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 December 31, 2006

or

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

For the transition period from to

Commission file number: 001-15957

Capstone Turbine Corporation
(Exact name of Registrant as specified in its charter)

Delaware	**95-4180883**
(State or other jurisdiction of incorporation or organization)	(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 January 31, 2007 was 144,751,391.

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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)

	December 31, 2006	March 31, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 25,498	$ 58,051
Accounts receivable, net of allowance for doubtful accounts and sales returns of $800 at December 31, 2006 and $858 at March 31, 2006	4,456	5,869
Inventories	20,188	12,545
Prepaid expenses and other current assets	1,232	1,050
Total current assets	51,374	77,515
Property, plant and equipment, net	6,736	7,816
Non-current portion of inventories	3,009	3,113
Intangible asset, net and other long-term assets	1,072	1,273
Total	$ 62,191	$ 89,717
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	$ 5,976	$ 8,144
Accrued salaries and wages	1,041	1,623

Accrued warranty reserve	6,408	6,998
Deferred revenue	993	632
Current portion of notes payable	19	19
Total current liabilities	14,437	17,416
Long-term portion of notes payable	32	47
Other long-term liabilities	580	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; 105,302,599 shares issued and 104,751,391 shares outstanding at December 31, 2006; 103,521,829 shares issued and 102,970,621 shares outstanding at March 31, 2006	104	104
Additional paid-in capital	576,297	572,787
Accumulated deficit	(528,746)	(500,542)
Deferred stock compensation	—	(208)
Treasury stock, at cost; 551,208 shares	(513)	(513)
Total stockholders' equity	47,142	71,628
Total	$ 62,191	$ 89,717

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Revenue	$ 5,715	$ 7,040	$ 15,227	$ 16,552
Cost of goods sold (includes stock-based compensation of $29, $0, $80 and $0, for the periods presented, respectively)	6,191	9,793	19,275	23,785
Gross loss	(476)	(2,753)	(4,048)	(7,233)
Operating expenses:				
Research and development (includes stock-based compensation of $63, $0, $175 and $0, for the periods presented, respectively)	2,021	3,093	7,419	7,926
Selling, general and administrative (includes stock-based compensation of $513, $176, $1,779 and $753, for the periods presented, respectively)	6,366	9,045	18,342	21,570
Total operating expenses	8,387	12,138	25,761	29,496
Loss from operations	(8,863)	(14,891)	(29,809)	(36,729)
Interest income	410	708	1,608	1,481
Interest expense	—	(1)	(2)	(22)
Other income	—	3	1	27
Loss before income taxes	(8,453)	(14,181)	(28,202)	(35,243)
Provision for income taxes	—	—	2	2
Net loss	$ (8,453)	$ (14,181)	$ (28,204)	$ (35,245)
Net loss per share of common stock — Basic and Diluted	$ (0.08)	$ (0.14)	$ (0.27)	$ (0.39)
Weighted average shares used to calculate Basic and Diluted net loss per share	103,968	102,341	103,731	90,624

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended December 31,	
	2006	2005
Cash Flows from Operating Activities:		

Net loss	$ (28,204)	$ (35,245)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,353	3,231
Provision for(Benefit from) allowance for doubtful accounts and sales returns	(58)	244
Inventory write-downs	1,186	1,526
Provision for warranty expenses	1,323	1,243
Loss(Gain) on disposal of equipment	171	(21)
Stock-based compensation	2,034	753
Changes in operating assets and liabilities:		
Accounts receivable	1,471	(3,043)
Inventories	(8,725)	(3,904)
Prepaid expenses and other assets	(182)	53
Accounts payable and accrued expenses	(2,100)	976
Accrued salaries and wages and long-term liabilities	(629)	(645)
Accrued warranty reserve	(1,913)	(1,926)
Deferred revenue	361	(103)
Net cash used in operating activities	(32,912)	(36,861)
Cash Flows from Investing Activities:		
Acquisition of and deposits on equipment and leasehold improvements	(1,360)	(966)
Proceeds from disposal of equipment	49	30
Net cash used in investing activities	(1,311)	(936)
Cash Flows from Financing Activities:		
Net proceeds from sale of common stock	—	39,089
Repayment of notes payable and capital lease obligations	(15)	(14)
Exercise of stock options and employee stock purchases	1,685	1,319
Net cash provided by financing activities	1,670	40,394
Net Increase(Decrease) in Cash and Cash Equivalents	(32,553)	2,597
Cash and Cash Equivalents, Beginning of Period	58,051	63,593
Cash and Cash Equivalents, End of Period	$ 25,498	$ 66,190
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 2	$ 22
Income taxes	$ 2	$ 2
Supplemental Disclosures of Non-Cash Information:		
During the nine months ended December 31, 2006 and 2005, the Company purchased on account $39 and $88 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.

Stock-Based Compensation

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards 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 nine months ended December 31, 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 nine months ended December 31, 2006 was $0.6 million and $2.0 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 $65,000 and $0.3 million for the three months and nine months ended December 31, 2006. The impact of the adoption of SFAS 123(R) on basic and diluted net loss per common share was $(0.08) and $(0.25) for the three months and nine months ended December 31, 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 nine months ended December 31, 2005 (in thousands, except per share data):

	Three Months Ended December 31, 2005	Nine Months Ended December 31, 2005
Net loss, as reported	$ (14,181)	$ (35,245)
Add: Stock-based employee and director compensation included in reported net loss	62	214
Deduct: Total stock-based employee and director compensation expense determined under fair value based method	(857)	(2,441)
Pro forma net loss	$ (14,976)	$ (37,472)
Net loss per share — Basic and Diluted:		
As reported	$ (0.14)	$ (0.39)
Pro forma	$ (0.15)	$ (0.41)

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 December 31, 2005	Nine Months Ended December 31, 2005
Risk-free interest rates	4.1%	4.0%
Expected lives (in years)	5.3 - 5.4	5.3 - 5.4
Dividend yield	—%	—%
Expected volatility	105.0 - 105.9%	103.9 – 106.2%
Weighted average volatility	105.2%	104.7%

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, three customers accounted for 18%, 16% and 15% of revenue, respectively, for the three months ended December 31, 2006, totaling approximately 49% of revenue. For the three months ended December 31, 2005, three customers accounted for 26%, 17% and 12% of revenue, respectively. For the three months ended December 31, 2006 and 2005, United Technologies Corporation ("UTC") accounted for approximately 15% and 26% of revenue, respectively (see Note 10).

Individually, one customer accounted for 15% of revenue for the nine months ended December 31, 2006. For the same period last year, individually, one customer accounted for 23% of revenue. UTC accounted for approximately 8% and 23% of revenue for the nine months ended December 31, 2006 and 2005, respectively.

Accounts receivable included $0.8 million and $1.6 million for unpaid billings to the U.S. government under cost-sharing programs at December 31 and March 31, 2006, respectively. Individually, three additional customers accounted for 24%, 17% and 11% of net accounts receivable, respectively, as of December 31, 2006, totaling approximately 52% 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:

	December 31, 2006	March 31, 2006
	(In thousands)	
Raw materials	$ 17,026	$ 13,237
Work in process	1,509	705
Finished goods	4,662	1,716
Total	23,197	15,658
Less non-current portion	3,009	3,113
Current portion	$ 20,188	$ 12,545

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:

	December 31, 2006	March 31, 2006
	(In thousands)	
Machinery, equipment and furniture	$ 18,200	$ 18,493
Leasehold improvements	8,730	8,656
Molds and tooling	3,741	3,538
	30,671	30,687
Less, accumulated depreciation and amortization	(23,935)	(22,871)
Total property, plant and equipment, net	$ 6,736	$ 7,816

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 December 31 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 $0.2 million of amortization expense for each of the three months and nine months ended December 31, 2006 and 2005, respectively. The manufacturing license is scheduled to be fully amortized by Fiscal 2011 with corresponding amortization estimated to be $66,000 for the remainder of Fiscal 2007, $0.3 million for each of Fiscal 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 $10,000 and $15,000 were earned by the supplier for the three months ended December 31, 2006 and 2005, respectively. Royalties of $23,000 and $38,000 were earned by the supplier for the nine months ended December 31, 2006 and 2005, respectively. As of December 31, 2006, a total of $99,000 was earned under the terms of the agreement. Earned royalties of $10,000 were unpaid as of December 31, 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 to coordinate the provisions for change in control 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 December 31, 2006, 2,663,395 shares were available for future grant.

