repairs, in addition to repairs under warranty, for products sold in prior periods. The liability was recorded at the time of management's commitment to the programs. In total, in fiscal 2004, we recorded \$8.5 million of warranty charges related to preexisting warranties and the reliability repair programs, in addition to \$1.3 million recorded at the time of product shipments. By contrast, in fiscal 2005, we recorded \$3.4 million of warranty charges related to products shipped in the period and a benefit of \$4.1 million from changes in estimates related to preexisting warranties and the reliability repair programs. On a net basis, the fiscal 2005 warranties were a benefit of \$0.7 million. Overall, the standard warranty cost per unit was lower in fiscal 2005 than in the prior year as a result of our efforts to focus on reliability. However, certain models of products shipped in fiscal 2005 will be subject to repairs identified under the reliability repair programs. The additional warranty liabilities related to the reliability repair programs were recorded for those units as they shipped. All products being shipped as of the end of fiscal 2005 incorporated virtually all of the changes represented by the reliability repair programs. Throughout fiscal year 2005, we have experienced reductions in the accruals for preexisting warranties and the reliability repair programs. The reductions in the preexisting warranties arose because of improvements that have been made through engineering design changes. When we have statistically valid evidence that product changes are altering the historical failure occurrence rates, the impact of such changes is then taken into account in estimating future warranty liabilities. We have also experienced lower than anticipated costs overall from the reliability repair programs. Since recording the liabilities, advances in our technology and know how have resulted in revisions to the estimated costs to remediate the identified problems. In addition, after the reliability repair programs were established, one customer did not participate in a program as agreed upon and therefore, their portion of the program was cancelled. Changes in estimates are recorded in the period that new information becomes available. Based on incorporation of the reliability repair items in the products we now ship and the improvement we are experiencing in historical warranty occurrence rates, we expect warranty costs per unit recorded at the time of product shipment to be lower in fiscal 2006 than were recorded in either fiscal 2005 or fiscal 2004.

We had previously fully written-down inventories of recuperator cores and have started using some of these cores in production, which had reduced our gross loss. We used \$0.3 million and \$0.5 million of these cores during the years ended March 31, 2005 and 2004, respectively.

We expect to continue to incur gross losses until such time as we are able to increase our contribution margins, through higher sales volumes and margins, as well as lower direct materials costs, and lower our manufacturing costs through efforts such as outsourcing non-core functions.

R&D Expenses

R&D expenses include compensation, engineering department expenses, overhead allocations for administration and facilities and material costs associated with development. R&D expenses increased \$0.5 million to \$11.8 million for the year ended March 31, 2005 from \$11.2 million for the year ended March 31, 2004. R&D expenses are reported net of benefits from cost sharing programs. These benefits were \$0.5 million in fiscal 2005 compared to \$1.5 million in fiscal 2004. Therefore, the underlying spending was nearly the same for the two periods. The benefits from cost sharing programs vary from period-to-period depending on the phases of the programs. Our remaining funding under the DOE Advanced Microturbine System program is approximately \$1.0 million as of March 31, 2005. Our remaining funding under the DOE program for the research, development and testing of packaged cooling, heating and power systems for buildings is approximately \$1.7 million as of March 31, 2005 which would require us to provide at least \$1.3 million of our own R&D expenditures. We expect R&D spending in fiscal 2006 to be somewhat lower than in fiscal 2005. This change is expected to come from higher spending, but with the increased spending more than offset by cost sharing programs. We expect to enter into at least one new cost sharing program in fiscal 2006. If we do not enter into the cost sharing programs as expected, we will not incur some of the planned costs and would, as a result, expect our spending in fiscal 2006 to be roughly equivalent to that incurred in fiscal 2005.

Selling, General and Administrative Expenses ("SG&A")

SG&A expenses include compensation and related expenses in support of our general corporate functions, which include human resources, finance and accounting, shareholder relations, quality, information systems and legal services. SG&A expenses increased \$1.6 million to \$22.4 million for the year ended March 31, 2005 from \$20.8 million for the year ended March 31, 2004. Of the increased spending between years, approximately \$2.0 million was for consulting services used to assist the Company with its Sarbanes-Oxley compliance efforts, enhancement of its information technology systems and related processes, as well as assistance with developing sales opportunities in its target markets. This increase was partially offset by a \$0.4 million reduction in all other spending. We expect the SG&A costs in fiscal 2006 to be slightly lower.

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Interest Income

Interest income was consistent between periods at \$1.3 million for each of the years ended March 31, 2005 and 2004. We expect interest income to decline in fiscal 2006 as we continue to use cash.

Income Tax Provision

At March 31, 2005, we had federal and state net operating loss carryforwards of approximately \$342.3 million and \$233.8 million, respectively, which may be utilized to reduce future taxable income, subject to limitations. Utilization of the net operating losses and tax credits are subject to an annual limitation of approximately \$57.6 million due to the ownership change limitations of the Internal Revenue Code of 1986 and similar state provisions. We have provided a valuation allowance for 100% of our net deferred tax asset of \$154.9 million at March 31, 2005 due to the uncertainty surrounding realizing the benefits of these favorable tax attributes in future income tax returns. Similarly, in fiscal 2004, the net deferred tax asset was fully reserved.

Year Ended March 31, 2004 Compared to Year Ended December 31, 2002

Revenues

Revenues decreased \$6.9 million to \$12.6 million for the year ended March 31, 2004 from \$19.5 million for the year ended December 31, 2002. Revenues are reported net of sales returns and allowances. Shipments during the period were 11.5 megawatts compared with 18.7 megawatts in the prior period. The lower sales resulted from our change in strategy to focus on selling products in our targeted markets where we expect to ultimately realize higher contribution margins, rather than focusing on sales volume alone. We are becoming more selective in selling products into markets that we intend to develop rather than into a wide array of applications. We chose our targeted markets, which broadly, are in the categories of CHP, CCHP, resource recovery, power reliability and remote power, because we believe they have near term prospects for adoption of our products and higher average contribution margins than other potential markets. Until we develop improved channels for sales into our targeted markets, we expect our sales will be adversely impacted.

No customer accounted for 10% or more of the Company's net revenues for the year ended March 31, 2004. Two customers accounted for 12% and 10% of the Company's net revenues for the year ended December 31, 2002.

Gross Loss

Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. We had a gross loss of \$16.8 million for the year ended March 31, 2004, compared with \$22.0 million for the year ended December 31, 2002. Cost of goods sold in calendar 2002 included a partial impairment loss of \$5.0 million related to our recuperator core facility, inventory write-downs of \$4.8 million and warranty charges of \$6.2 million. In fiscal 2004, we had no impairment loss; inventory write-downs were \$0.9 million; and warranty charges were \$9.8 million. In the fourth quarter of fiscal 2004, we recorded a liability for several reliability repair programs based on a decision we made to voluntarily undertake programs to provide some repairs, in addition to repairs under warranty, for products sold in prior periods. The liability was recorded at the time of management's commitment to the programs. In fiscal 2004, we recorded \$8.5 million of warranty charges related to preexisting warranties and the reliability repair programs. In addition we recorded \$1.3 million in per-unit warranties related to products sold in the year. While total revenues decreased 35% from calendar 2002 to fiscal 2004 the gross loss was comparable before consideration of the impairment loss recorded in calendar 2002.

We had previously fully written-down inventories of recuperator cores and have started using some of these cores in production, which had reduced our gross loss. We used \$0.5 million of these cores during the year ended March 31, 2004.

We expect to continue to incur gross losses until such time as we are able to increase our contribution margins, through higher sales volumes and margins, as well as lower warranty and direct materials costs, and lower our manufacturing costs through efforts such as outsourcing non-core functions.

R&D Expenses

R&D expenses increased \$4.2 million to \$11.2 million for the year ended March 31, 2004 from \$7.0 million for the year ended December 31, 2002. R&D expenses are reported net of benefits from cost sharing programs. These benefits were \$1.5 million in fiscal 2004 compared to \$5.6 million in calendar 2002. Therefore, the underlying spending was nearly the same for the two periods. The benefits from cost sharing programs vary from period-to-period depending on the phases of the programs. Our remaining funding under

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the DOE Advanced Microturbine System program was approximately \$1.0 million as of March 31, 2004 which would require us to provide at least \$3.3 million of our own R&D expenditures. Our remaining funding under the DOE program for the research, development and testing of packaged cooling, heating and power systems for buildings was approximately \$2.0 million as of March 31, 2004 which would require us to provide at least \$1.6 million of our own R&D expenditures.

SG&A Expenses

SG&A expenses decreased \$11.0 million to \$20.8 million for the year ended March 31, 2004 from \$31.8 million for the year ended December 31, 2002. In calendar 2002, we had amortization expense of \$2.7 million related to marketing rights that were fully impaired in the second quarter of calendar 2002. Other key drivers of the lower SG&A expenses in fiscal 2004 were reduced spending on labor of \$2.6 million, consulting services of \$2.7 million, legal services of \$0.7 million and facilities of \$1.0 million.

Impairment Loss

In the second quarter of calendar 2002, as a result of a change in our sales forecast, we evaluated the remaining book value of the marketing rights and determined that this asset was impaired based on the assessment of the expected cash flows that could be generated during its remaining term. Expected favorable margins in the latter years of the term of the marketing rights were not sufficient to offset losses in the early years. The recorded impairment loss was approximately \$16.0 million, representing the remaining carrying value of the asset.

Interest Income

Interest income decreased \$1.5 million to \$1.3 million for the year ended March 31, 2004 from \$2.8 million for the year ended December 31, 2002. The decrease was primarily attributable to lower cash balances.

Income Tax Provision

At March 31, 2004, we had federal and state net operating loss carryforwards of approximately \$298.8 million and \$214.8 million, respectively, which may be utilized to reduce future taxable income, subject to limitations. Utilization of the net operating losses and tax credits are subject to an annual limitation of approximately \$57.6 million due to the ownership change limitations of the Internal Revenue Code of 1986 and similar state provisions. We have provided a valuation allowance for 100% of our net deferred tax asset of \$140.0 million at March 31, 2004 due to the uncertainty surrounding realizing the benefits of these favorable tax attributes in future income tax returns.

Quarterly Results of Operations

The following table presents unaudited quarterly financial information. This information was prepared in accordance with GAAP, and, in the opinion of management, contains all adjustments necessary for a fair presentation of such quarterly information when read in conjunction with the financial statements included elsewhere herein. Our operating results for any prior quarters may not necessarily indicate the results for any future periods.

Amounts in thousands, except per share data

(Unaudited)	Year Ended March 31, 2005				Year Ended March 31, 2004			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total net revenues	\$ 2,955	\$ 3,925	\$ 4,683	\$ 5,405	\$ 4,132	\$ 2,347	\$ 3,251	\$ 2,877
Cost of goods sold	5,090	5,625	6,427	6,766	6,739	4,551	6,359	11,736
Gross loss	(2,135)	(1,700)	(1,744)	(1,361)	(2,607)	(2,204)	(3,108)	(8,859)
Operating costs and expenses:								
R&D	3,414	2,919	2,793	2,635	2,450	2,402	3,034	3,335
Selling, general and administrative	5,208	5,193	5,612	6,406	4,676	4,643	5,688	5,833
Loss from operations	(10,757)	(9,812)	(10,149)	(10,402)	(9,733)	(9,249)	(11,830)	(18,027)
Net loss	<u>\$(10,534)</u>	<u>\$(9,147)</u>	<u>\$(9,770)</u>	<u>\$(9,998)</u>	<u>\$(9,398)</u>	<u>\$(8,992)</u>	<u>\$(11,567)</u>	<u>\$(17,780)</u>
Net loss per common share – basic and diluted	<u>\$ (0.13)</u>	<u>\$ (0.11)</u>	<u>\$ (0.12)</u>	<u>\$ (0.12)</u>	<u>\$ (0.12)</u>	<u>\$ (0.11)</u>	<u>\$ (0.14)</u>	<u>\$ (0.21)</u>

In the fourth quarter of fiscal 2005, we reported three significant items. First, in March 2005 we decided to sell assets previously held for production. This equipment was identified for sale because current production techniques and volume requirements indicated

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it would not be needed to support production. The intended purchaser has offered \$80,000 for this equipment, which we believe reasonably approximates the fair market value. Accordingly, the assets have been written down to this market value and a loss on assets held for sale of \$614,000 was recorded in Cost of Goods Sold. Second, the warranty reliability repair liability was reduced \$1.8 million based on newly available statistically valid evidence that product changes are altering the historical failure occurrence rates. This information was used to estimate future warranty liabilities and resulted in the reduction of the previously recorded warranty liability. And third, we recorded an adjustment of \$609,000 to increase depreciation and amortization expense on equipment and leasehold improvements to correct an error that resulted because our financial accounting software was not properly configured during our change in fiscal year, which was implemented in the quarter ended March 31, 2004. Of the \$609,000, \$382,000 related to expenses that should have been recorded in the first three quarters of fiscal 2005 and the remaining \$227,000 was an expense related to the fourth quarter's operations.

In the last quarter of fiscal 2004, the Company recorded an \$8.9 million liability for reliability repair programs committed to at that time.

Liquidity and Capital Resources

Our cash requirements depend on many factors, including the execution of our strategic plan. We expect to continue to devote substantial capital resources to running our business and creating the strategic changes summarized herein. We believe that our current cash balance is sufficient to fund operating losses and our currently projected commitments to reach the point of positive cash flow. We have invested our cash in an institutional fund that invests in high quality short-term money market instruments to provide liquidity for operations and for capital preservation.

We used a total of \$38.8 million of cash and cash equivalents during the year ended March 31, 2005 compared to \$30.2 million for the year ended March 31, 2004. The cash was used in:

Operating Activities — During the year ended March 31, 2005 we used \$37.4 million in cash in our operating activities, which consisted of a net loss for the period of approximately \$39.4 million, offset by non-cash adjustments (primarily depreciation and impairment charges) of \$6.3 million and cash used for working capital of approximately \$4.3 million. This compared to operating cash usage of \$29.5 million during the year ended March 31, 2004, which consisted of a net loss for the period of approximately \$47.7 million, offset by non-cash adjustments (primarily depreciation and warranty charges) of \$18.1 million and cash generated from working capital of approximately \$0.2 million. The increased cash used to fund the net loss was \$4.2 million higher spending for labor and consulting throughout the Company, offset by \$0.9 million in lower spending for insurance. The change between periods due to working capital is largely attributable to a \$7.9 million use from increases in inventory in the current year as compared with decreases in the prior year, offset by \$2.2 million less cash used for warranties and \$1.5 million more cash generated from collections of accounts receivable. A year ago, inventory reductions yielded working capital benefits. This year, inventories have increased from purchases made in anticipation of expected future demands, and this has used cash. By contrast, accounts receivable increased last year, but in fiscal 2005, they reduced, yielding higher cash collections. Warranties used cash in each period but because of the improved product performance being experienced, less cash was used for warranties in fiscal 2005 than in the prior year.

Investing Activities — Net cash used in investing activities for acquisition of fixed assets was \$1.1 million for the year ended March 31, 2005 compared to \$1.3 million for the year ended March 31, 2004. Our cash usage for investing activities has been relatively low. Our significant capital expenditures were made in the previous years.

Financing Activities — During the year ended March 31, 2005, we used \$0.3 million for financing activities as compared with the prior year where \$0.6 million was generated. The exercise of stock options, restricted stock awards and employee stock purchases yielded \$0.3 million in cash in fiscal 2005 as compared with \$2.1 million in the prior year. Repayments of capital lease obligations used \$0.6 million this year as compared with \$1.4 million a year ago because the leases were fully paid off during this year.

We anticipate that as a result of our efforts to build sales and margins while controlling costs we will lower our cash usage. Our goal for fiscal 2006 is to use less cash for operating and investing activities than in any prior annual period in our history as a public company.

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Contractual Obligations and Commercial Commitments

At March 31, 2005, our commitments under the note payable and non-cancelable operating leases were as follows:

	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Contractual Obligations:					
Note payable	\$ 83,000	\$ 19,000	\$ 39,000	\$ 25,000	\$ —
Operating lease commitments	\$ 8,384,000	\$ 1,698,000	\$ 2,956,000	\$ 3,130,000	\$ 600,000

As of March 31, 2005, we had firm commitments to purchase inventories of approximately \$7.8 million. Inventory delivery dates and related payments are not firmly scheduled. Therefore, amounts under these firm purchase commitments will be due concurrent with the receipt of the related inventory.

In June 2001, we were awarded a \$3.0 million grant from the DOE for the research, development and testing of packaged cooling, heating and power systems for buildings. The contract is estimated to cost \$5.5 million, which would require us to provide approximately \$2.5 million of our own R&D expenditures. We billed the DOE under this agreement \$1.3 million through March 31, 2005. Our remaining funding under this program is approximately \$1.7 million as of March 31, 2005 which would require us to provide at least \$1.3 million of our own R&D expenditures. There are no required scheduled due dates related to the incurrence of the additional expenditures under this program.

Impact of Recently Issued Accounting Standards

In May 2005, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 154, “Accounting Changes and Error Corrections” (“SFAS No. 154”). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. In addition, it carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 requires retrospective application to prior periods’ financial statements of changes in accounting principle in most circumstances. We plan to prospectively adopt SFAS No. 154 at the beginning of fiscal 2007.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of ARB 43, Chapter 4” (“SFAS No. 151”). SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of “so abnormal”. In addition, it requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted. We plan to adopt SFAS No. 151 at the beginning of fiscal 2007. We have not determined the impact that adoption of this standard will have on our financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123R”). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, “Accounting for Stock Issued to Employees”. We will be required to adopt SFAS No. 123R at the beginning of fiscal 2007. We believe that the adoption of SFAS No. 123R could have a material impact on the amount of earnings the we report in fiscal 2007. We have not yet determined the specific impact that adoption of this standard will have on our financial position or results of operations.

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Item 7A. *Quantitative and Qualitative Disclosure About Market Risk.*

We do not currently use derivative financial instruments that expose us to market risk. Information required by this item is included in this Annual Report on Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 2 of the Notes to Consolidated Financial Statements.

Foreign Currency

We currently develop products in the U.S. and market and sell our products predominantly in North America, Europe and Asia. As a result, factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets could affect our financial results. As all of our sales and supplies are currently made in U.S. dollars, we do not utilize foreign exchange contracts to reduce our exposure to foreign currency fluctuations. In the future, as our customers, employees and vendor bases expand, we anticipate entering into more transactions that are denominated in foreign currencies.

Interest

We have no long-term debt outstanding, except for a note payable, capital leases and deferred rent, and do not use any derivative instruments. We have invested our cash in an institutional fund that invests in high quality short-term money market instruments.

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Item 8. *Financial Statements and Supplementary Data.*

CAPSTONE TURBINE CORPORATION
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Capstone Turbine Corporation
Chatsworth, California

We have audited the accompanying consolidated balance sheets of Capstone Turbine Corporation and subsidiary (the "Company") as of March 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years ended March 31, 2005 and 2004, three months ended March 31, 2003 and year ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2005 and 2004, and the results of its operations and its cash flows for each of the years ended March 31, 2005 and 2004, three months ended March 31, 2003 and year ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of March 31, 2005, based on *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 29, 2005 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Los Angeles, California
June 29, 2005

CAPSTONE TURBINE CORPORATION
CONSOLIDATED BALANCE SHEETS

	<u>March 31,</u> <u>2005</u>	<u>March 31,</u> <u>2004</u>
Assets		
Current Assets:		
Cash and cash equivalents	\$ 63,593,000	\$ 102,380,000
Accounts receivable, net of allowance for doubtful accounts and sales returns of \$536,000 in 2005 and \$479,000 in 2004	3,150,000	4,170,000
Inventory	11,273,000	7,893,000
Prepaid expenses and other current assets	912,000	1,099,000
Assets held for sale	<u>80,000</u>	<u>—</u>
Total current assets	<u>79,008,000</u>	<u>115,542,000</u>
Equipment and Leasehold Improvements:		
Machinery, equipment and furniture	18,760,000	20,877,000
Leasehold improvements	8,563,000	8,499,000
Molds and tooling	<u>3,096,000</u>	<u>4,363,000</u>
	30,419,000	33,739,000
Less accumulated depreciation and amortization	<u>19,890,000</u>	<u>18,718,000</u>
Total equipment and leasehold improvements	10,529,000	15,021,000
Non-Current Portion of Inventory	3,990,000	3,936,000
Intangible Asset, net	1,427,000	1,694,000
Other Assets	<u>236,000</u>	<u>352,000</u>
Total	<u>\$ 95,190,000</u>	<u>\$ 136,545,000</u>
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	\$ 3,324,000	\$ 2,790,000
Accrued salaries and wages	1,442,000	1,664,000
Other accrued liabilities	2,472,000	2,043,000
Accrued warranty reserve	8,667,000	11,695,000
Deferred revenue	1,522,000	1,166,000
Current portion of notes payable and capital lease obligations	<u>19,000</u>	<u>582,000</u>
Total current liabilities	<u>17,446,000</u>	<u>19,940,000</u>
Long-Term Portion of Note Payable and Capital Lease Obligations	64,000	13,000
Other Long-Term Liabilities	1,002,000	1,149,000
Commitments and Contingencies	—	—
Stockholders' Equity:		
Preferred stock, \$.001 par value; 10,000,000 shares authorized; none issued	—	—
Common stock, \$.001 par value; 415,000,000 shares authorized; 85,379,446 shares issued and 84,828,238 shares outstanding at March 31, 2005; 85,025,817 shares issued and 84,474,609 shares outstanding at March 31, 2004	85,000	85,000
Additional paid-in capital	530,931,000	530,394,000
Accumulated deficit	(453,469,000)	(414,020,000)
Less deferred stock compensation	(356,000)	(503,000)
Less treasury stock, at cost; 551,208 shares in 2005 and 2004	<u>(513,000)</u>	<u>(513,000)</u>
Total stockholders' equity	<u>76,678,000</u>	<u>115,443,000</u>
Total	<u>\$ 95,190,000</u>	<u>\$ 136,545,000</u>

See accompanying notes to consolidated financial statements.

CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended		Three	Year Ended
	March 31,		Months	December 31,
	2005	2004	Ended	2002
	March 31,		March 31,	
			2003	
Net Revenues	\$ 16,968,000	\$ 12,607,000	\$ 2,782,000	\$ 19,529,000
Cost of Goods Sold	<u>23,908,000</u>	<u>29,385,000</u>	<u>4,956,000</u>	<u>41,530,000</u>
Gross Loss	(6,940,000)	(16,778,000)	(2,174,000)	(22,001,000)
Operating Expenses:				
Research and development	11,761,000	11,221,000	1,006,000	6,966,000
Selling, general and administrative	22,419,000	20,840,000	4,821,000	31,846,000
Impairment loss on marketing rights	<u>—</u>	<u>—</u>	<u>—</u>	<u>15,999,000</u>
Total operating costs and expenses	<u>34,180,000</u>	<u>32,061,000</u>	<u>5,827,000</u>	<u>54,811,000</u>
Loss from Operations	(41,120,000)	(48,839,000)	(8,001,000)	(76,812,000)
Interest Income	1,338,000	1,284,000	439,000	2,840,000
Interest Expense	(37,000)	(183,000)	(73,000)	(407,000)
Other Income, net	<u>372,000</u>	<u>1,000</u>	<u>2,000</u>	<u>26,000</u>
Loss Before Income Taxes	(39,447,000)	(47,737,000)	(7,633,000)	(74,353,000)
Provision for Income Taxes	<u>2,000</u>	<u>2,000</u>	<u>2,000</u>	<u>2,000</u>
Net Loss	<u>\$(39,449,000)</u>	<u>\$(47,739,000)</u>	<u>\$(7,635,000)</u>	<u>\$(74,355,000)</u>
Net Loss Per Share of Common Stock — Basic and Diluted	<u>\$ (0.47)</u>	<u>\$ (0.58)</u>	<u>\$ (0.09)</u>	<u>\$ (0.95)</u>
Weighted Average Common Shares Outstanding	<u>84,377,794</u>	<u>82,348,711</u>	<u>81,410,614</u>	<u>78,130,795</u>

See accompanying notes to consolidated financial statements.

CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Deferred Stock Compensation	Treasury Stock	Total Stockholders' Equity
	Shares	Amount					
Balance, December 31, 2001	77,207,383	\$77,000	\$521,668,000	\$(284,291,000)	\$ —	\$ —	\$237,454,000
Stock-based compensation			1,024,000				1,024,000
Issuance of common stock	3,994,817	4,000	3,981,000				3,985,000
Exercise of stock options and employee stock purchases	432,835	1,000	279,000				280,000
Purchase of treasury stock						(206,000)	(206,000)
Net loss				(74,355,000)			(74,355,000)
Balance, December 31, 2002	81,635,035	82,000	526,952,000	(358,646,000)		(206,000)	168,182,000
Stock-based compensation			214,000				214,000
Exercise of stock options and employee stock purchases	65,700		22,000				22,000
Purchase of treasury stock						(215,000)	(215,000)
Net loss				(7,635,000)			(7,635,000)
Balance, March 31, 2003	81,700,735	82,000	527,188,000	(366,281,000)		(421,000)	160,568,000
Stock-based compensation			533,000				533,000
Exercise of stock options and employee stock purchases	2,825,082	2,000	2,083,000				2,085,000
Purchase of treasury stock						(92,000)	(92,000)
Exercise of restricted stock award	500,000	1,000	590,000		(590,000)		1,000
Amortization of deferred stock compensation					87,000		87,000
Net loss				(47,739,000)			(47,739,000)
Balance, March 31, 2004	85,025,817	85,000	530,394,000	(414,020,000)	(503,000)	(513,000)	115,443,000
Stock-based compensation			157,000				157,000
Exercise of stock options and employee stock purchases	310,543		304,000				304,000
Stock awards to Board of Directors	43,086		76,000				76,000
Amortization of deferred stock compensation					147,000		147,000
Net loss				(39,449,000)			(39,449,000)
Balance, March 31, 2005	85,379,446	\$85,000	\$530,931,000	\$(453,469,000)	\$ (356,000)	\$(513,000)	\$ 76,678,000

See accompanying notes to consolidated financial statements.

CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Year Ended December 31, 2002
Cash Flows from Operating Activities:				
Net loss	\$ (39,449,000)	\$ (47,739,000)	\$ (7,635,000)	\$ (74,355,000)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	5,181,000	6,180,000	1,573,000	9,891,000
Non-cash reversal of administrative expenses	—	—	(1,099,000)	
Impairment loss on fixed assets and manufacturing license	614,000	—	—	5,016,000
Impairment loss on marketing rights	—	—	—	15,999,000
Provision for doubtful accounts and returns	57,000	280,000	220,000	215,000
Inventory write-down	744,000	931,000	243,000	4,793,000
(Benefit) provision for warranty expenses	(682,000)	9,749,000	385,000	6,175,000
Loss on disposal of fixed assets	24,000	315,000	—	102,000
Non-employee stock compensation	129,000	92,000	4,000	—
Employee and director stock compensation	251,000	528,000	210,000	1,024,000
Changes in operating assets and liabilities:				
Accounts receivable	963,000	(509,000)	732,000	2,907,000
Inventory	(4,062,000)	3,871,000	(967,000)	1,272,000
Prepaid expenses and other assets	187,000	258,000	990,000	(1,202,000)
Accounts payable	534,000	440,000	(873,000)	830,000
Accrued salaries and wages and other accrued and long term liabilities	60,000	890,000	(580,000)	683,000
Accrued warranty reserve	(2,346,000)	(4,551,000)	(634,000)	(3,406,000)
Deferred revenue	356,000	(247,000)	512,000	(737,000)
Net cash used in operating activities	<u>(37,439,000)</u>	<u>(29,512,000)</u>	<u>(6,919,000)</u>	<u>(30,793,000)</u>
Cash Flows from Investing Activities:				
Acquisition of and deposits on equipment and leasehold improvements	(1,057,000)	(1,299,000)	(271,000)	(2,515,000)
Proceeds from sale of equipment	3,000	28,000	—	—
Net cash used in investing activities	<u>(1,054,000)</u>	<u>(1,271,000)</u>	<u>(271,000)</u>	<u>(2,515,000)</u>
Cash Flows from Financing Activities:				
Repayment of capital lease obligations	(598,000)	(1,415,000)	(343,000)	(1,309,000)
Exercise of stock options, restricted stock award and employee stock purchases	304,000	2,086,000	22,000	280,000
Purchase of treasury stock	—	(92,000)	(215,000)	(206,000)
Net proceeds from issuance of common stock	—	—	—	3,985,000
Net cash provided by (used in) financing activities	<u>(294,000)</u>	<u>579,000</u>	<u>(536,000)</u>	<u>2,750,000</u>
Net Decrease in Cash and Cash Equivalents	(38,787,000)	(30,204,000)	(7,726,000)	(30,558,000)
Cash and Cash Equivalents, Beginning of Year	102,380,000	132,584,000	140,310,000	170,868,000
Cash and Cash Equivalents, End of Year	<u>\$ 63,593,000</u>	<u>\$102,380,000</u>	<u>\$ 132,584,000</u>	<u>\$140,310,000</u>
Supplemental Disclosures of Cash Flow Information				
Cash paid during the year for:				
Interest	\$ 35,000	\$ 183,000	\$ 73,000	\$ 407,000
Income taxes	\$ 2,000	\$ 2,000	\$ 2,000	\$ 2,000

See accompanying notes to consolidated financial statements.

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of the Company

Capstone Turbine Corporation (the "Company") develops, manufactures, and markets microturbine generator sets for use in co-generation, resource recovery, power reliability and remote power applications in the markets for distributed power generation. The Company was organized in 1988 and has been commercially producing microturbine generators since 1998.

The Company has incurred significant operating losses since its inception. Management anticipates incurring additional losses until the Company can produce sufficient revenues to cover costs. To date, the Company has funded its activities primarily through private and public equity offerings.

2. Summary of Significant Accounting Policies

Principles of Consolidation — The consolidated financial statements include the accounts of the parent company and Capstone Turbine International, Inc., its wholly owned subsidiary that was formed in June 2004, after elimination of inter-company transactions.

Change in Fiscal Year — On December 12, 2003, the Company changed its fiscal year end from December 31 to March 31. The results of operations and cash flows for the transition period of January 1, 2003 to March 31, 2003 are included in this Annual Report. For comparative purposes, the unaudited statement of operations for the three months ended March 31, 2002 are presented below. The unaudited statement of operations reflects all adjustments (consisting of normal recurring adjustments) that are, in the opinion of management, necessary to a fair statement of the results for the interim period presented.

	Three Months Ended March 31, 2002
Revenues	\$ 4,591,000
Cost of Goods Sold	7,549,000
Gross Loss	(2,958,000)
Operating Costs and Expenses:	
Research and development	1,439,000
Selling, general and administrative	8,360,000
Total operating costs and expenses	9,799,000
Loss from Operations	(12,757,000)
Interest Income	823,000
Interest Expense	(115,000)
Other Income, net	21,000
Loss Before Income Taxes	(12,028,000)
Provision for Income Taxes	2,000
Net Loss	\$ (12,030,000)
Weighted Average Common Shares Outstanding	77,387,574
Net Loss Per Share of Common Stock — Basic and Diluted	\$ (0.16)

Cash Equivalents — The Company considers only those investments that are highly liquid, readily convertible to cash with original maturities of three months or less at date of purchase as cash equivalents.

Financial Instruments — The carrying value of certain financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair market value based on their short-term nature.

Accounts Receivable — The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. The Company also provides an allowance for sales returns. While the Company sells without rights of return, because occasional exceptions have been made, an allowance is provided based on historical return rates.

The following table shows the changes in the allowance for doubtful accounts and sales returns from December 31, 2002 to March 31, 2005:

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	<u>Balance at Beginning of Year</u>	<u>Additions Charged to Operations</u>	<u>Deductions from Reserve</u>	<u>Balance at End of Year</u>
Allowance for doubtful accounts and sales returns:				
December 31, 2002	\$ 163,000	\$ 215,000	\$ 184,000	\$ 194,000
March 31, 2003	\$ 194,000	\$ 220,000	\$ —	\$ 414,000
March 31, 2004	\$ 414,000	\$ 280,000	\$ 215,000	\$ 479,000
March 31, 2005	\$ 479,000	\$ 488,000	\$ 431,000	\$ 536,000

Inventories — The Company values inventories at lower of cost or market. The composition of inventory is routinely evaluated to identify slow-moving, excess, obsolete or otherwise impaired inventories. Inventories identified as impaired are evaluated to determine if write-downs are required. Included in the assessment is a review for obsolescence as a result of engineering changes in the Company's products. All inventories expected to be used in more than one year are classified as long-term.

Assets Held for Sale — Assets held for sale consists of those assets where: (a) management, having the authority to approve the action, committed to plans to sell the assets, (b) the assets are available for immediate sale in their present condition, subject to terms that are usual and customary for sales of such assets, (c) an active program to locate buyers and other actions required to complete the plans to sell the assets have been initiated, (d) the sales of the assets are probable and transfers of the assets are expected to qualify for recognition as a completed sale within one year, (e) the assets are being actively marketed for sale at a price that is reasonable in relation to their current fair market value, and (f) actions required to complete the plans to sell the assets indicate that it is unlikely that significant changes to the plans will be made or that the plans will be withdrawn. As a result of manufacturing efficiency improvements, assets previously held for production were identified as excess and made available for sale. This resulted in an impairment charge of \$0.6 million in fiscal 2005. These assets are being marketed to identified potential customers and are expected to be sold within one year.

Depreciation and Amortization — Depreciation and amortization are provided for using the straight-line method over the estimated useful lives of the related assets, ranging from three to ten years. Leasehold improvements are amortized over the period of the lease or the estimated useful lives of the assets, whichever is shorter. Intangible assets that have finite useful lives are amortized over their estimated useful lives using the straight-line method. Amortization of assets under capital leases and intangible assets are included with depreciation and amortization expense. Depreciation and amortization expense was \$5,181,000, \$6,180,000 and \$9,891,000 for the years ended March 31, 2005, March 31, 2004 and December 31, 2002, respectively. Depreciation and amortization expense was \$1,573,000 for the three months ended March 31, 2003.

Long-Lived Assets — The Company reviews the recoverability of long-lived assets whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. If the expected future cash flows from the use of such assets (undiscounted and without interest charges) are less than the carrying value, the Company's policy is to record a write-down, which is determined based on the difference between the carrying value of the assets and their estimated fair value.

Deferred Revenue — Deferred revenue consists of deferred service revenues and customer deposits. Deferred revenue will be recognized when earned in accordance with the Company's revenue recognition policy. The Company has the right to retain all or part of deposits under certain conditions.

Revenues — The Company's revenues consist of sales of products, accessories, parts and service, net of discounts and allowances for sales returns. Capstone's distributors purchase products and parts for sale to end users and are also required to provide a variety of additional services, including application engineering, installation, commissioning and post-commissioning services. The Company's standard terms of sales to distributors and direct end users include transfer of title, care, custody and control at the point of shipment, payment terms ranging from full payment in advance of shipment to payment in 60 days, no right of return or exchange, and no post-shipment performance obligations by Capstone except for warranties provided on the products and parts sold. In accordance with the Securities and Exchange Commission's Staff Accounting Bulletin No. 104, the Company recognizes revenue when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, selling price is fixed or determinable and collectibility is reasonably assured. While there are no rights of return privileges on product sales, the Company has made some limited exceptions to the no-right-of-return policy. Therefore, the Company has provided for an allowance for future sales returns based on historical information. Service revenues are recognized as performed. To date, the Company has not had significant levels of service revenues. Services performed by the Company have consisted primarily of commissioning and time and materials based contracts. The time and materials contracts are usually related to out-of-warranty units.

Warranty Policy — The Company provides for the estimated costs of warranties at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the product sold, geography of sale and the length of extended

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

warranties sold. The Company's product warranties generally start from the delivery date and continue for up to three years. Factors that affect the Company's warranty obligation include product failure rates, anticipated hours of product operations and costs of repair or replacement in correcting product failures. These factors are estimates that change based on new information that becomes available each period. Similarly, the Company also accrues the estimated costs to address reliability repairs on products no longer in warranty when, in the Company's judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. The Company assesses the adequacy of recorded warranty liabilities quarterly and makes adjustments to the liability as necessary. When the Company has statistically valid evidence that product changes are altering the historical failure occurrence rates, the impact of such changes is then taken into account in estimating future warranty liabilities.

Research and Development ("R&D") — The Company accounts for grant distributions as offsets to R&D expenses. Total offsets to R&D expenses amounted to \$0.5 million, \$1.5 million, \$1.7 million and \$5.6 million for the years ended March 31, 2005 and March 31, 2004, three months ended March 31, 2003, and year ended December 31, 2002, respectively.

Income Taxes — Deferred income tax assets and liabilities are computed for differences between the financial statement and income tax bases of assets and liabilities. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amounts expected to be realized.

Contingencies — The Company accounts for contingencies in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, "Accounting for Contingencies". SFAS No. 5 requires that the Company record an estimated loss from a loss contingency when information available prior to issuance of its financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.

Risk Concentrations — Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents with high credit quality institutions. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential credit losses.

The Company sells only microturbines and related parts and services. One customer accounted for 15% of the Company's net revenues for the year ended March 31, 2005. No customer accounted for 10% or more of the Company's net revenues for the year ended March 31, 2004. Two customers accounted for 32% and 18% of the Company's net revenues for the three months ended March 31, 2003. Two customers accounted for 12% and 10% of the Company's net revenues for the year ended December 31, 2002. Accounts receivable included \$477,000 and \$2,228,000 for unpaid billings to the government under cost-sharing programs at March 31, 2005 and March 31, 2004, respectively.

The Company's production relies on metals, which are currently in high demand and therefore can be difficult or expensive to obtain. Additionally, several components of the Company's products are available from a limited number of suppliers. An interruption in supply could cause a delay in manufacturing and a possible loss of sales, which would affect operating results adversely.

Estimates and Assumptions — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Net Loss Per Common Share — Basic loss per common share is computed using the weighted-average number of common shares outstanding for the period. For purposes of computing basic loss per share and diluted loss per share, shares of restricted common stock which are contingently returnable (i.e., subject to repurchase if the purchaser's status as an employee or consultant terminates) are not considered outstanding until they are vested. Diluted loss per share is also computed without consideration to potentially dilutive instruments because the Company incurred losses which would make such instruments antidilutive. Outstanding stock options at March 31, 2005, March 31, 2004, March 31, 2003 and December 31, 2002 were 9.0 million, 8.1 million, 10.0 million and 10.6 million, respectively.

Stock-Based Compensation — The Company accounts for employee stock option plans under the intrinsic value method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The Company accounts for equity instruments issued to other than employees using the fair value at the date of grant as prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation".

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123.

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Year Ended December 31, 2002
Net loss attributable to common stockholders, as reported	\$(39,449,000)	\$(47,739,000)	\$ (7,635,000)	\$(74,355,000)
Add: Stock-based employee compensation associated with stock options included in reported net loss	151,000	528,000	210,000	1,024,000
Deduct: Total stock-based employee compensation expense associated with stock options determined under fair value based method for all awards	<u>(3,803,000)</u>	<u>(5,233,000)</u>	<u>(1,897,000)</u>	<u>(9,117,000)</u>
Pro forma net loss	<u>\$(43,101,000)</u>	<u>\$(52,444,000)</u>	<u>\$ (9,322,000)</u>	<u>\$(82,448,000)</u>
Net Loss per share – Basic and Diluted:				
As reported	\$ (0.47)	\$ (0.58)	\$ (0.09)	\$ (0.95)
Pro forma	\$ (0.51)	\$ (0.64)	\$ (0.11)	\$ (1.06)

In computing the impact of SFAS No. 123, the weighted-average fair value per option share of stock option grants of \$1.46, \$1.26, \$0.80, and \$1.27 for the years ended March 31, 2005 and March 31, 2004, three months ended March 31, 2003 and year ended December 31, 2002, respectively, was estimated at the dates of grant using the following assumptions: risk-free interest rate of approximately 3.6%, 3.1%, 2.9% and 3.8%, respectively, and no assumed dividend yield. The weighted average expected life of the options was five years. The volatility used was 109%, 119%, 120% and 127%, respectively. For purposes of determining the SFAS No. 123 pro forma compensation expense, the fair value of the options is amortized over the vesting period. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models even though such models were developed to estimate the fair value of freely tradable and fully transferable options, without vesting restrictions, which significantly differ from the Company's stock option awards.

Supplemental Cash Flow Information — During 2005, the Company financed an equipment purchase of \$94,000 through a note payable obligation. During 2004, the Company financed an equipment purchase of \$21,000 through a capital lease obligation.

Segment Reporting — The Company is considered to be a single operating segment in conformity with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." The business activities of this operating segment are the development, manufacture and sale of turbine generator sets and their related accessories, parts and service. Following is the geographic revenue information based on the customer's primary operating location:

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Year Ended December 31, 2002
United States	\$ 8,859,000	\$ 6,965,000	\$ 1,411,000	\$11,246,000
Japan	1,659,000	1,888,000	78,000	4,132,000
Italy	1,143,000	317,000	9,000	2,042,000
Mexico	1,075,000	819,000	891,000	—
All others	<u>4,232,000</u>	<u>2,618,000</u>	<u>393,000</u>	<u>2,109,000</u>
Total Net Revenues	<u>\$16,968,000</u>	<u>\$12,607,000</u>	<u>\$ 2,782,000</u>	<u>\$19,529,000</u>

Revenues and gross loss for the year ended December 31, 2002 were reported net of \$569,000 and \$79,000, respectively, that resulted from the repossession of 20 units of our 30-kilowatt products from a distributor in Nigeria.

Substantially all of the Company's operating assets are in the United States.

Reclassifications — Certain prior year balances have been reclassified to conform to the current year presentation.

