
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from to

Commission file number: 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 and zip code)

818-734-5300

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of outstanding shares of the registrant's common stock as of October 31, 2006 was 103,939,563.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

CAPSTONE TURBINE CORPORATION CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands, except share amounts) (Unaudited)

	<u>September 30, 2006</u>	<u>March 31, 2006</u>
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 39,329	\$ 58,051
Accounts receivable, net of allowance for doubtful accounts and sales returns of \$805 at September 30, 2006 and \$858 at March 31, 2006	2,532	5,869
Inventories	18,968	12,545
Prepaid expenses and other current assets	1,695	1,050
Total current assets	<u>62,524</u>	<u>77,515</u>
Property, plant and equipment, net	6,762	7,816
Non-current portion of inventories	2,569	3,113
Intangible asset, net and other long-term assets	1,139	1,273
Total	<u>\$ 72,994</u>	<u>\$ 89,717</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 8,445	\$ 8,144
Accrued salaries and wages	1,376	1,623
Accrued warranty reserve	6,876	6,998
Deferred revenue	688	632

Current portion of notes payable	19	19
Total current liabilities	17,404	17,416
Long-term portion of notes payable	37	47
Other long-term liabilities	592	626
Stockholders' Equity:		
Preferred stock, \$.001 par value; 10,000,000 shares authorized; none issued	—	—
Common stock, \$.001 par value; 415,000,000 shares authorized; 104,765,257 shares issued and 104,214,049 shares outstanding at September 30, 2006; 103,521,829 shares issued and 102,970,621 shares outstanding at March 31, 2006	104	104
Additional paid-in capital	575,663	572,787
Accumulated deficit	(520,293)	(500,542)
Deferred stock compensation	—	(208)
Treasury stock, at cost; 551,208 shares	(513)	(513)
Total stockholders' equity	54,961	71,628
Total	\$ 72,994	\$ 89,717

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Revenue	\$ 2,946	\$ 5,705	\$ 9,512	\$ 9,512
Cost of goods sold (includes stock-based compensation of \$23, \$0, \$51 and \$0, for the periods presented, respectively)	5,282	6,768	13,084	13,992
Gross loss	(2,336)	(1,063)	(3,572)	(4,480)
Operating expenses:				
Research and development (includes stock-based compensation of \$56, \$0, \$112 and \$0, for the periods presented, respectively)	2,592	2,728	5,398	4,833
Selling, general and administrative (includes stock-based compensation of \$591, \$449, \$1,266 and \$577, for the periods presented, respectively)	6,061	6,788	11,976	12,525
Total operating expenses	8,653	9,516	17,374	17,358
Loss from operations	(10,989)	(10,579)	(20,946)	(21,838)
Interest income	571	377	1,198	773
Interest expense	(1)	(19)	(2)	(21)
Other income	—	22	1	24
Loss before income taxes	(10,419)	(10,199)	(19,749)	(21,062)
Provision for income taxes	—	—	2	2
Net loss	\$ (10,419)	\$ (10,199)	\$ (19,751)	\$ (21,064)
Net loss per share of common stock — Basic and Diluted	\$ (0.10)	\$ (0.12)	\$ (0.19)	\$ (0.25)
Weighted average shares used to calculate Basic and Diluted net loss per share	103,901	84,955	103,612	84,673

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended September 30,	
	2006	2005
Cash Flows from Operating Activities:		
Net loss	\$ (19,751)	\$ (21,064)

Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,665	2,184
Provision (benefit) for allowance for doubtful accounts and sales returns	(53)	166
Inventory write-downs	989	716
Provision for warranty expenses	1,354	645
Loss on disposal of equipment	203	—
Stock-based compensation	1,429	577
Changes in operating assets and liabilities:		
Accounts receivable	3,390	1,455
Inventories	(6,868)	(4,029)
Prepaid expenses and other assets	(645)	(697)
Accounts payable and accrued expenses	212	1,846
Accrued salaries and wages and long-term liabilities	(281)	(217)
Accrued warranty reserve	(1,476)	(1,327)
Deferred revenue	56	(118)
Net cash used in operating activities	<u>(19,776)</u>	<u>(19,863)</u>
Cash Flows from Investing Activities:		
Acquisition of and deposits on equipment and leasehold improvements	(607)	(548)
Proceeds from disposal of equipment	16	1
Net cash used in investing activities	<u>(591)</u>	<u>(547)</u>
Cash Flows from Financing Activities:		
Repayment of notes payable and capital lease obligations	(10)	(8)
Exercise of stock options and employee stock purchases	1,655	876
Net cash provided by financing activities	<u>1,645</u>	<u>868</u>
Net Decrease in Cash and Cash Equivalents	(18,722)	(19,542)
Cash and Cash Equivalents, Beginning of Period	58,051	63,593
Cash and Cash Equivalents, End of Period	<u>\$ 39,329</u>	<u>\$ 44,051</u>
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$ 2	\$ 21
Income taxes	\$ 2	\$ 2
Supplemental Disclosures of Non-Cash Information:		
During the six months ended September 30, 2006 and 2005, the Company purchased on account \$196 and \$53 of fixed assets, respectively.		

See accompanying notes to condensed consolidated financial statements.

CAPSTONE TURBINE CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Business and Organization

Capstone Turbine Corporation (the “Company”) develops, manufactures, markets and services microturbine technology solutions for use in stationary distributed power generation applications, including cogeneration (combined heat and power (“CHP”) and combined cooling, heat and power (“CCHP”)), resource recovery and secure power. In addition, the Company’s microturbines can be used as generators for hybrid electric vehicle applications. The Company was organized in 1988 and has been commercially producing its 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 revenue to cover its operating costs. To date, the Company has funded its activities primarily through private and public equity offerings.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles”) for interim financial information and with the instructions to Form 10-Q and Regulation S-X promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The condensed consolidated balance sheet at March 31, 2006 was derived from audited financial statements included in the Company’s annual report on Form 10-K for the year ended March 31, 2006. In the opinion of management, the interim condensed consolidated financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial condition, results of operations and cash flows for such periods. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. These condensed consolidated financial statements should be read in

conjunction with the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended March 31, 2006. This quarterly report on Form 10-Q refers to the Company's fiscal years ending March 31st as its "Fiscal" year.

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

Certain reclassifications have been made to some prior years balances to conform to the current year's presentation.

Stock-Based Compensation

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)"), which requires the measurement and recognition of compensation expense for all stock options issued to employees and directors based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method. The Company's condensed consolidated financial statements as of and for the three months and six months ended September 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense for the three months and six months ended September 30, 2006 was \$0.7 million and \$1.4 million, respectively. If not for the adoption of SFAS 123(R) in the first quarter of Fiscal 2007, stock-based compensation expense under existing guidance would have been approximately \$72,000 and \$0.2 million for the three months and six months ended September 30, 2006.

As noted above, prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25. The Company also accounted for equity

instruments issued to non-employees using the fair value at the date of grant as prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation" and Emerging Issues Task Force No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Service." The following table illustrates the effect on stock-based compensation expense and net loss per common share if the Company had applied the fair value recognition provisions of SFAS 123 to its employee and director stock option grants, stock purchases, restricted stock and stock awards during the three months and six months ended September 30, 2005 (in thousands, except per share data):

	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
Net loss, as reported	\$ (10,199)	\$ (21,064)
Add: Stock-based employee and director compensation included in reported net loss	76	152
Deduct: Total stock-based employee and director compensation expense determined under fair value based method	(679)	(1,584)
Pro forma net loss	<u>\$ (10,802)</u>	<u>\$ (22,496)</u>
Net loss per share — Basic and Diluted:		
As reported	\$ (0.12)	\$ (0.25)
Pro forma	\$ (0.13)	\$ (0.27)

On November 10, 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. SFAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee share-based compensation awards that are outstanding upon adoption of SFAS 123(R). We are currently in the process of evaluating whether to adopt the provisions of SFAS 123(R)-3.

Prior to the adoption of SFAS 123(R), the Company would have presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of the Emerging Issues Task Force Issue No 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option." However, the Company has not recorded tax benefits associated with the exercise of stock options based on the losses incurred to date. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis.

3. Customer Concentrations and Accounts Receivable

Individually, two customers accounted for 11% and 10% of revenue, respectively, for the three months ended September 30, 2006, totaling approximately 21% of revenue. For the three months ended September 30, 2005, four customers each accounted for 16%, 14%, 13% and 10% of revenues, respectively. For the three months ended September 30, 2006 and 2005, United Technologies Corporation ("UTC") accounted for approximately 11% and 6% of revenues, respectively (see Note 10).

Individually, two customers accounted for 22% and 11% of revenues, respectively, for the six months ended September 30, 2006, totaling approximately 33% of revenue. For the same period last year, individually, two customers each accounted for 21% and 10% of revenues, respectively. UTC accounted for approximately 4% and 21% of revenues for the six months ended September 30, 2006 and 2005, respectively.

