AMERICAN SUPERCONDUCTOR CORP /DE/
Form 10-Q
February 09, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended: December 31, 2006**

¨ **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**Commission File Number: 0-19672**

# American Superconductor Corporation

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **04-2959321** |
| **(State or other jurisdiction of** | **(I.R.S. Employer** |
| **incorporation or organization)** | **Identification No.)** |

**Two Technology Drive**

**Westborough, Massachusetts 01581**

**(Address of principal executive offices, including zip code)**

**(508) 836-4200**

**(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 x 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.

Large accelerated filer ¨ Accelerated filer x 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 x

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

| **Common Stock, par value $.01 per share** | **34,747,540** |
|---|---|
| **Class** | **Outstanding as of February 6, 2007** |

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | December 31, 2006 (Unaudited) | March 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 12,847,903 | $ 35,171,181 |
| Marketable securities | 28,766,070 | 30,497,424 |
| Accounts receivable, net | 11,375,180 | 9,014,035 |
| Inventory | 9,787,444 | 9,006,034 |
| Prepaid expenses and other current assets | 952,831 | 901,606 |
| Total current assets | 63,729,428 | 84,590,280 |
| Property, plant and equipment: | | |
| Land | 4,021,611 | 4,021,611 |
| Construction in progress - equipment | 7,362,636 | 1,971,019 |
| Building | 34,893,279 | 34,286,378 |
| Equipment | 42,095,152 | 40,405,415 |
| Furniture and fixtures | 3,368,361 | 3,341,075 |
| Leasehold improvements | 5,988,969 | 5,988,968 |
| | 97,730,008 | 90,014,466 |
| Less: accumulated depreciation | (47,462,762) | (45,234,899) |
| Property, plant and equipment, net | 50,267,246 | 44,779,567 |
| Goodwill | 1,107,735 | 1,107,735 |
| Other assets | 2,965,256 | 2,992,880 |
| Total assets | $ 118,069,665 | $ 133,470,462 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ 19,117,848 | $ 16,498,373 |
| Deferred revenue | 2,955,859 | 1,872,126 |
| Total current liabilities | 22,073,707 | 18,370,499 |
| Commitments and contingencies (Note 8) | | |
| Stockholders equity: | | |
| Common stock, $.01 par value | | |
| Authorized shares-100,000,000; shares issued and outstanding 33,447,032 and 32,890,264 at December 31, 2006 and March 31, 2006, respectively | 334,470 | 328,903 |
| Additional paid-in capital | 469,280,321 | 466,605,479 |
| Deferred compensation | | (1,330,393) |
| Deferred contract costs - warrant | (15,049) | (19,564) |
| Accumulated other comprehensive income (loss) | 21,591 | (105,181) |
| Accumulated deficit | (373,625,375) | (350,379,281) |
| Total stockholders equity | 95,995,958 | 115,099,963 |

| | | |
|---|---|---|
| Total liabilities and stockholders equity | $ 118,069,665 | $ 133,470,462 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Three months ended December 31, | | Nine months ended December 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | (Unaudited) | |
| Revenues: | | | | |
| Contract revenue | $ 389,642 | $ 426,078 | $ 1,533,478 | $ 1,464,011 |
| Product sales and prototype development contracts | 9,062,163 | 13,070,223 | 31,564,056 | 35,114,997 |
| Total revenues | 9,451,805 | 13,496,301 | 33,097,534 | 36,579,008 |
| Costs and expenses: | | | | |
| Costs of revenue-contract revenue | 381,332 | 353,718 | 1,263,934 | 1,254,603 |
| Costs of revenue-product sales and prototype development contracts | 11,069,836 | 14,519,086 | 33,232,167 | 37,326,939 |
| Research and development | 4,099,071 | 4,039,399 | 11,700,387 | 11,198,344 |
| Selling, general and administrative | 4,112,167 | 2,862,118 | 12,026,698 | 8,622,473 |
| Total costs and expenses | 19,662,406 | 21,774,321 | 58,223,186 | 58,402,359 |
| Operating loss | (10,210,601) | (8,278,020) | (25,125,652) | (21,823,351) |
| Interest income | 510,454 | 676,777 | 1,779,256 | 1,909,779 |
| Other income (expense), net | 153,848 | 149,324 | 100,302 | 64,422 |
| Net loss | $ (9,546,299) | $ (7,451,919) | $ (23,246,094) | $ (19,849,150) |
| Net loss per common share | | | | |
| Basic and Diluted | $ (0.29) | $ (0.23) | $ (0.71) | $ (0.61) |
| Weighted average number of common shares outstanding | | | | |
| Basic and Diluted | 32,965,989 | 32,592,878 | 32,889,911 | 32,696,223 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