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

New Accounting Pronouncements — In May 2005, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 154, “Accounting Changes and Error Corrections” (“SFAS No. 154”). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. In addition, it carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 requires retrospective application to prior periods’ financial statements of changes in accounting principle in most circumstances. The Company plans to prospectively adopt SFAS No. 154 at the beginning of fiscal 2007.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of ARB 43, Chapter 4” (“SFAS No. 151”). SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of “so abnormal”. In addition, it requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted. The Company plans to adopt SFAS No. 151 at the beginning of fiscal 2007. The Company has not determined the impact that adoption of this standard will have on its financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123R”). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, “Accounting for Stock Issued to Employees”. The Company will be required to adopt SFAS No. 123R at the beginning of fiscal 2007. The Company believes that the adoption of SFAS No. 123R could have a material impact on the amount of earnings the Company reports in fiscal 2007. The Company has not yet determined the specific impact that adoption of this standard will have on its financial position or results of operations.

3. Inventories

Inventories are stated at the lower of standard cost (which approximates actual cost on the first-in, first-out method) or market and consist of the following:

	March 31, 2005	March 31, 2004
Raw materials	\$11,333,000	\$ 7,899,000
Work in process	2,580,000	2,570,000
Finished goods	1,350,000	1,360,000
Total	15,263,000	11,829,000
Less non-current portion	3,990,000	3,936,000
Current portion	<u>\$11,273,000</u>	<u>\$ 7,893,000</u>

The non-current portion of inventory represents that portion of the inventory in excess of amounts expected to be sold or used in the next twelve months.

4. Intangible Assets and Long-Lived Assets

The Company’s sole intangible asset is a manufacturing license as follows:

Gross carrying amount	\$ 3,663,000
Accumulated amortization and impairment loss	<u>(1,702,000)</u>
Balance, March 31, 2003	1,961,000
Amortization for the year ended March 31, 2004	<u>(267,000)</u>
Balance, March 31, 2004	1,694,000
Amortization for the year ended March 31, 2005	<u>(267,000)</u>
Balance, March 31, 2005	<u>\$ 1,427,000</u>

In August 2000, the Company entered into a Transition Agreement and Amended and Restated License Agreement with a supplier, requiring a total of \$9.1 million in payments based on various milestones through April 2001. All payments had been made as of December 31, 2001. Under the terms of the agreements, the Company acquired fixed assets and manufacturing technology, which provide the Company with the ability to manufacture recuperator cores previously purchased from the supplier. The agreements require the Company to pay a per-unit royalty fee over a seventeen-year period for cores manufactured and sold by the Company using the technology. As of March 31, 2005, royalties of \$23,000 were earned under the terms of the agreements. No royalties were

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

earned in prior periods. As a result of these agreements, the Company and the supplier mutually terminated any obligations under their prior agreements. The total consideration of \$9,100,000 was allocated as follows:

Fixed assets	\$3,665,000
Manufacturing license	3,663,000
Inventory	658,000
Expense	<u>1,114,000</u>
	<u>\$9,100,000</u>

The fixed assets acquired are being depreciated over their useful lives, ranging from three to ten years. The intangible asset represents the license granted to the Company to use the former supplier's intellectual property for the design and manufacture of licensed product for use in microturbines. In December 2002, due to a change in sales forecast, the Company recognized a partial impairment loss of \$5.0 million which is included in cost of goods sold and was allocated as follows: \$4.2 million to fixed assets and \$0.8 million to the manufacturing license. The Company estimated the fair value of these assets based on the present value of expected future cash flows for the remaining life of the manufacturing license, which is the primary asset of the Company's recuperator core manufacturing facility.

The intangible asset is being amortized over its estimated useful life of ten years. The Company recorded \$267,000, \$267,000, and \$374,000 of amortization expense for the years ended March 31, 2005, March 31, 2004 and December 31, 2002, respectively, and \$68,000 for the three months ended March 31, 2003. The manufacturing license is scheduled to be fully amortized by fiscal year 2011 with corresponding amortization estimated to be \$267,000, \$267,000, \$267,000, \$267,000, \$267,000 and \$92,000 for fiscal years 2006, 2007, 2008, 2009, 2010 and thereafter, respectively.

In 1999, the Company reacquired contractual marketing rights for certain territories from a former shareholder. As part of the agreement with the former shareholder, the Company paid \$5.0 million in 1999 and \$4.0 million in January 2000 for the marketing rights. In February 2000, the Company issued 1,250,000 shares of Series G preferred stock with a fair value of \$8.3 million as part of the consideration paid to reacquire the marketing rights. In addition, the agreement for the repurchase of the marketing rights provided for the acceleration of future royalty payments in the event of an initial public offering. In July 2000, the Company paid \$11.0 million in royalty payments, consisting of \$204,000 in a previously recorded royalty liability and \$10.8 million in an accelerated royalty liability. The Company recorded an intangible asset for the repurchase of marketing rights in the total amount of \$28.0 million. The marketing rights were amortized over the original agreement period of 6 years. The Company recorded \$2.7 million of amortization expense in selling, general, and administrative expenses for the year ended December 31, 2002. In June 2002, due to a change in sales forecast in the territories covered by the agreement, the Company recognized a full impairment loss on the marketing rights of \$16.0 million. The Company estimated the fair value of the marketing rights based on the present value of expected future cash flows for the remaining life of the marketing rights.

5. Accrued Warranty Reserve

Changes in accrued warranty reserve are as follows:

	March 31, 2005	March 31, 2004	March 31, 2003
Balance, beginning of the period	\$11,695,000	\$ 6,497,000	\$6,746,000
Warranty provision relating to products shipped during the period	3,410,000	1,256,000	148,000
Changes for accruals related to preexisting warranties or reliability repair programs	(4,092,000)	8,493,000	237,000
Deductions for warranty payments made in cash or in kind	<u>(2,346,000)</u>	<u>(4,551,000)</u>	<u>(634,000)</u>
Balance, end of the period	<u>\$ 8,667,000</u>	<u>\$11,695,000</u>	<u>\$6,497,000</u>

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Income Taxes

The Company's deferred tax assets and liabilities consisted of the following at March 31, 2005 and March 31, 2004:

	<u>March 31,</u> <u>2005</u>	<u>March 31,</u> <u>2004</u>
Deferred tax assets:		
Inventory	\$ 3,564,000	\$ 2,453,000
Warranty reserve	3,713,000	5,010,000
Deferred revenue	652,000	495,000
Net operating loss ("NOL") carryforwards	137,045,000	120,569,000
Tax credit carryforwards	15,515,000	13,440,000
Depreciation, amortization and impairment loss	2,176,000	4,545,000
Other	<u>2,466,000</u>	<u>3,065,000</u>
Total deferred tax assets	165,131,000	149,577,000
Deferred tax liabilities:		
State taxes	<u>(10,220,000)</u>	<u>(9,546,000)</u>
Net deferred tax assets before valuation allowance	154,911,000	140,031,000
Valuation allowance	<u>(154,911,000)</u>	<u>(140,031,000)</u>
Total deferred income tax assets	<u>\$ —</u>	<u>\$ —</u>

Due to the uncertainty surrounding the timing of realizing the benefits of our favorable tax attributes in future income tax returns, the Company has placed a valuation allowance against its deferred income tax assets.

The Company's NOL and tax credit carryforwards for federal and state income tax purposes at March 31, 2005 were as follows:

	<u>Amount</u>	<u>Expiration</u> <u>Period</u>
Federal NOL	\$342,275,000	2009-2025
State NOL	\$233,834,000	2007-2010
Federal tax credit carryforwards	\$ 8,720,000	2009-2025
State tax credit carryforwards	\$ 6,795,000	Various

The NOLs and federal and state tax credits can be carried forward to offset future taxable income, if any. The federal tax credit carryforward is a Research and Development credit, which may be carried forward. The state tax credits consist of a Manufacturer's Investment Credit of approximately \$800,000, which expires from 2005-2014, as well as a Research and Development Credit of approximately \$5,995,000, which may be carried forward indefinitely. Utilization of the NOLs and tax credits are subject to an annual limitation of approximately \$57.6 million due to the ownership change limitations of the Internal Revenue Code of 1986 and similar state provisions. In September 2002, changes in certain California tax laws were enacted, which, among other provisions, suspended the use of corporations' California NOL carryforwards to offset taxable income in 2002 and 2003. Corporations were permitted to resume using their NOLs to offset taxable income in 2004. Suspended net operating losses generated prior to 2002 that are unavailable for usage as a result of the change in law have an additional two-year life.

Tax benefits arising from the disposition of certain shares issued upon exercise of stock options within two years of the date of grant or within one year of the date of exercise by the option holder ("Disqualifying Dispositions") provide the Company with a tax deduction equal to the difference between the exercise price and the fair market value of the stock on the date of exercise. Approximately \$26.1 million of the Company's federal and state NOL carryforwards as of March 31, 2005 were generated by Disqualifying Dispositions of stock options and exercises of nonqualified stock options. Upon realization, if any, tax benefits of \$10.4 million associated with these stock options will be excluded from the provision (benefit) for income taxes and credited directly to additional paid-in-capital.

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation of income tax benefit to the federal statutory rate follows:

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Year Ended December 31, 2002
Federal income tax at the statutory rate	\$(13,412,000)	\$(16,231,000)	\$ (2,596,000)	\$(25,281,000)
State taxes, net of federal effect	(2,302,000)	(2,785,000)	(445,000)	(4,338,000)
Other	834,000	(955,000)	4,366,000	(795,000)
Valuation allowance	14,880,000	19,971,000	(1,325,000)	30,414,000
Income tax benefit	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

7. Stockholders' Equity

During the year ended March 31, 2005, the Company granted a total of 427,500 non-qualified stock options to consultants under the 2000 Equity Incentive Plan ("2000 Plan"). The Company recorded \$103,000 of stock-based compensation for these grants. The Company records stock based compensation for consultants as prescribed by SFAS No. 123. To estimate the fair value of the options, the Company utilizes the Black-Scholes option pricing model even though such model was developed to estimate the fair value of freely tradable and fully transferable options, without vesting restrictions, which significantly differ from the Company's stock option awards.

During the year ended March 31, 2004, the Company issued a total of 4,195,000 non-qualified common stock options outside of the 2000 Plan at exercise prices equal to the fair market value of its common stock, as inducement grants to new executive officers and employees of the Company. Accordingly, no stock-based compensation was recorded for these grants. Included in the 4,195,000 options were 2,000,000 options to the Company's President and Chief Executive Officer ("CEO"), 800,000 options to the Company's then Senior Vice President of Sales and Service, 800,000 options to the Company's then Senior Vice President of Operations and an aggregate of 595,000 options to five employees. Although the options were not granted under the 2000 Plan, they were governed by terms and conditions identical to those under the 2000 Plan. All, except for options granted to the Company's CEO which are subject to the same vesting provision as is the restricted stock described below, are subject to the following vesting provision: one-fourth vests one year after the issuance date and 1/48th vests on the first day of each full month thereafter, so that all shall be vested on the first day of the 48th month after the issuance date.

On August 4, 2003, the Company sold 500,000 shares of restricted common stock at a price of \$0.001 per share to the Company's new President and CEO as part of his compensation package. Deferred stock compensation of \$590,000 was recorded based on the fair market value of the stock at the date of issuance. The restricted stock is subject to the following vesting provision: one-fourth vests one year after the issuance date and 1/48th vests on the first day of each full month thereafter, so that all shall be vested on the first day of the 48th month after the issuance date; provided, however, that if the President/CEO is terminated by the Company other than for cause prior to the one-year anniversary of the date of the issuance, 1/48th vests on the one-month anniversary of the issuance date until the termination date. The deferred stock compensation related to the restricted common stock is being amortized through fiscal 2008 based on the vesting period.

On June 25, 2003, the Company made a tender offer to eligible employees to exchange options with exercise prices greater than or equal to \$2.00 per share. 610,950 options were tendered by eligible employees in the exchange offer. The tendered options were cancelled on July 25, 2003. 125,087 options were forfeited as a result of terminations prior to January 26, 2004. On January 26, 2004, the Company granted 485,863 new options at an exercise price of \$2.36 per share which represented the fair market value on that date. Each new option is a non-statutory stock option, with vesting as follows: 12.5% vested on January 26, 2004 with the remainder to vest monthly over the next 42 months, subject to the option holders' continued employment. In accordance with FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation (an Interpretation of APB Opinion No. 25)" and APB No. 25 "Accounting for Stock Issued to Employees", no stock-based compensation was recorded for the grant since the new options were granted six months and one day from the cancellation date. For purposes of disclosure under the requirements of SFAS No. 123, compensation expense is calculated for the options that vest each period.

In November 2002, the Company issued 3,840,000 non-qualified common stock options outside of the 2000 Plan at an exercise price equal to the fair market value of its common stock. Accordingly, no stock-based compensation was recorded for the grant. The options were issued as part of the compensation package of the Company's Interim Chief Executive Officer, who at the time the options were granted was the Company's Interim Chief Operating Officer. Although the options were not granted under the

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2000 Plan, they were governed by terms and conditions identical to those under the 2000 Plan. 1/48th of the options vested each month. In July 2003, 3,174,194 unvested options were canceled. A total of 665,806 vested options were exercised.

In October 2002, the Company entered into a strategic alliance with United Technologies Corporation (“UTC”) through its UTC Power Division. The strategic alliance between UTC and Capstone involved a ten-year agreement for the integration, marketing, sales and service of combined cooling heat and power (“CCHP”) solutions targeted for commercial buildings. The UTC agreement provided for the combination of Capstone MicroTurbine products with UTC absorption chillers. Under the agreement, UTC became the exclusive distributor for the combined Capstone MicroTurbines with UTC absorption chillers and a non-exclusive distributor generally for Capstone MicroTurbines. The UTC agreement was limited to North America and most of Europe. As part of the UTC agreement, UTC purchased 3,994,817 shares of Capstone’s common stock for an aggregate price of approximately \$4.0 million. The UTC shares were subject to a lock-up period of nine months subject to certain exceptions provided for in the UTC agreement.

In January 2002, the Company issued 350,000 non-qualified common stock options outside of the 2000 Plan at an exercise price equal to the fair market value of its common stock. Accordingly, no stock-based compensation was recorded for the grant. The options were issued as part of the compensation package of the Company’s CFO. Although the options were not granted under the 2000 Plan, they are governed by terms and conditions identical to those under the 2000 Plan. One-fourth of the options vest one year after the grant date and 1/48th vest on the first day of each full month thereafter, so that all of the options shall be vested on the first day of the 48th month after the grant date.

In November 2001, the Company issued 800,000 non-qualified common stock options outside of the 2000 Plan at an exercise price equal to the fair market value of its common stock. Accordingly, no stock-based compensation was recorded for the grant. The options were issued as part of the compensation package of the Company’s former Chief Operating Officer who resigned in 2002. Although the options were not granted under the 2000 Plan, they are governed by terms and conditions identical to those under the 2000 Plan. In November 2002, 600,000 unvested options were canceled. In February 2003, 200,000 vested options expired unexercised.

In June 2000, the Company adopted the 2000 Plan, as a successor plan to the 1993 Incentive Stock Plan (“1993 Plan”). The 2000 Plan was amended in January 2004 to update certain administrative provisions, amended in September 2004 to add 2,380,000 shares of common stock to the total available for issuance under awards, and amended again on January 31, 2005 and March 17, 2005 so that the provisions for change in control are coordinated with the Company’s change in control agreements and programs. The 2000 Plan provides for awards of up to 6,080,000 shares of common stock, plus 7,800,000 shares previously authorized under the 1993 Plan; provided, however, that the maximum aggregate number of shares which may be issued upon exercise of incentive stock options is 13,880,000 shares. The 2000 Plan is administered by a Committee designated by the Board of Directors. The Committee’s authority includes determining the number of options granted and vesting provisions. As of March 31, 2005, 3,360,531 shares were available for future grant.

In June 2000, the Company adopted the 2000 Employee Stock Purchase Plan (the “Purchase Plan”), which provides for the granting of rights to purchase common stock to regular full and part-time employees or officers of the Company and its subsidiaries. Under the Purchase Plan, shares of common stock will be issued upon exercise of the purchase rights. Under the Purchase Plan, an aggregate of 900,000 shares may be issued pursuant to the exercise of purchase rights. The maximum amount that an employee can contribute during a purchase right period is \$25,000 or 15% of the employee’s regular compensation. Under the Purchase Plan, the exercise price of a purchase right will be the lesser of 85% of the fair market value of such shares on the first day of the purchase right period or the last day of the purchase right period. For this purpose, the fair market value of the stock is its closing price as reported on the Nasdaq Stock Market on the day in question. As of March 31, 2005, 362,836 shares were available for future grant.

During the years ended December 31, 1999 and 2000, the Company granted options at less than the fair value of its common stock. In addition, in fiscal 2004, the Company issued shares of restricted common stock at less than the fair value of its common stock. Accordingly, the Company recorded stock-based compensation expense based on the vesting of these issuances as follows:

	Year Ended March 31, 2005	Year Ended March 31, 2004	Three Months Ended March 31, 2003	Year Ended December 31, 2002
Cost of goods sold	\$ —	\$ 49,000	\$ 9,000	\$ 41,000
Research and development	4,000	186,000	59,000	268,000
Selling, general and administrative	147,000	293,000	142,000	715,000
Total	<u>\$ 151,000</u>	<u>\$ 528,000</u>	<u>\$ 210,000</u>	<u>\$ 1,024,000</u>

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2005, the Company had \$356,000 in deferred stock compensation related to restricted stock which will be amortized through fiscal 2008.

Information relating to all outstanding stock options, except for rights associated with the Purchase Plan, is as follows:

	Shares	Weighted-Average Exercise Price
Outstanding at December 31, 2001	6,612,741	\$ 6.91
Granted	5,716,025	\$ 1.58
Exercised	(285,349)	\$ 0.41
Canceled	<u>(1,451,683)</u>	\$ 8.57
Outstanding at December 31, 2002	10,591,734	\$ 4.05
Granted	22,600	\$ 1.01
Exercised	(65,700)	\$ 0.33
Canceled	<u>(592,116)</u>	\$ 8.45
Outstanding at March 31, 2003	9,956,518	\$ 3.81
Granted	5,910,809	\$ 1.62
Exercised	(2,673,193)	\$ 0.73
Canceled	<u>(5,103,561)</u>	\$ 4.65
Outstanding at March 31, 2004	8,090,573	\$ 2.69
Granted	2,137,591	\$ 1.81
Exercised	(212,619)	\$ 0.69
Canceled	<u>(972,121)</u>	\$ 3.40
Outstanding at March 31, 2005	<u>9,043,424</u>	\$ 2.46

Options exercisable at March 31, 2005, March 31, 2004, March 31, 2003 and December 31, 2002 were 3,752,357, 1,882,043, 4,008,495 and 3,772,586 with weighted average exercise prices of \$3.48, \$5.39, \$4.55 and \$4.94, respectively.

Additional information regarding options outstanding at March 31, 2005 is as follows:

Exercise Price	Options Outstanding			Options Exercisable	
	Number of Shares Outstanding at March 31, 2005	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Exercisable at March 31, 2005	Weighted Average Exercise Price
Up to \$1.00	398,794	3.3	\$ 0.72	398,294	\$ 0.72
\$1.01 to \$2.00	6,743,674	8.6	\$ 1.53	2,298,781	\$ 1.51
\$2.01 to \$5.00	1,503,085	8.0	\$ 3.05	663,594	\$ 3.58
Greater than \$5.00	397,871	5.5	\$ 17.78	391,688	\$ 17.69
	<u>9,043,424</u>	8.1	\$ 2.46	<u>3,752,357</u>	\$ 3.48

8. Commitments and Contingencies

As of March 31, 2005, the Company had firm commitments to purchase inventories of approximately \$7.8 million.

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through fiscal 2011. All of the leases require the Company to pay maintenance, insurance and property taxes. The lease agreements provide for rent escalation over the lease term. Rent expense is recognized on a straight-line basis over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to "Deferred rent" which is included in Other Long-term Liabilities. Deferred rent amounted to \$931,000 and \$975,000 as of March 31, 2005 and 2004, respectively. Rent expense amounted to approximately \$1,965,000, \$1,793,000 and \$1,843,000 for the years ended March 31, 2005, March 31, 2004 and December 31, 2002, respectively. Rent expense amounted to approximately \$442,000 for the three months ended March 31, 2003. In August 2003, the Company entered into a sublease agreement for a portion of its former sales office, which expires in March 2006. The sublessee vacated the premises during the third quarter of fiscal 2005 and is no longer paying the sublease amount. The space remains vacant.

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company had equipment under capital leases that were paid off during fiscal 2005. At March 31, 2004 the equipment under capital lease had a cost of \$3,173,000, and accumulated amortization of \$2,841,000. The deferred gain on sale-leaseback capital lease obligations at March 31, 2004 was \$7,000, which was recognized as an offset to amortization expense over the useful life of the asset. The related assets collateralized the capital lease obligations.