Accounts receivable included \$0.3 million and \$1.6 million for unpaid billings to the U.S. government under cost-sharing programs at September 30 and March 31, 2006, respectively. Individually, three additional customers accounted

for 27%, 13% and 10% of net accounts receivable, respectively, as of September 30, 2006, totaling approximately 50% of net accounts receivable and one customer accounted for 27% of net accounts receivable as of March 31, 2006.

While the Company has individual customers who, in any given period, may represent a significant portion of the Company's business, overall, the Company is not dependent on any single customer or particular group of customers.

4. Inventories

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

	September 30, 2006	March 31, 2006
	(In thousands)	
Raw materials	\$ 17,181	\$ 13,237
Work in process	829	705
Finished goods	3,527	1,716
Total	21,537	15,658
Less non-current portion	2,569	3,113
Current portion	<u>\$ 18,968</u>	<u>\$ 12,545</u>

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

5. Property, Plant and Equipment

Property, plant and equipment consisted of the following:

	September 30, 2006	March 31, 2006
	(In thousands)	
Machinery, equipment and furniture	\$ 17,648	\$ 18,493
Leasehold improvements	8,730	8,656
Molds and tooling	3,708	3,538
	30,086	30,687
Less, accumulated depreciation and amortization	(23,324)	(22,871)
Total property, plant and equipment, net	<u>\$ 6,762</u>	<u>\$ 7,816</u>

6. Intangible Asset

The Company's sole intangible asset is a manufacturing license. The gross carrying amount is \$3.7 million. The balance of the intangible asset was \$1.0 million and \$1.2 million as of September 30 and March 31, 2006, respectively. The intangible asset is being amortized over its estimated useful life of ten years. The Company recorded \$67,000 and \$0.1 million of amortization expense for each of the three months and six months ended September 30, 2006 and 2005, respectively. The manufacturing license is scheduled to be fully amortized by Fiscal 2011 with corresponding amortization estimated to be \$0.1 million for the remainder of Fiscal 2007, \$0.3 million for each of the fiscal years 2008, 2009 and 2010, and \$92,000 for Fiscal 2011.

The manufacturing license provides the Company with the ability to manufacture recuperator cores previously purchased from the supplier. The Company is required to pay a per-unit royalty fee over a seventeen-year period for cores manufactured and sold by the Company using the technology. Royalties of \$3,000 and \$15,000 were earned by the supplier for the three months ended September 30, 2006 and 2005, respectively. Royalties of \$12,000 and \$23,000 were earned by the supplier for the six months ended September 30, 2006 and 2005, respectively. As of September 30, 2006, a total of \$89,000 was earned under the terms of the agreement. Earned royalties of \$2,900 were unpaid as of September 30, 2006.

7. Stock-Based Compensation

1993 Incentive Stock Plan and 2000 Stock Incentive Plan

In 1993, the Board of Directors adopted and the stockholders approved the 1993 Incentive Stock Plan ("1993 Plan"). A total of 7,800,000 shares of common stock were initially reserved for issuance under the 1993 Plan. In June 2000, the Company adopted the 2000 Equity Incentive Plan ("2000 Plan") as a successor plan to the 1993 Plan. A total of 3,300,000 shares of common stock were initially reserved for issuance under the 2000 Plan. The 2000 Plan was amended in May 2002 to add 400,000 shares of common stock to the total available for issuance, 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 the Compensation Committee as designated by the Board of Directors. The Compensation Committee's authority includes determining the number of options granted and vesting provisions. As of September 30, 2006, 2,518,521 shares were available for future grant.

As of September 30, 2006, the Company had outstanding 4,045,000 non-qualified common stock options issued outside of the 2000 Plan. These stock options were originally granted at exercise prices equal to the fair market value of its common stock on the grant date, as inducement grants to new executive officers and employees of the Company. Included in the 4,045,000 options were 1,500,000 options to the Company's then President and Chief Executive Officer, 1,000,000 options to the Company's Executive Vice President and Chief Financial Officer, 800,000 options to the Company's then Senior Vice President of Sales and Service, 500,000 options to the Company's Vice President of Operations and an aggregate of 245,000 options to two 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 options granted 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. All outstanding options have a contractual term of ten years.

Valuation and Expense Information under SFAS 123(R)

In the three months ended September 30, 2006 and 2005, the Company recognized stock-based compensation expense of \$0.7 million and \$0.4 million, respectively. In the six months ended September 30, 2006 and 2005, the Company recognized stock-based compensation expense of \$1.4 million and \$0.6 million, respectively. The Company has not capitalized as an asset any stock-based compensation costs.

The Company calculated the estimated fair value of each stock option on the date of grant using the Black-Scholes option-pricing model and the following weighted-average assumptions:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Risk-free interest rates	5.1%	4.0%	5.0%	4.0%
Expected lives (in years)	6.1	5.5	6.1	5.4
Dividend yield	—%	—%	—%	—%
Expected volatility	102.6%	104.3%	103.4%	104.3%

The Company's computation of expected volatility for the three months and six months ended September 30, 2006 and 2005 was based on historical volatility. The Company estimated the expected life of each stock option granted in the three months and six months ended September 30, 2006 using the short-cut method permissible under SAB 107, which utilizes the weighted average expected life of each tranche of the stock option, determined based on the sum of each

tranche's vesting period plus one-half of the period from the vesting date of each tranche to the stock option's expiration. The risk-free interest rate is based on the implied yield available on U.S. Treasury securities with an equivalent remaining term. Included in the calculation is the Company's forfeiture rate. SFAS 123(R) requires that equity-based compensation expense be based on awards that are ultimately expected to vest and accordingly, equity-based compensation recognized in the three months and six months ended September 30, 2006, has been reduced by estimated forfeitures. Our estimate of forfeitures is based on historical option forfeiture behavior.

A summary of employee and non-employee stock option activity for the six months ended September 30, 2006 is as follows:

Weighted

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Average Remaining Contractual Term (years)</u>	<u>Aggregate Intrinsic Value</u>
Options outstanding at March 31, 2006	10,372,018	\$ 2.58		
Granted	981,600	2.53		
Exercised	(1,026,991)	1.58		
Forfeited	(1,696,688)	1.79		
Expired	(883,970)	7.44		
Options outstanding at September 30, 2006	<u>7,745,969</u>	<u>\$ 2.32</u>	<u>7.95</u>	<u>\$ 428,410</u>
Options exercisable at September 30, 2006	<u>3,687,903</u>	<u>\$ 2.13</u>	<u>6.91</u>	<u>\$ 416,077</u>
Options fully vested at September 30, 2006 and those expected to vest beyond September 30, 2006	<u>6,890,867</u>	<u>\$ 2.29</u>	<u>7.82</u>	<u>\$ 425,789</u>

The weighted average per share grant date fair value of options granted during the three months ended September 30, 2006 and 2005 was \$1.67 and \$1.87, respectively. The weighted average per share grant date fair value of options granted during the six months ended September 30, 2006 and 2005 was \$2.09 and \$1.71, respectively. The total intrinsic value of options exercised by the Company from option exercises during the three months ended September 30, 2006 and 2005, was approximately \$0.3 million and \$1.1 million, respectively. The total intrinsic value of options exercised by the Company from option exercises during the six months ended September 30, 2006 and 2005, was approximately \$1.4 million and \$1.1 million, respectively. As of September 30, 2006, there was approximately \$6.8 million of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over a weighted average period of 1.37 years.

Effective July 31, 2006, 500,000 stock options were forfeited in accordance with the consulting agreement between the Company and its former Chief Executive Officer. A summary of restricted stock activity for the six months ended September 30, 2006 is as follows:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested restricted stock outstanding at March 31, 2006	177,083	\$ 1.23
Granted	335,933	1.94
Vested	(68,140)	1.53
Forfeited	(135,000)	1.28
Nonvested restricted stock outstanding at September 30, 2006	<u>309,876</u>	<u>\$ 1.92</u>

The restricted stock awards vest in equal installments over a period of two to four years. The restricted stock awards were valued based on the closing price of the Company's common stock on the date of grant, and compensation cost is recorded on a straight-line basis over the share vesting period. The Company recorded expense of approximately \$65,000 and \$0.1 million associated with its restricted stock awards in the three and six months ended September 30, 2006, respectively, and approximately \$37,000 and \$74,000 associated with its restricted stock awards in the three and six months ended September 30, 2005, respectively. As of September 30, 2006, there was approximately \$0.6 million of unrecognized compensation cost related to restricted stock awards that would be recognized as expense over a weighted average period of 1.59 years.

Effective July 31, 2006, 125,000 unvested shares of restricted stock were repurchased for \$125 by the Company in accordance with the consulting agreement between the Company and its former Chief Executive Officer.

8. Accrued Warranty Reserve

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 warranties sold. The Company's product warranties generally start from the delivery date and continue for up to eighteen months. 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.