As of December 31, 2006, the Company had outstanding 6,045,000 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 6,045,000 options were 2,000,000 options to the Company’s President and Chief Executive Officer, 1,500,000 options to the Company’s former 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 December 31, 2006 and 2005, the Company recognized stock-based compensation expense of $0.6 million and $0.2 million, respectively. In the nine months ended December 31, 2006 and 2005, the Company recognized stock-based compensation expense of $2.0 million and $0.8 million, respectively. The fair value of options vested during the three months ended December 31, 2006 and 2005 was $0.4 million and $0.6 million, respectively. The fair value of options vested during the nine months ended December 31, 2006 and 2005 was $1.7 million and $2.0 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 December 31, 2006	Nine Months Ended December 31, 2006
Risk-free interest rates	4.5%	4.5 – 5.1%
Expected lives (in years)	6.1	6.1
Dividend yield	—%	—%
Expected volatility	100.9%	100.9 – 103.5%
Weighted average volatility	100.9%	101.7%

The Company's computation of expected volatility for the three months and nine months ended December 31, 2006 and 2005 was based on historical volatility. The Company estimated the expected life of each stock option granted in the three months and nine months ended December 31, 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. This method is available for options granted prior to December 31, 2007. 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 estimated 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 nine months ended December 31, 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 nine months ended December 31, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2006	10,372,018	$ 2.58		
Granted	2,981,600	1.68		
Exercised	(1,029,805)	1.58		
Forfeited	(1,788,939)	1.80		
Expired	(947,807)	7.06		
Options outstanding at December 31, 2006	9,587,067	$ 2.11	8.17	$ 130,236
Options exercisable at December 31, 2006	4,091,208	$ 2.16	6.85	$ 129,223
Options fully vested at December 31, 2006 and those expected to vest beyond December 31, 2006	8,263,243	$ 2.13	7.98	$ 130,045

The weighted average per share grant date fair value of options granted during the three months ended December 31, 2006 and 2005 was $1.03 and $2.18, respectively. The weighted average per share grant date fair value of options granted during the nine months ended December 31, 2006 and 2005 was $1.38 and $1.94, respectively. The total intrinsic value of options exercised by the Company from option exercises during the three months ended December 31, 2006 and 2005, was approximately $3,000 and $0.4 million, respectively. The total intrinsic value of options exercised by the Company from option exercises during the nine months ended December 31, 2006 and 2005, was approximately $1.4 million and $1.5 million, respectively. As of December 31, 2006, there was approximately $7.5 million of

unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over a weighted average period of 1.59 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 nine months ended December 31, 2006 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested restricted stock outstanding at March 31, 2006	177,083	$ 1.23
Granted	847,147	1.54
Vested	(79,354)	1.50
Forfeited	(136,300)	1.29
Nonvested restricted stock outstanding at December 31, 2006	808,576	$ 1.52

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 $72,000 and $0.2 million associated with its restricted stock awards in the three and nine months ended December 31, 2006, respectively, and approximately $37,000 and $111,000 associated with its restricted stock awards in the three and nine months ended December 31, 2005, respectively. As of December 31, 2006, there was approximately $0.9 million of unrecognized compensation cost related to restricted stock awards that would be recognized as expense over a weighted average period of 2.03 years.

On December 18, 2006 the Company issued a restricted stock grant for 500,000 shares of the Company's common stock to the Company's President and Chief Executive Officer that will become 25% vested each year of service over four years.

Effective July 31, 2006, 125,000 unvested shares of restricted stock were repurchased and retired 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 nine months ended December 31, 2006 are as follows:

	(In thousands)
Balance, March 31, 2006	$ 6,998
Warranty provision relating to products shipped during the period	368
Deduction for performance on warranty claims	(1,913)
Changes for accruals related to preexisting warranties or reliability repairs programs	955
Balance, December 31, 2006	$ 6,408

9. Commitments and Contingencies

As of December 31, 2006, the Company had firm commitments to purchase inventories of approximately $6.8 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 December 31, 2006 and March 31, 2006.

In December 2001, a purported shareholder class action lawsuit was filed in the United States District Court for the Southern District of New York (the "District Court") 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. In June 2004, a committee of our 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 our underwriters.

The District Court requested that any objections to preliminary approval of the settlement be submitted by July 14, 2004. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District Court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005. The settlement fairness hearing was held on April 24, 2006, and the District Court reserved decision. On December 5, 2006, the United States Court of Appeals for the Second Circuit (the "Second Circuit") issued an opinion vacating the District Court's certification of a litigation class in that portion of the case between the Plaintiffs and the underwriter defendants. Because the Second Circuit's opinion was directed to the class certified by the District Court for the Plaintiffs' litigation against the underwriter defendants, the opinion's effect on the class certified by the District Court for the Company's settlement is unclear. On January 5, 2007, Plaintiffs filed a petition for rehearing en banc by the Second Circuit.

The proposed settlement is pending final approval by the District Court. There can be no assurance that the settlement will be approved and, because of the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the case if it is not. However, any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers.

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 $0.8 million and $1.8 million for the three-month periods ended December 31, 2006 and 2005, respectively. Sales for the nine months ended December 31, 2006 and 2005 were $1.2 million and $3.9 million, respectively. Related accounts receivable were $30,000 and $0.3 million at December 31, 2006 and March 31, 2006, respectively. 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 December 31, 2006 and 2005, respectively, and the Company had no unpaid balances with UTRC at December 31, 2006 or March 31, 2006. For the nine months ended December 31, 2006 and 2005, there were approximately $0 and $35,000 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 December 31, 2006 and 2005, the number of antidilutive stock options excluded from diluted net loss per common share computations was approximately 9,587,000 and 10,071,000 shares, respectively. As of December 31, 2006, 808,576 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 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

Effective January 24, 2007, the Company completed a registered direct offering in which it sold 40,000,000 shares of common stock of the Company, par value $0.001 per share, and warrants to purchase 20,000,000 shares of common stock with an initial exercise price of $1.30 per share, at a price of $1.14 per unit. The five-year warrants are immediately exercisable and include anti-dilution provisions, subject to certain limitations.

The sale resulted in gross proceeds of $45.6 million and proceeds net of direct incremental costs of the offering of $42.4 million.

The Company effected the issuance and sale pursuant to a shelf registration statement on Form S-3 (Registration No. 333-128164) declared effective by the Securities and Exchange Commission on September 14, 2005.

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. This method is available for options granted prior to December 31, 2007.
- 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 and bio-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. Additionally, in 2000, we shipped the first commercial unit of our Model C60 microturbine. An overview of our overall direction, targets and key initiatives 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 third quarter of Fiscal 2007, we booked $5.9 million of orders and shipped $4.6 million of products, resulting in $8.1 million in backlog as of December 31, 2006. Our actual product shipments during the third quarter of Fiscal 2007 were: 42% for use in CHP applications, 18% for use in CCHP applications and 36% for use in resource recovery applications. Other markets (including secure power) were 4%.

2) *Sales and Distribution Channel*— We continually refine our channels of distribution. We seek out distributors, dealers and representatives that have business experience and capabilities to support our growth plans in our targeted markets. In the Americas, we currently have nine distributors, three dealers and one project reseller. Internationally, outside of the Americas, we currently have thirteen distributors, two dealers and six resellers. We continue to refine the distribution channels to address our specific targeted markets.

3) *Geographic Focus*— Within the United States, our primary focus is on California and the Northeast states. We use our corporate headquarters to serve the California market and our sales and service office in New York 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. 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.

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 third quarter of Fiscal 2007, we continued to present alternatives to customers under-served by our distributor and ASC base through Capstone factory direct service. Service revenue is less than 10% of

total revenue. 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*— To 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*— 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.

We believe that execution in each of these key areas 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 progress in achieving many aspects of our corporate strategies, we have established the end of the fourth quarter of Fiscal 2008, or March 2008, as our goal to achieve positive cash flow.