At March 31, 2005, the Company's minimum commitments under non-cancelable operating leases are as follows:

<u>Year Ending March 31,</u>	<u>Operating Leases</u>
2006	\$1,698,000
2007	1,470,000
2008	1,486,000
2009	1,554,000
2010	1,576,000
Thereafter	600,000
Total minimum lease payments	<u>\$8,384,000</u>

In June 2001, the Company was awarded a \$3.0 million grant from the Department of Energy ("DOE") for the research, development and testing of packaged cooling, heating and power systems for buildings. The contract is estimated to cost \$5.5 million, which would require the Company to provide approximately \$2.5 million of its own R&D expenditures. The Company billed the DOE under this agreement \$1.3 million through March 31, 2005. The Company's remaining funding under this program is approximately \$1.7 million as of March 31, 2005 which would require the Company to provide at least \$1.3 million of its own R&D expenditures. The Company accounts for grant distributions as offsets to R&D expenses. Total offsets to R&D expenses such as the DOE award amounted to \$0.5 million, \$1.5 million, \$1.7 million and \$5.6 million for the years ended March 31, 2005 and March 31, 2004, three months ended March 31, 2003, and year ended December 31, 2002 respectively.

Agreements we have with some of our Distributors and Authorized Service Companies ("ASCs") require that if we obsolete parts inventories they own and hold in support of their obligations to serve fielded microturbines, then we are required to replace the affected stock at no cost to the Distributors or ASCs. While we have never incurred costs or obligations for these types of replacements, it is possible that future changes in our product technology could result and yield costs that have a material effect on our results of operations or financial position.

In December 2001, a purported shareholder class action lawsuit was filed against the Company, two of its then officers, and the underwriters of the Company's initial public offering. The suit purports to be a class action filed on behalf of purchasers of the Company's common stock during the period from June 28, 2000 to December 6, 2000. An amended complaint was filed on April 19, 2002. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company's June 28, 2000 initial public offering and November 16, 2000 secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. Plaintiffs allege that the prospectuses for these two public offerings were false and misleading in violation of the securities laws because they did not disclose these arrangements. A committee of the Company's Board of Directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers. The proposed settlement is pending final approval by parties to the action and the United States District Court Southern District of New York.

A demand for arbitration has been filed by a party in March 2004 that conducts business with the Company, claiming damages for breach of contract in excess of \$10 million. The arbitration is currently scheduled for January 2006. The Company intends to vigorously defend against this action. As with any such action, the ultimate outcome is uncertain.

9. Employee Benefit Plans

The Company maintains a defined contribution 401(k) profit-sharing plan in which all employees are eligible to participate. Employees may contribute up to Internal Revenue Service annual limits or, if less, 90% of their eligible compensation. Employees are fully vested in their contributions to the plan. The plan also provides for both Company matching and discretionary contributions, which are to be determined by the Board of Directors. No Company contributions have been made to the plan since its inception.

CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company has a deferred compensation plan providing eligible executives with the opportunity to participate in an unfunded, deferred compensation program. Under the program, participants may defer base compensation and bonuses and earn interest on their deferred amounts. The program is not qualified under Section 401 of the Internal Revenue Code. The balance of participant deferrals and earnings thereon was \$129,000 and \$164,000 at March 31, 2005 and 2004, which is included in Other Long-Term Liabilities. The participant deferrals earn interest at the prime interest rate set by Wells Fargo Bank plus 1% per year.

10. Related Party Transactions

Mr. Eliot Protsch is the Chairman of the Company's Board of Directors. Mr. Protsch is Senior Vice-President and Chief Financial Officer of Alliant Energy Corporation. Alliant Energy Resources, Inc., a subsidiary of Alliant Energy Corporation, was a distributor for the Company. Sales to Alliant Energy Resources, Inc. were approximately \$-0-, \$25,000, \$-0-, and \$1.5 million for the years ended March 31, 2005 and 2004, three months ended March 31, 2003, and year ended December 31, 2002, respectively.

In October 2002, the Company entered into a strategic alliance with UTC, a stockholder, through its UTC Power Division (see Note 7). In March 2005, Capstone and UTC replaced the strategic alliance agreement with an original equipment manufacturer ("OEM") agreement. The OEM agreement involves the integration, marketing, sales and service of CCHP solutions worldwide. Sales to UTC's affiliated companies were approximately \$2,485,000, \$1,044,000 and \$11,000 for the years ended March 31, 2005 and 2004, and three months ended March 31, 2003, respectively. There were no sales to UTC's affiliated companies in the year ended December 31, 2002. Related accounts receivable were \$1,496,000 and \$467,000 at March 31, 2005 and 2004. In December 2003, the Company engaged United Technologies Research Center ("UTRC") to be a subcontractor of the Company in relation to one of the DOE awards. UTRC is the research and development branch of UTC. UTRC billed the Company \$220,000 under this subcontract for the year ended March 31, 2005, of which \$220,000 was unpaid at March 31, 2005. For the year ended March 31, 2004, \$450,000 was billed under the subcontract, of which \$81,000 was outstanding at March 31, 2004.

In October 2002, the Company entered into a Transition Agreement and Mutual Release with its then President and Chief Executive Officer. On February 27, 2003, the Board accepted his resignation as President and Chief Executive Officer and a member of the Board. He continued as an employee and a senior advisor to the Company through May 6, 2003. Under the transition agreement, he continued to receive his monthly salary for six months through May 6, 2003, which totaled approximately \$185,000, he received incentive consideration of \$100,000 upon executing a Supplemental Release and he received approximately \$185,000, payable in equal installments, less applicable withholding taxes, during the twelve-month period following his separation as an employee. In May 2003, the Company entered into a consulting agreement with him, which provides payment of \$5,921 monthly in arrears for 38 months through June 2006. His payment will be reduced by 50% if he engages in any full-time employment. His stock options will also continue to vest through June 2006. Accordingly, non-employee stock-based compensation pertaining to this modification is re-measured and recorded at each vesting period and amounted to \$22,000 and \$85,000 for the years ended March 31, 2005 and March 31, 2004, respectively.

During the year ended December 31, 2002, the Company paid consulting fees of \$225,000 to its former Chief Operating Officer.

In December 2001, the Company entered into a Separation and Consulting Agreement with its then CFO. The agreement provided, among other items, an acceleration of vesting of his then unvested common stock options. The Company recognized stock-based compensation of \$548,000 in 2001 based upon the intrinsic value of the unvested options that became vested. The Company paid him consulting fees of approximately \$99,000 in 2002.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Capstone had no changes in independent auditors during the fiscal years ended March 31, 2005 and 2004.

Item 9A. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

In connection with the preparation of this Annual Report on Form 10-K, as of March 31, 2005, an evaluation was performed under the supervision and with the participation of the Company's management, including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Our CEO and CFO have concluded that, for the reasons set forth below, our disclosure controls and procedures were not adequate to ensure that all of the information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the SEC.

(b) Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is designed 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. Our internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;
- Provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of March 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control-Integrated Framework*. Our independent registered public accounting firm, Deloitte & Touche LLP, has issued an attestation report on management's assessment of internal control over financial reporting. That report appears on page 50 of this annual report on Form 10-K.

As a result of its evaluation, management has concluded that three control deficiencies identified in its internal control over financial reporting as of March 31, 2005 constitute "material weaknesses" within the meaning of the Public Company Accounting Oversight Board Auditing Standard No. 2. A material weakness is defined as a significant deficiency, or combination of significant deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Because management has identified material weaknesses, management has concluded that the Company's internal control over financial reporting was ineffective as of March 31, 2005.

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The first material weakness relates to a deficiency in the design of controls for ensuring that the Company's financial accounting software was properly configured, during the Company's change in fiscal year, to correctly calculate depreciation and amortization expense of equipment and leasehold improvements. In the three month period ended March 31, 2004, the software was configured to change to fiscal from calendar years. Controls designed to detect errors in depreciation and amortization expense, principally the reconciliation and review of depreciation and amortization expense for reasonableness, did not operate effectively as they did not detect the error. These deficiencies in controls resulted in the Company recording an adjustment of \$609,000 to increase depreciation and amortization expense in the fourth quarter of fiscal 2005. The impact of such adjustment on prior quarters was not significant. The second material weakness, a deficiency in the operation of controls for identifying and recording accounts payable and accrued liabilities, principally from the failure of the Company's controls to detect an understatement of accrued liabilities for legal expenses, resulted in recording adjustments aggregating \$277,000 to increase accounts payable and accrued liabilities and corresponding expenses as of and for the year ended March 31, 2005. The third material weakness relates to a deficiency in the operation of controls for compiling fiscal year-end physical inventory counts for work-in-process inventory, principally inadequate compiling of inventory count tags and the lack of review by supervisors sufficient to detect errors arising from manually input data.

The Company has taken steps to remediate the control deficiencies identified. The Company will calculate and record depreciation and leasehold amortization expense until such time as the SAP system can be correctly configured and will be diligent in the accrual of legal fees and in compiling year-end physical inventory counts. Management has discussed these issues and remediation efforts in detail with our Audit Committee. Our CEO and our CFO believe that these remediation measures will address these material weaknesses and will also allow us to conclude that our disclosure controls and procedures and our internal controls over financial reporting are effective at a reasonable level of assurance at future filing dates.

Item 9B. Other Information.

None.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Capstone Turbine Corporation
Chatsworth, California

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Capstone Turbine Corporation and subsidiary (the "Company") did not maintain effective internal control over financial reporting as of March 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment:

1. A deficiency in the design of controls for ensuring that the Company's financial accounting software was properly configured during the Company's change in fiscal year, which was implemented in the three month period ended March 31, 2004, to calculate depreciation and amortization of equipment and leasehold improvements and to a deficiency in the operation of controls designed to detect errors in depreciation and amortization expense, principally the reconciliation and review of depreciation and amortization expense for reasonableness, which did not operate effectively as they did not detect an error. These deficiencies in controls resulted in the Company recording an adjustment of \$609,000 to increase depreciation and amortization expense for the year ended March 31, 2005.
2. A deficiency in the operation of controls for identifying and recording accounts payable and accrued liabilities, principally from the failure of the Company's controls to detect an understatement of accrued liabilities for legal expenses, resulted in

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recording adjustments aggregating \$277,000 to increase accounts payable and accrued liabilities and corresponding expenses as of and for the year ended March 31, 2005.

3. A deficiency in the operation of controls for compiling fiscal year-end physical inventory counts for work-in-process inventory, principally inadequate compiling of inventory count tags and the lack of review by supervisors sufficient to detect errors arising from manually input data.

These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended March 31, 2005, of the Company and this report does not affect our report on such financial statements.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of March 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of March 31, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended March 31, 2005, of the Company and our report dated June 29, 2005 expressed an unqualified opinion on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Los Angeles, California
June 29, 2005

PART III

Item 10. *Directors and Executive Officers of the Registrant.*

The information required by this Item 10 is incorporated by reference from Capstone's definitive proxy statement for its 2005 annual meeting of stockholders, scheduled to be held on September 16, 2005.

Item 11. *Executive Compensation.*

The information required by this Item 11 is incorporated by reference from Capstone's definitive proxy statement for its 2005 annual meeting of stockholders, scheduled to be held on September 16, 2005.

Item 12. *Security Ownership of Certain Beneficial Owners and Management.*

The information required by this Item 12 is incorporated by reference from Capstone's definitive proxy statement for its 2005 annual meeting of stockholders, scheduled to be held on September 16, 2005.

Item 13. *Certain Relationships and Related Transactions.*

The information required by this Item 13 is incorporated by reference from Capstone's definitive proxy statement for its 2005 annual meeting of stockholders, scheduled to be held on September 16, 2005.

Item 14. *Principal Accountant Fees and Services.*

The information required by this Item 14 is incorporated by reference from Capstone's definitive proxy statement for its 2005 annual meeting of stockholders, scheduled to be held on September 16, 2005.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

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Financial Statement Schedules.

Schedule I – Condensed Financial Information of Registrant – not applicable

Schedule II – Valuation and Qualifying Accounts – required information is provided in the footnotes to the financial statements

Schedule III – Real Estate and Accumulated Depreciation – not applicable

Schedule IV – Mortgage Loans on Real Estate – not applicable

Schedule V – Supplemental Information Concerning Property-Casualty Insurance Operations – not applicable

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3. Index to Exhibits.

Exhibit Number	Description
3.1(2)	Second Amended and Restated Certificate of Incorporation of Capstone Turbine.
3.2(1)	Amended and Restated Bylaws of Capstone Turbine.
4.1(2)	Specimen stock certificate.
9.1(2)	Investor Rights Agreement.
9.2(2)	Amendment No. 1 to Investors Rights Agreement.
9.3(3)	Amendment No. 2 to Investors Rights Agreement.
9.4(3)	Amendment No. 3 to Investors Rights Agreement.
10.1(2)	Lease between Capstone Turbine and Northpark Industrial — Leahy Division LLC, dated December 1, 1999, for leased premises at 21211 Nordhoff Street, Chatsworth, California.
10.2(2)	1993 Incentive Stock Option Plan.
10.3(2)	Employee Stock Purchase Plan.
10.4(1)	Amended and Restated 2000 Equity Incentive Plan.
10.6(4)	Transition Agreement, dated August 2, 2000, by and between Capstone Turbine and Solar Turbines Incorporated.
10.7(4)	Amended and Restated License Agreement, dated August 2, 2000, by and between Solar Turbines Incorporated and Capstone Turbine.
10.8(6)	Lease between Capstone Turbine and AMB Property, L.P., dated September 25, 2000, for leased premises at 16640 Stagg Street, Van Nuys, California.
10.9(6)	Lease between Capstone Turbine and AH Warner Center Properties, Limited Liability Company, dated February 16, 2001, for leased premises at 21700 Oxnard Street, Woodland Hills, California.
10.10(5)	Deferred Compensation Plan of Capstone Turbine.
10.11(7)	Executive Incentive Compensation Plan.
10.12(1)	Amended and Restated Capstone Turbine Corporation Change of Control Severance Plan.
10.13(5)	Capstone Turbine Corporation Restricted Stock Purchase Agreement with John Tucker dated August 4, 2003.
10.14(7)	Amendment to the Capstone Turbine Corporation Restricted Stock Purchase Agreement with John Tucker dated August 4, 2003.
10.16(14)	Stock Option Agreement with Karen Clark dated January 29, 2002.
10.17(15)	Stock Option Agreement with Michael Redmond dated August 25, 2003.
10.18(15)	Stock Option Agreement with John Fink III dated August 25, 2003.
14.1(11)	Code of Business Conduct.
14.2(11)	Code of Ethics for Senior Financial Officers and Chief Executive Officer.
23.1(1)	Consent of Deloitte & Touche LLP.
24.1(1)	Power of Attorney (included in the signature page of this Form 10-K).
31.1 (1)	CEO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
31.2 (1)	CFO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
32.1 (1)	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the CEO and CFO.

(1) Filed herewith.

(2) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-1 (File No. 333-33024).

(3) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-1 (File No. 333-48524).

(4) Incorporated by reference to Capstone Turbine's Current Report on Form 8-K filed on October 16, 2000 (File No. 001-15957).

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- (5) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-8 (File No. 333-66390).
- (6) Incorporated by reference to Capstone Turbine's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 001-15957).
- (7) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004 (File No. 001-15957).
- (8) Incorporated by reference to Capstone Turbine's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 001-15957).
- (9) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2003 (File No. 001-15957).
- (10) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003 (File No. 001-15957).
- (11) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2003 (File No. 001-15957).
- (12) Incorporated by reference to Capstone Turbine's Proxy Statement on Form DEF 14A for the annual Shareholders Meeting on September 10, 2004.
- (13) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 (File No. 001-15957).
- (14) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-8 filed on November 14, 2002.
- (15) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-8 filed on December 1, 2003.

**AMENDED AND RESTATED BYLAWS OF
CAPSTONE TURBINE CORPORATION**

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AMENDED AND RESTATED BYLAWS

OF

CAPSTONE TURBINE CORPORATION

ARTICLE I

OFFICES

Section 1. *Registered Office.* The registered office of Capstone Turbine Corporation (hereinafter, called the “corporation”) shall be in the City of Dover, County of Kent, State of Delaware.

Section 2. *Other Offices.* The corporation may also have offices at such other places both within and without the State of Delaware as the Board of Directors may from time to time determine or the business of the corporation may require.

ARTICLE II

STOCKHOLDERS

Section 1. *Place of Meetings.* Meetings of stockholders shall be held at any place within or outside the State of Delaware designated by the board of directors. In the absence of any such designation, stockholders’ meetings shall be held at the principal executive office of the corporation.

Section 2. *Annual Meetings of Stockholders.* The annual meeting of stockholders shall be held each year on a date and time designated by the board of directors. Any previously scheduled annual meeting of the stockholders may be postponed by resolution of the board of directors upon public notice given prior to the date previously scheduled for such annual meeting of the stockholders.

Section 3. *Special Meetings.* A special meeting of the stockholders may be called at any time by the chairman of the board of directors, or by a majority of the directors or by a committee of the board of directors which has been duly designated by the board of directors and whose powers and authority, as provided in a resolution of the board of directors, include the power to call such meetings, but such special meetings may not be called by any other person or persons. Any previously scheduled special meeting of the stockholders may be postponed by resolution of the board of directors upon public notice given prior to the date previously scheduled for such special meeting of the stockholders.

Section 4. *Notice of Stockholders’ Meetings.* All notices of meetings of stockholders shall be sent or otherwise given in accordance with Section 5 of this Article II not less than ten (10) nor more than sixty (60) days before the date of the meeting being noticed. The notice shall specify the place, date and hour of the meeting and in the case of a special meeting, the general nature of the business to be transacted.

Section 5. *Manner of Giving Notice; Affidavit of Notice.* Notice of any meeting of stockholders shall be deemed to have been given:

(A) when deposited in the mail, postage prepaid, directed to the stockholder at his address appearing on the books of the corporation or given by the stockholder to the corporation for the purpose of notice; or

(B) if electronically transmitted as provided in Article VIII, Section 1 of these bylaws.

An affidavit of the mailing, electronic transmission or other means of giving any notice of any stockholders' meeting shall be executed by the secretary, assistant secretary or any transfer agent of the corporation giving such notice, and shall be filed and maintained in the minute book of the corporation.

Section 6. *Quorum.* The presence in person or by proxy of the holders of a majority of the shares entitled to vote at any meeting of stockholders shall constitute a quorum for the transaction of business. The stockholders present at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding the withdrawal of enough stockholders to leave less than a quorum, if any action taken (other than adjournment) is approved by at least a majority of the shares required to constitute a quorum.

Section 7. *Adjourned Meeting and Notice Thereof.* Any stockholders' meeting, annual or special, whether or not a quorum is present, may be adjourned from time to time by the chairman of the meeting, but in the absence of a quorum, no other business may be transacted at such meeting, except as provided in Section 6 of this Article II.

When any meeting of stockholders, either annual or special, is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place thereof are announced at a meeting at which the adjournment is taken, unless a new record date for the adjourned meeting is fixed, or unless the adjournment is for more than thirty (30) days from the date set for the original meeting. Notice of any such adjourned meeting, if required, shall be given to each stockholder of record entitled to vote at the adjourned meeting in accordance with the provisions of Sections 4 and 5 of this Article II. At any adjourned meeting the corporation may transact any business which might have been transacted at the original meeting.

Section 8. *Voting.* The stockholders entitled to vote at any meeting of stockholders shall be determined in accordance with the provisions of Section 11 of this Article II. Such vote may be by voice vote or by ballot, at the discretion of the chairman of the meeting. Any stockholder entitled to vote on any matter (other than the election of directors) may vote part of the shares in favor of the proposal and refrain from voting the remaining shares or vote them against the proposal; but, if the stockholder fails to specify the number of shares such stockholder is voting affirmatively, it will be conclusively presumed that the stockholder's approving vote is with respect to all shares such stockholder is entitled to vote. If a quorum is present, the affirmative vote of the majority of the shares represented at the meeting and entitled to vote on any matter shall be the act of the stockholders, unless the vote of a greater number or voting by classes is

required by the Delaware General Corporation Law (the “DGCL”) or the certificate of incorporation or the certificate of determination of preferences as to any preferred stock.

At a stockholders’ meeting involving the election of directors, no stockholder shall be entitled to cumulate (*i.e.*, cast for any one or more candidates a number of votes greater than the number of the stockholders shares). The candidates receiving the highest number of votes, up to the number of directors to be elected, shall be elected.

Section 9. *Waiver of Notice or Consent by Absent Stockholders.* The transactions of any meeting of stockholders, either annual or special, however called and noticed, and wherever held, shall be as valid as though had at a meeting duly held after regular call and notice, if a quorum be present either in person or by proxy, and if, either before or after the meeting, each person entitled to vote, not present in person or by proxy, delivers a written waiver signed by such person (or a waiver by electronic transmission by such person) of notice or a consent (manually signed or submitted by electronic transmission) to the holding of the meeting, or an approval of the minutes thereof. The waiver of notice or consent need not specify either the business to be transacted or the purpose of any annual or special meeting of stockholders. All such waivers, consents or approvals shall be filed with the corporate records or made part of the minutes of the meeting.