Changes in accrued warranty reserve during the six months ended September 30, 2006 are as follows:

	<u>(In thousands)</u>
Balance, March 31, 2006	\$ 6,998
Warranty provision relating to products shipped during the period	220
Deduction for performance on warranty claims	(1,476)
Changes for accruals related to preexisting warranties or reliability repairs programs	1,134
Balance, September 30, 2006	<u>\$ 6,876</u>

9. Commitments and Contingencies

As of September 30, 2006, the Company had firm commitments to purchase inventories of approximately \$9.9 million.

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through the year ending March 31, 2011. All of the leases require the Company to pay maintenance, insurance and property taxes. The material lease agreements provide for rent escalation over the lease term and renewal options for five year periods. 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 in the accompanying condensed consolidated balance sheets. Deferred rent amounted to \$0.6 million as of both September 30, 2006 and March 31, 2006.

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 include, among other things, a release of the Company and of the individual defendants for liability associated with the conduct alleged in the action to be wrongful in the amended complaint. The Company would agree to undertake other responsibilities under the proposed 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 for the Southern District of New York.

From time to time, the Company may become subject to additional legal proceedings, claims and litigation arising in the ordinary course of business. Other than the matters discussed above, the Company is not a party to any other material legal proceedings, nor is the Company aware of any other pending or threatened litigation that would have a material adverse effect on the Company's business, operating results, cash flows or financial condition should such litigation be resolved unfavorably.

10. Related Party Transactions

In October 2002, the Company entered into a strategic alliance with UTC, a stockholder, through its UTC power division. In March 2005, the Company and UTC replaced the strategic alliance agreement with an original equipment manufacturer agreement (the "OEM Agreement") between the Company and UTC Power LLC ("UTCP"). The OEM Agreement involves the integration, marketing, sales and service of CCHP solutions worldwide. Sales to UTC's affiliated companies were approximately \$0.3 million for each of the three-month periods ended September 30, 2006 and 2005, respectively. Sales for the six months ended September 30, 2006 and 2005 were \$0.4 million and \$2.0 million, respectively. Related accounts receivable were \$0.3 million at both September 30, 2006 and March 31, 2006. In December 2003, the Company engaged United Technologies Research Center ("UTRC") to be a subcontractor of the Company in relation to one of the awards that the Company received from the Department of Energy (the "DOE"). UTRC is the research and development branch of UTC. UTRC billed the Company \$0 and \$8,000 under this subcontract for the three months ended September 30, 2006 and 2005, respectively, and the Company had no unpaid balances with UTRC at September 30, 2006 or March 31, 2006. For the six months ended September 30, 2006 and 2005, there were approximately \$0 and \$26,000 in billings from UTRC, respectively.

On September 11, 2005, the Company gave notice to UTCP, pursuant to the OEM Agreement, of certain breaches of the OEM agreement by UTCP, including failure to meet sales targets for the year. With respect to most of the breaches, UTCP had 90 calendar days following its receipt of the notice in which to cure the breaches. The Company could elect to terminate the OEM Agreement if UTCP fails to cure the breaches. While management believes that UTCP has not yet cured some key breaches of the agreement, the Company has not terminated the agreement. Additionally, as the Company continues to work with UTCP under the existing OEM Agreement, it has encouraged UTCP to resolve the underlying causes of the breaches. If this relationship is terminated, the Company will honor sales orders committed to prior to the date of termination in accordance with the OEM Agreement.

11. Net Loss Per Common Share

Basic loss per share of common stock 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 and subject to repurchase if the purchaser's status as an employee 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 in the period covered by this Form 10-Q which would make these instruments antidilutive. As of September 30, 2006 and 2005, the number of antidilutive stock options excluded from diluted net loss per common share computations was approximately 7,746,000 and 9,236,000 shares, respectively. As of September 30, 2006, 309,876 shares of restricted common stock were contingently returnable.

12. Recent Accounting Pronouncements

New Accounting Pronouncements—In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements.” SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally

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accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, SFAS No. 157 does not require any new fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is evaluating any impact that the adoption of this pronouncement may have on the Company’s consolidated financial position or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (“SAB 108”), “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statement.” Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. The Company does not believe SAB 108 will have a material impact on our results of operations or financial position.

In June 2006, the FASB issued Interpretation No. 48 (“FIN 48”), “Accounting for Uncertainty in Income Taxes.” FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is evaluating any impact that the adoption of this interpretation may have on the Company’s consolidated financial position or results of operations.

13. Subsequent Events

On September 27, 2006, the Company entered into a lease agreement Addendum 1 (the “Lease Addendum”) in connection with the property located at 10101-C Avenue D, Brooklyn, New York 11236 (the “Facility”). The Lease Addendum amends the lease agreement between Capstone and CapGen CHP, Inc. (“CapGen”), dated October 15, 2005 (the “Lease”). Under the terms of the Lease Addendum, the Company leased an additional 41,500 square feet of space to accommodate additional office, warehousing and manufacturing and light component assembly work. Prior to the Lease Addendum, the existing leased square footage of the Facility was approximately 6,000 square feet and was used primarily for warehousing. The aggregate total leased space in the Facility is now approximately 47,500 square feet (the “Leased Premises”). CapGen, a dealer of the Company, also currently performs consulting services under a five-year consulting agreement dated August 1, 2006.

The initial term of the Lease is five years and the Company has three one-year renewal options. The initial term of the Lease expires October 14, 2010. The base monthly rate for the Facility was \$8,375 per month. The monthly rent for the Facility as of October 1, 2006 is \$45,850 through October 14, 2007. The rent will increase to \$47,250 per month from October 15, 2007 through October 14, 2009 and increase again to \$48,250 per month from October 15, 2009 through October 14, 2010. The Lease requires the Company to pay certain telephone and utility costs and expenses associated with the Leased Premises. The Company will also be responsible for the costs of certain tenant improvements associated with the Leased Premises in amounts yet to be determined.

In addition to the Leased Premises, the Company also leases temporary office space outside of the Facility under a separate commercial lease (the “Temporary Lease”). The terms of the Temporary Lease were also amended to reduce the monthly lease payment from \$10,000 per month to \$6,500 per month effective October 1, 2006. The Temporary Lease expires upon the earlier to occur of March 31, 2007 or the completion of the construction of permanent office space in the Facility.

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes included in this Form 10-Q and within the Company’s Annual Report on Form 10-K for the year ended March 31, 2006. When used in this Form 10-Q, 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 Risk Factors in Item 1A of Part II of this Form 10-Q. Readers are cautioned

not to place undue reliance on forward-looking statements, which speak only as of the date hereof. All dollar amounts are approximate.

Critical Accounting Policies and Estimates

The preparation of the Company's condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Management believes the most complex and sensitive judgments, because of their significance to the condensed consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Actual results could differ from management's estimates. We believe the critical accounting policies listed below affect our more significant accounting judgments and estimates used in the preparation of the condensed consolidated financial statements. These policies are described in greater detail in our Annual Report on Form 10-K for Fiscal 2006 and continue to include the following areas:

- Impairment of long-lived assets, including intangible assets;
- Inventory write-downs and classification of inventories;
- Estimates of warranty obligations;
- Sales returns and allowances;
- Allowance for doubtful accounts;
- Deferred tax assets; and
- Loss contingencies.

In addition to the policies noted above, we have assessed stock-based compensation as a critical accounting policy. Our adoption of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") in the first quarter of Fiscal 2007 requires that we recognize stock-based compensation expense associated with stock options in the statement of operations, rather than disclose it in a pro forma footnote to the condensed consolidated financial statements. Determining the amount of stock-based compensation to be recorded requires us to develop estimates to be used in calculating the grant-date fair value of stock options. We calculate the grant-date fair values using the Black-Scholes valuation model. The use of valuation models requires us to make estimates of the following assumptions:

- Expected volatility — The estimated stock price volatility was derived based upon the Company's actual historic stock prices over the expected option life, which represents the Company's best estimate of expected volatility.
- Expected option life — The Company's estimate of an expected option life was calculated in accordance with the Staff Accounting Bulletin No. 107 simplified method for calculating the expected term assumption.
- Risk-free interest rate — We used the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected life assumption as the risk-free interest rate.

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term "forfeitures" is distinct from "cancellations" or "expirations" and represents only the unvested portion of the surrendered option. We reviewed historical forfeiture data and determined the appropriate forfeiture rate based on that data. We will re-evaluate this analysis periodically and adjust the forfeiture rate as necessary. Ultimately, we will recognize the actual expense over the vesting period only for the shares that vest.

New Accounting Pronouncements—In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, SFAS No. 157 does not require any new fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are evaluating any impact that the adoption of this pronouncement may have on our consolidated financial position or results of operations.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108"), "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statement." Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. We do not believe SAB 108 will have a material impact on our results of operations or financial position.

In June 2006, the FASB issued Interpretation No. 48 (“FIN 48”), “Accounting for Uncertainty in Income Taxes.” FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are evaluating any impact that the adoption of this interpretation may have on our consolidated financial position, results of operations or disclosures.