| | Three months ended December 31, | | Nine months ended December 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | (Unaudited) | |
| Net loss | $ (9,546,299) | $ (7,451,919) | $ (23,246,094) | $ (19,849,150) |
| Other comprehensive income (loss) | | | | |
| Foreign currency translation | 2,689 | (737) | 4,332 | (1,735) |
| Unrealized gain (loss) on marketable securities | 4,328 | (18,890) | 122,440 | 8,801 |
| Other comprehensive income (loss) | 7,017 | (19,627) | 126,772 | 7,066 |
| Comprehensive loss | $ (9,539,282) | $ (7,471,546) | $ (23,119,322) | $ (19,842,084) |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Nine months ended December 31, 2006 | 2005 |
|---|---|---|
| | (Unaudited) | |
| Cash flows from operating activities: | | |
| Net loss | $ (23,246,094) | $ (19,849,150) |
| Adjustments to reconcile net loss to net cash used in operations: | | |
| Depreciation and amortization | 3,057,986 | 5,748,665 |
| Stock-based compensation expense | 2,718,934 | 343,301 |
| Stock-based compensation expense - non-employee | 159,310 | |
| Loss on disposal of PP&E and abandoned patents | 54,008 | 127,280 |
| Amortization of deferred warrant costs | 4,515 | 4,515 |
| Gain on re-valuation of warrant | (110,760) | (69,900) |
| Changes in operating asset and liability accounts : | | |
| Accounts receivable | (2,361,145) | (432,821) |
| Inventory | (781,410) | (1,911,644) |
| Prepaid expenses and other current assets | (47,106) | (105,169) |
| Accounts payable and accrued expenses | 2,730,235 | (652,884) |
| Deferred revenue | 1,083,733 | 947,447 |
| Net cash used in operating activities | (16,737,794) | (15,850,360) |
| Cash flows from investing activities: | | |
| Purchase of property, plant and equipment | (7,926,718) | (1,071,598) |
| Proceeds from the sale of property, plant and equipment | 51,500 | 23,435 |
| Purchase of marketable securities | (58,413,919) | (75,598,454) |
| Proceeds from the sale of marketable securities | 60,267,713 | 84,537,285 |
| Increase in other assets | (696,618) | (549,807) |
| Net cash (used in) provided by investing activities | (6,718,042) | 7,340,861 |
| Cash flows from financing activities: | | |
| Proceeds from issuances of common stock | 1,132,558 | 962,767 |
| Net cash provided by financing activities | 1,132,558 | 962,767 |
| Net decrease in cash and cash equivalents | (22,323,278) | (7,546,732) |
| Cash and cash equivalents at beginning of period | 35,171,181 | 38,592,032 |
| Cash and cash equivalents at end of period | $ 12,847,903 | $ 31,045,300 |
| Noncash issuance of common stock | $ | $ 629,145 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

## 1. Nature of the Business and Operations

American Superconductor Corporation (the Company or AMSC) was founded on April 9, 1987. The Company is focused on developing, manufacturing and selling products using two core technologies: high temperature superconductor (HTS) wires and power electronic converters for electric power applications. The Company also assembles superconductor wires and power electronic converters into fully-integrated products, such as HTS ship propulsion motors and dynamic reactive compensation systems, which the Company sells or plans to sell to end users. The Company operates in three business segments AMSC Wires, SuperMachines and Power Electronic Systems.

The Company has generated operating losses since its inception in 1987 and expects to continue incurring losses until at least the end of fiscal 2009. Operating losses for the fiscal years ended March 31, 2006, 2005 and 2004 have contributed to net cash used by operating activities of $19,588,588, $9,283,107 and $17,421,953, respectively, for these periods. For the nine months ended December 31, 2006, net cash used by operating activities was $16,737,794.

The Company had cash, cash equivalents and short-term marketable securities of $41,613,973 as of December 31, 2006. To supplement the Company s cash available for operations, as well as for capital expenditures for the scale-up of manufacturing of second generation (2G) wire, the Company issued 4,600,000 shares of its common stock in a public equity offering in March 2005 that raised $45,540,000 (after deducting underwriting commissions and discounts but before deducting offering expenses).

The Company currently derives a portion of its revenue from research and development contracts. The Company recorded contract revenue related to research and development contracts of $389,642 and $426,078 for the three months ended December 31, 2006 and 2005, respectively, and $1,533,478 and $1,464,011 for the nine months ended December 31, 2006 and 2005, respectively. In addition, the Company recorded prototype development contract revenue on U.S. Navy and other contracts of $925,395 and $8,731,222 for the three months ended December 31, 2006 and 2005, respectively, and $11,323,406 and $16,742,882 for the nine months ended December 31, 2006 and 2005, respectively which are included under Revenues Product sales and prototype development contracts.