Attendance of a person at a meeting shall also constitute a waiver of notice of such meeting, except when the person objects, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened, and except that attendance at a meeting is not a waiver of any right to object to the consideration of matters not included in the notice of the meeting if such objection is expressly made at the meeting.

Section 10. *No Stockholder Action by Written Consent Without a Meeting.* Stockholders may take action only at a regular or special meeting of stockholders.

Section 11. *Record Date for Stockholder Notice and Voting.* For purposes of determining the holders entitled to notice of any meeting or to vote, the board of directors may fix, in advance, a record date, which shall not be more than sixty (60) days nor less than ten (10) days prior to the date of any such meeting, and in such case only stockholders of record on the date so fixed are entitled to notice and to vote, notwithstanding any transfer of any shares on the books of the corporation after the record date fixed as aforesaid, except as otherwise provided in the Delaware General Corporation Law.

If the board of directors does not so fix a record date, the record date for determining stockholders entitled to notice of or to vote at a meeting of stockholders shall be at the close of business on the business day next preceding the day on which notice is given or, if notice is waived, at the close of business on the business day next preceding the day on which the meeting is held.

Section 12. *Proxies.* Every person entitled to vote for directors or on any other matter shall have the right to do so either in person or by one or more agents authorized (a) by a written proxy signed by the person and filed with the secretary of the corporation or (b) by an electronic transmission permitted by law filed in accordance with the procedure established for the meeting.

A validly executed proxy which does not state that it is irrevocable shall continue in full force and effect unless (i) revoked by the person executing it, prior to the vote pursuant thereto, by a writing delivered to the corporation (whether manually signed or electronically transmitted) stating that the proxy is revoked or by a subsequent proxy executed or electronically transmitted by, or attendance at the meeting and voting in person by, the person executing or electronically transmitting the proxy, or (ii) written notice of the death or incapacity of the maker of such proxy is received by the corporation before the vote pursuant thereto is counted; provided, however, that no such proxy shall be valid after the expiration of one (1) year from the date of such proxy, unless otherwise provided in the proxy.

Section 13. *Inspectors of Election; Opening and Closing the Polls.* The board of directors by resolution shall appoint one or more inspectors, which inspector or inspectors may include individuals who serve the corporation in other capacities, including, without limitation, as officers, employees, agents or representatives, to act at the meetings of stockholders and make a written report thereof. One or more persons may be designated as alternate inspectors to replace any inspector who fails to act. If no inspector or alternate has been appointed to act or is able to act at a meeting of stockholders, the chairman of the meeting shall appoint one or more inspectors to act at the meeting. Each inspector, before discharging his or her duties, shall take and sign an oath faithfully to execute the duties of inspector with strict impartiality and according to the best of his or her ability. The inspectors shall have the duties prescribed by law.

The chairman of the meeting shall fix and announce at the meeting the date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting.

Section 14. *Nomination and Stockholder Business Bylaw.*

(A) *Annual Meetings of Stockholders.*

(1) Nominations of persons for election to the board of directors of the corporation and the proposal of business to be considered by the stockholders may be made at an annual meeting of stockholders (a) pursuant to the corporation's notice of meeting, (b) by or at the direction of the board of directors or (c) by any stockholder of the corporation who was a stockholder of record at the time of giving of notice provided for in this bylaw, who is entitled to vote at the meeting and who complies with the notice procedures set forth in this bylaw.

(2) For nominations or other business to be properly brought before an annual meeting by a stockholder pursuant to clause (c) of paragraph (A)(1) of this bylaw, the stockholder must have given timely notice thereof in writing to the secretary of the corporation and such other business must otherwise be a proper matter for stockholder action. To be timely, a stockholder's notice shall be delivered to the secretary at the principal executive offices of the corporation not less than the close of business on the 120th calendar day in advance of the first anniversary of the date the corporation's proxy statement was released to security holders in connection with the preceding year's annual meeting; provided, however, that if no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than thirty (30) calendar days from the date contemplated at the time of the previous year's proxy statement, a proposal shall be received by the corporation no later than the close of business on the tenth day following the day on which notice of the date of the meeting was mailed or public announcement of the date of the meeting was made, whichever comes first.

In no event shall the public announcement of an adjournment of an annual meeting commence a new time period for the giving of a stockholder's notice as described above. Such stockholder's notice shall set forth (a) as to each person whom the stockholder proposes to nominate for election or reelection as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to applicable federal securities laws, including, without limitation, Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 14a-11 thereunder (including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected); (b) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and the beneficial owner, if any, on whose behalf the proposal is made; and (c) as to the stockholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made (i) the name and address of such stockholder, as they appear on the corporation's books, and of such beneficial owner and (ii) the class and number of shares of the corporation which are owned beneficially and of record by such stockholder and such beneficial owner.

(3) Notwithstanding anything in the second sentence of paragraph (A)(2) of this bylaw to the contrary, in the event that the number of directors to be elected to the board of directors of the corporation is increased and there is no public announcement by the corporation naming all of the nominees for director or specifying the size of the increased board of directors at least 70 days prior to the first anniversary of the date of the preceding year's annual meeting, a stockholders notice required by this bylaw shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be delivered to the secretary at the principal executive offices of the corporation not later than the close of business on the 10th day following the day on which such public announcement is first made by the corporation.

(B) *Special Meetings of Stockholders.* Only such business shall be conducted at a special meeting of stockholders as shall be brought before the meeting pursuant to the corporation's notice of meeting. A stockholder's nomination of one or more persons for election to the board of directors shall only be permitted to be made at a special meeting of stockholders if: (i) the corporation's notice of such meeting specified that directors are to be elected at such special meeting; (ii) such stockholder was a stockholder of record entitled to vote at the meeting at the time of giving of notice provided for in this bylaw; and (iii) if such stockholder complies with the notice procedures set forth in this bylaw. In the event the corporation calls a special meeting of stockholders for the purpose of electing one or more directors to the board of directors, any such stockholder may nominate a person or persons (as the case may be), for election to such position(s) as specified in the corporation's notice of meeting, if the stockholder's notice required by paragraph (A)(2) of this bylaw shall be delivered to the secretary at the principal executive offices of the corporation not earlier than the close of business on the 90th day prior to such special meeting and not later than the close of business on the later of the 60th day prior to such special meeting or the 10th day following the day on which public announcement is first made of the date of the special meeting and of the nominees proposed by the board of directors

to be elected at such meeting. In no event shall the public announcement of an adjournment of a special meeting commence a new time period for the giving of a stockholder's notice as described above.

(C) *General.*

(1) Only such persons who are nominated in accordance with the procedures set forth in this bylaw shall be eligible to serve as directors. Except as otherwise provided by law, the certificate of incorporation or these bylaws, the chairman of the meeting shall have the power and authority to determine the procedures of a meeting of stockholders, including, without limitation, the authority to determine whether a nomination or any other business proposed to be brought before the meeting was made or proposed, as the case may be, in accordance with the procedures set forth in this bylaw and, if any proposed nomination or business is not in compliance with this bylaw, to declare that such defective proposal or nomination shall be disregarded.

(2) For purposes of this bylaw, "public announcement" shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or comparable national news service or in a document publicly filed by the corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act.

(3) Notwithstanding the foregoing provisions of this bylaw, a stockholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to the matters set forth in this bylaw. Nothing in this bylaw shall be deemed to affect any rights (i) of stockholders to request inclusion of proposals in the corporation's proxy statement pursuant to Rule 14a-8 under the Exchange Act or (ii) of the holders of any series of preferred stock, if any, to elect directors under certain circumstances.

ARTICLE III

DIRECTORS

Section 1. *Powers.* Subject to the provisions of the Delaware General Corporation Law and any limitations in the certificate of incorporation and these bylaws relating to action required to be approved by the stockholders or by the outstanding shares, the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board of directors.

Section 2. *Number and Qualification of Directors.* Until otherwise determined by resolution by the Board of Directors, the number of directors of the corporation shall be eight (8).

Section 3. *Election and Term of Office of Directors.* Directors shall be elected at the annual meeting of the stockholders. Each director, including a director elected to fill a vacancy, shall serve for a term ending on the next annual meeting following the annual meeting at which such director was elected and until a successor has been elected and qualified or the earlier of his resignation or removal.

Section 4. *Vacancies.* Vacancies in the board of directors may be filled by a majority of the remaining directors, though less than a quorum, or by a sole remaining director. Each director elected to fill a vacancy shall hold office for the remainder of the term of the person whom he succeeds, and until a successor has been elected and qualified.

A vacancy or vacancies in the board of directors shall be deemed to exist in the case of the death, retirement, resignation or removal of any director, or if the board of directors by resolution declares vacant the office of a director who has been declared of unsound mind by an order of court or convicted of a felony, or if the authorized number of directors be increased, or if the stockholders fail at any meeting of stockholders at which any director or directors are elected, to elect the full authorized number of directors to be voted for at that meeting.

Any director may resign or voluntarily retire upon giving notice in writing or by electronic transmission to the chairman of the board, the president, the secretary or the board of directors. Such retirement or resignation shall be effective upon the giving of the notice, unless the notice specifies a later time for its effectiveness. If such retirement or resignation is effective at a future time, the board of directors may elect a successor to take office when the retirement or resignation becomes effective.

No reduction of the authorized number of directors shall have the effect of removing any director prior to the expiration of his term of office.

Section 5. *Place of Meetings and Telephonic Meetings.* Regular meetings of the board of directors may be held at any place within or without the State of Delaware that has been designated from time to time by resolution of the board. In the absence of such designation, regular meetings shall be held at the principal executive office of the corporation. Special meetings of the board shall be held at any place within or without the State of Delaware that has been designated in the notice of the meeting or, if not stated in the notice or there is no notice, at the principal executive office of the corporation. Any meeting, regular or special, may be held by conference telephone or similar communication equipment, so long as all directors participating in such meeting can hear one another, and all such directors shall be deemed to be present in person at such meeting.

Section 6. *Annual Meetings.* Immediately following each annual meeting of stockholders, the board of directors shall hold a regular meeting for the purpose of organization, any desired election of officers and transaction of other business. Notice of this meeting shall not be required.

Section 7. *Other Regular Meetings.* Other regular meetings of the board of directors shall be held at such time as shall from time to time be determined by the board of directors. Such regular meetings may be held without notice provided that notice of any change in the determination of time of such meeting shall be sent to all of the directors. Notice of a change in the determination of the time shall be given to each director in the same manner as for special meetings of the board of directors.

Section 8. *Special Meetings.* Special meetings of the board of directors for any purpose or purposes may be called at any time by the chairman of the board or the president or any vice president or the secretary or any two directors.

Notice of the time and place of special meetings shall be delivered personally or by telephone to each director, sent by facsimile, first-class mail or telegram, charges prepaid, addressed to each director at his or her address as it is shown upon the records of the corporation, or sent by electronic mail addressed to each director at his or her electronic mail address as it is shown upon the records of the corporation. In case such notice is mailed, it shall be deposited in the United States mail at least four (4) days prior to the time of the holding of the meeting. In case such notice is delivered personally, by telephone, facsimile, telegram or electronic mail, it shall be delivered personally, or by telephone, by facsimile, to the telegraph company or by electronic mail at least twenty-four (24) hours prior to the time of the holding of the meeting. Any oral notice given personally or by telephone may be communicated to either the director or to a person at the office of the director who the person giving the notice has reason to believe will promptly communicate it to the director. The notice need not specify the purpose of the meeting nor the place if the meeting is to be held at the principal executive office of the corporation.

Section 9. *Quorum.* A majority of the authorized number of directors shall constitute a quorum for the transaction of business, except to adjourn as hereinafter provided. Every act or decision done or made by a majority of the directors present at a meeting duly held at which a quorum is present shall be regarded as the act of the board of directors. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for such meeting.

Section 10. *Waiver of Notice.* The transactions of any meeting of the board of directors, however called and noticed or wherever held, shall be as valid as though had at a meeting duly held after regular call and notice if a quorum be present and if, either before or after the meeting, each of the directors not present delivers a written waiver signed by such director (or a waiver by electronic transmission by such director) of notice or a consent (manually signed or submitted by electronic transmission) to the holding of the meeting, or an approval of the minutes thereof. The waiver of notice or consent need not specify the purpose of the meeting. All such waivers, consents and approvals shall be filed with the corporate records or made a part of the minutes of the meeting. Notice of a meeting shall also be deemed given to any director who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to such director.

Section 11. *Adjournment.* A majority of the directors present, whether or not constituting a quorum, may adjourn any meeting to another time and place.

Section 12. *Notice of Adjournment.* Notice of the time and place of an adjourned meeting need not be given, unless the meeting is adjourned for more than twenty-four (24) hours, in which case notice of such time and place shall be given prior to the time of the adjourned meeting, in the manner specified in Section 8 of this Article III, to the directors who were not present at the time of the adjournment.

Section 13. *Action Without Meeting.* Any action required or permitted to be taken by the board of directors may be taken without a meeting, if all members of the board shall individually or collectively consent in writing or by electronic transmission to such action. Such action by

written consent or electronic transmission shall have the same force and effect as a unanimous vote of the board of directors. Such written consent or consents or electronic transmission or transmissions shall be filed with the minutes of the proceedings of the board.

Section 14. *Fees and Compensation of Directors.* Directors and members of committees may receive such compensation, if any, for their services and such reimbursement of expenses, as may be fixed or determined by resolution of the board of directors. Nothing herein contained shall be construed to preclude any director from serving the corporation in any other capacity as an officer, agent, employee, or otherwise, and receiving compensation for such services.

ARTICLE IV

COMMITTEES

Section 1. *Committees of Directors.* The board of directors may, by resolution adopted by a majority of the authorized number of directors, designate one or more committees, including an executive committee, each consisting of two or more directors, to serve at the pleasure of the board. The board may designate one or more directors as alternate members of any committee, who may replace any absent member at any meeting of the committee. Any such committee, to the extent provided in the resolution of the board, shall have all the authority of the board, except with respect to:

- (a) the approval of any action which, under the General Corporation Law of Delaware, also requires the approval of the full board of directors, or the stockholders of the outstanding shares;
- (b) the filling of vacancies on the board of directors or in any committee;
- (c) the fixing of compensation of the directors for serving on the board or on any committee;
- (d) the amendment or repeal of bylaws or the adoption of new bylaws;
- (e) the amendment or repeal of any resolution of the board of directors which by its express terms is not so amendable or repealable;
- (f) a distribution to the stockholders of the corporation, except at a rate or in a periodic amount or within a price range determined by the board of directors; or
- (g) the appointment of any other committees of the board of directors or the members thereof.

Section 2. *Meetings and Action of Committees.* Meetings and action of committees shall be governed by, and held and taken in accordance with, the provisions of Article III of these bylaws, Sections 5 (place of meetings), 7 (regular meetings), 8 (special meetings and notice), 9 (quorum), 10 (waiver of notice), 11 (adjournment), 12 (notice of adjournment) and 13 (action without meetings), with such changes in the context of those bylaws as are necessary to substitute the committee and its members for the board of directors and its members, except that the time of regular meetings of committees may be determined by resolution of the board of directors as well as the committee, special meetings of committees may also be called by resolution of the board of directors, and notice of special meetings of committees shall also be given to all alternate members, who shall have the right to attend all meetings of the committee. The board of directors may adopt rules for the government of any committee not inconsistent with the provisions of these bylaws.

ARTICLE V

OFFICERS

Section 1. *Officers.* The officers of the corporation shall be chosen by the board of directors and shall include a chairman of the board or president, or both, a vice president, a secretary and a chief financial officer. The corporation may also have, at the discretion of the board of directors, a president, one or more additional vice presidents, one or more assistant secretaries, one or more assistant treasurers, and such other officers as may be held by the same person.

Section 2. *Election of Officers.* The officers of the corporation, except such officers as may be appointed in accordance with the provisions of Section 3 or Section 5 of this Article V, shall be chosen annually by the board of directors, and each shall hold his office until he shall resign or be removed or otherwise disqualified to serve or his successor shall be appointed in accordance with the provisions of Section 3 of this Article V. Any number of officers may be elected and qualified.

Section 3. *Subordinate Officers, etc.* The board of directors may appoint, and may empower the chairman of the board to appoint, such other officers as the business of the corporation may require, each of whom shall hold office for such period, have such authority and perform such duties as are provided in the bylaws or as the board of directors may from time to time determine.

Section 4. *Removal and Resignation of Officers.* Any officer may be removed, either with or without cause, by the board of directors, at any regular or special meeting thereof, or, except in case of an officer chosen by the board of directors, by any officer upon whom such power of removal may be conferred by the board of directors.

Any officer may resign at any time by giving written notice to the corporation. Any such resignation shall take effect at the date of the receipt of such notice or at any later time specified therein; and, unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective.

Section 5. *Vacancies in Office.* A vacancy in any office because of death, resignation, removal, disqualification, or any other cause shall be filled in the manner prescribed in these bylaws for regular appointments to such office.

Section 6. *Chairman of the Board.* The chairman of the board shall preside at all meetings of the stockholders and of the board of directors. The chairman of the Board shall be responsible for the general management of the affairs of the corporation and shall perform all duties incidental to his office which may be required by law and all such other duties as are properly required of him by the board of directors. Except where by law the signature of the president is required, the chairman of the board shall possess the same power as the president to sign all

certificates, contracts, and other instruments of the corporation which may be authorized by the board of directors. He shall make reports to the board of directors and the stockholders, and shall perform all such other duties as are properly required of him by the board of directors. He shall see that all orders and resolutions of the board of directors and of any committee thereof are carried into effect.

Section 7. *President.* The president shall act in a general executive capacity and shall assist the chairman of the board in the administration and operation of the corporation's business and general supervision of its policies and affairs. The president shall, in the absence of or because of the inability to act of the chairman of the board, perform all duties of the chairman of the board and preside at all meetings of stockholders and of the board of directors. The president may sign, alone or with the secretary, or an assistant secretary, or any other proper officer of the corporation authorized by the board of directors, certificates, contracts, and other instruments of the corporation as authorized by the board of directors.

Section 8. *Vice Presidents.* In the absence or disability of the president, a vice president designated by the board of directors shall perform all the duties of the president, and when so acting shall have all the powers of, and be subject to all the restrictions upon, the president. The vice presidents shall have such other powers and perform such other duties as from time to time may be prescribed for them respectively by the board of directors or the bylaws.

Section 9. *Secretary.* The secretary shall keep or cause to be kept, at the principal executive office or such other place as the board of directors may order, a book of minutes of all meetings and actions of directors, committees of directors and stockholders, with the time and place of holding, whether regular or special, and, if special, how authorized, the notice thereof given, the names of those present at directors' and committee meetings, the number of shares present or represented at stockholders' meetings, and the proceedings thereof.

The secretary shall keep, or cause to be kept, at the principal executive office or at the office of the corporation's transfer agent or registrar, as determined by resolution of the board of directors, a stock register, or a duplicate register, showing the names of all stockholders and their addresses, the number and classes of shares held by each, the number and date of certificates issued for the same, and the number and date of cancellation of every certificate surrendered for cancellation.

The secretary shall give, or cause to be given, notice of all meetings of the stockholders and of the board of directors required by the bylaws or by law to be given and shall have such other powers and perform such other duties as may be prescribed by the board of directors or by the bylaws.

Section 10. *Chief Financial Officer.* The chief financial officer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and records of accounts of the properties and business transactions of the corporation, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, retained earnings and shares. The books of account shall be open at all reasonable times to inspection by any director.

The chief financial officer shall deposit all monies and other valuables in the name and to the credit of the corporation with such depositories as may be designated by the board of directors. The chief financial officer shall disburse the funds of the corporation as may be ordered by the board of directors, shall render to the chairman of the board and directors, whenever they request it, an account of all of his transactions as chief financial officer and of the financial condition of the corporation, and shall have other powers and perform such other duties as may be prescribed by the board of directors or the bylaws.

Section 11. *Assistant Secretaries and Assistant Treasurers.* Any assistant secretary may perform any act within the power of the secretary, and any assistant treasurer may perform any act within the power of the chief financial officer, subject to any limitations which may be imposed in these bylaws or in board resolutions.

ARTICLE VI

INDEMNIFICATION OF DIRECTORS, OFFICERS, EMPLOYEES AND OTHER AGENTS

Section 1. *Indemnification.* The corporation shall indemnify, in the manner and to the full extent permitted by law, any person (or the estate of any person) who was or is a party to, or is threatened to be made a party to, any threatened, pending or completed action, suit or proceeding, whether or not by or in the right of the corporation, and whether civil, criminal, administrative, investigative or otherwise, by reason of the fact that such person is a director or officer of the corporation, and at the discretion of the board of directors may indemnify any person (or the estate of any person) who is such a party or threatened to be made such a party by reason of the fact that such person is or was an employee or agent of the corporation or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise. The corporation may, to the full extent permitted by law, purchase and maintain insurance on behalf of any such person against any liability which may be asserted against him and may enter into contracts providing for the indemnification of such person to the full extent permitted by law. To the full extent permitted by law, the indemnification provided herein shall include expenses (including attorneys' fees), judgments, fines and amounts paid in settlement, and, in the manner provided by law, any such expenses may be paid by the corporation in advance of the final disposition of such action, suit or proceeding. The indemnification provided herein shall not be deemed to limit the right of the corporation to indemnify any other person for any such expenses to the full extent permitted by law, nor shall it be deemed exclusive of any other rights to which any person seeking indemnification from the corporation may be entitled under any agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

For the purposes of this Article VI, references to "the corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors or officers so that any person who is or was a director or officer of such constituent corporation, or is or was serving at the request of such constituent corporation as a director or officer of another corporation,

partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article VI with respect to the resulting or surviving corporation as he would have with respect to such constituent corporation if its separate existence had continued.