Results of Operations

Three Months Ended December 31, 2006 and 2005

Revenue. Revenue for the third quarter of Fiscal 2007 decreased $1.3 million, or 19%, to $5.7 million from $7.0 million for the same period last year. Revenue from complete microturbine product shipments decreased $1.1 million, or 19%, to $4.6 million during the current period from $5.7 million for the same period last year. Shipments of complete microturbine units were 5.1 megawatts during the third quarter of Fiscal 2007 compared with 6.8 megawatts for the same period last year. Revenue from accessories, parts and service for the third quarter of Fiscal 2007 decreased $0.2 million to $1.1 million from $1.3 million for the same period last year. Included in the overall revenue decline was a $1.8 million decrease in revenue from the North American and Asian markets. While sales have not increased at the expected rate, we continue to pursue market penetration through the use of worldwide distributors and our direct sales resources.

Individually, three customers accounted for 18%, 16% and 15% of revenue, respectively, for the third quarter of Fiscal 2007, totaling 49% of revenue. For the same period last year, individually, three customers each accounted for 26%, 17% and 12% of revenue, respectively. UTC accounted for 15% and 26% of revenue for the three months ended December 31, 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 $0.5 million, or 8% of revenue, for the third quarter of Fiscal 2007 compared to $2.8 million, or 39% of revenue, for the same period last year. The decrease in the gross loss and corresponding improvement in the gross loss percentage reflects a change in product mix with increased sales of higher margin C-60 Series units, reduced manufacturing costs of $0.6 million as well as decreased warranty and inventory charges of $1.1 million and higher absorption of overhead costs into ending inventory 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 enhancement programs. Warranty expense decreased $0.2 million over the

same period last year. Warranty expense for unit shipments decreased $0.1 million as a result of lower volumes and improvements that have been made through engineering design changes and product robustness. Additionally, warranty expenses for reliability programs decreased by $0.1 million compared to the corresponding period in the prior year. These changes in program estimates are recorded in the period that new information, such as design changes and product enhancements become available.

We expect to continue to incur gross losses until we are able to achieve higher unit sales volumes to cover our fixed manufacturing costs. Additionally, other contributions to profitability include initiatives to further reduce direct material costs and reductions in other manufacturing and warranty costs.

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 third quarter of Fiscal 2007 decreased $1.1 million, or 35%, to $2.0 million from $3.1 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 $0.5 million of such benefits this quarter and for the same period last year. The overall net decrease in R&D expenses of $1.1 million resulted from decreased spending for labor and consulting of $0.7 million and decreased spending on developmental hardware for various engineering projects of $0.4 million. Included in the net decrease of labor and consulting expenses for the third quarter of Fiscal 2007 were $63,000 of non-cash stock compensation charges. There were no such charges for the same period in the prior year. The non-cash stock compensation charges 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 overall spending.

Selling, General, and Administrative ("SG&A") Expenses. SG&A expenses for the third quarter of Fiscal 2007 decreased $2.6 million, or 29%, to $6.4 million from $9.0 million for the same period last year. Included in SG&A expenses in the quarter ended December 31, 2006 was $0.5 million of non-cash stock compensation, compared to $0.2 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. Included in the SG&A decrease was $2.0 million related to a legal settlement in the 2005 period. Additionally, we incurred $0.7 million of reduced professional services including legal, accounting, insurance and consulting, a decrease of $0.5 million related to marketing, supplies and facility maintenance costs, and $0.1 million in labor-related costs, including salaries, recruitment and relocation expenses to support our continuous process improvement throughout the organization. We expect SG&A costs, with the exception of non-cash stock compensation charges, for Fiscal 2007 year to be lower than the prior year.

Interest Income. Interest income for the third quarter of Fiscal 2007 decreased $0.3 million, or 42%, to $0.4 million from $0.7 million for the same period last year. The decrease during the current period was attributable to decreased aggregate cash balances during the recent quarter.

Nine Months Ended December 31, 2006 and 2005

Revenue. Revenue for the nine months ended December 31, 2006 decreased $1.4 million, or 8%, to $15.2 million from $16.6 million for the same period last year. Revenue from complete microturbine product shipments decreased $1.5 million, or 12.0%, to $11.4 million during the current period from $12.9 million for the same period last year. Shipments of complete microturbine units were 11.9 megawatts during the nine-month period ended December 31, 2006 compared with 15.4 megawatts for the same period last year. Revenue from accessories, parts and service for the nine months ended December 31, 2006 increased $0.1 million to $3.8 million from $3.7 million for the same period last year. Included in the overall revenue decline was a $3.6 million decrease in revenue from the North American and Asian markets offset by an increase of $1.8 million from the European and Russian markets. While sales have not increased at the expected rate, we continue to pursue market penetration through the use of worldwide distributors and our direct sales resources.

One customer accounted for 15% of revenue for the nine months ended December 31, 2006. For the same period last year, one customer accounted for 23% of revenue. UTC accounted for 8% and 23% of revenue for the nine months ended December 31, 2006 and 2005, respectively.

Gross loss. For the nine months ended December 31, 2006, the gross loss was $4.0 million, or 27% of revenue, compared to $7.2 million, or 44% of revenue, for the same period last year. The decrease in the gross loss and corresponding improvement in the gross loss percentage reflects a change in product mix with increased sales of higher margin C-60 Series units and reduced manufacturing costs of $2.3 million as well as higher absorption of overhead costs into ending inventory of $1.2 million offset by increased warranty and inventory charges of $0.3 million. Warranty expense increased $1.1 million over the same period a year ago. Warranty expense for unit shipments decreased $0.8 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 $1.9 million in reliability enhancement programs primarily due to benefits realized from program changes in the prior year. These changes in 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 nine months ended December 31, 2006 decreased $0.5 million, or 6%, to $7.4 million from $7.9 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 $1.4 million of such benefits for the nine months ended December 31, 2006, compared with $1.6 million for the same period last year. This decrease in benefits of $0.2 million offset the overall $0.7 million net decrease in R&D expenses. This net decrease in R&D spending is the result of decreased development hardware costs for various engineering projects of $0.2 million as well as a decrease in labor and consulting spending of $0.7 million offset by an increase in facilities expenses of $0.2 million. Included in the net decrease in labor and consulting spending for the nine months ended December 31, 2006 were $0.2 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 nine months ended December 31, 2006 decreased $3.3 million, or 15%, to $18.3 million from $21.6 million for the same period last year. Included in SG&A expenses for the nine months ended December 31, 2006 was $1.8 million of non-cash stock compensation, compared to $0.8 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. Other SG&A expenses decreased $4.4 million compared to the 2005 period. Included in the SG&A decrease was $2.0 million related to legal settlement costs incurred in the prior period, $2.0 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 $0.1 million in labor-related costs.

Interest Income. Interest income for the nine months ended December 31, 2006 increased $0.1 million, or 9%, to $1.6 million from $1.5 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 nine months ended December 31, 2006.

Liquidity and Capital Resources

Our cash requirements depend on many factors, including the execution of our corporate strategies. 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 nine months ended December 31, 2006 we used $32.9 million in cash in our operating activities, which consisted of a net loss for the period of $28.2 million and cash used for working capital of $11.7 million, offset by non-cash adjustments (primarily depreciation, warranty, stock compensation and inventory charges) of $7.0 million. This compared to operating cash usage of $36.9 million during the nine months ended December 31, 2005, which consisted of a net loss for the period of $35.3 million and cash used for working capital of $8.6 million, offset by non-cash adjustments of $7.0 million. The increase in working capital cash usage of $3.1 million is largely attributable to an increase in finished goods inventories to support expected sales in future periods.

Investing Activities. Net cash used in investing activities relate primarily to the acquisition of fixed assets of $1.4 million and $0.9 million for the nine months ended December 31, 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 nine months ended December 31, 2006, we generated $1.7 million from financing activities, a decrease of $38.7 million, as compared with the prior year period, in which we generated $40.4 million. In the prior period, the funds generated from financing activities were primarily the result of $39.1 million of net proceeds received from a registered offering of the Company's common stock that closed on October 21, 2005. The funds generated from financing activities in the nine months ended December 31, 2006 were primarily the result of the exercise of stock options. Repayments of capital lease obligations were $15,000 during the nine months ended December 31, 2006 as compared with $14,000 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 used for operating and investing activities than in Fiscal 2006.

Except for scheduled payments made on operating and capital leases during the first nine 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.

Effective January 24, 2007, we completed a registered direct offering in which we sold 40,000,000 shares of common stock of the Company, par value $0.001 per share, and warrants to purchase 20,000,000 shares of common stock at an initial exercise price of $1.30 per share, at a price of $1.14 per unit. The five-year warrants are immediately exercisable and include anti-dilution provisions, subject to certain limitations.