Costs of revenue include research and development (R&D) and selling, general, and administrative (SG&A) expenses that are incurred in the performance of these development contracts.

R&D and SG&A expenses included as costs of revenue were as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | (Unaudited) | |
| Research and development expenses | $ 5,181,215 | $ 9,432,938 | $ 17,230,558 | $ 22,215,435 |
| Selling, general and administrative expenses | $ 769,576 | $ 1,986,219 | $ 3,303,554 | $ 3,934,804 |

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**2. Basis of Presentation**

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles. The unaudited condensed consolidated financial statements of the Company presented herein have been prepared in accordance with the Securities and Exchange Commission s (SEC) instructions to Form 10-Q and as such do not include all of the information and note disclosures included in annual financial statements prepared in accordance with generally accepted accounting principles. Certain information and footnote disclosure normally included in the Company s annual consolidated financial statements have been condensed or omitted. The interim condensed consolidated financial statements, in the opinion of management, reflect all adjustments (consisting of normal recurring accruals) necessary for a fair statement of the results for the interim periods ended December 31, 2006 and 2005 and the financial position at December 31, 2006.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the fiscal year. The Company suggests that these interim condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements for the fiscal year ended March 31, 2006 which are contained in the Company s Annual Report on Form 10-K covering the fiscal year ended March 31, 2006.

**3. Stock-Based Compensation**

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, which requires the Company to account for stock-based payment transactions using a fair value-based method and recognize the related expense in the results of operations. The Company applied the provisions of Staff Accounting Bulletin No. 107 in its adoption of SFAS No. 123(R). Prior to its adoption of SFAS No. 123(R), the Company accounted for stock-based payments to employees using the Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, intrinsic value method and, therefore, the Company recognized compensation expense for restricted stock awards and did not recognize compensation cost for employee stock options where the exercise price of the stock option was equal to the market value of the underlying common stock on the date of grant. SFAS No. 123(R) allows companies to choose one of two transition methods: the modified prospective method or the modified retrospective transition method. Effective April 1, 2006, the Company elected the modified prospective method of transition and accordingly has not restated the results of prior periods. Stock-based compensation expense includes expense for the unvested awards outstanding at March 31, 2006 and all awards granted subsequent to March 31, 2006.

Under the fair value recognition provisions of SFAS No. 123(R), stock-based compensation is estimated at the grant date based on the fair value of the award and is recognized as expense over the requisite service period of the award. The fair value of restricted stock awards is determined by reference to the fair market value of the Company s common stock on the date of grant. Consistent with the valuation method the Company used for disclosure-only purposes under the provisions of SFAS No. 123, the Company uses the Black-Scholes model to value service condition and performance condition awards under SFAS No. 123(R). For awards with service conditions, the Company recognizes compensation cost on a

**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

straight-line basis over the requisite service/vesting period. For awards with service and performance conditions and graded-vesting features (a certain percentage of stock awards vest each period), the Company recognizes compensation costs on an accelerated, graded-vesting basis over the requisite service/vesting period. The Company uses the lattice model to value market condition awards. For awards with market conditions with a single cliff vest feature, the Company recognizes compensation costs on a straight-line basis over the requisite service period.

Determining the appropriate fair value model and related assumptions requires judgment, including estimating stock price volatilities of the Company s common stock, forfeiture rates and expected terms. The expected volatility rates are estimated based on historical and implied volatilities of the Company s common stock. The expected term represents the average time that the options that vest are expected to be outstanding based on the vesting provisions and the Company s historical exercise, cancellation and expiration patterns. The Company estimates pre-vesting forfeitures when recognizing compensation expense based on historical and forward-looking factors. Changes in estimated forfeiture rates and differences between estimated forfeiture rates and actual experience may result in significant, unanticipated increases or decreases in stock-based compensation expense from period to period. The termination of employment by certain employees who hold large numbers of stock-based compensation instruments may also have a significant, unanticipated impact on forfeiture experience and, therefore, on stock-based compensation expense. The Company will update these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are warranted.

The estimated fair value of the Company s stock-based awards, less expected annual forfeitures of 15%, is amortized over the awards service period. Based on the fair value of options, restricted stock and employee stock purchase rights, the Company recognized stock-based compensation expense of $919,997 and $2,718,934 for the three and nine months ended December 31, 2006, respectively. The total unrecognized compensation cost for unvested stock-based compensation awards outstanding at December 31, 2006 is $4.7 million. This expense will be recognized over a weighted average expense period of approximately 1.6 years.