For purposes of this Article VI, references to “other enterprises” shall include employee benefit plans; references to “fines” shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to “serving at the request of the corporation” shall include service as a director or officer of the corporation which imposes duties on, or involves services by, such director or officer with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner he reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner “not opposed to the best interests of the corporation” as referred to in this section.

ARTICLE VII

GENERAL CORPORATE MATTERS

Section 1. *Record Date for Purposes Other Than Notice and Voting.* For purposes of determining the stockholders entitled to receive payment of any dividend or other distribution or allotment of any rights or entitled to exercise any rights in respect of any other lawful action, the board of directors may fix, in advance, a record date, which date shall not precede the date upon which the resolution fixing the record date is adopted by the board of directors, and which shall not be more than sixty (60) nor less than ten (10) days prior to any such action, and in such case only stockholders of record on the date so fixed are entitled to receive the dividend, distribution or allotment of rights or to exercise the rights, as the case may be, notwithstanding any transfer of any shares on the books of the corporation after the record date fixed as aforesaid, except as otherwise provided in the Delaware General Corporation Law.

A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the board of directors may fix a new record date for the adjourned meeting. In order that the corporation may determine the stockholders entitled to consent to corporate action in writing or by electronic transmission without a meeting, the board of directors may fix a record date which shall not be more than ten days after the date upon which the resolution fixing the record date is adopted by the board of directors.

Section 2. *Checks, Drafts, Evidences of Indebtedness.* All checks, drafts or other orders for payment of money, notes or other evidences of indebtedness, issued in the name of or payable to the corporation shall be signed or endorsed by such person or persons and in such manner as, from time to time, shall be determined by resolution of the board of directors.

Section 3. *Corporate Contracts and Instruments, How Executed.* The board of directors, except as otherwise provided in these bylaws, may authorize any officer or officers, agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of the corporation, and such authority may be general or confined to specific instances; and, unless so authorized or ratified by the board of directors or within the agency power of an officer, no officer, agent or employee shall have any power or authority to bind the corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or to any amount.

Section 4. *Stock Certificates.* A certificate or certificates for shares of the capital stock of the corporation shall be issued to each stockholder when any such shares are fully paid. All certificates shall be signed in the name of the corporation by the chairman of the board or the president or vice president and by the chief financial officer, the treasurer or an assistant treasurer or the secretary or any assistant secretary, certifying the number of shares and the class or series of shares owned by the stockholder. Any or all of the signatures on the certificate may be facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate shall have ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued by the corporation with the same effect as if such person were an officer, transfer agent or registrar at the date of issue.

Section 5. *Lost Certificates.* Except as hereinafter in this Section 5 provided, no new stock certificate shall be issued in lieu of an old certificate unless the latter is surrendered to the corporation and canceled at the same time. The board of directors may in case any stock certificate or certificate for any other security is lost, stolen or destroyed, authorize the issuance of a new certificate in lieu thereof, upon such terms and conditions as the board of directors may require, including provision for indemnification of the corporation secured by a bond or other adequate security sufficient to protect the corporation against any claim that may be made against it, including any expense or liability, on account of the alleged loss, theft or destruction of such certificate or the issuance of such new certificate.

Section 6. *Representation of Stock of Other Corporations.* The chairman of the board, the president, or any vice president, or any other person authorized by resolution of the board of directors by any of the foregoing designated officers, is authorized to vote on behalf of the corporation any and all stock of any other corporation or corporations, foreign or domestic, standing in the name of the corporation. The authority herein granted to said officers to vote or represent on behalf of the corporation any and all stock by the corporation in any other corporation or corporations may be exercised by any such officer in person or by any person authorized to do so by proxy duly executed by said officer.

Section 7. *Construction and Definitions.* Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the Delaware General Corporation Law shall govern the construction of the bylaws. Without limiting the generality of the foregoing, the singular number includes the plural, the plural number includes the singular, and the term "person" includes both a corporation and a natural person.

Section 8. *Fiscal Year.* The fiscal year of the corporation shall be fixed by resolution of the board of directors.

ARTICLE VIII

NOTICE BY ELECTRONIC TRANSMISSION

Section 1. *Notice by Electronic Transmission.* Without limiting the manner by which notice otherwise may be given effectively to stockholders pursuant to the DGCL, the certificate of incorporation or these bylaws, any notice to stockholders given by the Company under any provision of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. Any such consent shall be revocable by the stockholder by written notice to the Company. Any such consent shall be deemed revoked if:

(A) the Company is unable to deliver by electronic transmission two consecutive notices given by the Company in accordance with such consent; and

(B) such inability becomes known to the secretary or an assistant secretary of the Company or to the transfer agent, or other person responsible for the giving of notice.

However, the inadvertent failure to treat such inability as a revocation shall not invalidate any meeting or other action.

Any notice given pursuant to the preceding paragraph shall be deemed given:

(A) if by facsimile telecommunication, when directed to a number at which the stockholder has consented to receive notice;

(B) if by electronic mail, when directed to an electronic mail address at which the stockholder has consented to receive notice;

(C) if by a posting on an electronic network together with separate notice to the stockholder of such specific posting, upon the later of (i) such posting and (ii) the giving of such separate notice; and

(D) if by any other form of electronic transmission, when directed to the stockholder.

An affidavit of the secretary or an assistant secretary or of the transfer agent or other agent of the Company that the notice has been given by a form of electronic transmission shall, in the absence of fraud, be prima facie evidence of the facts stated therein.

Section 2. *Definition of Electronic Transmission.* An “electronic transmission” means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

Section 3. *Inapplicability.* Notice by a form of electronic transmission shall not apply to Sections 164, 296, 311, 312 or 324 of the DGCL.

ARTICLE IX

AMENDMENTS

Section 1. *Amendment.* The bylaws, or any of them, may be rescinded, altered, amended or repealed, and new bylaws may be made (i) by the board of directors, by vote of a majority of the number of directors then in office as directors, acting at any meeting of the board of directors, or (ii) by the stockholders, by the vote of the holders of sixty-six and two-thirds percent (66-2/3%) of the outstanding voting stock of the corporation, at any annual or special meeting of stockholders, provided that notice of such proposed amendment, modification, repeal or adoption is given in the notice of the annual or special meeting; provided, however, that the bylaws can only be amended if such amendment would not conflict with the certificate of incorporation. Any bylaw made or altered by the requisite number of stockholders may be altered or repealed by the board of directors or may be altered or repealed by the requisite number of stockholders.

* * * *

CERTIFICATE OF SECRETARY

I, the undersigned, do hereby certify:

- (a) That I am the duly elected and acting Secretary of Capstone Turbine Corporation, a Delaware corporation (the "Corporation"); and
- (b) That the foregoing Amended and Restated Bylaws constitute the Amended and Restated Bylaws of the Corporation, as duly adopted by the Board of Directors of the Corporation at a meeting duly held on May 12, 2005.

IN WITNESS WHEREOF, I have hereunto subscribed my name as of this 20th day of May 2005.

/s/ KAREN CLARK

Karen Clark,
Secretary

CAPSTONE TURBINE CORPORATION
AMENDED AND RESTATED 2000 EQUITY INCENTIVE PLAN

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CAPSTONE TURBINE CORPORATION
AMENDED AND RESTATED 2000 EQUITY INCENTIVE PLAN

RECITALS:

WHEREAS, the Company previously established the Plan as an equity incentive plan, and last amended and restated the Plan effective January 27, 2005;

WHEREAS, the Company desires to amend the Plan to conform the terms of the Plan with regard to a change in the change of control of the Company with the other severance and compensation arrangements maintained by the Company;

NOW, THEREFORE, pursuant to authorization by the Board of Directors of the Company, the Plan is hereby amended and restated, effective on March 17, 2005:

1. Purposes of the Plan. The purposes of the Capstone Turbine Corporation Amended and Restated 2000 Equity Incentive Plan are to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to Employees, Directors and Consultants and to promote the success of the Company's business. Options granted under the Plan may be Incentive Stock Options or Non-Qualified Stock Options, as determined by the Committee at the time of grant. Restricted Stock, Stock Purchase Rights and Stock Bonuses may also be granted under the Plan.

2. Definitions. As used herein, the following definitions shall apply:

(a) "Acquisition" means, unless specified otherwise in an Agreement,

(i) the successful acquisition by a person or related group of persons, (other than the Company or a person that directly or indirectly controls, is controlled by or is under common control with, the Company) of beneficial ownership (within the meaning of Rule 13d-3 of the Exchange Act) of securities possessing more than 50% of the total combined voting power of the Company's outstanding securities pursuant to a transaction or series of related transactions which the Board does not at any time recommend the Company's stockholders to accept or approve;

(ii) the first date within any period of 18 consecutive months or less on which there is effected a change in the composition of the Board such that a majority of the Board ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been members of the Company's Board continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time such election or nomination was approved by the Board;

(iii) a merger or consolidation in which the Company is not the surviving entity, except for a transaction the principal purpose of which is to change the state in which the Company is incorporated;

(iv) the sale, transfer or other disposition of all or substantially all of the assets of the Company in complete liquidation or dissolution of the Company;

(v) any reverse merger in which the Company is the surviving entity but in which securities possessing more than 50% of the total combined voting power of the Company's outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such merger; or

(vi) the issuance by the Company to a single person or related group of persons (other than the Company or a person that directly or indirectly controls, is controlled by or is under common control with, the Company) of securities possessing more than 50% of the total combined voting power of the Company's outstanding securities (determined after such issuance) in a single transaction or a series of related transactions.

(b) "Agreement" means a written agreement between the Company and a Holder evidencing the terms and conditions of an individual award or grant of an Option, Restricted Stock, Stock Bonus, or Stock Purchase Right. Each Agreement is subject to the terms and conditions of the Plan, except as otherwise provided for herein.

(c) "Applicable Laws" means the requirements relating to the administration of stock option plans under U.S. state corporate laws, U.S. federal and state securities laws, the Code, any stock exchange or quotation system on which the Common Stock is listed or quoted and the applicable laws of any foreign country or jurisdiction where Options, Stock Purchase Rights or Stock Bonuses are granted under the Plan.

(d) "Board" means the Board of Directors of the Company.

(e) "Cause" means the commission of any act of fraud, embezzlement, theft or dishonesty by a Holder, any unauthorized use or disclosure by a Holder of confidential information or trade secrets of the Company (or any parent or subsidiary thereof), or any other intentional misconduct by a Holder adversely affecting the business or affairs of the Company (or any parent or subsidiary) in a material manner. The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Company (or any parent or subsidiary) may consider as grounds for the dismissal or discharge of any Holder.

(f) "Code" means the Internal Revenue Code of 1986, as amended, or any successor statute or statutes thereto. Reference to any particular Code section shall include any successor section.

(g) "Committee" means a committee appointed by the Board in accordance with Section 4 hereof to administer the Plan.

(h) "Common Stock" means the Common Stock of the Company, par value \$0.001 per share.

(i) "Company" means Capstone Turbine Corporation, a Delaware corporation.

(j) "Consultant" means any consultant or adviser if: (i) the consultant or adviser renders bona fide services to the Company; (ii) the services rendered by the consultant or adviser are not in connection with the offer or sale of securities in a capital-raising transaction and do not directly or indirectly promote or maintain a market for the Company's securities; and (iii) the consultant or adviser is a natural person who has contracted directly with the Company to render such services.

(k) "Director" means a member of the Board.

(l) "Employee" means any person, including an Officer or Director, who is an employee (as defined in accordance with Section 3401(c) of the Code) of the Company or any Parent or Subsidiary of the Company. A Service Provider shall not cease to be an Employee in the case of (i) any leave of absence approved by the Company or (ii) transfers between locations of the Company or between the Company, its Parent, any Subsidiary, or any successor. For purposes of Incentive Stock Options, no such leave may exceed 90 days, unless reemployment upon expiration of such leave is guaranteed by statute or contract. Neither service as a Director nor payment of a director's fee by the Company shall be sufficient, by itself, to constitute "employment" by the Company.

(m) "Exchange Act" means the Securities Exchange Act of 1934, as amended, or any successor statute or statutes thereto. Reference to any particular Exchange Act section shall include any successor section.

(n) "Fair Market Value" means, as of any date, the value of a share of Common Stock determined as follows:

(i) If the Common Stock is listed on any established stock exchange or a national market system, including, without limitation, the Nasdaq National Market or The Nasdaq SmallCap Market of The Nasdaq Stock Market, its Fair Market Value shall be the closing sales price for a share of such stock (or the closing bid, if no sales were reported) as quoted on such exchange or system, as reported in The Wall Street Journal or such other source as the Committee deems reliable;

(ii) If the Common Stock is regularly quoted by a recognized securities dealer but selling prices are not reported, its Fair Market Value shall be the mean between the high bid and low asked prices for a share of the Common Stock; or

(iii) In the absence of an established market for the Common Stock, the Fair Market Value thereof shall be determined in good faith by the Committee.

(o) “Holder” means a person who has been granted or awarded an Option, Restricted Stock or Stock Purchase Right, or who holds Shares acquired pursuant to the exercise of an Option or Stock Purchase Right or pursuant to a Stock Bonus.

(p) “Incentive Stock Option” means an Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code and which is designated as an Incentive Stock Option by the Committee.

(q) “Independent Director” means a Director who is:

(i) An “outside director,” within the meaning of Section 162(m) of the Code;

(ii) A “non-employee director” within the meaning of Rule 16b-3; and

(iii) An “independent director” under the listing standards of The Nasdaq Stock Market.

(r) “Non-Qualified Stock Option” means an Option (or portion thereof) that is not designated as an Incentive Stock Option by the Committee, or which is designated as an Incentive Stock Option by the Committee but fails to qualify as an incentive stock option within the meaning of Section 422 of the Code.

(s) “Officer” means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

(t) “Option” means a stock option granted pursuant to the Plan.

(u) “Option Exchange Program” means a program whereby outstanding Options are surrendered or cancelled in exchange for Options that are granted more than six months and one day following such surrender or cancellation and are of the same type (which may have a lower exercise price or purchase price), of a different type and/or cash, and subject to certain conditions (*e.g.*, continued employment).

(v) “Parent” means any corporation, whether now or hereafter existing (other than the Company), in an unbroken chain of corporations ending with the Company if each of the corporations other than the last corporation in the unbroken chain owns stock possessing more than fifty percent of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(w) “Plan” means the Capstone Turbine Corporation Amended and Restated 2000 Equity Incentive Plan.

(x) “Public Trading Date” means the first date upon which Common Stock of the Company is listed (or approved for listing) upon notice of issuance on any securities exchange or designated (or approved for designation) upon notice of issuance as a national market security on an interdealer quotation system.

(y) “Restricted Stock” means Shares acquired pursuant to the exercise of an unvested Option in accordance with Section 10(h), or pursuant to an election pursuant to a Stock Purchase Right granted under Section 12(b) or Section 14.

(z) “Rule 16b-3” means that certain Rule 16b-3 under the Exchange Act, as such Rule may be amended from time to time.

(aa) “Section 16(b)” means Section 16(b) of the Exchange Act, as such Section may be amended from time to time.

(bb) “Securities Act” means the Securities Act of 1933, as amended, or any successor statute or statutes thereto. Reference to any particular Securities Act section shall include any successor section.

(cc) “Service Provider” means an Employee, Director or Consultant.

(dd) “Share” means a share of Common Stock, as adjusted in accordance with Section 15 below.

(ee) “Stock Bonus” means a grant of Common Stock granted pursuant to Section 14(e) or elected pursuant to Section 12(b).

(ff) “Stock Purchase Right” means a right to purchase Common Stock pursuant to Section 14.

(gg) “Subsidiary” means any corporation, whether now or hereafter existing (other than the Company), in an unbroken chain of corporations beginning with the Company if each of the corporations other than the last corporation in the unbroken chain owns stock possessing more than 50% of the total combined voting power of all classes of stock in one of the other corporations in such chain.

3. Stock Subject to the Plan. Subject to the provisions of Section 15, the shares of stock subject to Options, Stock Purchase Rights or Stock Bonuses shall be Common Stock, initially shares of the Company’s Common Stock, par value \$0.001 per share. Subject to the provisions of Section 15, the maximum aggregate number of Shares which may be issued upon exercise of such Options or Stock Purchase Rights or pursuant to such Stock Bonuses is 6,080,000 – Shares, plus the number of Shares previously authorized and remaining available under the Company’s 1993 Stock Incentive Plan, as amended, as of the Public Trading Date, plus any Shares covered by options granted under the Company’s 1993 Stock Incentive Plan that are forfeited or expire unexercised or otherwise become available after the Public Trading Date; *provided, however*, that the maximum aggregate number of Shares which may be issued upon exercise of Incentive Stock Options is 13,880,000 Shares. The total shares originally made available under the 1993 Stock Incentive Plan was 7,800,000. Shares issued upon exercise of Options or Stock Purchase Rights or pursuant to Stock Bonuses may be authorized but unissued, or reacquired Common Stock. If an Option or Stock Purchase Right expires or becomes unexercisable without having been exercised in full, or is surrendered pursuant to an Option Exchange Program, the unpurchased Shares which were subject thereto shall become available for future grant or sale under the Plan (unless the Plan has terminated). Shares which are delivered by the Holder or

withheld by the Company upon the exercise of an Option or Stock Purchase Right or in respect of a Stock Bonus under the Plan, in payment of the exercise price thereof or tax withholding thereon, may again be optioned, granted or awarded hereunder, subject to the limitations of this Section 3. If Shares of Restricted Stock are repurchased by the Company at their original purchase price, such Shares shall become available for future grant under the Plan. Notwithstanding the provisions of this Section 3, no Shares may again be optioned, granted or awarded if such action would cause an Incentive Stock Option to fail to qualify as an Incentive Stock Option under Code Section 422.

4. Administration of the Plan.

(a) Administration Committee. The Plan shall be administered by the Committee that is established and designated by the Board to administer the Plan. Prior to the 2004 annual meeting of shareholders of the Company, the Committee shall be comprised of at least two individuals who are all Independent Directors. Effective at the conclusion of the 2004 annual meeting of shareholders of the Company, the Committee shall be comprised of at least three individuals who are all Independent Directors. The Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board, including the power to delegate to a subcommittee any of the administrative powers the Committee is authorized to exercise, subject, however, to such resolutions or Committee charter, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. Within the scope of such authority, the Committee may delegate (i) to the chief executive officer of the Company the authority to grant awards under the Plan to eligible persons who are (1) not "covered employees," within the meaning of Section 162(m) of the Code, (2) not expected to be "covered employees" at the time of recognition of income resulting from such award, and (3) not subject to liability under Section 16 of the Exchange Act, and/or (ii) to any officer of the Company any other authority that is included in Sections 4(b)(iv), (viii), (ix) or (xi) or Section 9(b).

(b) Powers of the Committee. Subject to the provisions of the Plan and the specific duties delegated by the Board to such Committee, and subject to the approval of any relevant authorities, the Committee shall have the authority in its sole discretion:

(i) to determine the Fair Market Value;

(ii) to select the Service Providers to whom Options, Stock Purchase Rights, and Stock Bonuses may from time to time be granted hereunder;

(iii) to determine the number of Shares to be covered by each such award granted hereunder;

(iv) to approve forms of Agreement for use under the Plan;

(v) to determine the terms and conditions of any award granted hereunder (such terms and conditions include, but are not limited to, the exercise price, the time or times when Options or Stock Purchase Rights may vest or be exercised (which may be based on performance criteria), any vesting acceleration or waiver of forfeiture restrictions, and any restriction or limitation regarding any award granted hereunder or the Common Stock relating thereto, based in each case on such factors as the Committee, in its sole discretion, shall determine);

(vi) to institute an Option Exchange Program that has been approved by the Board; provided, however, that the effectiveness of the Option Exchange Program is subject to the approval of the Company's shareholders;

(vii) to determine whether to offer to buyout a previously granted Option as provided in subsection 10(i) and to determine the terms and conditions of such offer and buyout (including whether payment is to be made in cash or Shares);

(viii) to prescribe, amend and rescind rules and regulations relating to the Plan, including rules and regulations relating to sub-plans established for the purpose of qualifying for preferred tax treatment under foreign tax laws;

(ix) to allow Holders to satisfy withholding tax obligations by electing to have the Company withhold from the Shares to be issued upon exercise of an Option or Stock Purchase Right or pursuant to a Stock Bonus that number of Shares having a Fair Market Value equal to the minimum amount required to be withheld based on the statutory withholding rates for federal and state tax purposes that apply to supplemental taxable income. The Fair Market Value of the Shares to be withheld shall be determined on the date that the amount of tax to be withheld is to be determined. All elections by Holders to have Shares withheld for this purpose shall be made in such form and under such conditions as the Committee may deem necessary or advisable;

(x) to amend any Option or Stock Purchase Right granted under the Plan as provided in Section 14; and

(xi) to construe and interpret the terms of the Plan and awards granted pursuant to the Plan and to exercise such powers and perform such acts as the Committee deems necessary or desirable to promote the best interests of the Company which are not in conflict with the provisions of the Plan.