The sale resulted in gross proceeds of $45.6 million and proceeds net of direct incremental costs of the offering of $42.4 million.

We effected the issuance and sale pursuant to a shelf registration statement on Form S-3 (Registration No. 333-128164) declared effective by the Securities and Exchange Commission on September 14, 2005.

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.

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 nine months ended December 31, 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***

We recently updated the risk factors disclosed in our Annual Report on Form 10-K for the year ended March 31, 2006. Our updated risk factors are below:

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

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

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

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

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

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

Capstone microturbines compete with several technologies, including reciprocating engines, fuel cells and solar power. Competing technologies may receive certain benefits, like governmental subsidies or promotion, or be able to offer consumer rebates or other incentives that we cannot receive or offer to the same extent. This could enhance our competitors' abilities to fund research, penetrate markets or increase sales.

Our competitors include several well-known companies with histories of providing power solutions. They have substantially greater resources than we have and have established worldwide presence. Because of greater resources, some of our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer

requirements, to devote greater resources to the promotion and sale of their products than we can or they may introduce governmental regulations and policies to create competitive advantage vis-à-vis our products. We believe that developing and maintaining a competitive advantage will require continued investment by us in product development and quality, as well as attention to product performance, our product prices, our conformance to industry standards, manufacturing capability and sales and marketing. In addition, current and potential competitors have established or may in the future establish collaborative relationships among themselves or with third parties, including third parties with whom we have business relationships. Accordingly, new competitors or alliances may emerge and rapidly acquire significant market share.

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

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

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

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

Our sales and marketing efforts may not achieve intended results and therefore may not generate the net revenue we anticipate. As a result of our corporate strategies, we have decided to focus our resources on selected vertical markets, such as cogeneration (CHP and CCHP), resource recovery and secure power. We may change our focus to other markets or applications in the future. There can be no assurance that our focus or our near term plans will be successful. If we are not able to successfully address markets for our products, we may not be able to grow our business, compete effectively or achieve profitability.

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

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

Approval of the New York City Department of Buildings' Materials Equipment Acceptance ("MEA") application for listing our product on the MEA Index may not result in an increase in sales.

Our sales efforts may not achieve our intended targets with regards to the New York market and, therefore, may not generate the net revenue we anticipate. As a result of our corporate strategies, we decided to focus resources on the New York market to support the sales that may result from the approval of the New York City Department of Buildings'

MEA application for listing our product on the MEA Index. Though we received our MEA approval from the New York City Department of Buildings MEA Division and the New York Fire Department on May 24, 2006, certain applications of our products will require further approval and there can be no assurance that our focus on, or our near-term plans for, the New York market will be successful.

Approval of Capstone-branded products for listing on the General Service Administration ("GSA") Schedule does not ensure that we will supply products to the federal government and may not result in an increase in sales.

We have publicly announced that our products have been approved by the GSA. The GSA approval provides the opportunity for federal end-user customers to negotiate and acquire products and services from commercial suppliers. There is no assurance that we will achieve our intended targets with regards to the sale of our products to the federal government, and, therefore, we may not generate the net revenue we anticipate.

We do not have a definitive agreement with Broad USA, Inc. to develop jointly fully integrated cogeneration (CCHP) systems, and this strategic relationship is subject to negotiation and execution of a definitive agreement and may not result in an increase in sales.

We have publicly announced that we have negotiated and signed a Memorandum of Understanding ("MOU") with Broad USA, Inc. to jointly develop fully integrated cogeneration (CCHP) systems. The basis of the agreement will synchronize the two companies to follow our "cookie-cutter" concept for market standardization of on-site power and CCHP solutions. We do not have a definitive agreement with Broad USA, Inc., and no assurance can be given that we will reach such an agreement. If we enter into such an agreement, our sales efforts may not achieve intended targets with regards to the anticipated strategic relationship with Broad USA, Inc. and therefore may not generate the net revenue we anticipate.

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

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

A significant customer may not achieve its forecasted sales growth, and we have given it notice of certain breaches of contract that have not been cured and could result in termination of our agreement with this customer.

Sales to UTC Power, LLC ("UTCP"), an affiliate of United Technologies Corporation, accounted for approximately 17% and 15% of our net revenue for the years ended March 31, 2006 and 2005. Our OEM agreement with UTCP permits UTCP to package the Capstone microturbine products with chillers and heat exchange equipment manufactured by UTCP and to sell and service the integrated CCHP units. UTCP's performance as it relates to engineering, installation and provision of after-market service could have a significant impact on our reputation and products. On September 11, 2005, we gave notice to UTCP, pursuant to our 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 ninety (90) calendar

days following its receipt of the notice in which to cure the breaches. We could elect to terminate the OEM agreement if UTCP fails to cure the breaches. While we believe that UTCP has not yet cured some key breaches of the agreement, we have continued to work with UTCP and have encouraged UTCP to resolve the underlying causes of the breaches. Meanwhile, we are continuing to do business with UTCP under the OEM agreement, and we have not terminated the agreement. If this relationship is terminated, we will honor sales orders committed to prior to the date of termination in accordance with the OEM agreement; however, our near-term sales, cash flow and profitability could be adversely affected. Furthermore, while this relationship is important to us, UTCP has not and may not achieve its forecasted sales growth, which could affect our ability to meet our sales, cash flow and profitability targets.

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

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

Changes in our product components may require us to replace parts held at distributors and ASCs.

We have entered into agreements with some of our distributors and ASCs that require that if we render parts obsolete in inventories they own and hold in support of their obligations to serve fielded microturbines, then we are required to replace the affected stock at no cost to the distributors or ASCs. It is possible that future changes in our product technology could involve costs that have a material adverse effect on our results of operations or financial position.

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 are applicable to microturbines as of January 1, 2007. We have not yet been able to achieve compliance with these new standards. 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. In addition, the addressable market will be reduced in certain parts of California as customers will not be allowed to apply for air emissions permits to install a Capstone microturbine. This will have an effect on installations and add 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. There is no assurance that we will achieve compliance with the new standards. Non-compliance with the new standards could have a material adverse effect on our operating results.

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 California customers and depriving them of a significant incentive for purchases of microturbines. Loss of this incentive would cause a material adverse effect on our operating results,

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

Utility companies or governmental entities could place barriers on the installation of our product or the interconnection of the product with the electric grid. Further, they may charge additional fees to customers who install on-site generation, or for having the capacity to use power from the grid for back-up or standby purposes. These types of restrictions, fees or charges could hamper the ability to install or effectively use our product or increase the cost to our potential customers for using our systems. This could make our systems less desirable, thereby adversely affecting our revenue and profitability potential. In addition, utility rate reductions can make our products less competitive which would have a material adverse effect on our operations. The cost of electric power generation is ultimately tied to the cost of natural gas. However, changes to electric utility tariffs often require lengthy regulatory approval and include a mix of fuel types as well as customer categories. Potential customers may perceive the resulting swings in gas and electric pricing as an increased risk of investing in on-site generation.

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

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

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

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

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

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

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

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

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

Commodity market factors impact our costs and availability of materials.

Our products contain a number of commodity materials, from metals, which includes steel, special high temperature alloys, copper, nickel and molybdenum, to computer components. The availability of these commodities could impact our ability to acquire the materials necessary to meet our requirements. The cost of metals has historically fluctuated. The pricing could impact the costs to manufacture our product. If we are not able to acquire commodity materials at prices and on terms satisfactory to us or at all, our operating results may be materially adversely affected.

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

Some of our components are currently available only from a single source or limited sources. We may experience delays in production if we fail to identify alternative suppliers, or if any parts supply is interrupted, each of which could materially adversely affect our business and operations. In order to reduce manufacturing lead times and ensure adequate component supply, we enter into agreements with certain suppliers that allow them to procure inventories based upon criteria defined by us. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete inventories, which could adversely affect our business. Our inability to meet volume commitments with suppliers could affect the availability or pricing of our parts and components. A reduction or interruption in supply, a significant increase in price of one or more components or a decrease in demand of products could materially adversely affect our business and operations and could materially damage our customer relationships. Financial problems of suppliers on whom we rely could limit our supply or increase our costs. Also, we cannot guarantee that any of the parts or components that we purchase will be of adequate quality or that the prices we pay for the parts or components will not increase. Inadequate quality of products from suppliers could interrupt our ability to supply quality products to our customers in a timely manner. Additionally, defects in materials or products supplied by our suppliers that are not identified before our products are placed in service by our customers could result in higher warranty costs and damage to our reputation. We also outsource approximately 2% of our components internationally and expect to increase international outsourcing of components. As a result of outsourcing internationally, we may be subject to delays in delivery due to the timing or regulations associated with the import/export process, delays in transportation or regional instability.