The Company s financial statements for periods prior to April 1, 2006 for which stock-based compensation was accounted for under APB No. 25, Accounting for Stock Issued to Employees, have not been restated. The adoption of SFAS No. 123(R) had a significant impact on the Company s results of operations. The Company s consolidated statement of operations for the three and nine months ended December 31, 2006 includes the following stock-based compensation expense:

| **Stock-based compensation in the Statement of Operations by line item** | **For three months ended December 31, 2006** | **For nine months ended December 31, 2006** |
|---|---|---|
| Costs of revenue-product sales | $ 111,038 | $ 279,398 |
| Research and development | 228,097 | 659,781 |
| Selling, general and administrative | 580,862 | 1,779,755 |
| Total stock-based compensation expense | $ 919,997 | $ 2,718,934 |

Stock-based compensation costs are classified in costs of revenue and operating expenses consistent with the classification of cash compensation paid to the same employees. As a result

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

of the adoption of SFAS No.123(R), stock-based compensation expense (excluding restricted stock awards) increased the net loss and net loss per share by $522,479 and $0.02 and $1,417,054 and $0.04 for the three and nine months ended December 31, 2006, respectively, than if the Company had continued to account for stock-based compensation under APB Opinion No. 25. In addition, stock compensation expense included $397,518 and $1,301,880 for the three and nine months ended December 31, 2006, respectively, relating to restricted stock and stock awards that would have been recognized as expense under APB No. 25.

The components of stock-based compensation for the three and nine months ended December 31, 2006 were as follows:

| Stock-based compensation expense by type of award | For three months ended December 31, 2006 | For nine months ended December 31, 2006 |
|---|---|---|
| Stock options | $ 508,890 | $ 1,371,102 |
| Restricted stock and stock awards | 397,518 | 1,301,880 |
| Employee stock purchase plan | 13,589 | 45,952 |
| Total stock-based compensation expense | $ 919,997 | $ 2,718,934 |

The following table summarizes information about employee and non-employee stock options, warrants and unvested restricted stock outstanding at December 31, 2006:

| Range of Exercise Prices | | Outstanding: Number Outstanding at December 31, 2006 | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Exercisable: Number Exercisable at December 31, 2006 | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life |
|---|---|---|---|---|---|---|---|
| $ 0.00 | 5.89 | 842,711 | $ 1.61 | 7.8 | 332,153 | $ 3.59 | |
| 5.89 | 11.78 | 1,859,606 | 9.84 | 5.4 | 1,338,264 | 9.92 | |
| 11.78 | 17.66 | 901,510 | 13.16 | 4.7 | 717,805 | 13.11 | |
| 17.66 | 29.44 | 387,500 | 25.64 | 3.3 | 387,500 | 25.64 | |
| 29.44 | 35.33 | 750,000 | 32.56 | 3.6 | 750,000 | 32.56 | |
| 35.33 | 41.21 | 5,000 | 40.75 | 3.6 | 5,000 | 40.75 | |
| 41.21 | 58.88 | 40,000 | 58.88 | 3.2 | 40,000 | 58.88 | |
| $ 0.00 | 58.88 | 4,786,327 | $ 14.30 | 5.2 | 3,570,722 | $ 17.03 | 4.10 |

The following table summarizes the information concerning currently outstanding and exercisable employee and non-employee options and warrants:

| | Options/ Shares | Weighted average Exercise Price | Number Exercisable |
|---|---|---|---|
| Outstanding at March 31, 2006 | 4,468,750 | $ 15.62 | 3,331,228 |
| Granted at fair value | 235,500 | 10.02 | |
| Exercised | (158,361) | 5.86 | |
| Forfeited/canceled | (222,980) | 12.61 | |
| Outstanding at December 31, 2006 | 4,322,909 | $ 15.83 | 3,570,722 |
| Available for grant at December 31, 2006: | 1,683,157 | | |

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

The weighted-average grant-date fair value of time-based stock option awards granted during the nine months ended December 31, 2006 was $6.08 per share. The aggregate intrinsic value of all outstanding options at December 31, 2006 was $3,148,882. The aggregate intrinsic value of exercisable options at December 31, 2006 was $2,615,937 and the aggregate intrinsic value of options exercised during the three and nine months ended December 31, 2006 was $81,418 and $719,661, respectively. Intrinsic value represents the amount by which the market price of the common stock exceeds the exercise price of the options. The total fair value of options vested during the three and nine months ended December 31, 2006 was $25,250 and $2,861,469, respectively.