Overview

We develop, manufacture, market and service microturbine technology solutions for use in stationary distributed power generation applications, including cogeneration (combined heat and power (“CHP”) and combined cooling, heat and power (“CCHP”)), resource recovery and secure power. 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 cleaner, on-site power with longer 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. Our microturbines are sold primarily through our distributors and dealers. We, along with our Authorized Service Companies (“ASCs”), provide installation and service. Successful implementation of the microturbine relies on the quality of the microturbine, the ability to sell into appropriate applications, and the quality of the installation and support.

We believe we were the first company to offer a commercially available power source using microturbine technology. Our 30- kilowatt (“Model C30”) and 60 and 65 kilowatt (“C60 Series”) products are designed to produce electricity for commercial and small industrial users. A Model C30 product can produce enough electricity to power a small

convenience store. The C60 Series products 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 liquid lubricants. This means they do not require routine maintenance to change oil or other lubrications, as do the most common competing products. The Model C30 product can be fueled by various sources including natural gas, propane, sour gas, renewable fuels such as landfill or digester gas, kerosene and diesel. The C60 Series products can be fueled by natural gas or renewable fuels such as landfill or digester gas. The C60 Series products are 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.

The market for our products is highly competitive and is changing rapidly. Our microturbines compete with existing technologies, such as the utility grid and reciprocating engines, and may also compete with emerging distributed generation technologies, including solar power, wind-powered systems, fuel cells and other microturbines. Additionally, many of our distributed generation competitors are well-established firms that derive advantages from production economies of scale and have a worldwide presence and greater resources, which they can devote to product development or promotion.

We began commercial sales of our Model C30 products in 1998. In 2000, we shipped the first commercial unit of our Model C60 microturbine. At the end of Fiscal 2006, we revisited our strategic plan. With the first two years of the initial plan behind us, we reassessed our view of Fiscal 2007 and 2008, and added on our expectations for Fiscal 2009. While some aspects of the initial plan were modified, the overall direction, targets and key initiatives remained intact. 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 focus on vertical markets that we identify as having the greatest near-term potential. In our primary products and applications (CHP and CCHP, resource recovery and secure power), we identify specific targeted vertical market segments. Within each of these markets, we identify the critical factors to penetrating these markets and have based our plans on those factors.

During the second quarter of Fiscal 2007, we booked \$2.9 million of orders and shipped \$1.5 million of products, resulting in \$6.8 million in backlog as of September 30, 2006. Our actual product shipments during the second quarter of Fiscal 2007 were: 27% for use in CHP applications, 3% for use in CCHP applications and 55% for use in resource recovery applications. Other markets (including secure power) were 15%.

- 2) *Sales and Distribution Channel*—Previously, we identified the need to refine our channels of distribution. While some distributors, dealers 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, dealers and representatives who were experienced in our target markets. We made significant progress in tailoring our distribution channels in the past two years. In the Americas, we currently have nine distributors, five dealers and six project resellers. Internationally, outside of the Americas, we currently have twenty distributors, two dealers and no resellers. We continue to refine the distribution channels to

address our specific targeted markets.

- 3) *Geographic Focus*—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. During the year ended March 31, 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 the European countries and Russia will offer significant opportunities, we opened a European headquarters office in Milan, Italy in Fiscal 2005 and an office in Nottingham, England in Fiscal 2007. Since establishing the office in Italy, we experienced an improvement of \$4.0 million, or 94%, in our sales to European countries and Russia during Fiscal 2006. Additionally, we have continued to see strength in these regions in Fiscal 2007. Accordingly, we expect to continue to develop our distribution base and market presence in Europe. In Japan, we are focused on developing niche opportunities that we believe offer the potential for increasing sales volumes over the next three years. Throughout Asia we are focusing resources on increased distribution channels to the market with the expectation that China will become a significant market in the years ahead. Additionally, we have established an office in Mexico.

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- 4) *Service*—During Fiscal 2005, we entered the direct service business. Previously, our 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 the second quarter of Fiscal 2007, we continued to present alternatives to customers under-served by our distributor and ASC base through Capstone factory direct service. We also intend to establish spare parts distribution centers 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 C60 Series 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 and the team met this goal early in Fiscal 2005. These product robustness enhancements are expected to continue to lower 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 will allow us to monitor installed units and rapidly collect operating data on a continual basis. We will use this information to anticipate and more quickly respond to field performance issues, evaluate component robustness and identify areas for continuous improvement. This feature is important in 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 C60 Series, will be our foundational product lines for the foreseeable future. Our product development efforts are centered on enhancing the features of these base products. Our C200 product beta testing was successfully implemented during Fiscal 2005. Testing and engineering continue on strategic areas of the engine.
- 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 opportunities to save costs through outsourcing. In conjunction with these changes, we have launched a strategic supply chain initiative to begin developing suppliers in China and other parts of Asia. Although we are only in the early stages of this initiative, we are encouraged by the improved cost opportunities this effort may produce. While we are striving to reduce costs, commodity price increases in mid-to-late Fiscal 2005 increased our costs of goods sold. In response to this development, in late Fiscal 2005 and again in February 2006, we increased selling prices approximately 7% in each period.

We believe that execution in each of these key areas of our strategic plan will be necessary to continue Capstone’s transition from an R&D focused company with a promising technology and early market leadership to achieving positive cash flow with growing market presence and improving financial performance. Though we have seen good progress in achieving many aspects of our strategic plan, we have adjusted the timing of attaining our goal of positive cash flow from the end of the second quarter of Fiscal 2008, or September 2007, to the end of the fourth quarter of Fiscal 2008, or March 2008, due to slower than expected sales growth.

Results of Operations

Three Months Ended September 30, 2006 and 2005

Revenue. Revenue for the second quarter of Fiscal 2007 decreased \$2.8 million, or 48%, to \$2.9 million from \$5.7 million for the same period last year. Revenue from complete microturbine product shipments decreased \$3.0 million, or 67%, to \$1.5 million during the current period from \$4.5 million for the same period last year. Shipments of complete microturbine units were 1.4 megawatts during the second

5.1 megawatts for the same period last year. Revenue from accessories, parts and service for the second quarter of Fiscal 2007 increased \$0.2 million to \$1.5 million from \$1.3 million for the same period last year. Included in the overall revenue decline was a \$1.0 million decrease in revenue from the European and Russian markets.

Individually, two customers accounted for 11% and 10% of revenue, respectively, for the second quarter of Fiscal 2007, totaling approximately 21% of revenue. For the same period last year, individually, four customers each accounted for 16%, 14%, 13% and 10% of revenues, respectively. UTC accounted for approximately 11% and 6% of revenues for the three months ended September 30, 2006 and 2005, respectively.

Gross loss. Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. The gross loss was \$2.3 million, or 79% of revenue, for the second quarter of Fiscal 2007 compared to \$1.1 million, or 19% of revenue, for the same period last year. The increase in the gross loss and corresponding decline in the gross loss percentage reflects the effect of operating leverage from reduced revenue over fixed manufacturing costs of approximately \$0.4 million and increased warranty charges, offset by increased unit sale prices and higher margin products and parts mix of \$0.6 million. Warranty expense is a combination of a per-unit warranty accrual recorded at the time the product is shipped and changes in estimates for several reliability enhancements programs. Warranty expense increased \$1.2 million over the prior quarter. Warranty expense for unit shipments decreased approximately \$0.3 million as a result of lower volumes and improvements that have been made through engineering design changes and product robustness. This decrease was offset by an increase of approximately \$1.5 million compared to the corresponding period in the prior year in reliability enhancement programs primarily due to benefits realized from program changes in the prior year. These program estimates are recorded in the period that new information, such as design changes and product enhancements, becomes available.

We expect to continue to incur gross losses until we are able to increase our margins through higher sales volumes, lower warranty and direct materials costs, and reduced manufacturing costs through efforts such as outsourcing non-core functions, including design, assembly, test and installation support.

Research and Development ("R&D") Expenses. R&D expenses include compensation, engineering department expenses, overhead allocations for administration and facilities and materials costs associated with development. R&D expenses for the second quarter of Fiscal 2007 decreased \$0.1 million, or 5%, to \$2.6 million from \$2.7 million for the same period last year. R&D expenses are reported net of benefits from cost-sharing programs such as the DOE funding. There were approximately \$0.4 million of such benefits this quarter, compared with \$0.3 million for the same period last year. The increase in benefits of \$0.1 million contributed to the overall net decrease in R&D expenses of \$0.1 million. Additionally, the decreased R&D spending for labor and consulting of \$0.2 million was offset by higher spending on developmental hardware for various engineering projects of approximately \$84,000 and an increase in facilities spending of \$60,000. Included in the net decrease of labor and consulting expenses for the second quarter of Fiscal 2007 were \$56,000 of non-cash stock compensation charges. There were no such charges for the same period in the prior year. The non-cash stock compensation charge resulted from the Company's adoption of SFAS 123(R) during the first quarter of Fiscal 2007. Cost-sharing programs vary from period to period depending on the phases of the programs. We expect R&D expense in Fiscal 2007 to be somewhat lower than in Fiscal 2006. This change is expected to occur as a result of lower spending being offset by increased cost-sharing programs.