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

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

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

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

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

To the extent that the funds we now have on hand are insufficient to fund our future operating requirements, we would need to raise additional funds, through further public or private equity or debt financings depending upon prevailing market conditions. These financings may not be available or, if available, may be on terms that are not favorable to us and could result in dilution to our stockholders and reduction of the price of our stock. Downturns in worldwide capital markets could also impede our ability to raise additional capital on favorable terms or at all. If adequate capital were not available to us, we would likely be required to significantly curtail or possibly even cease our operations.

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

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

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

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

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

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

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to include in our Annual Reports on Form 10-K our assessment of the effectiveness of our internal controls over financial reporting. Furthermore, our independent registered public accounting firm is required to audit our assessment of the effectiveness of our internal controls over financial reporting and separately report on whether it believes we maintain, in all material respects,

effective internal controls over financial reporting. We identified three material weaknesses in our system of internal controls as of March 31, 2005.

Since March 31, 2005, we have adequately addressed the three material weaknesses. We cannot provide assurance that our system of internal controls will be effective in the future as our operations and control environment change. If we cannot adequately maintain the effectiveness of our internal controls over financial reporting, our financial reporting may be inaccurate. If reporting errors actually occur, we could be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. These results could adversely affect our financial results or the market price of our common stock.

Our operations are vulnerable to interruption by fire, earthquake and other events beyond our control.

Our operations are vulnerable to interruption by fire, earthquake and other events beyond our control. Our executive offices and manufacturing facilities are located in Southern California. Because the Southern California area is located in an earthquake-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our facilities in Southern California and the surrounding transportation infrastructure, which could affect our ability to make and transport our products. The Company does not maintain earthquake coverage for personal property or resulting business interruption. If an earthquake, fire or other natural disaster occurs at or near our facilities, our business, financial condition and operating results could be materially adversely affected.

The market price of our common stock has been and may continue to be highly volatile and an investment in our securities could suffer a decline in value.

An investment in our securities is risky, and shareholders could suffer significant losses and wide fluctuations in the market value of their investment. The market price of our common stock is highly volatile and is likely to continue to be volatile. As a result of the factors discussed below, our operating results for a particular quarter are difficult to predict. Given the continued uncertainty surrounding many variables that may affect the industry in which we operate, our ability to foresee results for future periods is limited. This variability could affect our operating results and thereby adversely affect our stock price. Many factors that contribute to this volatility are beyond our control and may cause the market price of our common stock to change, regardless of our operating performance. Factors that could cause fluctuation in our stock price may include, among other things:

- actual or anticipated variations in quarterly operating results;
- market sentiment toward alternate energy stocks in general or toward Capstone;
- changes in financial estimates or recommendations by securities analysts;
- conditions or trends in our industry or the overall economy;
- loss of one or more of our significant customers;
- errors, omissions or failures by third parties in meeting commitments to the Company;
- changes in the market valuations or earnings of our competitors or other technology companies;
- the trading of options on our common stock;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, divestitures, joint ventures or other strategic initiatives;
- announcements of significant market events, such as power outages, regulatory changes or technology changes;
- changes in the estimation of the future size and growth rate of our market;
- future equity financings;
- the failure to achieve our near-term plans for the federal government despite receiving listing on the General Service Administration Schedule;
- the failure to achieve our near-term plans for the New York market despite receiving the New York MEA approval;
- failure to enter into a definitive agreement with Broad USA, Inc.;
- litigation or disputes with customers or business partners;

- capital commitments;
- additions or departures of key personnel;

- sales or purchases of the Company's common stock;
- the trading volume of our common stock;
- developments relating to litigation or governmental investigations; and
- decrease in oil and electricity prices.

In addition, the stock market in general, and the Nasdaq Global Market and the market for technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of particular companies affected. The market prices of securities of technology companies and companies servicing the technology industries have been particularly volatile. These broad market and industry factors may cause a material decline in the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class-action litigation has often been instituted against that company. This type of litigation, if instituted against us and regardless of whether we prevail on the underlying claim, could result in substantial costs and a diversion of management's attention and resources, which could materially harm our financial condition and results of operations.

Provisions in our certificate of incorporation, bylaws and our stockholder rights plan, as well as Delaware law, may discourage, delay or prevent a merger or acquisition at a premium price.

Provisions of our second amended and restated certificate of incorporation, amended and restated bylaws and our stockholder rights plan, as well as provisions of the General Corporation Law of the State of Delaware, could discourage, delay or prevent unsolicited proposals to merge with or acquire us, even though such proposals may be at a premium price or otherwise beneficial to you. These provisions include our board's authorization to issue shares of preferred stock, on terms the board determines in its discretion, without stockholder approval, and provisions of Delaware law that restrict many business combinations.

We are subject to the provisions of Section 203 of the General Corporation Law of the State of Delaware, which could prevent us from engaging in a business combination with a 15% or greater stockholder for a period of three years from the date it acquired such status unless appropriate board or stockholder approvals are obtained. Our board of directors has adopted a stockholder rights plan, pursuant to which one preferred stock purchase right has been issued for each share of our common stock authorized and outstanding at the close of business on July 18, 2005. The rights plan is intended to protect our stockholders in the event of an unfair or coercive offer to acquire the Company. However, the existence of the rights plan may discourage, delay or prevent a merger or acquisition of the Company that is not supported by the board of directors.

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

None

Item 3. ***Defaults Upon Senior Securities***

None

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

None

Item 5. ***Other Information***

None

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(1)	Inducement Stock Option Agreement between Capstone Turbine Corporation and Darren R. Jamison, effective December 18, 2006
10.2(1)	Restricted Stock Agreement between Capstone Turbine Corporation and Darren R. Jamison, effective December 18, 2006
10.3(1)	Letter Agreement between Capstone Turbine Corporation and Darren R. Jamison, dated December 1, 2006
10.4(1)	Change of Control Severance Agreement between Capstone Turbine Corporation and Darren R. Jamison, effective December 18, 2006
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).

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: February 9, 2007

CAPSTONE TURBINE CORPORATION

INDUCEMENT STOCK OPTION AGREEMENT

THIS AGREEMENT is entered into on this 18th day of December, 2006 by and between Capstone Turbine Corporation (the "Company") with **Darren R. Jamison** (the "Optionee") to evidence the award of an option to purchase the common stock of the Company that was made on December 18, 2006.

RECITALS:

WHEREAS, the Company, through action of the compensation committee of its board of directors taken on December 18, 2006, made a conditional option award to Optionee to purchase the Company's Common Stock (the "Option") as an inducement to encourage Optionee to accept an offer of employment as the Company's president and chief executive officer;

WHEREAS, the parties, in connection therewith, entered into a letter agreement dated December 1, 2006, that sets forth general terms of employment of the Optionee by the Company, including the terms of the Option that is evidenced by this Agreement;

WHEREAS, the parties desire to set forth the terms of such Option and to acknowledge that the shares of Common Stock that may be acquired hereunder shall be registered under the Securities Act of 1933, as amended ("Securities Act") on Form S-8; and

WHEREAS, the parties further acknowledge that this Option is granted separately from the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "2000 Plan"), but desire that this Option be subject to the terms contained in the of the 2000 Plan, except as otherwise provided for herein;

NOW, THEREFORE, in consideration of these premises, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties do hereby agree to the following terms and conditions regarding the Option covered hereby:

I. NOTICE OF STOCK OPTION GRANT

Notice is hereby given of the grant of the Option, subject to the following terms. References in this Agreement to certain terms of the Option shall be as defined in this Article I:

Date of Grant:	December 18, 2006
Exercise Price:	$1.27 per Share
Total Number of Shares:	2,000,000
Total Exercise Price:	$2,540,000.00
Type of Option:	Non-Qualified Stock Option
Term:	10 years commencing on Date of Grant

Exercise and Vesting Schedule:

This Option shall vest and become exerciseable on the dates and as described in this paragraph, subject to the Optionee continuing to be either an Employee or a Consultant to the Company on such vesting dates. On **December 18, 2007**, Optionee shall be vested in and have the right to exercise the Option with respect to 500,000 Shares. Thereafter, Optionee shall become vested in and have the right to exercise this Option with respect to 1/48th of the number of Shares subject to the Option on the day of each month corresponding to the Date of Grant, so that the Option shall be fully vested and exercisable on the fourth anniversary of the Date of Grant. However, if Optionee is terminated by the Company other than for Cause prior to the one-year anniversary of the Date of Grant, Optionee shall become vested in and have the right to exercise this Option with respect to 1/48th of the number of Shares subject to the Option for each full month of employment following the Date of Grant, based on the day of the month corresponding to the Date of Grant, through the date of such termination.