The cash proceeds from employee stock purchases and option exercises under all stock-based payment arrangements for the three and nine months ended December 31, 2006 were $212,052 and $1,132,558, respectively.

The weighted average assumptions used in the Black-Scholes valuation model for stock options granted during the three and nine months ended December 31, 2006 are as follows:

| | For three months ended December 31, 2006 | For nine months ended December 31, 2006 |
|---|---|---|
| Dividend yield | None | None |
| Expected volatility | 61.10% | 62.20% |
| Risk-free interest rate | 4.625% | 4.7% |
| Expected life (years) | 5.8 | 5.8 |

The expected volatility rate was estimated based on an equal weighting of the historical volatility of the Company s common stock and the implied volatility of the Company s traded options. The expected term was estimated based on an analysis of the Company s historical experience of exercise, cancellation, and expiration patterns. The risk-free interest rate is based on five-year U.S. Treasury rates.

The following table summarizes the employee and non-employee restricted stock activity for the nine months ended December 31, 2006:

| | Shares | Weighted average grant date fair value | Weighted average remaining contractual life |
|---|---|---|---|
| Outstanding at March 31, 2006 | 210,225 | $ 10.36 | 8.71 |
| Granted | 355,288 | 9.88 | |
| Vested | (87,800) | 9.90 | |
| Forfeited | (14,295) | 10.24 | |
| Outstanding at December 31, 2006 | 463,418 | $ 10.08 | 9.08 |

The total fair value of time-based restricted stock that vested during the three and nine months ended December 31, 2006 was $0 and $881,015, respectively.

**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

***Pro forma Information under SFAS 123 and APB25***

Prior to April 1, 2006, the Company accounted for its stock plans under the provisions of APB No. 25 and elected to apply the disclosure only provisions of SFAS No. 123. Had compensation cost for awards granted under the Company s stock-based compensation plan been determined based on the fair value at the grant dates consistent with the method set forth under SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, the effect on certain financial information of the Company would have been as follows for the three and nine months ended December 31, 2005:

| | For three months ended December 31, 2005 | For nine months ended December 31, 2005 |
|---|---|---|
| Net loss | $ (7,451,919) | $ (19,849,150) |
| Add: Stock compensation expense under APB 25 in the statements of operations | 99,500 | 343,301 |
| Less: Stock compensation costs, net of tax, had all options been recorded at fair value per SFAS 123 | (814,250) | (2,661,551) |
| Pro forma net loss | $ (8,166,669) | $ (22,167,400) |
| Weighted average shares, basic and diluted | 32,592,878 | 32,696,223 |
| Net loss per share, as reported | $ (0.23) | $ (0.61) |
| Net loss per share, pro forma | $ (0.25) | $ (0.68) |

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants:

| | For three months ended December 31, 2005 | For nine months ended December 31, 2005 |
|---|---|---|
| Dividend yield | None | None |
| Expected volatility | N/A | 51.01% |
| Risk-free interest rate | N/A | 3.875% |
| Expected life (years) | N/A | 6.12 |

The weighted-average fair value of options granted was $5.85 for the nine months ended December 31, 2005. There were no options granted during the three months ended December 31, 2005.

***Stock-Based Compensation Plans***

The Company has two active stock plans: the Second Amended and Restated 1997 Director Stock Option Plan (the 1997 Director Plan) and the 2004 Stock Incentive Plan (the 2004 Plan).

The Plans provide for the issuance of restricted stock, incentive stock options and non-qualified stock options to purchase the Company s common stock. In the case of incentive stock options, the exercise price shall be equal to at least the fair market value of the common stock, as determined by the Board of Directors, on the date of grant. The contractual life of options is generally 10 years. Options generally vest over a 3-5 year period while restricted stock generally vests over a 2-5 year period. The 1997 Director Plan is for members of the Board of Directors

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

who are not also employees of the Company (outside directors). Effective July 27, 2006 under the 1997 Director Plan, each outside director will receive an annual award of 5,000 fully-vested shares of common stock. The 1997 Director Plan has 270,000 shares available for future issuance and the 2004 Plan has 1,240,157 shares available for future issuance.

***Employee Stock Purchase Plan***

Effective April 1, 2006, the Company amended its employee stock purchase plan (ESPP) to eliminate the look-back option feature but retained the 15% purchase discount. The Company recognized compensation expense of $13,589 for the three months ended December 31, 2006 and $45,952 for the nine months ended December 31, 2006 related to the ESPP. The ESPP has 111,343 shares available for future issuance.