Selling, General, and Administrative ("SG&A") Expenses. SG&A expenses for the second quarter of Fiscal 2007 decreased \$0.7 million, or 11%, to \$6.1 million from \$6.8 million for the same period last year. Included in SG&A expenses in the quarter ended September 30, 2006 was \$0.6 million of non-cash stock compensation, compared to \$0.4 million for the same period last year. This increase is a result of the Company's adoption of SFAS 123(R) during the first quarter of Fiscal 2007. Net of the \$0.6 million and \$0.4 million non-cash stock compensation charges for the three months ended September 30, 2006 and 2005, respectively, SG&A expenses decreased approximately \$0.7 million compared to the same period last year. This net decrease of \$0.7 million reflects a decrease of approximately \$1.0 million related to reduced professional services including legal, accounting, insurance and consulting, a decrease of approximately \$0.4 million in labor related costs, including salaries, recruitment and relocation expenses to support our continuous process improvement throughout the organization, a decrease of \$0.2 million related to other administrative expenses, including dues and subscriptions, tax and license, bad debt and annual shareholder meeting expenses, offset by an increase of approximately \$0.3 million related to marketing, supplies and facility maintenance costs. We expect SG&A costs, with the exception of non-cash stock compensation charges, for the entire Fiscal 2007 year to be lower than the prior year.

Interest Income. Interest income for the second quarter of Fiscal 2007 increased \$0.2 million, or 51%, to \$0.6 million from \$0.4 million for the same period last year. The increase during the current period was attributable to increased investment yields over the same period last year, offset by decreased aggregate cash balances during the recent quarter.

Six Months Ended September 30, 2006 and 2005

Revenue. Revenue for the six months ended September 30, 2006 remained consistent with the same period of the prior year. Revenue from complete microturbine product shipments decreased \$0.5 million, or 6.0%, to \$6.7 million during the current period from \$7.2 million

for the same period last year. Shipments of complete microturbine units were 6.7 megawatts during the six-month period ended September 30, 2006 compared with 8.5 megawatts for the same period last year. Revenue from accessories, parts and service for the six months ended September 30, 2006 increased \$0.5 million to \$2.8 million from \$2.3 million for the same period last year. Included in the overall revenue decline was a \$1.5 million decrease in revenue from the European and Russian markets.

Individually, two customers accounted for 22% and 11% of revenues, respectively, for the six months ended September 30, 2006, totaling approximately 33% of revenue. For the same period last year, individually, two customers each accounted for 21% and 10% of revenues, respectively. UTC accounted for approximately 4% and 21% of revenues for the six months ended September 30, 2006 and 2005, respectively.

Gross loss. Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. For the six months ended September 30, 2006, the gross loss was \$3.6 million, or 38% of revenue, compared to \$4.5 million, or 47% of revenue, for the same period last year. The improvement in the gross loss percentage reflects the increase in sales of higher margin products. While sales were constant period over period, volumes were lower period over period, providing increased contribution margin to cover fixed manufacturing costs of approximately \$1.6 million, in addition to higher absorption of overhead costs into ending inventory of approximately \$0.4 million. Warranty expense increased \$1.3 million over the same period a year ago. Warranty expense for unit shipments decreased approximately \$0.7 million as a result of lower volumes and improvements that have been made through engineering design changes and product robustness. This decrease was offset by an increase of approximately \$2.0 million in reliability enhancement programs primarily due to benefits realized from program changes in the prior year. These program estimates are recorded in the period that new information, such as design changes and product enhancements, becomes available.

Research and Development ("R&D") Expenses. R&D expenses for the six months ended September 30, 2006 increased \$0.6 million, or 12%, to \$5.4 million from \$4.8 million for the same period last year. R&D expenses are reported net of benefits from cost-sharing programs such as the DOE funding. There were approximately \$0.8 million of such benefits for the six months ended September 30, 2006, compared with \$1.1 million for the same period last year. This decrease in benefits of \$0.3 million contributed to the overall net increase in R&D expenses. Additionally, there was an increase of \$0.3 million in R&D spending. This increase in R&D spending is primarily the result of increased development hardware costs for various engineering projects of \$0.2 million and facilities expenses of \$0.1 million, offset by a decrease in labor and consulting spending of \$74,000. Included in the net decrease in labor and consulting spending for the six months ended September 30, 2006 were \$0.1 million of non-cash stock compensation charges. There were no such charges for the same period in the prior year. The non-cash stock compensation charge resulted from the Company's adoption of SFAS 123(R) during the first quarter of Fiscal 2007. Cost-sharing programs vary from period to period depending on the phases of the programs.

Selling, General, and Administrative ("SG&A") Expenses. SG&A expenses for the six months ended September 30, 2006 decreased \$0.5 million, or 4%, to \$12.0 million from \$12.5 million for the same period last year. Included in SG&A expenses for the six months ended September 30, 2006 was \$1.3 million of non-cash stock compensation, compared to \$0.6 million for the same period last year. This increase is a result of the Company's adoption of SFAS 123(R) during the first quarter of Fiscal 2007. Net of the \$1.3 million and \$0.6 million non-cash stock compensation charges for the six months ended September 30, 2006 and 2005, respectively, SG&A expenses decreased approximately \$0.5 million compared to the same period last year. This net decrease of \$0.5 million reflects a decrease of approximately \$1.9 million related to reduced professional services including legal, accounting, insurance and consulting, a decrease of \$0.3 million related to other administrative expenses and a decrease of approximately \$0.1 million in labor related costs, offset by an increase of approximately \$0.5 million related to marketing, supplies and facility maintenance costs.

Interest Income. Interest income for the six months ended September 30, 2006 increased \$0.4 million, or 55%, to \$1.2 million from \$0.8 million for the same period last year. The increase during the current period was attributable to increased investment yields over the same period last year, offset by slightly decreased aggregate cash balances during the six months ended September 30, 2006.

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 have invested our cash in an institutional fund, with maturities of less than sixty days, that invests in high quality short-term money market instruments to provide liquidity for capital preservation and for operations.

Operating Activities. During the six months ended September 30, 2006 we used \$19.8 million in cash in our operating activities, which consisted of a net loss for the period of approximately \$19.8 million and cash used for working capital of approximately \$5.6 million, offset by non-cash adjustments (primarily depreciation, warranty, stock compensation and inventory charges) of \$5.6 million. This compared to operating cash usage of \$19.9 million during the six months ended September 30, 2005, which consisted of a net loss for the period of approximately \$21.0 million and cash used for working capital of approximately \$3.1 million, offset by non-cash adjustments of \$4.3 million. The increase in working capital cash usage of approximately \$2.5 million is largely attributable to an increase in inventories to support expected sales in future periods.

Investing Activities. Net cash used in investing activities for acquisition of fixed assets was \$0.6 million and \$0.5 million for the six months ended September 30, 2006 and 2005, respectively. Our cash usage for investing activities has been relatively low. Our significant capital expenditures were made in previous periods.

Financing Activities. During the six months ended September 30, 2006, we generated \$1.6 million from financing activities, an increase

of \$0.7 million, as compared with the prior year period, in which we generated \$0.9 million. The funds generated from financing activities in the six months ended September 30, 2006 were primarily the result of the exercise of stock options. Repayments of capital lease obligations were \$10,000 during the six months ended September 30, 2006 as compared with \$8,000 for the same period a year ago.

We anticipate that, as a result of our efforts to generate sales and margins while controlling costs, we will lower our cash usage in future periods. Our operating plan for Fiscal 2007 calls for less cash for operating and investing activities than in Fiscal 2006.

Except for scheduled payments made on operating and capital leases during the first six months of Fiscal 2007, there has only been one material change in the Company's remaining commitments under non-cancelable operating leases and capital leases as disclosed in the Company's Annual Report on Form 10-K for Fiscal 2006. In September 2006, we entered into a lease agreement Addendum 1 ("Lease Addendum") in connection with our facility located in Brooklyn, New York (the "Facility"). The Lease Addendum amends the lease agreement between Capstone and CapGen CHP, Inc. ("CapGen") dated October 15, 2005 (the "Lease"). Under the terms of the Lease Addendum, we leased an additional 41,500 square feet of space to accommodate additional office, warehousing and manufacturing and light component assembly work. Prior to the Lease Addendum, the existing leased square footage of the Facility was approximately 6,000 square feet and was used primarily for warehousing. The aggregate total leased space in the Facility is now approximately 47,500 square feet (the "Leased Premises").

The initial term of the Lease is five years and we have three one-year renewal options. The initial term of the Lease expires October 14, 2010. The base monthly rate for the Facility was \$8,375 per month. The monthly rent for the Facility as of October 1, 2006 is \$45,850 through October 14, 2007. The rent will increase to \$47,250 per month from October 15, 2007 through October 14, 2009 and increase again to \$48,250 per month from October 15, 2009 through October 14, 2010. The Lease requires that we pay certain telephone and utility costs and expenses associated with the Leased Premises. We will also be responsible for the costs of certain tenant improvements associated with the Leased Premises in amounts yet to be determined.