Option Termination:

The Option shall terminate on **December 18, 2016**; provided, however, that if Optionee ceases to be either an Employee or a Consultant prior thereto, then the Option shall terminate earlier pursuant to the terms of Sections 10(d), 10(e), and 10(f) of the Plan.

II. AGREEMENT

1. Grant of Option. The Option to purchase the Shares of Common Stock is subject to the terms set forth in Article I of this

Agreement. Except as expressly provided for herein, this Option is also subject to the terms, definitions and provisions of the 2000 Plan, which are incorporated herein by reference. All capitalized terms used in this Agreement shall have the meanings ascribed to such terms in the 2000 Plan, except as may be otherwise defined herein. The Option evidenced in this Agreement is intended by the parties to be granted in fulfillment of the Company's obligation to award a stock option pursuant to the letter agreement between the parties dated December 1, 2006; the terms of this Agreement completely replace and supersede the terms addressing the subject matter contained in such letter agreement.

2. Exercise of Option. The Option shall be exercisable cumulatively according to the vesting schedule set forth in Article I of this Agreement, based on Optionee's continued status as an Employee or a Consultant, and subject to the procedures and methods for payment set forth in the 2000 Plan. Any portion of the exercisable portion of the Option may be exercised at any time by the Optionee until the Option has terminated.

3. Lock-Up Period. Optionee hereby agrees that if so requested by the Company or any representative of the underwriters (the "Managing Underwriter") in connection with any registration of the offering of any securities of the Company under the Securities Act or any applicable state laws, Optionee shall not sell or otherwise transfer any Shares or other securities of the Company during the 180-day period (or such longer period as may be requested in writing by the Managing Underwriter and agreed to in writing by the Company) (the "Market Standoff

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Period") following the effective date of a registration statement of the Company filed under the Securities Act. The Company may impose stop-transfer instructions with respect to securities subject to the foregoing restrictions until the end of such Market Standoff Period.

4. Non-Transferability of Option. The Option may not be transferred in any manner except by will or by the laws of descent or distribution. It may be exercised during the lifetime of Optionee only by Optionee. The terms of the Option shall be binding upon the executors, administrators, heirs, successors and assigns of the Optionee.

This Agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which shall constitute one document.

CAPSTONE TURBINE CORPORATION

By: /s/ WALTER J. MCBRIDE
Walter J. McBride
Executive VP & Chief Financial Officer

OPTIONEE ACKNOWLEDGES AND AGREES THAT THE VESTING OF SHARES PURSUANT TO THE OPTION HEREOF IS EARNED ONLY BY CONTINUING EMPLOYMENT OR CONSULTANCY AT THE WILL OF THE COMPANY (NOT THROUGH THE ACT OF BEING HIRED, BEING GRANTED THE OPTION OR ACQUIRING SHARES HEREUNDER). OPTIONEE FURTHER ACKNOWLEDGES AND AGREES THAT NOTHING IN THIS STOCK OPTION AGREEMENT, NOR IN THE CAPSTONE TURBINE CORPORATION 2000 EQUITY INCENTIVE PLAN, WHICH IS INCORPORATED HEREIN BY REFERENCE, SHALL CONFER UPON OPTIONEE ANY RIGHT WITH RESPECT TO CONTINUATION OF EMPLOYMENT OR CONSULTANCY BY THE COMPANY, NOR SHALL IT INTERFERE IN ANY WAY WITH OPTIONEE'S RIGHT OR THE COMPANY'S RIGHT TO TERMINATE OPTIONEE'S EMPLOYMENT OR CONSULTANCY AT ANY TIME, WITH OR WITHOUT CAUSE.

Optionee hereby acknowledges receipt of the 2000 Plan and a current prospectus for the offering represented by the grant of this Option. Optionee represents that he is familiar with the terms and provisions of the 2000 Plan and this Agreement and does hereby accept the Option subject to all of its terms. Optionee has had an opportunity to obtain the advice of counsel prior to executing this Agreement and fully understands all provisions of this Agreement and the Option granted hereunder. Optionee hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Committee upon any questions arising under the 2000 Plan or this Agreement. Optionee further agrees to notify the Company upon any change in the residence address indicated below.

Dated: January 25, 2007

/s/ DARREN R. JAMISON
Darren R. Jamison, Optionee

Residence Address: ______________________

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EXHIBIT A

CAPSTONE TURBINE CORPORATION

NOTICE OF EXERCISE

Capstone Turbine Corporation
21211 Nordhoff Street
Chatsworth, CA 91311

Attention: Corporate Secretary

1. Exercise of Option. Effective as of today, , 20 , the undersigned ("Optionee") hereby elects to exercise the right to purchase shares of the Common Stock (the "Shares") of Capstone Turbine Corporation (the "Company") under and pursuant to the terms of that certain option granted on **December, 2006,** as evidenced in an agreement dated December , 2006 (the "Agreement").

2. Representations of Optionee. Optionee acknowledges that he/she has received, read and understands the Agreement, the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "2000 Plan") and all materials constituting the prospectus for the option described in the Agreement. Optionee has had opportunity to consult with legal and tax counsel prior to this exercise.

3. Rights as Stockholder. Optionee understands that (i) the Company shall promptly issue (or cause to be issued) Shares to be acquired upon the exercise signified in this notice, (ii) Optionee has no right to vote or receive dividends or any other rights as a stockholder with respect to Shares covered hereby until the Shares are issued, as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company, (iii) no adjustment will be made for a dividend or other right for which the record date is prior to the date the Shares are issued, except as provided in Section 15 of the 2000 Plan.

4. Tax Consultation. Optionee acknowledges that adverse tax consequences can result from the purchase or disposition of the Shares. Optionee represents that Optionee has consulted with any tax advisors that Optionee deems appropriate in connection with the purchase or disposition of the Shares and that Optionee is not relying on the Company for any tax advice.

5. Successors and Assigns. The Company may assign any of its rights under this notice to single or multiple assignees, and this notice shall inure to the benefit of the successors and assigns of the Company. This notice shall be binding upon Optionee and his heirs, executors, administrators, successors and assigns.

6. Interpretation. Any dispute regarding the interpretation of this notice shall be submitted by Optionee or by the Company forthwith to the Company's Board of Directors or the committee thereof that administers the 2000 Plan (the "Committee"), which shall review such dispute at its next regular meeting. The resolution of such a dispute by the Committee shall be final and binding on the Company and on Optionee.

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7. Governing Law; Severability. This notice shall be governed by and construed in accordance with the laws of the State of Delaware excluding that body of law pertaining to conflicts of law. Should any provision of this notice be determined by a court of law to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

8. Notices. Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery or upon deposit in the United States mail by certified mail, with postage and fees prepaid, addressed to the other party at its address as shown below beneath its signature, or to such other address as such party may designate in writing from time to time to the other party.

9. Further Instruments. The parties agree to execute such further instruments and to take such further action as may be reasonably necessary to carry out the purposes and intent of this notice.

10. Delivery of Payment. Optionee herewith delivers to the Company the full Exercise Price for the Shares, as well as any applicable withholding tax.

11. Entire Agreement. The 2000 Plan and the Agreement are incorporated herein by reference. This notice, the 2000 Plan and the Agreement constitute the entire agreement of the parties and supersede in their entirety all prior undertakings and agreements of the Company and Optionee with respect to the subject matter hereof.