**4. Net Loss per Common Share**

Basic earnings per share (EPS) is computed by dividing net loss available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed using the weighted average number of common shares and dilutive common equivalent shares outstanding during the period. Common equivalent shares include the effect of the exercise of stock options and warrants, and unvested restricted stock. For the three and nine months ended December 31, 2006 and 2005, common equivalent shares of 4,786,327 and 4,886,216, respectively, were not included in the calculation of diluted EPS as they were considered antidilutive.

**5. Accounts Receivable**

Accounts receivable at December 31, 2006 and March 31, 2006 consisted of the following:

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| Accounts receivable (billed) | $ 3,804,445 | $ 5,148,407 |
| Accounts receivable (unbilled) | 7,570,735 | 3,865,628 |
| Total accounts receivable | $ 11,375,180 | $ 9,014,035 |

Revenues on prototype development contracts and certain product sales are recognized on a percentage of completion basis, but milestone payments can only be billed upon the completion of the individual milestones. A contract modification for the U.S. Navy 36.5 megawatt (MW) motor program was received on April 26, 2006, converting the contract from a cost-plus-incentive-fee contract to a firm-fixed-price contract with milestone-based billings. The unbilled receivable balance at December 31, 2006 includes $5,012,906 for the 36.5 MW motor program compared to $516,426 at March 31, 2006. It is anticipated that the majority of such unbilled accounts receivable will be billed during the quarter ending March 31, 2007 as milestones are achieved.

**6. Inventory**

Inventories at December 31, 2006 and March 31, 2006 consisted of the following:

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| Raw materials | $ 692,619 | $ 948,422 |
| Work-in-progress | 4,485,261 | 2,202,152 |
| Finished goods | 1,888,569 | 2,773,413 |
| Deferred program costs | 2,720,995 | 3,082,047 |
| | $ 9,787,444 | $ 9,006,034 |

Deferred program costs of $2,720,995 as of December 31, 2006 represent costs incurred in excess of funding on a Department of Energy (DOE) sponsored program to install a HTS power cable in the transmission grid of the Long Island Power Authority (LIPA). These costs include material, labor, overhead and subcontractor costs incurred and were recorded as inventory because receipt of future funding sufficient to cover these deferred costs was deemed probable. During the three months ended December 31, 2006, the Company received incremental funding from the DOE of $397,000. In addition, in January 2007 the Company received additional incremental funding from the DOE of $799,665. The Company expects the remaining deferred program costs of $1,921,330 to be recovered as the DOE continues to release incremental funding over the next several months under Continuing Resolution. During the three months ended December 31, 2006, costs of revenue include $1,916,300 in costs on the LIPA project that have been incurred through December 31, 2006, in excess of the current contract ceiling of $23,455,561. These costs incurred in excess of the contract ceiling as of December 31, 2006 were expensed as incurred to costs of revenues in the third quarter of fiscal 2007 because funding necessary to recover these costs was not deemed probable as of December 31, 2006 in the absence of a contract modification from the DOE to cover the cost growth on the current contract.

The deferred program costs of $3,082,047 as of March 31, 2006 represent costs incurred in excess of funding on the U.S. Navy program to build a 36.5 MW motor. These costs were relieved from inventory and the related revenue was recognized in the first quarter of fiscal 2007 upon receipt of incremental funding from the Navy in April 2006. During the three months ended December 31, 2006, as a result of cost overruns and changes in estimates, the Company recorded an estimated loss accrual of approximately $1,616,000 related to the Navy 36.5MW motor program.

Finished goods inventory includes the cost of products shipped to customers on contracts on which revenue will be deferred until final customer acceptance.

**7. Accounts Payable and Accrued Expenses**

Accounts payable and accrued expenses at December 31, 2006 and March 31, 2006 consisted of the following:

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| Accounts payable | $ 10,047,459 | $ 7,758,543 |
| Accrued expenses | 3,940,715 | 2,484,094 |
| Accrued subcontractor program costs | 2,744,804 | 3,869,351 |
| Accrued litigation costs (including warrants) | 835,500 | 946,260 |
| Accrued vacation | 788,313 | 881,444 |
| Accrued management bonus | 761,057 | 558,681 |
| Accounts payable and accrued expenses | $ 19,117,848 | $ 16,498,373 |

**8. Commitments and Contingencies**

Under Delaware law and the Company s by-laws, the Company is required to indemnify its officers and directors for liabilities incurred under certain circumstances. The maximum potential amount of future payments the Company could be required to make is unlimited; however, the Company has a Director and Officer insurance policy that limits its indemnification exposure and enables it to recover a portion of certain future amounts paid. As a result of its insurance policy coverage, the Company believes its indemnification exposure is minimal. These indemnification obligations were grandfathered under the provisions of Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 45 as they were in effect prior to March 31, 2003. Accordingly, the Company has no liabilities recorded under FIN No. 45 as of December 31, 2006.