We believe that our existing cash and cash equivalents are sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months. However, based on our cash usage over the last twelve months, by the end of Fiscal 2007, historical cash burn rates would not support the same assertion. Therefore, it is possible, if not likely, that we may need or elect to raise additional funds to fund our activities beyond the next year. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity or debt securities or obtain credit facilities for other reasons. We cannot be assured that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing stockholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our working capital and capital expenditure needs for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will require us to achieve dramatically increased sales volumes which is dependent on many factors, including:

- the market acceptance of our products and services;
- our business, product and capital expenditure plans;
- capital improvements to new and existing facilities;
- our competitors' response to our products and services; and
- our relationships with customers, distributors, dealers and project resellers.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

No material changes have occurred in the quantitative and qualitative market risk disclosure of the Company as presented in its Annual Report on Form 10-K for the year ended March 31, 2006.

Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation of the effectiveness of the design and operation of our "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934, as amended ("Exchange Act"), Rules 13a-15(e) and 15d-15(e)) under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective.

Changes in Internal Control Over Financial Reporting

Additionally, our Chief Executive Officer and Chief Financial Officer have determined that there have been no changes to our internal

control over financial reporting during the six months ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. *Legal Proceedings*

None

Item 1A. *Risk Factors*

There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K for the year ended March 31, 2006, other than the following updates to previously disclosed risk factors:

We operate in a highly regulated business environment, and changes in regulation could impose significant 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 the implementation and operation of our products or that 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, the California Air Resources Board (“CARB”) has recently determined that the CARB 2007 standards will be applicable to Microturbines as of January 1, 2007. We may not be able to achieve compliance with these new standards by that date. Until we are able to produce Microturbines in compliance with these standards, if we choose to do so, our customers in certain parts of California would have to receive air emission permits before installation of a Capstone Microturbine. This may have the affect of slowing installations and adding incremental cost to the customer. 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 cause rule changes that may reduce or eliminate some of the advantages of such deregulation and restructuring. We cannot determine how the deregulation and the restructuring of the electric utility industry may 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 could increase the cost to our potential customers, making our systems less desirable, and thereby adversely affect our revenue and potential profitability.

In addition, the State of California Self-Generation Incentive Program Level 3 (Non-Renewable / Non-Solar) is scheduled to expire in December 2007. If the efforts to extend these credits are not successful, our customers would lose the benefit of these incentives, thus reducing the economic benefits for customers and depriving them of a significant incentive for purchases of Microturbines in California.

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. On July 18, 2006, Mr. John R. Tucker submitted his resignation as the Chief Executive Officer, President and a director of the Company, effective July 31, 2006. Mr. Mark Gilbreth, the Company’s Executive Vice President and Chief Operating Officer, will serve as Interim President and Chief Executive Officer until the Board of Directors acts to name a permanent replacement. There can be no assurance that the Board of Directors will be able to retain a permanent

replacement to the former Chief Executive Officer or that the transition will not have an adverse effect on the Company and its business.

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.

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

None

Item 3. Defaults Upon Senior Securities

None

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

- (a) The annual meeting of stockholders of the Company was held on August 18, 2006.
- (b) Eliot Protsch, Richard Atkinson, John Jagers, Noam Lotan, Gary Simon and Darrell Wilk stood for election, and all were elected as directors. John Tucker resigned as a director of the Company effective July 31, 2006 and did not stand for re-election.
- (c) The only matter voted upon at the meeting was the election of the directors. The votes cast with respect to such matter were as follows:

Election of Directors: Director	Votes Cast	
	For	Withheld
Eliot Protsch	73,383,924	2,257,037
Richard Atkinson	74,790,643	850,318
John Jagers	73,267,455	2,373,506
Noam Lotan	73,363,075	2,277,886
Gary Simon	73,365,833	2,275,128
Darrell Wilk	74,815,901	825,060

Item 5. Other Information

None

Item 6. Exhibits

The following exhibits are filed with, or incorporated by reference into, this Form 10-Q:

Exhibit Number	Description
3.1(3)	Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation
3.2(4)	Amended and Restated Bylaws of Capstone Turbine Corporation
4.1(2)	Specimen stock certificate
10.1(5)	Consulting Agreement between Capstone Turbine Corporation and John R. Tucker, dated July 24, 2006.
10.2(1)	Lease Agreement dated October 15, 2005 with Addendum, dated September 27, 2006, with CapGen CHP, Inc.
31.1(1)	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2(1)	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1(1)	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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- (1) Filed herewith.
 - (2) Incorporated by reference to Capstone Turbine Corporation's registration statement on Form S-1/A, dated June 21, 2000 (File No. 333-33024).
 - (3) Incorporated by reference to Capstone Turbine Corporation's registration statement on Form S-1/A, dated May 8, 2000 (File No. 333-33024).
 - (4) Incorporated by reference to Capstone Turbine Corporation's quarterly report on Form 10-Q, dated February 9, 2006 (File No. 001-15957).
 - (5) Incorporated by reference to Capstone Turbine Corporation's current report on Form 8-K, dated July 24, 2006 (File No. 001-15957).

SIGNATURES

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

CAPSTONE TURBINE CORPORATION

By: _____
/s/ Walter J. McBride
Walter J. McBride
*Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)*

Date: November 9, 2006

LEASE AGREEMENT

THIS LEASE AGREEMENT, dated the fifteenth day of October, 2005, by and between CapGen CHP, Inc., whose address is 10101 - C. Avenue D, Brooklyn, New York, 11236, (hereinafter called "Landlord"), and Capstone Turbine Corporation, whose address is 21211 Nordhoff Street, Chatsworth, California, 91311 (hereinafter called "Tenant").

WHEREAS, the City of New York is the fee owner of the property known as 101 - 01 Avenue D, Brooklyn, New York (the "Property"), as more particularly described in the Master Lease. The City of New York has heretofore entered into that certain Subordinate Lease, dated as of September 1, 1984, with Laura Realty Co. (successor in interest to Rentar Development Corporation, and hereinafter referred to as "LRC"), as tenant (the "Master Lease").

WHEREAS, LRC further subleased the property to A.P.L. Corporation (predecessor in interest to Landlord) pursuant to that certain lease dated September 7th, 1967, as amended by that First Amending Agreement, dated April 30, 1968, and that certain Second Amending Agreement, dated October 21, 1968, and that certain Agreement pursuant to Section 2.03, dated May 6, 1969, and made a part hereof (said lease and all of the above agreements, as amended, being referred to as the "Lease").

For and in consideration of the respective covenants, conditions and agreements set forth herein Landlord does hereby demise to Tenant approximately 6,000 +/- square feet of space in the Property together with all required or necessary easements, rights and ways appurtenant thereto, and those portions of Landlord's rights, title and interest necessary for access in all public ways adjoining the same and any buildings, improvements, equipment and fixtures located within the rental property hereinafter collectively called the "premises").

Representations. (a) Landlord represents that (1) It has a leasehold interest in the premises pursuant to the Lease, and that the term of the Lease is equal to or greater than the lease term hereof, including the renewal term set forth in paragraph 4 hereof; (2) Landlord has full power and authority to lease the premises to Tenant; and (3) Landlord covenants the Tenant, upon payment or lease and performance of the covenants contained herein, shall peaceably and quietly have, hold and enjoy the premises during term of the lease agreement and any renewal thereof.

(b) Tenant represents that (1) it has full power and authority to enter into this agreement and (2) the execution and delivery of this agreement has been duly authorized by Tenant.

Term. The primary term of this lease agreement shall commence on October 15, 2005, and end upon October 14, 2010 unless modified by an approved sub-lease prior to the ending date.

Rent. During the term of this Lease agreement, Tenant agrees to pay to Landlord for the premises, the following sums:

Years 1 and 2	(10/15/05 - 10/14/07)	\$8,375.00 per month
Years 3 and 4	(10/15/07 - 10/14/09)	\$8,850.00 per month
Year 5	(10/15/09 - 10/14/10)	\$9,250.00 per month

(Tenant shall also have three (3) individual one year options to extend this lease for year 6 at \$9,250.00 per month, year 7 and year 8 at \$ 9,750.00 per month)

(b) Lease shall commence on October 15, 2005. As used herein the "Year" shall mean the period from the commencement of the term to the end of the (12th) full calendar month thereafter; subsequent years shall commence on the first (1st) day of the next month of the term and on each anniversary thereafter. Tenant covenants and agrees to pay all lease amounts reserved hereunder to Landlord, without notice or demand, in advance, on the first (1st) day of each month during the term of this agreement.

(c) All payments shall be paid to CapGen CHP, Inc., 10101 - C. Avenue D, Brooklyn, New York, 11236, or at such other place or to such appointee of the Landlord as the Landlord may from time to time designate in writing.