Submitted by:	Accepted by:
	CAPSTONE TURBINE CORPORATION
______________________________	
OPTIONEE: Darren R. Jamison	By: ______________________________
	Name: ______________________________
	Title ______________________________

Exhibit 10.2

CAPSTONE TURBINE CORPORATION

RESTRICTED STOCK AGREEMENT

THIS AGREEMENT is entered into on this 18th day of December, 2006 by and between Capstone Turbine Corporation (the "Company") with **Darren R. Jamison** ("Jamison") to evidence the award of the common stock of the Company that was made on December 18, 2006.

RECITALS:

WHEREAS, the Company, through action of the compensation committee of its board of directors taken on December 1, 2006, made a conditional award of the Company's Common Stock (the "Award") as an inducement to encourage Executive to accept an offer of employment as the Company's president and chief executive officer;

WHEREAS, the parties, in connection therewith, entered into a letter agreement dated December 1, 2006, that sets forth general terms of employment of the Executive by the Company, including the terms of the Award that is evidenced by this Agreement;

WHEREAS, the parties desire to set forth the terms of such Award and to acknowledge that the shares of Common Stock that may be acquired hereunder shall be registered under the Securities Act of 1933, as amended ("Securities Act") on Form S-8; and

WHEREAS, the parties further acknowledge that this Award is granted separately from the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "2000 Plan"), but desire that this Award be subject to the terms contained in the of the 2000 Plan, except as otherwise provided for herein;

NOW, THEREFORE, in consideration of these premises, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties do hereby agree to the following terms and conditions regarding the Award covered hereby:

I. NOTICE OF STOCK AWARD

Notice is hereby given of the grant of the Award, subject to the following terms. References in this Agreement to certain terms of the Award shall be as defined in this Article I:

Date of Grant:	December 18, 2006
Total Number of Shares:	500,000
Type of Award:	Restricted Stock Units
Term for Vesting:	4 Years

Transfer of Shares; Vesting Schedule:

Pursuant to the Award, ownership of the Common Stock shall be transferred to Executive on the dates and in the amounts described in this paragraph, subject to the Executive continuing to be either an Employee or a Consultant to the Company on such dates:

Transfer Date	Shares Transferred
December 18, 2007	125,000
December 18, 2008	Additional 125,000 shares
December 18, 2009	Additional 125,000 shares
December 18, 2010	Additional 125,000 shares

The Common Stock transferred to Executive pursuant to this Award shall be fully vested and not subject to restrictions or forfeiture on the respective transfer dates, except as provided in this Agreement. If Executive's employment is terminated by the Company other than for Cause prior to the one-year anniversary of the Date of Grant, Executive shall become vested in and have the vested right to receive a transfer of the Common Stock under this Award with respect to 1/48th of the number of Shares subject to the Award for each full month of employment following the Date of Grant, based on the day of the month corresponding to the Date of Grant, through the date of such termination.

Award Termination:

The Award shall terminate on the date that Executive ceases to be either an Employee or a Consultant of the Company. Upon termination, any unvested portion of the Award will lapse.

II. AGREEMENT

1. Grant of Award. This Award is subject to the terms set forth in Article I of this Agreement and, except as expressly provided for herein, the terms, definitions and provisions of the 2000 Plan regarding awards of Common Stock (including Stock Bonus grants), which are incorporated herein by reference. All capitalized terms used in this Agreement shall have the meanings ascribed to such terms in the 2000 Plan, except as may be otherwise defined herein. The Award evidenced in this Agreement is intended by the parties to be granted in fulfillment of the Company's obligation to award restricted stock pursuant to the letter agreement between the parties dated December 1, 2006; the terms of this Agreement completely replace and supersede the terms addressing the subject matter contained in such letter agreement.

2. Status of Executive. The Executive shall not be deemed a stockholder of the Company with respect to Common Stock covered by this Award and shall not be entitled to receive dividends and exercise voting rights with respect thereto until such Shares are Transferred to Executive on the dates described in Article I of this Agreement. The Company is not required to deliver shares of Common Stock to the Participant until all applicable requirements of law have been complied with and such shares shall have been duly listed on any securities exchange on which the Common Stock may then be listed. Any certificates

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representing the shares of Common Stock awarded pursuant to this Agreement shall be issued in the Participant's name.

3. Tax Withholding. At the time that any portion of the Award becomes vested and Shares are transferred to the Executive, the Company shall withhold from the Shares to be delivered to Executive a number of Shares that have a Fair Market Value equivalent to the tax withholdings that are required to be remitted by the Company to the appropriate governmental entity or entities on behalf of the Executive with respect to such transaction.

4. No Effect on Capital Structure. This Award shall not affect the right of the Company or any Subsidiary to reclassify, recapitalize or otherwise change its capital or debt structure or to merge, consolidate, convey any or all of its assets, dissolve, liquidate, windup, or otherwise reorganize.

5. Committee Authority. Any question concerning the interpretation of this Agreement, any adjustments required to be made under the Plan and any controversy that may arise under the Plan or this Agreement shall be determined by the Committee in its sole discretion. Such decision by the Committee shall be final and binding.

6. Lock-Up Period. Executive hereby agrees that if so requested by the Company or any representative of the underwriters (the "Managing Underwriter") in connection with any registration of the offering of any securities of the Company under the Securities Act or any applicable state laws, Executive shall not sell or otherwise transfer any Shares or other securities of the Company during the 180-day period (or such longer period as may be requested in writing by the Managing Underwriter and agreed to in writing by the Company) (the "Market Standoff Period") following the effective date of a registration statement of the Company filed under the Securities Act. The Company may impose stop-transfer instructions with respect to securities subject to the foregoing restrictions until the end of such Market Standoff Period.

7. Non-Transferability of Award. The Award may not be transferred in any manner except by will or by the laws of descent or distribution. It may be exercised during the lifetime of Executive only by Executive. The terms of the Award shall be binding upon the executors, administrators, heirs, successors and assigns of the Executive.

This Agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which shall constitute one document.

CAPSTONE TURBINE CORPORATION

By: /s/ WALTER J. MCBRIDE
Walter J. McBride
Executive VP & Chief Financial Officer

EXECUTIVE ACKNOWLEDGES AND AGREES THAT THE TRANSFER AND VESTING OF SHARES PURSUANT TO THIS AWARD IS EARNED ONLY BY CONTINUING EMPLOYMENT OR CONSULTANCY AT THE WILL OF THE COMPANY (NOT THROUGH THE ACT OF BEING

HIRED, BEING GRANTED THE AWARD OR ACQUIRING SHARES HEREUNDER). EXECUTIVE FURTHER ACKNOWLEDGES AND AGREES THAT NOTHING IN THIS AGREEMENT, NOR IN THE CAPSTONE TURBINE CORPORATION 2000 EQUITY INCENTIVE PLAN, WHICH IS INCORPORATED HEREIN BY REFERENCE, SHALL CONFER UPON EXECUTIVE ANY RIGHT WITH RESPECT TO CONTINUATION OF EMPLOYMENT OR CONSULTANCY BY THE COMPANY, NOR SHALL IT INTERFERE IN ANY WAY WITH EXECUTIVE'S RIGHT OR THE COMPANY'S RIGHT TO TERMINATE EXECUTIVE'S EMPLOYMENT OR CONSULTANCY AT ANY TIME, WITH OR WITHOUT CAUSE.

Executive hereby acknowledges receipt of the 2000 Plan and a current prospectus for the offering represented by the grant of this

Award. Executive represents that he is familiar with the terms and provisions of the 2000 Plan and this Agreement and does hereby accept the Award subject to all of its terms. Executive has had an opportunity to obtain the advice of counsel prior to executing this Agreement and fully understands all provisions of this Agreement and the Award granted hereunder. Executive hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Committee upon any questions arising under the 2000 Plan or this Agreement. Executive further agrees to notify the Company upon any change in the residence address indicated below.

Dated: January 25, 2007

/s/ DARREN R. JAMISON
Darren R. Jamison

Residence Address: ______________________

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Exhibit 10.3

December 1, 2006

Mr. Darren R. Jamison
201 Hawley Road
Shelburne, Vermont 05482

Dear Darren:

I am pleased to offer you the position of President and Chief Executive Officer of Capstone Turbine Corporation reporting to the Board of Directors at a salary of $400,000.00 annually, payable at $15,400.00 bi-weekly.