(c) Effect of Committee's Decision. All decisions, determinations and interpretations of the Committee shall be final and binding on all Holders.

5. Eligibility. Non-Qualified Stock Options, Stock Purchase Rights and Stock Bonuses may be granted to Service Providers. Incentive Stock Options may be granted only to Employees. If otherwise eligible, an Employee or Consultant who has been granted an Option, Stock Purchase Right or Stock Bonus may be granted additional Options, Stock Purchase Rights or Stock Bonuses. In addition to the foregoing, each Non-Employee Director (defined in Section 12) shall be granted Options at the times and in the manner set forth in Section 12 and may receive Stock Bonuses in lieu of cash compensation as described in Section 12.

6. Limitations.

(a) Each Option shall be designated by the Committee in the Agreement as either an Incentive Stock Option or a Non-Qualified Stock Option. However, notwithstanding such designations, to the extent that the aggregate Fair Market Value of Shares subject to a Holder's Incentive Stock Options and other incentive stock options granted by the Company, any Parent or Subsidiary, which become exercisable for the first time during any calendar year (under all plans of the Company or any Parent or Subsidiary) exceeds \$100,000, such excess Options or other options shall be treated as Non-Qualified Stock Options.

For purposes of this Section 6(a), Incentive Stock Options shall be taken into account in the order in which they were granted, and the Fair Market Value of the Shares shall be determined as of the time of grant.

(b) None of the Plan, any Option, Stock Purchase Right or Stock Bonus shall confer upon a Holder any right with respect to continuing the Holder's employment or consulting relationship with the Company, nor shall they interfere in any way with the Holder's right or the Company's right to terminate such employment or consulting relationship at any time, with or without cause.

(c) No Service Provider shall be granted, in any calendar year, Options, Stock Purchase Rights or Stock Bonuses to acquire more than 3,000,000 Shares. The foregoing limitation shall be adjusted proportionately in connection with any change in the Company's capitalization as described in Section 15. For purposes of this Section 6(c), if an Option is canceled in the same calendar year it was granted (other than in connection with a transaction described in Section 15), the canceled Option will be counted against the limit set forth in this Section 6(c). For this purpose, if the exercise price of an Option is reduced, the transaction shall be treated as a cancellation of the Option and the grant of a new Option.

7. Term of Plan. The Plan shall become effective upon its initial adoption by the Board and shall continue in effect until it is terminated under Section 17. No Options, Stock Purchase Rights or Stock Bonuses may be issued under the Plan with respect to the shares specified in Section 3 hereof after the tenth anniversary of the earlier of (i) the date upon which the Plan is adopted by the Board or (ii) the date the Plan is approved by the stockholders. If the number of shares specified in Section 3 is increased by an amendment to this Plan, Options Stock Purchase Rights or Stock Bonuses may be awarded with respect to such increased shares for a period of ten years after the earlier of the date that the amendment to the Plan is adopted by the Board or the date that the amendment is approved by the stockholders. Options, Stock Purchase Rights and Stock Bonuses granted before such dates shall remain valid in accordance with their terms.

8. Term of Option. The term of each Option shall be stated in the Agreement; *provided, however*, that the term shall be no more than ten years from the date of grant thereof; and *provided further* that, in the case of an Incentive Stock Option granted to a Holder who, at the time the Option is granted, owns (or is treated as owning under Code Section 424) stock representing more than 10% of the voting power of all classes of stock of the Company or any Parent or Subsidiary, the term of the Option shall be no more than five years from the date of grant thereof.

9. Option Exercise Price and Consideration.

(a) Except as provided in Section 13, the per share exercise price for the Shares to be issued upon exercise of an Option shall be such price as is determined by the Committee, but shall be subject to the following:

(i) In the case of an Incentive Stock Option

(A) granted to an Employee who, at the time of grant of such Option, owns (or is treated as owning under Code Section 424) stock representing more than 10% of the voting power of all classes of stock of the Company or any Parent or Subsidiary, the per Share exercise price shall be no less than 110% of the Fair Market Value per Share on the date of grant.

(B) granted to any other Employee, the per Share exercise price shall be no less than 100% of the Fair Market Value per Share on the date of grant.

(ii) In the case of a Non-Qualified Stock Option

(A) granted to a Service Provider who, at the time of grant of such Option, owns stock representing more than 10% of the voting power of all classes of stock of the Company or any Parent or Subsidiary, the exercise price shall be no less than 110% of the Fair Market Value per Share on the date of the grant.

(B) granted to any other Service Provider, the per Share exercise price shall be no less than 85% of the Fair Market Value per Share on the date of grant.

(iii) Notwithstanding the foregoing, Options may be granted with a per Share exercise price other than as required in this subsection (a) above pursuant to a merger or other corporate transaction.

(b) The consideration to be paid for the Shares to be issued upon exercise of an Option, including the method of payment, shall be determined by the Committee (and, in the case of an Incentive Stock Option, shall be determined at the time of grant). Such consideration may consist of (1) cash, (2) check, (3) with the consent of the Committee, actual or constructive delivery of Shares which (x) in the case of Shares acquired from the Company, have been owned by the Holder for more than six months on the date of surrender, and (y) have a Fair Market Value on the date of surrender equal to the aggregate exercise price of the Shares as to which such Option shall be exercised, (4) with the consent of the Committee, payment in connection with the pledge of Shares and a loan through a broker in a transaction described in Securities and Exchange Commission Regulation T, (5) any other consideration acceptable to the Committee, or (6) with the consent of the Committee, any combination of the foregoing methods of payment.

10. Exercise of Option.

(a) Vesting; Fractional Exercises. Except as provided in Section 13, Options granted hereunder shall be vested and exercisable according to the terms hereof at such times and under such conditions as determined by the Committee and set forth in the Agreement. An Option may not be exercised for a fraction of a Share.

(b) Deliveries upon Exercise. All or a portion of an exercisable Option shall be deemed exercised upon delivery of all of the following to the Secretary of the Company or his or her office:

(i) A written or electronic notice complying with the applicable rules established by the Committee stating that the Option, or a portion thereof, is exercised. The notice shall be signed by the Holder or other person then entitled to exercise the Option or such portion of the Option;

(ii) Such representations and documents as the Committee, in its sole discretion, deems necessary or advisable to effect compliance with Applicable Laws. The Committee may, in its sole discretion, also take whatever additional actions it deems appropriate to effect such compliance, including, without limitation, placing legends on share certificates and issuing stop transfer notices to agents and registrars;

(iii) Upon the exercise of all or a portion of an unvested Option pursuant to Section 10(h), an Agreement covering the purchase of the Restricted Stock in a form determined by the Committee and signed by the Holder or other person then entitled to exercise the Option or such portion of the Option;

(iv) In the event that the Option shall be exercised pursuant to Section 10(f) by any person or persons other than the Holder, appropriate proof of the right of such person or persons to exercise the Option; and

(v) The receipt by the Company of full payment for such Shares, including payment of any applicable withholding tax. Tax withholding may, in the sole discretion of the Committee, be paid in the form of (i) deduction from wages otherwise payable to the Holder, (ii) consideration used by the Holder to pay for such Shares under Section 9(b), or (iii) Shares that have a Fair Market Value equal to the minimum required withholdings and that would otherwise be deliverable to the Holder upon exercise of the Option.

(c) Conditions to Delivery of Share Certificates. The Company shall not be required to issue or deliver any certificate or certificates for Shares purchased upon the exercise of any Option or portion thereof prior to fulfillment of all of the following conditions:

(i) The admission of such Shares to listing on all stock exchanges on which such class of stock is then listed;

(ii) The completion of any registration or other qualification of such Shares under any state or federal law, or under the rulings or regulations of the Securities and Exchange Commission or any other governmental regulatory body which the Committee shall, in its sole discretion, deem necessary or advisable;

(iii) The obtaining of any approval or other clearance from any state or federal governmental agency which the Committee shall, in its sole discretion, determine to be necessary or advisable; and

(iv) The lapse of such reasonable period of time following the exercise of the Option as the Committee may establish from time to time for reasons of administrative convenience.

(d) Termination of Relationship as a Service Provider. If a Holder ceases to be a Service Provider for any reason, the Holder's continuing rights, if any, to Options, Restricted Stock, Stock Bonuses or Stock Purchase Rights will be as specified in the terms of the Agreement. In the absence of a provision in the Agreement that specifies the date of expiration when the Holder ceases to be a Service Provider, each Option shall remain exercisable in accordance with the provisions set forth herein, as follows: (i) upon termination as a Service

Provider for reasons other than Cause, death or disability, the Option shall remain exercisable for three months following the termination of the Holder's relationship as a Service Provider (but in no event later than the expiration of the term of such Option as set forth in the Agreement or terms of the grant) to the extent that the Option is then vested and the Shares covered by the unvested portion of the Option shall immediately become available for issuance under the Plan; (ii) any unexercised portion of the Option shall terminate at the end of the three-month period specified herein and the Shares covered thereby shall immediately become available for issuance under the Plan; (iii) if a Holder's relationship as a Service Provider is terminated for Cause, the entire Option shall immediately terminate, and the Shares covered thereby shall immediately become available for issuance under the Plan, and (iv) if a Holder is terminated for reasons of death or disability, the rights under the Option shall be determined by Sections 10(e) and 10(f).

(e) Disability of Holder. If a Holder ceases to be a Service Provider as a result of the Holder's disability, and the applicable Agreement does not specify the date of expiration when the Holder ceases to be a Service Provider, an Option shall remain exercisable for 12 months following the Holder's termination due to disability (but in no event later than the expiration of the term of such Option as set forth in the Agreement or terms of the grant), but only to the extent that the Option was exercisable on the date of disability, and the Shares covered by the unvested portion of the Option shall immediately become available for issuance under the Plan. To the extent that the Option is not exercised by the end of the 12 month period, the Option shall expire and the Shares covered thereby shall again become available for issuance under the Plan. For purposes of Incentive Stock Options, the term "disability" shall be defined in accordance with Section 22(e)(3) of the Code.

(f) Death of Holder. If a Holder dies while a Service Provider, and the applicable Agreement does not specify the date of expiration when the Holder ceases to be a Service Provider, an Option shall remain exercisable for 12 months following the Holder's death (but in no event later than the expiration of the term of such Option as set forth in the Agreement or terms of the grant), but only to the extent that the Option was exercisable on the date of death, and the Shares covered by the unvested portion of the Option shall immediately become available for issuance under the Plan. To the extent that the Option is not exercised by the end of the 12 month period, the Option shall expire and the Shares covered thereby shall again become available for issuance under the Plan. The Option may be exercised by the executor or administrator of the Holder's estate or, if applicable, by the person(s) entitled to exercise the Option under the Holder's will or the laws of descent or distribution.

(g) Regulatory Extension. A Holder's Agreement may provide that if the exercise of the Option following the termination of the Holder's status as a Service Provider (other than upon the Holder's death or Disability) would be prohibited at any time solely because the issuance of shares would violate the registration requirements under the Securities Act, then the Option shall terminate on the earlier of (i) the expiration of the term of the Option set forth in Section 8 or (ii) the expiration of a period of three months after the termination of the Holder's status as a Service Provider during which the exercise of the Option would not be in violation of such registration requirements.

(h) Buyout Provisions. The Committee may at any time offer to buyout for a payment in cash or Shares, an Option previously granted, based on such terms and conditions as the Committee shall establish and communicate to the Holder at the time that such offer is made.

11. Non-Transferability. Options, Restricted Stock, Stock Bonuses and Stock Purchase Rights may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution and may be exercised, during the lifetime of the Holder, only by the Holder.

12. Granting of Options to and Stock Elections by Non-Employee Directors.

(a) A person who is a Director but is not an employee of the Company or any of its affiliates (a "Non-Employee Director") who is initially elected to the Board shall, during the term of the Plan, be granted an Option to purchase 21,600 Shares (subject to adjustment as provided in Section 15) on such initial election (an "Initial Option"), and (ii) an Option to purchase 10,000 Shares (subject to adjustment as provided in Section 15) on the date of the first annual meeting of stockholders that occurs each year that the Non-Employee Director is reelected to the Board (the "Annual Option"). Members of the Board who are employees of the Company who subsequently retire from the Company and remain on the Board will not receive an Initial Option but, to the extent that they are otherwise eligible as Non-Employee Directors, will receive, after retirement from employment with the Company, the Annual Option.

(b) In the event that the Company provides cash compensation to Non-Employee Directors for service as a Director or for service as a member or chairperson of a committee of the Board (collectively "Cash Compensation"), each Non-Employee Director may elect to receive (subject to limitations in Section 12(b)(i)), in lieu of receiving any portion of his or her Cash Compensation, a Stock Bonus. Such an election shall be made by filing an election with the Company, in accordance with procedures adopted by the Committee, prior to the time that such Cash Compensation is paid. All elections made hereunder are subject to the following:

(i) The number of Shares payable under a Stock Bonus shall be calculated by dividing (A) the amount of the Cash Compensation that would have been payable to the Non-Employee Director in the absence of an election, by (B) the Fair Market Value of a Share on the date that the Cash Compensation would have otherwise been paid; *provided, however*, that no more than 20,000 Shares can be made subject to a Stock Bonus during any 12-month period that begins with the annual meeting of the shareholders of the Company in which Board members are elected. Any amount of the Cash Compensation subject to the election that exceeds the Fair Market Value of the Shares that are calculated hereunder shall be paid in cash to the Non-Employee Director.

(ii) Other than the right of the Non-Employee Director herein to elect to receive a Stock Bonus, the terms thereof shall be subject to the provisions of Section 14.

13. Terms of Non-Employee Director Options. The per Share price of each Option granted to a Non-Employee Director (as defined in Section 12) shall be equal to 100% of the Fair Market Value of a share of Common Stock on the date the Option is granted. Initial Options (as defined in Section 12) granted to Non-Employee Directors shall become exercisable in

cumulative annual installments of one-third of the Shares subject to such option on each of the yearly anniversaries of the date of Initial Option grant that the Non-Employee Director remains a Director, commencing with the first such anniversary, such that each Initial Option shall be 100% vested on the third anniversary of its date of grant if the Non-Employee Director continues to be a Director on such date. Annual Options (as defined in Section 12) granted to Non-Employee Directors shall become exercisable in cumulative quarterly installments of one-fourth of the Shares subject to such Option on the first day of each of calendar quarter that follows the date of the Annual Option grant that the Non-Employee Director remains a Director, such that each Annual Option shall be 100% vested on the one-year anniversary of its date of grant if the Non-Employee Director continues to be a Director on such date. Subject to Section 10, the term of each Option granted to a Non-Employee Director shall be ten years from the date the Option is granted. No portion of an Option which is unexercisable at the time of an Non-Employee Director's termination of membership on the Board shall thereafter become exercisable.

14. Stock Purchase Rights and Stock Bonuses.

(a) Rights to Purchase. Stock Purchase Rights may be issued either alone, in addition to, or in tandem with Options granted under the Plan and/or cash awards made outside of the Plan. After the Committee determines that it will offer Stock Purchase Rights under the Plan, it shall advise the offeree in writing of the terms, conditions and restrictions related to the offer, including the number of Shares that such person shall be entitled to purchase, the price to be paid, and the time within which such person must accept such offer. The offer shall be accepted by execution of an Agreement that covers the purchase of Restricted Stock in the form determined by the Committee.

(b) Repurchase Right. Unless the Committee determines otherwise, the Agreement for the purchase of Restricted Stock shall grant the Company the right to repurchase Shares acquired upon exercise of a Stock Purchase Right upon the termination of the purchaser's status as a Service Provider for any reason. Subject to Section 22, the purchase price for Shares repurchased by the Company pursuant to such repurchase right and the rate at which such repurchase right shall lapse shall be determined by the Committee in its sole discretion, and shall be set forth in the Agreement.

(c) Other Provisions. The Agreement shall contain such other terms, provisions and conditions not inconsistent with the Plan as may be determined by the Committee in its sole discretion.

(d) Rights as a Shareholder. Once the Stock Purchase Right is exercised, the purchaser shall have rights equivalent to those of a shareholder and shall be a shareholder when his or her purchase is entered upon the records of the duly authorized transfer agent of the Company. No adjustment shall be made for a dividend or other right for which the record date is prior to the date the Stock Purchase Right is exercised, except as provided in Section 15 of the Plan.

(e) Stock Bonuses. Notwithstanding any other provision of the Plan, the Committee may grant Stock Bonuses, as compensation or as bonuses, to such Service Providers as the Committee may select in its sole discretion from time to time. Such Stock Bonuses may be

issued either alone, in addition to, or in tandem with Options or Stock Purchase Rights granted under the Plan and/or cash awards made outside of the Plan. After the Committee determines that it will offer Stock Bonuses under the Plan, it shall advise the offeree in writing of the terms and conditions related to the offer, including the number of Shares that such person shall be entitled to receive, the time within which such person must accept such offer, and the manner of acceptance of such offer.

15. Adjustments upon Changes in Capitalization, Merger or Asset Sale. The terms of this Section 15 will apply to the rights of a Holder under all Agreements issued hereunder; *provided, however*, that the terms of an Agreement will control with respect to the Holder's rights and adjustments that are made with respect to a merger, asset purchase or other acquisition transaction if the Agreement specifically makes provision for rights and adjustments upon the occurrence of any such acquisition transaction.

(a) In the event that the Committee determines that any dividend or other distribution (whether in the form of cash, Common Stock, other securities, or other property), recapitalization, reclassification, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, liquidation, dissolution, or sale, transfer, exchange or other disposition of all or substantially all of the assets of the Company, or exchange of Common Stock or other securities of the Company, issuance of warrants or other rights to purchase Common Stock or other securities of the Company, or other similar corporate transaction or event, in the Committee's sole discretion, affects the Common Stock such that an adjustment is determined by the Committee to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan or with respect to any Option, Stock Purchase Right or Restricted Stock, then the Committee shall, in such manner as it may deem equitable, adjust any or all of:

(i) the number and kind of shares of Common Stock (or other securities or property) with respect to which Options or Stock Purchase Rights may be granted or awarded (including, but not limited to, adjustments of the limitations in Section 3 on the maximum number and kind of shares which may be issued and adjustments of the maximum number of Shares that may be purchased by any Holder in any calendar year pursuant to Section 6(c));

(ii) the number and kind of shares of Common Stock (or other securities or property) subject to outstanding Options, Stock Purchase Rights or Restricted Stock; and

(iii) the grant or exercise price with respect to any Option or Stock Purchase Right.

(b) In the event of any transaction or event described in Section 15(a), the Committee, in its sole discretion, and on such terms and conditions as it deems appropriate, either by the terms of the Option, Stock Purchase Right or Restricted Stock or by action taken prior to the occurrence of such transaction or event and either automatically or upon the Holder's request, is hereby authorized to take any one or more of the following actions whenever the Committee determines that such action is appropriate in order to prevent dilution or enlargement

of the benefits or potential benefits intended by the Company to be made available under the Plan or with respect to any Option, Stock Purchase Right or Restricted Stock granted or issued under the Plan or to facilitate such transaction or event:

(i) To provide for either the purchase of any such Option, Stock Purchase Right or Restricted Stock for an amount of cash equal to the amount that could have been obtained upon the exercise of such Option or Stock Purchase Right or realization of the Holder's rights had such Option, Stock Purchase Right or Restricted Stock been currently exercisable or payable or fully vested or the replacement of such Option, Stock Purchase Right or Restricted Stock with other rights or property selected by the Committee in its sole discretion;

(ii) To provide that such Option or Stock Purchase Right shall be exercisable as to all shares covered thereby, notwithstanding anything to the contrary in the Plan or the provisions of such Option or Stock Purchase Right;

(iii) To provide that such Option, Stock Purchase Right or Restricted Stock be assumed by the successor or survivor corporation, or a parent or subsidiary thereof, or shall be substituted for by similar options, rights or awards covering the stock of the successor or survivor corporation, or a parent or subsidiary thereof, with appropriate adjustments as to the number and kind of shares and prices;

(iv) To make adjustments in the number and type of shares of Common Stock (or other securities or property) subject to outstanding Options and Stock Purchase Rights, and/or in the terms and conditions of (including the grant or exercise price), and the criteria included in, outstanding Options, Stock Purchase Rights or Restricted Stock or Options, Stock Purchase Rights or Restricted Stock which may be granted in the future; and

(v) To provide that immediately upon the consummation of such event, such Option or Stock Purchase Right shall not be exercisable and shall terminate; *provided*, that for a specified period of time prior to such event, such Option or Stock Purchase Right shall be exercisable as to all Shares covered thereby, and the restrictions imposed under an Agreement upon some or all Shares may be terminated and, in the case of Restricted Stock, some or all shares of such Restricted Stock may cease to be subject to repurchase, notwithstanding anything to the contrary in the Plan or the provisions of such Option, Stock Purchase Right or Restricted Stock or any Agreement.