Utilities. Telephone and any other utilities installed and utilized or consumed in the premises shall be billed directly to Tenant, and Tenant shall be responsible for payment of said bills. Tenant shall be responsible for the cost of bringing telephone and other related utilities into the premises and the cost of their use. Landlord represents that such utilities have been brought to the premises by landlord and tenant must merely bring same into the demised premises.

Real Estate Taxes. (a) Landlord shall pay the real estate taxes on the premises. Tenant shall pay any tax assessed on the personal property, inventory, or additional equipment used in the operation of his business.

Security Deposits. Upon execution of this lease agreement, Tenant shall deliver to Landlord the first month payment based on the monthly lease price.

Assignment and Subletting. Tenant shall not have the right to assign this agreement or sub-lease or to sublet all or any portion of the rental premises, without Landlord's consent which shall not be unreasonably withheld or delayed.

Use of Premises. Tenant shall use the premises for office space to support sales of its products and services. Tenant shall not change the use

of the premises without the prior written consent of the Landlord which shall not be unreasonably withheld or delayed. No hazardous waste or hazardous material shall be stored, disposed of or used on the premises. Tenant agrees to comply with all applicable zoning and other laws and regulations, and provide and install at its own expense any additional equipment or alterations required to comply with all such laws and regulations as required from time to time. Tenant further covenants and agrees (1) to use the premises in a manner which does not interfere with the rights of quiet enjoyment of any other tenants of the building and which is not a nuisance, and (ii) not to make any objectionable use of the premises to generate any objectionable odor therefrom. Notwithstanding the portioning Landlord represents premises to have a valid Certificate of Occupancy for Tenant's use of this premise.

Parking. Tenant shall have a non-exclusive use of the parking lot or parking areas. Tenant shall abide by the terms and conditions as stated for In the Non-Exclusive use of the Common Area of the parking lot, but will enjoy exclusive use of those areas designated for parking in the additional Warehouse & Manufacturing spaces lease.

Compliance with Laws: Environmental.

(a) Tenant covenants and agrees that it will, at its own expense, observe, comply with and execute all laws, orders, rules, requirements and regulations of any and all governmental departments, bodies, bureaus, agencies and officers, and all rules, directions, requirements recommendations of local board of fire underwriters and the fire insurance rating organizations having jurisdiction over the area In which the premises are situated, or other bodies or agencies now or hereinafter exercising similar functions in the area in which the premises are situated, (collectively "Laws"), in any way pertaining to the premises or the use and occupancy of the premises except that Landlord shall be responsible for the Certificate of Occupancy and structural repairs. In the event tenant shall fail or neglect to comply with any of the Laws, Landlord or its agents may enter the premises and take all such action and do all such work in or to the premises as may be necessary in order to cause compliance with such laws, orders, rules, requirements or recommendations, and Tenant covenants and agrees to reimburse Landlord promptly upon demand for the expense incurred by Landlord in taking such action performing such work, which may be the responsibility of Tenant.

(b) Tenant will not do, or suffer to be done, anything in or about the premises contrary to use clause herein, or keep anything in or about the premises, contrary to use clause herein, which will contravene or affect any policy of insurance against loss by fire or other hazards, including, but not limited to, public liability, now existing or which the Landlord may hereafter place thereon, or which will prevent the Landlord from procuring such policies in companies acceptable to Landlord at standard rates.

(c) Tenant shall use and operate the premises, at all times during the term hereof, under and in compliance with all federal and State of New York laws and regulations, and in compliance with all applicable Environmental Legal Requirements. "Environmental Legal Requirements" shall mean any applicable law relating to public health, safety, or the environment, including, without limitation, relating to releases, discharges or omissions to air, water, land or groundwater, to the withdrawal or use Of groundwater, to the use and handling of polychlorinated biphenyls ("PCB's") or asbestos, or asbestos containing products, to the

disposal, treatment storage or management of solid or other hazardous or harmful wastes or to exposure to toxic, hazardous or other harmful materials (collectively Hazardous Substances") to the handling, transportation, discharge or release of gaseous or liquid substance and any regulation or final order or directive issues pursuant to such statute or ordinance, in each case applicable to the premises, the building or its operation, construction or modification, including without limitation the following: the Clean Air Act, the Federal Water Pollution Control Act ("FWPCA"), the Safe Drinking Water Act, the Toxic Substances Control Act, the Comprehensive Environmental Response Compensation and Liability Act, as amended by the Solid and Hazardous Waste Amendments of 1984 ("RCRA"), the Occupational Safety and Health Act, the Emergency Planning and Community Right-to-Know Act of 1936, the Solid Waste Disposal Act, and any state statutes addressing similar matters, and any state statute providing for financial responsibility for clean-up or other actions with respect to the release or threatened release of any the above-referenced substances.

(d) Tenant hereby indemnifies and saves landlord harmless from all liabilities and claims arising from the use, storage or placement of any Hazardous Substances upon the premises or elsewhere within the property of the Landlord related to the premises.of Landlord (if brought or placed thereon by Tenant, its agents, employees, contractors or invitees); and Tenant shall (i) within fifteen (15) days after written notice thereof, take or cause to be taken, at its sole expense, such actions as may be necessary to comply with all Environmental Legal Requirements and (ii) within fifteen (15) days after written demand therefore, reimburse Landlord for any amounts expended by Landlord to comply with any Environmental Requirements with respect to the premises or with respect to any other portions of Landlord's property related to the premises as the result of the placement or storage of Hazardous Substance by Tenant, its agents, employees, contractors or invitees, or in connection with any judicial or administrative investigation or proceeding relating thereto, including, without limitation, reasonable attorneys' fees, fines or the penalty payments.

(e) For purposes of this provision, Tenant shall be conclusively deemed to have violated the Environmental Legal Requirements if (i) any notice or orders directed to either Landlord or Tenant by any governmental agency, body, or court alleging that such violation by Tenant has occurred; or (ii) if Landlord obtains and delivers to Tenant a certified report prepared by an engineer or other party engaged in the business of testing for determining the existence of Hazardous Substances, which report states that there are Hazardous Substances used, stored or placed upon the premises by Tenant.

Indemnification. (a) Tenant shall defend all actions against and shall pay, protect, indemnify and hold harmless the Landlord or any officer, director, employee or shareholder of Landlord, from and against any and all liabilities, losses, damages, costs, expenses (including, without limitation, reasonable attorneys' fees and expenses), causes of action, suits, claims, demands or judgments of any nature (but excepting such as may be due to the negligence of Landlord) arising out of (a) any breach by tenant of any warranty, representation or covenant contained in this Rental agreement; (b) the violation of the permitted specified occupancy or use of the premises by tenant. The foregoing indemnification shall survive the expiration or sooner termination of the lease agreement.

(b) Landlord shall defend all actions against and shall pay, protect, indemnify and hold harmless the Tenant or any officer, director, employee or shareholder of Tenant, from and against any and all liabilities, losses, damages, costs, expenses (including, without limitation, reasonable attorneys' fees and expenses), causes of action, suits, claims, demands or judgments of any nature (but excepting such as may be due to the negligence of Tenant) arising out of any breach by Landlord of any warranty, representation or covenant contained in the rental agreement. The foregoing indemnification shall survive the expiration or sooner termination of the rental agreement.

Tenant shall be responsible for any legal requirements made necessary by any act or work performed by Tenant or by the particular nature of Tenant's use of the premises except for Landlord's Certificate of Occupancy obligation. Landlord shall be responsible for any legal requirements made necessary by any act or work performed by Landlord or its agents. Any legal requirement not meeting either of the above criteria shall be the responsibility of Tenant if such requirements relate to a non-structural item and apply to the premises (but not to other portions of the property of Landlord or any easement area) and shall be the responsibility of Landlord if such requirements relate to a structural item as they pertain to the premises or relate to a structural or non-structural item as they pertain to any other portions of Landlord's property excluding the premises (including any easement area).

Maintenance and Repairs and Work by Landlord. Throughout the Term, Landlord shall be responsible for all repairs, maintenance or replacement of structural portions of the premises, all easement areas, the roof, building systems, parking lot, sidewalks, exterior of the building, facade, all other areas other than the nonstructural portions of the premises and any damage caused by the negligence of Landlord, its agents, contractors, employees, invitees or licensees. Landlord's obligations to repair, maintain or replace shall not apply with respect to any damage caused by the negligence of Tenant, its agents, contractors, employees, invitees or licensees.

Maintenance, Repairs and Work by Tenant.

(a) Tenant shall be responsible for all other repairs not expressly reserved to Landlord. Tenant shall obtain certificates of insurance from any contractors performing work on the premises as reasonably required by Landlord, Laura Realty Company and/or the City of New York.