The Company received notice on November 5, 2003 of a lawsuit filed against it on October 28, 2003 in the Court of Chancery of the State of Delaware in and for New Castle County by TM Capital Corp. (TM Capital), a past financial advisor to the Company, under which TM Capital claimed to be entitled to cash and equity compensation with respect to the Company s October 2003 public equity offering.

On April 4, 2005, the Company and TM Capital agreed to resolve all claims between them and entered into a settlement agreement that provides for, among other things, the cash payment by the Company to TM Capital of $1,700,000 and the issuance by the Company to TM Capital of a common stock purchase warrant for 200,000 shares of the Company s common stock, exercisable for a five-year term, with an exercise price of $9.50 per share (the Warrant). The Company valued the Warrant at $953,340 as of March 31, 2005 using the Black-Scholes method.

The Company and TM Capital also entered into a registration rights agreement wherein the Company agreed to register for public resale the shares of the Company s common stock issuable upon exercise of the Warrant. In connection with the settlement, the Company recorded the liability on its balance sheet as of March 31, 2005 and the SG&A expense of $2,653,340 on its Statement of Operations for the year ended March 31, 2005.

The accrued warrant cost will continue to be classified as a current liability in accordance with Emerging Issues Task Force (EITF) Issue No. 00-19 until such time as the Warrant is exercised, and will be marked to market based primarily on the current price and expected volatility of the Company s common stock as of the end of each reporting period. The Warrant was re-valued at $835,500 as of December 31, 2006, resulting in a gain of $110,760 (reported

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

under Other income (expense) in the Condensed Consolidated Statements of Operations for the nine months ended December 31, 2006), compared to the March 31, 2006 warrant valuation of $946,260. The following Black-Scholes assumptions were used:

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| Expected volatility | 50.15% | 52.4% |
| Risk-free interest rate | 4.63% | 4.63% |
| Expected life (years) | 3.25 | 4.0 |

**9. Cost-Sharing Arrangements**

The Company has entered into several cost-sharing arrangements with various agencies of the United States government. Funds paid to the Company under these agreements are not reported as revenues but are used to directly offset a portion of the Company s R&D and SG&A expenses, and to purchase capital equipment. The Company recorded costs and funding under these agreements of $1,819,054 and $746,241, respectively, for the three months ended December 31, 2006 and $1,115,417 and $553,254, respectively, for the three months ended December 31, 2005. The Company recorded costs and funding under these agreements of $5,411,304 and $2,289,880, respectively, for the nine months ended December 31, 2006 and $1,750,812 and $861,889, respectively, for the nine months ended December 31, 2005. At December 31, 2006, total funding received to date under these agreements was $22,551,000.

**10. Business Segment Information**

The Company has three reportable business segments AMSC Wires, SuperMachines, and Power Electronic Systems.

The AMSC Wires business segment develops, manufactures and sells HTS wire. The focus of this segment s current development, manufacturing and sales efforts is on HTS wire for power transmission cables, motors, generators, synchronous condensers, fault current limiters, and specialty electromagnets.

The SuperMachines business segment develops and commercializes electric motors, generators, and synchronous condensers based on HTS wire. Its primary focus for motors and generators is on ship propulsion.

The Power Electronic Systems business segment develops and sells power electronic converters and designs, manufactures and sells integrated systems based on those converters for power quality and reliability solutions and for wind farm applications.

A majority of the Company s sales are to U.S.-based customers. All of the Company s revenue transactions are originated and fulfilled from the U.S.

The operating results for the three business segments are as follows:

**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

| Revenues* | Three Months Ended December 31, 2006 | Three Months Ended December 31, 2005 | Nine Months Ended December 31, 2006 | Nine Months Ended December 31, 2005 |
|---|---|---|---|---|
| AMSC Wires | $ 1,342,997 | $ 3,207,299 | $ 4,238,818 | $ 10,015,413 |
| SuperMachines | 991,230 | 8,862,816 | 11,720,055 | 17,136,116 |
| Power Electronic Systems | 7,117,578 | 1,426,186 | 17,138,661 | 9,427,479 |
| Total | $ 9,451,805 | $ 13,496,301 | $ 33,097,534 | $ 36,579,008 |

* See Note 9. Cost-sharing funding is not included in reported revenues.