(c) Subject to Section 3, the Committee may, in its sole discretion, include such further provisions and limitations in any Option, Stock Purchase Right, Restricted Stock, Agreement or certificate, as it may deem equitable and in the best interests of the Company.

(d) If the Company undergoes an Acquisition, then any surviving corporation or entity or acquiring corporation or entity, or affiliate of such corporation or entity, may assume any Options, Stock Purchase Rights or Restricted Stock outstanding under the Plan or may substitute similar stock awards (including an award to acquire the same consideration paid to the stockholders in the transaction described in this subsection 15(d)) for those outstanding under the Plan. In the event any surviving corporation or entity or acquiring corporation or entity in an Acquisition, or affiliate of such corporation or entity, does not assume such Options, Stock

Purchase Rights or Restricted Stock or does not substitute similar stock awards for those outstanding under the Plan, then with respect to (i) Options, Stock Purchase Rights or Restricted Stock held by participants in the Plan whose status as a Service Provider has not terminated prior to such event, the vesting of such Options, Stock Purchase Rights or Restricted Stock (and, if applicable, the time during which such awards may be exercised) shall be accelerated and made fully exercisable and all restrictions thereon shall lapse at least ten days prior to the closing of the Acquisition (and the Options or Stock Purchase Rights terminated if not exercised prior to the closing of such Acquisition), and (ii) any other Options or Stock Purchase Rights outstanding under the Plan, such Options or Stock Purchase rights shall be terminated if not exercised prior to the closing of the Acquisition.

(e) In the event the Company undergoes an Acquisition and any surviving corporation or entity or acquiring corporation or entity, or affiliate of such corporation or entity, does assume any Options, Stock Purchase Rights or Restricted Stock outstanding under the Plan (or substitutes similar stock awards, including an award to acquire the same consideration paid to the stockholders in the transaction described in this subsection 15(e), for those outstanding under the Plan), then, with respect to each stock award held by participants in the Plan then performing services as Employees or Directors, the vesting of each such stock award (and, if applicable, the time during which such stock award may be exercised) shall be accelerated and such stock award shall immediately become fully vested and exercisable, if any of the following events occurs within 12 months after the effective date of the Acquisition or within the Trial Period (as defined herein) even if such Trial Period extends beyond 12 months after the effective date of the Acquisition:

- (i) the Employee status or Director status, as applicable, of the participant holding such stock award is terminated by the Company without Cause; or
- (ii) the Employee holding such stock award terminates his or her Employee status following (A) a change in position with the Company or any reduction in his or her level of responsibility; (B) any reduction in his or her level of compensation (including base salary, fringe benefits, participation in any plans and target bonuses under any corporate-performance based bonus or incentive programs); or (C) a relocation of the place of employment of the Employee by more than 50 miles; provided and only if such change, reduction or relocation is effected without such individual's consent. In the event that an individual consents to such change, the individual enters a trial period (the "Trial Period") of six months from the date of consent. At any time during the Trial Period an individual may revoke his or her consent and meet the conditions of a voluntary resignation following a change as stated in (A), (B), or (C) above, without the individual's consent.

(f) The existence of the Plan, any Agreement and the Options or Stock Purchase Rights granted hereunder shall not affect or restrict in any way the right or power of the Company or the stockholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company's capital structure or its business, any merger or consolidation of the Company, any issue of stock or of options, warrants or rights to purchase stock or of bonds, debentures, preferred or prior preference stocks whose

rights are superior to or affect the Common Stock or the rights thereof or which are convertible into or exchangeable for Common Stock, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.

16. Time of Granting Options, Stock Purchase Rights and Stock Bonuses. The date of grant of an Option, Stock Purchase Right or Stock Bonus shall, for all purposes, be the date on which the Committee makes the determination granting such Option, Stock Purchase Right or Stock Bonus, or such other date as is determined by the Committee. Notice of the determination shall be given to each Employee or Consultant to whom an Option, Stock Purchase Right or Stock Bonus is so granted within a reasonable time after the date of such grant.

17. Amendment and Termination of the Plan.

(a) Amendment and Termination. The Board may at any time wholly or partially amend, alter, suspend or terminate the Plan. However, without approval of the Company's stockholders given within 12 months before or after the action by the Board, no action of the Board may, except as provided in Section 15, increase the limits imposed in Section 3 on the maximum number of Shares which may be issued under the Plan or extend the term of the Plan under Section 7.

(b) Stockholder Approval. The Board shall obtain stockholder approval of any Plan amendment to the extent necessary and desirable to comply with Applicable Laws.

(c) Effect of Amendment or Termination. No amendment, alteration, suspension or termination of the Plan shall impair the rights of any Holder, unless mutually agreed otherwise between the Holder and the Committee, which Agreement must be in writing and signed by the Holder and the Company. Termination of the Plan shall not affect the Committee's ability to exercise the powers granted to it hereunder with respect to Options, Stock Purchase Rights, Stock Bonuses or Restricted Stock granted or awarded under the Plan prior to the date of such termination.

18. Stockholder Approval. The Capstone Turbine Corporation 2000 Equity Incentive Plan, as originally adopted, was submitted for the approval of the Company's stockholders and such approval was received within 12 months after the date of the Board's initial adoption thereof. In addition, amendments to increase the number of Shares authorized for issuance hereunder have been previously approved by the Company's stockholders, and such amendments are incorporated herein.

19. Inability to Obtain Authority. The inability of the Company to obtain authority from any regulatory body having jurisdiction, which authority is deemed by the Company's counsel to be necessary to the lawful issuance and sale of any Shares hereunder, shall relieve the Company of any liability in respect of the failure to issue or sell such Shares as to which such requisite authority shall not have been obtained.

20. Reservation of Shares. The Company, during the term of this Plan, shall at all times reserve and keep available such number of Shares as shall be sufficient to satisfy the requirements of the Plan.

21. Investment Intent. The Company may require a Plan participant, as a condition of exercising or acquiring stock under any Option, Stock Purchase Right or Stock Bonus, (i) to give written assurances satisfactory to the Company as to the participant's knowledge and experience in financial and business matters and/or to employ a purchaser representative reasonably satisfactory to the Company who is knowledgeable and experienced in financial and business matters and that he or she is capable of evaluating, alone or together with the purchaser representative, the merits and risks of exercising the Option or Stock Purchase Right, electing or accepting the Stock Bonus; and (ii) to give written assurances satisfactory to the Company stating that the participant is acquiring the stock subject to the Option, Stock Purchase Right or Stock Bonus for the participant's own account and not with any present intention of selling or otherwise distributing the stock. The foregoing requirements, and any assurances given pursuant to such requirements, shall be inoperative if (A) the issuance of the shares upon the exercise or acquisition of stock under the applicable Option, Stock Purchase Right or Stock Bonus has been registered under a then currently effective registration statement under the Securities Act or (B) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws. The Company may, upon advice of counsel to the Company, place legends on stock certificates issued under the Plan as such counsel deems necessary or appropriate in order to comply with applicable securities laws, including, but not limited to, legends restricting the transfer of the stock.

22. Governing Law. The validity and enforceability of this Plan shall be governed by and construed in accordance with the laws of the State of Delaware without regard to otherwise governing principles of conflicts of law.

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**CAPSTONE TURBINE CORPORATION
CHANGE OF CONTROL SEVERANCE PLAN**

Amended and Restated March 17, 2005

Capstone Turbine Company (the "Company") established the Capstone Turbine Corporation Change in Control Severance Plan (the "Plan") effective April 24, 2002 for the purpose of retaining its key executives by assuring them of adequate severance pay in the event of a change in the control of the Company. As authorized by its board of directors, the Company desires to amend the Plan, effective March 17, 2005, to: (1) modify the period for a Change of Control via a contested Board election to the first date within any period of 18 consecutive months or less on which there is effected a change in the composition of the Board from 12 months, and (2) to modify the Involuntary Termination language to provide that even if an individual consents to a change in position, compensation or location (as such items are used in the Involuntary Termination language) following a Change of Control, for a trial period of six months following such consent an individual may revoke his or her consent, thereby creating an Involuntary Termination. If the trial period extends beyond 12 months from the Change in Control event, the Executive will have the option for the remainder of the trial period to revoke his or her consent and, if so revoked, to be eligible for the Change of Control benefits as provided herein.

ELIGIBILITY

Eligibility in the Plan is limited to the executive officers or employees of the Company who are designated to participate in the Plan by the Company's board of directors (the "Board") from time to time. Each officer or employee who is so designated as eligible to participate in the Plan is referred to hereinafter as an "Executive." Executives may be added or deleted based on Board approval; provided that, only such Board approvals which have been received prior to the consummation of the applicable Change of Control shall be effective as to the addition or deletion of Executives.

SEVERANCE BENEFITS

In the event that an Executive is Involuntarily Terminated within 12 months of a Change of Control (as such terms are defined herein) or within the Trial Period (as hereinafter defined), even if such Trial Period extends beyond 12 months of a Change of Control, such Executive shall be entitled to receive from the Company an amount equal to such Executive's annual base salary plus the cash incentive compensation paid for the year in which the effective date for the Change in Control occurs (such amount, the "Salary"). The Salary shall be paid in one lump sum on the date such Executive was Involuntarily Terminated (the "Termination Date"). Pursuant to COBRA, the Company shall continue such Executive Officer's health care coverage as under the Company's medical and dental plans. The Company will pay for such coverage until 12 months after the Termination Date. Thereafter, such Executive shall be eligible to continue such coverage at his or her own expense for the remainder of his or her applicable COBRA continuation period. As used herein, the term "Involuntarily Terminated" shall mean the termination of an Executive's service by reason of:

1. involuntary dismissal or discharge by the Company for reasons other than Misconduct (as defined below), or

2. voluntary resignation following (A) a change in position with the Company or a reduction in his or her level of responsibility, (B) any reduction in his or her level of compensation (including base salary, fringe benefits, participation in any plans and target bonuses under any corporate-performance based bonus or incentive programs) or (C) a relocation of such individual's place of employment by more than 50 miles, provided and only if such change, reduction or relocation is effected without the individual's consent. In the event that an individual consents to such change, the individual enters a trial period (the "Trial Period") of six months from the date of consent. At any time during the Trial Period an individual may revoke his or her consent and meet the conditions of a voluntary resignation following a change as stated in (A), (B), or (C) above, without the individual's consent.

As used herein, "Misconduct" shall mean the commission of any act of fraud, embezzlement, theft or dishonesty by such individual, any unauthorized use or disclosure by such individual of confidential information or trade secrets of the Company (or any parent or subsidiary thereof), or any other intentional misconduct by such individual adversely affecting the business or affairs of the Company (or any parent or subsidiary) in a material manner. The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Company (or any parent or subsidiary) may consider as grounds for the dismissal or discharge of any Executive.

CHANGE OF CONTROL

For the purposes of this severance plan, the term "Change in Control" means any of the following:

1. the successful acquisition by a person or related group of persons, (other than the Company or a person that directly or indirectly controls, is controlled by or is under common control with, the Company) of beneficial ownership (within the meaning of Rule 13d-3 of the Securities Exchange Act of 1934, as amended) of securities possessing more than 50% of the total combined voting power of the Company's outstanding securities pursuant to a transaction or series of related transactions which the Board does not at any time recommend the Company's stockholders to accept or approve;

2. the first date within any period of 18 consecutive months or less on which there is effected a change in the composition of the Company's Board such that a majority of the Board ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (i) have been members of the Company's Board continuously since the beginning of such period or (ii) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (i) who were still in office at the time such election or nomination was approved by the Board;

3. a merger or consolidation in which the Company is not the surviving entity, except for a transaction the principal purpose of which is to change the state in which the Company is incorporated;

4. the sale, transfer or other disposition of all or substantially all of the assets of the Company in complete liquidation or dissolution of the Company;

5. any reverse merger in which the Company is the surviving entity but in which securities possessing more than 50% of the total combined voting power of the Company's outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such merger; or

6. the issuance by the Company to a single person or related group of persons (other than the Company or a person that directly or indirectly controls, is controlled by or is under common control with, the Company) of securities possessing more than 50% of the total combined voting power of the Company's outstanding securities (determined after such issuance) in a single transaction or a series of related transactions.

SUMMARY OF PLAN INFORMATION

The information in this section is intended to answer general questions regarding the operation of the Plan.

Except for those responsibilities specifically reserved to the Board herein, the Plan is administered by the "Administrator." The Administrator is the committee of officers or Board members designated from time to time by the Company to administer the Plan. In the absence of such designation, the Company shall be the Administrator. The Administrator may delegate any of its duties or authorities to any person or entity. The Administrator has absolute discretion to make all decisions under the Plan, including making determinations about eligibility for and the amounts of benefits payable under the Plan and interpreting all Plan provisions. All decisions of the Administrator are final, binding and conclusive. If a Change in Control occurs, as determined by the Administrator in its discretion, the Administrator shall consist of a committee of the individuals who were the chief executive officer of the Company, the chief financial officer of the Company and the senior human resources officer of the Company immediately prior to the Change in Control.

How to Make a Claim for Benefits

If severance benefits are not automatically paid upon a payment event, an Executive may file a request for benefits in writing with the "Administrator" (as defined in this section). Failure to timely submit an application for benefits in writing, as specified in Section 5, will result in a loss of Plan benefits. You may not assign your benefits. Any attempted assignment is void.

If an individual's claim for Benefits is denied, the Administrator will furnish written notice of denial to the individual ("Claimant") within 90 days of the date the claim is received, unless special circumstances require an extension of time for processing the claim. This extension will not exceed 90 days, and the Claimant must receive written notice stating the grounds for the extension and the length of the extension within the initial 90-day review period. If the Administrator does not provide written notice, the Claimant may deem the claim denied and seek review according to the appeals procedures set forth below.

1. The notice of denial to the Claimant shall state:

- (a) The specific reasons for the denial;
- (b) Specific references to pertinent provisions of the Plan on which the denial was based;
- (c) A description of any additional material or information needed for the Claimant to perfect his or her claim and an explanation of why the material or information is needed;
- (d) A statement that the Claimant may request a review upon written application to the Administrator, review pertinent Plan documents, and submit issues and comments in writing and that any appeal that the Claimant wishes to make of the adverse determination must be in writing to the Administrator within 60 days after the Claimant receives notice of denial of benefits; and
- (e) The name and address of the Administrator to which the Claimant may forward an appeal. The notice may state that failure to appeal the action to the Administrator in writing within the 60-day period will render the determination final, binding and conclusive.

2. If the Claimant appeals to the Administrator, the Claimant or his or her authorized representative may submit in writing whatever issues and comments he or she believes to be pertinent. The Administrator shall reexamine all facts related to the appeal and make a final determination of whether the denial of benefits is justified under the circumstances. The Administrator shall advise the Claimant in writing of:

- (a) The Administrator's decision on appeal.
- (b) The specific reasons for the decision.
- (c) The specific provisions of the Plan on which the decision is based.

Notice of the Administrator's decision shall be given within 60 days of the Claimant's written request for review, unless additional time is required due to special circumstances. In no event shall the Administrator render a decision on an appeal later than 120 days after receiving a request for a review.

Plan Amendment or Termination

The Company may terminate or amend the Plan in its sole discretion at any time prior to a Change in Control by a written amendment that is authorized by the Company. However, once a Change in Control occurs, or upon the execution of a letter of intent or definitive agreement for the Company to engage in a transaction that will result in a Change in Control, (i) no amendment or termination

will be effective with respect to an Executive unless he or she receives 30 days written notice of such amendment and consents thereto in writing after consultation with legal counsel, (ii) the identity of the Administrator may not be changed by an amendment without the express written consent of a majority of individuals who are or will become eligible to receive benefits hereunder as a result of the Change in Control.

The Company's authorization of an amendment must be evidenced by one of the following: (1) a resolution of the board of directors; (2) execution of the amendment by the Company's chief executive officer, president or secretary; or (3) ratification of the amendment by either a resolution of the board of directors or written confirmation of ratification by the chief executive officer, president or secretary. Notice of any amendment must be provided to or made available to the Administrator. Oral amendments and modifications of this Plan are not effective. All amendments and modifications must be in writing and signed as provided above to be effective.

Additional Information

Benefits are paid out of the general assets of the Company. The Company may, in its discretion establish a "grantor trust" to fund the payment of Benefits. Otherwise, this Plan does not give an Executive any rights to any particular assets of the Company. Cash amounts paid under a severance plan are generally considered taxable income to the recipient.

ERISA Rights

Participant in the Plan are entitled to certain rights and protections under ERISA. ERISA provides that all Plan participants shall be entitled to:

- Examine, without charge, at the Plan Administrator's office and at other specified locations, all Plan documents, including insurance contracts, and copies of all documents filed by the Plan with the U.S. Department of Labor, such as detailed annual reports and plan descriptions.
- Obtain copies of all Plan documents and other Plan information upon written request to the Plan Administrator. The Plan Administrator may make a reasonable charge for the copies.
- Receive a summary of the Plan's annual financial report. The Plan Administrator is required by law to furnish each participant with a copy of this summary annual report.

In addition to creating rights for Plan participants, ERISA imposes duties upon the people who are responsible for the operation of the employee benefit Plan. The people who operate your Plan, called "fiduciaries" of the Plan, have a duty to do so prudently and in the interest of you and other Plan participants and beneficiaries. No one, including the Company or any other person, may fire you or otherwise discriminate against you in any way to prevent you from obtaining a benefit under this Plan or from exercising your rights under ERISA. If a claim for a Benefit is denied in whole or in part, you must receive a written explanation of the reason for the denial. You have the right to have the Plan Administrator review and reconsider your claim.

Under ERISA, there are steps you can take to enforce the above rights. For instance, if you request materials from the Plan and do not receive them within 30 days, you may file suit in a federal court. In such a case, the court may require the Plan Administrator to provide the materials and pay you up to \$110 a day until you receive the materials, unless the materials were not sent because of reasons beyond the control of the Administrator.

If you have a claim for benefits that is denied or ignored, in whole or in part, and you have exhausted all administrative remedies provided herein and ERISA, you may file suit in a federal court. If it should happen that Plan fiduciaries misuse the Plan's money or if you are discriminated against for asserting your rights, you may seek assistance from the U.S. Department of Labor or you may file suit in a federal court. The court will decide who should pay court costs and fees. If you lose, the court may order you to pay these costs and fees, for example, if it finds your claim is frivolous.

If you have any questions about your Plan, you should contact the Plan Administrator. If you have any questions about this statement or about your rights under ERISA, you should contact the nearest Area Office of the U.S. Labor-Management Services Administration, Department of Labor.

Summary of Plan Information

Name of Plan: Capstone Turbine Corporation Change in Control Severance Plan

Company Address: Capstone Turbine Corporation
21211 Nordhoff Street
Chatsworth, CA 91311

Who Pays for the Plan: The cost of the Plan is paid entirely by the Company.

The Company's Employer Identification No.: 95-4180883

Plan Number: 510

Plan Year: January 1 to December 31

Plan Administrator: Administrator of the Change in Control Severance Plan
c/o Sharon Faltemier
Capstone Turbine Corporation
21211 Nordhoff Street
Chatsworth, CA 91311

(818) 734-5300

Agent for Service of Legal Process on the Plan: Chief executive officer of the Company or the Plan Administrator.

IN WITNESS WHEREOF, Capstone Turbine Corporation, acting through the undersigned authorized representative, has executed this Plan on the 20th day of March, 2005, to be effective as of March 17, 2005.

CAPSTONE TURBINE CORPORATION

By: /s/ Karen Clark

Its: Secretary to the Board

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-40838, 333-40846, 333-40868, 333-66390, 333-101201, 333-102039, 333-107628 and 333-110847 on Form S-8 and Registration Statement No. 333-102036 on Form S-3 of our reports dated June 29, 2005, relating to the financial statements of Capstone Turbine Corporation and management's report on the effectiveness of internal control over financial reporting (which report expresses an adverse opinion on the effectiveness of the Company's internal control over financial reporting because of material weaknesses), appearing in this Annual Report on Form 10-K of Capstone Turbine Corporation for the year ended March 31, 2005.

/s/ DELOITTE & TOUCHE LLP

Los Angeles, California
June 29, 2005

**CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
RULE 13a-14(b)/Rule 15d-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED
AND 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K of Capstone Turbine Corporation (the "Company") for the year ended March 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), John Tucker, Chief Executive Officer of the Company, and Karen Clark, Chief Financial Officer of the Company, certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), that the Report complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ JOHN TUCKER
John Tucker
President and Chief Executive Officer

By: /s/ KAREN CLARK
Karen Clark
Chief Financial Officer

Date: June 29, 2005