(b) Tenant shall submit in advance to Landlord details of plans for any work which will be reviewed by Landlord, and is reasonably acceptable to Landlord shall be submitted to CapGen, CHP Inc. Food Professionals, Inc. SETCO, LRC and the City of New York for consent. Tenant shall not begin such work or any other renovation or work without the prior written reasonable consent of Landlord, Setco, LRC, and the City of New York. Upon receipt of such consents, Tenant may commence the work provided that such work is material in conformance with the approved scope work and is performed in compliance with all applicable laws and codes.

(c) Tenant at its cost shall have the right to place, construct and maintain interior signs and, subject to Landlord's reasonable consent, exterior signs on the premises and the Building in compliance with all applicable laws, codes and governmental regulations.

(d) Tenant further agrees that it will maintain the premises at its own expense in a clean, orderly and sanitary condition, free of insects, rodents, vermin, and other pests; and that it will not permit undue accumulation of garbage, trash, rubbish or other refuse, but will remove the same at its own expense and will keep such refuse in proper containers within the interior of the premises until called for to be removed.

Insurance. Tenant at its sole cost and expense, shall provide and keep in force comprehensive general liability insurance against claims for bodily injury, death or property damage occurring in or about the premises, operation and control of the premises, including, but not limited to contractual liability in connection with the indemnification of Landlord, in a combined single event of not less than \$ 2,000,000.00 (Two million dollars.) Such Insurance shall be provided by an insurance company or Company's licensed to do business in the State of New York and reasonably acceptable to Landlord. Tenant shall cause Landlord to be named as an additional insured on said liability insurance and shall provide Landlord with a certificate evidencing such coverage. Landlord shall maintain fire, casualty and extended risk insurance coverage on the Building. Landlord represents and warrants that at all times during the term hereof it will maintain such insurance in full force and effect.

Miscellaneous. It is understood and agreed that all prior understandings and agreements between the parties hereto are merged in this instrument, which alone fully and completely expresses their agreement, with neither party relying upon any statement or representation made by the other which is not embodied in these instruments. These instruments may not be changed or terminated orally. The terms, covenants, and conditions of this rental agreement shall be binding upon, and inure to the benefit of each of the parties hereto, their heirs, personal representatives, successors and assigns, and shall run with the land. Whenever used herein, the singular number shall include the plural, the plural the singular and the use of any gender shall be applicable to all genders. At the request of either party, and at the expense of the requesting party, both parties shall execute recordable instruments evidencing this rental agreement.

Notices. All notices required hereunder shall be sent by certified mail, return receipt requested, or by recognized overnight delivery service to the following: To Landlord: at 10101-C Avenue D, Brooklyn, NY 11236. To Tenant: 21211 Nordhoff Street, Chatsworth, California, 91311.

Waiver of Jury Trial. THE LANDLORD AND THE TENDANT WAIVE ALL RIGHTS TO A TRIAL BY JURY IN ANY ACTION, COUNTERCLAIM, OR PROCEEDING BASED UPON, OR RELATED TO, THE SUBJECT MATTER OF THIS RENTAL AGREEMENT. THIS WAIVER APPLIES TO ALL CLAIMS AGAINST ALL

PARTIES TO SUCH ACTIONS AND PROCEEDINGS, INCLUDING PARTIES WHO ARE NOT PARTIES TO THIS RENTAL AGREEMENT. THIS WAIVER IS KNOWINGLY, INTENTIONALLY, AND INVOLUNTARILY MADE BY THE TENANT AND

THE TENANT ACKNOWLEDGES THAT NEITHER THE LANDLORD, NOR ANY PERSON ACTING ON BEHALF OF THE LANDLORD HAS MADE ANY REPRESENTATIONS OF FACT TO INDUCE THIS WAIVER OF TRIAL BY JURY OR IN ANY WAY MODIFY OR NULLIFY ITS EFFECTS.

IN WITNESS WHEREOF, the parties hereto have caused this rental agreement to be executed, and their respective seals affixed thereto, as of the date first above written.

Capstone Turbine Corporation

By /s/ John R Tucker
John R. Tucker, CEO and President

Date: 12/01/05

CapGen CHP, Inc.

By: /s/ Dennis Lane
Dennis Lane, Vice President

Date: 12/06/05

Addendum 1 to the Commercial Lease between CapGen CHP, Inc and Capstone Turbine Corporation

This addendum ("Addendum") to the commercial lease effective October 15, 2005 between CapGen CHP, Inc (signed in December, 2005) herein called Lessor, and Capstone Turbine Corporation, herein called Lessee, is entered into for the purpose of changing the monthly rent to accommodate additional square footage as follows:

Rent Paragraph of the lease is revised from:

Rent. During the term of this Lease agreement, Tenant agrees to pay to Landlord for the premises, the following sums:

Years 1 and 2	(10/15/05 - 10/14/07)	\$8,375.00 per month
Years 3 and 4	(10/15/07 - 10/14/09)	\$8,850 00 per month
Year 5	(10/15/09 - 10/14/10)	\$9,250 00 per month

(Tenant shall also have three (3) individual one year options to extend this lease for year 6 at \$9,250 00 per month, year 7 and year 8 at \$ 9.750 00 per month)

TO:

Rent During the term of this Lease agreement, Tenant agrees to pay to Landlord for the premises, the following sums:

Year 1	(10/15/05 - 09/30/06)	\$8,375 00 per month
Year 2	(10/01/06 - 10/14/07)	\$45,850 00 per month
Years 3 and 4	(10/15/07 - 10/14/09)	\$ 47,250 00 per month
Year 5	(10/15/09 - 10/14/10)	\$48,250 00 per month

(Tenant shall also have three (3) individual one year options to extend this lease for year 6 at \$ 49,250 00 per month, year 7 and year 8 at \$ 51,500 00 per month)

Assignment and Subletting Paragraph of the lease is revised from:

Assignment and Subletting Tenant shall not have the right to assign this agreement or sub-lease or to sublet all or any portion of the rental premises, without Landlord's consent which shall not be unreasonably withheld or delayed.

TO:

Assignment and Subletting Tenant shall not have the right to assign this agreement or sub-lease or to sublet all or any portion of the rental premises, without Landlord's consent which shall not be reasonably withheld or delayed. Because of the multiple occupancies and tenants within the building and their respective usage and utilization of the building, and Tenant's overlap of those adjoining occupancy spaces, additional documents and/or amendments to this lease may be required by the Landlord and Tenant in the future.

Use of Premises Paragraph of the lease is revised from:

Use of Premises Tenant shall use the premises for and as non-retail office space. Tenant shall not change the use of the premises without the prior written consent of the Landlord which shall not be unreasonably withheld or delayed. No hazardous waste or hazardous material shall be stored, disposed of or used on the premises. Tenant agrees to comply with all applicable zoning and other laws and regulations, and provide and install at its own expense any additional equipment or alterations required to comply with all such laws and regulations as required from time to time. Tenant further covenants and agrees (1) to use the premises in a manner which does not interfere with the rights of quiet enjoyment of any other tenants of the building and which is not a nuisance, and (ii) not to make any objectionable use of the premises to generate any objectionable odor therefrom. Notwithstanding the portioning Landlord represents premises to have a valid Certificate of Occupancy for Tenant's use of this premise.

TO:

Use of Premises Tenant shall use the premises for office space (approximately 5,000 sf), warehousing (approximately 17,500 sf), manufacturing and light component assembly work (approximately 25,000 sf), for an approximate aggregate total of 47,500 square feet. Tenant shall not change the use of the premises without the prior written consent of the Landlord which shall not be unreasonably withheld or delayed. No hazardous waste or hazardous material shall be stored, disposed of or used on the premises. Tenant agrees to comply with all applicable zoning and other laws and regulations, and provide and install at its own expense any additional equipment or alterations required to comply with all such laws and regulations as required from time to time. Tenant further covenants and agrees (1) to use the premises in a manner which does not interfere with the rights of quiet enjoyment of any other tenants of the building and which is not a nuisance, and (ii) not to make any objectionable use of the premises to generate any objectionable odor therefrom. Notwithstanding the portioning Landlord represents premises to have a valid Certificate of Occupancy for Tenant's use of this premise.

Signed this 27 day of September 2006

LESSEE:
CAPSTONE TURBINE CORPORATION

BY: /s/ Mark Gilbreth

NAME: Mark Gilbreth

TITLE: President & CEO/COO

DATE: 9/27/06

LESSOR:
CAPGEN CHP, INC,

BY: /s/ Dennis Lane

NAME Dennis Lane

TITLE: Vice President

DATE: 9/27/06

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER AND THE CHIEF FINANCIAL OFFICER PURSUANT TO 18
U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report on Form 10-Q of Capstone Turbine Corporation (“the Company”) for the period ended September 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (“the Report”), Mark G. Gilbreth, as Chief Executive Officer of the Company, and Walter J. McBride, as Chief Financial Officer, each hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to his knowledge, that:

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

Date: November 9, 2006

/s/ MARK G. GILBRETH

Mark G. Gilbreth

Interim President and Chief Executive Officer

Date: November 9, 2006

/s/ WALTER J. McBRIDE

Walter J. McBride

Executive Vice President and Chief Financial Officer