In addition to your salary you will receive the following:

- A "Signing Bonus" of $150,000.00 payable at the first pay period following your start date.
- A Non-Statutory Stock Option to purchase 2,000,000 shares of Capstone common stock which includes 25% vesting on the first anniversary date and monthly thereafter subject to the provisions of the 2000 Equity Incentive Plan. The purchase price will be the fair market value of Capstone common stock on the option grant date, which is expected to be the date of the start of your employment.
- A restricted stock grant of 500,000 shares of Capstone common stock subject to annual vesting of 25% and other provisions of the 2000 Equity Incentive Plan.
- A Special Performance Bonus of $100,000.00 to be paid upon the achievement of Capstone cash flow positive for any two (2) consecutive quarters during the first two years of employment. Payment will be in addition to any payments pursuant to the bonus plan noted in the following bullet.
- A cash bonus each year based on performance targets negotiated with the Compensation Committee of the Board with respect to each year in which the Company reports, after taking into account any such bonus, an operating profit. The target bonus shall be 100% of your base salary.
- Relocation provisions to include the third party purchase of your home in Vermont within 60 days of the start of your employment, with a provision for your family to use the home until their relocation in June, reasonable and customary relocation expenses including moving costs and two (2) trips per month from California to Vermont until June, 2007 (or such earlier date as you purchase and move into a home in California), interim housing allowance of $1,500.00 per month from January to June, 2007 and the shipment of your personal automobile to California. In addition, Capstone will reimburse you for expenses associated with your travel to your new place of residence. You agree that funds paid to you in conjunction with this relocation program must be repaid to Capstone if you voluntarily terminate your employment prior to your one (1) year anniversary with the Company. Also, Capstone will "gross-up" the taxable portion of your relocation expenses to insure that you do not incur addition personal income tax obligations.

You will be eligible to participate in the Capstone benefit plans which include paid holidays, four (4) weeks vacation per year, a 401(k) plan with Company match and several insurance choices for you and your family. Upon your first day of employment you will be required to sign our standard agreement with regard to confidentiality and the assignment of inventions.

Your employment at Capstone will be "at will" in that employment may be terminated with or without cause and with or without notice, at any time, either at your option or at the option of Capstone Turbine Corporation. Should you be terminated, without cause, during the first three (3) years of employment you will receive a termination benefit of continuation of your base salary for one (1) year. However, if your employment is terminated in connection with a change of control, instead of the termination benefit, you

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shall be entitled to an eighteen month (18) severance benefit which includes full acceleration of vesting of stock options and grants as detailed in our stock option plans. In addition, you will be required to resolve any disputes concerning your employment through the Capstone Dispute Resolution Procedure, details which will be made available to you under separate cover.

You will be covered by the Company's standard Indemnification Agreement and Directors and Officers Liability Policy.

As is our standard practice, you will be required to authorize Capstone to execute a standard background check, satisfactorily complete a drug screening test and provide proof of U.S. citizenship or qualification to work in the U.S.

We would like you to start as soon as possible and suggest a start date of December 18, 2006. This offer will expire at the close of business on December 6, 2006.

We are excited by the prospect of you becoming the President and Chief Executive Officer of Capstone, and believe that your leadership combined with the dedication and talent of our team will make the future of Capstone bright. All of us involved in the unique venture of Capstone look forward to working with you.

Sincerely,

/s/ ELIOT G. PROTSCH

Eliot G. Protsch
Chairman of the Board
Capstone Turbine Corporation

I hereby accept the employment offer as stated above:

/s/ DARREN R. JAMISON	December 4, 2006
Signature	Date

Exhibit 10.4

CHANGE OF CONTROL SEVERANCE AGREEMENT

THIS AGREEMENT ("the Agreement") is made and entered into between Capstone Turbine Corporation (the "Company") and **Darren R. Jamison** (the "Executive") to be effective December 18, 2006.

RECITALS:

WHEREAS, effective December 18, 2006, the Executive became the Company's president and chief executive officer pursuant to the terms of a letter agreement dated December 1, 2006, (the "Letter Agreement") which includes certain benefits and payments upon the severance of the Executive following a change in control of the Company;

WHEREAS, in connection therewith, the Executive has been made eligible for participation in the Capstone Turbine Corporation Change in Control Severance Plan (the "Plan"), which provides a portion of the severance benefits described in the Letter Agreement; and

WHEREAS, the parties desire to enter into this arrangement to provide the severance benefits described in the Letter Agreement that are not provided through the Plan;

NOW, THEREFORE, the parties do hereby agree to the following terms and conditions regarding severance payable to Executive in the events described herein:

Section 1. Termination of Employment Without Cause

In the event that Executive's employment is terminated by the Company for reasons other than Misconduct (as defined herein), the Executive will receive continuation of payments in the amount of his base salary then in effect for a period of one year following termination of employment. Provided, however, that the provisions of this Section 1 will not apply in the event that Executive is entitled to payments provided in Section 2 hereof. "Misconduct" shall mean the commission of any act of fraud, embezzlement, theft or dishonesty by Executive, any unauthorized use or disclosure by Executive of confidential information or trade secrets of the Company (or any parent or subsidiary thereof), or any other intentional misconduct by Executive adversely affecting the business or affairs of the Company (or any parent or subsidiary) in a material manner.

The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Company (or any parent or subsidiary) may consider as grounds for the termination of the employment of the Executive. Except as provided in Section 2, Executive will not be entitled to severance under this Agreement upon a termination of employment for reasons other than Misconduct.

Section 2. Termination Upon a Change in Control

In the event that Executive is Involuntarily Terminated within 12 months of a Change of Control or within the Trial Period, Executive shall be entitled to receive from the Company an amount equal to the base salary that would be payable to the Executive for a period of 18 months. The payment shall be made in one lump sum on the date of termination of employment. Notwithstanding anything herein to the contrary, the amount payable under this Section 2 shall be reduced by the amount of the cash severance amount payable to Executive under the Plan.

Section 3. General Terms

Except as otherwise provided herein, the capitalized terms used in this agreement shall have the meanings ascribed thereto in the Plan. The benefits provided through this Agreement and through the Plan are intended by the parties to be granted in fulfillment of the Company's obligations regarding cash severance payments pursuant to the Letter Agreement; the terms of this Agreement and the Plan completely replace and supersede the terms addressing the subject matter contained in the Letter Agreement.

Section 4. Term of Agreement

The provisions of this Agreement shall apply in the event of the termination of the employment of the Executive or a Change in Control that occurs during the period between December 18, 2006 and December 18, 2009.

Section 5. Commencement of Deferred Compensation Payments

Notwithstanding anything herein to the contrary, any payments to Executive that would be subject to an additional tax described in section 409A of the Internal Revenue Code shall commence six months following Executive's separation from service or, if sooner, upon the death of the Executive.

Section 6. Amendment or Termination

The Company may amend this Agreement in its sole discretion at any time, provided that any amendment that would diminish the rights of the Executive is subject to Executive's express written consent.

Section 7. Successors

This Agreement shall be binding upon and accrue to the benefit of any successors and assigns of the Company.

Section 8. Construction

This Agreement shall be construed under and enforced in accordance with the laws of the State of California.

IN WITNESS WHEREOF, the Company, acting through the undersigned authorized representative, has executed this instrument and the Executive has set his hand hereto on this the 25th day of January, 2007, but to be effective on the date first written above.

DARREN R. JAMISON	**CAPSTONE TURBINE CORPORATION**
/s/ DARREN R. JAMISON	By: /s/ LARRY COLSON
	Its: Executive Vice President, Human Resources

Exhibit 31.1

**CERTIFICATION OF THE 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**

I, Darren R. Jamison, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Capstone Turbine Corporation (the "Company");

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

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

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

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

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

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

   (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and

5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors:

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

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

Date: February 9, 2007

By: /s/ DARREN R. JAMISON
Darren R. Jamison
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION OF THE 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

I, Walter J. McBride, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Capstone Turbine Corporation (the "Company");

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

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

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

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

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

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

   (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and

5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors:

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

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

Date: February 9, 2007

By: /s/ WALTER J. McBRIDE

Walter J. McBride
Executive Vice President and
Chief Financial Officer

Exhibit 32.1

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 December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof ("the Report"), Darren R. Jamison, 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: February 9, 2007

/s/ DARREN R. JAMISON
Darren R. Jamison
President and Chief Executive Officer

Date: February 9, 2007

/s/ WALTER J. McBRIDE
Walter J. McBride
Executive Vice President and Chief Financial Officer