| Operating income (loss) | Three Months Ended December 31, 2006 | Three Months Ended December 31, 2005 | Nine Months Ended December 31, 2006 | Nine Months Ended December 31, 2005 |
|---|---|---|---|---|
| AMSC Wires | $ (4,796,418) | $ (5,526,202) | $ (12,830,390) | $ (16,237,645) |
| SuperMachines | (4,525,143) | (248,746) | (8,105,469) | (673,180) |
| Power Electronic Systems | 438,991 | (1,940,080) | (56,234) | (3,160,581) |
| Unallocated corporate expense** | (1,328,031) | (562,992) | (4,133,559) | (1,751,945) |
| Total | $ (10,210,601) | $ (8,278,020) | $ (25,125,652) | $ (21,823,351) |

** Unallocated corporate expenses include stock-based compensation expense of $919,997 and $99,500 for the three months ended December 31, 2006 and December 31, 2005, respectively; and $2,718,934 and $343,301 for the nine months ended December 31, 2006 and December 31, 2005, respectively.

The assets for the three business segments (plus Corporate cash and marketable securities) are as follows:

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| AMSC Wires | $ 56,468,352 | $ 51,897,218 |
| SuperMachines | 10,068,833 | 7,491,753 |
| Power Electronic Systems | 9,918,507 | 8,412,886 |
| Corporate cash and marketable securities | 41,613,973 | 65,668,605 |
| Total | $ 118,069,665 | $ 133,470,462 |

The accounting policies of the business segments are the same as those for the consolidated Company, except that certain corporate expenses which the Company does not believe are specifically attributable or allocable to any of the three business segments have been excluded from the segment operating income (loss). Corporate unallocated expenses include the rent and occupancy costs associated with the unoccupied portion of the Company s Westborough, MA corporate headquarters and stock-based compensation expenses.

**11. Expiration of Stock Rights**

On June 20, 2006, the Company amended the Rights Agreement dated as of October 30, 1998, as amended (the Rights Agreement), between the Company and American Stock Transfer & Trust Company, as Rights Agent, to change the final expiration date of the rights issued under the Rights Agreement from October 30, 2008 to June 30, 2006. As a result of such amendment, the rights expired and the Rights Agreement effectively terminated as of June 30, 2006.

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

**12. New Accounting Pronouncements**

A discussion of recent accounting pronouncements is included in Note 17 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006.

In June 2006, the FASB ratified the consensus reached by the EITF on Issue no. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF 06-3). EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, and some excise taxes. EITF 06-3 concluded that the presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed. In addition, for any such taxes that are reported on a gross basis, EITF 06-3 prescribes that a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The provisions of EITF 06-3 should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006 with earlier adoption permitted. The Company is currently evaluating the provisions of EITF 06-3.

In July 2006, the FASB issued Interpretation No. 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. FIN 48 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 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The Company is currently evaluating the provisions of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 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 157 does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier adoption permitted. The provisions of SFAS 157 should be applied prospectively as of the beginning of the fiscal year in which it is initially applied, with limited exceptions. The Company is currently evaluating the provisions of SFAS 157.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements expressing the Staff s views regarding the process of quantifying financial statement misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement errors: the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement including

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**AMERICAN SUPERCONDUCTOR CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**

**(unaudited)**

the reversing effect of prior year misstatements but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of the error on each financial statement and the related financial statement disclosure. This model is commonly referred to as a dual approach because it essentially requires quantification of errors under both the iron-curtain and the roll-over methods. The provisions of SAB 108 should be applied to annual financial statements covering the first fiscal year ending after November 15, 2006. The Company is currently evaluating the provisions of SAB 108.

**13. Subsequent Event**

On January 5, 2007, the Company completed the acquisition of Windtec Consulting GmbH (Windtec$^{TM}$). Windtec is an Austria-based designer and licensor of wind turbine systems and a provider of wind turbine electrical systems. Windtec is now a wholly-owned subsidiary of the Company and will be operated by its Power Electronic Systems business unit. The Windtec purchase price was 1.3 million shares of common stock of the Company, valued at approximately $13.1 million based on a five-day average stock price of $10.08 per share at the time of signing the definitive acquisition agreements on November 28, 2006. The shares are subject to a lockup whereby the former sole owner and founder of Windtec may sell only a certain number of shares per year through January 2010. The all-stock transaction also includes an earn-out opportunity with the potential for the issuance of up to an additional 1.4 million shares of common stock of the Company to the former owner and founder based on the achievement by Windtec of certain revenue growth targets for the fiscal years ending March 31, 2008 through March 31, 2011. The transaction includes the acquisition of 27 patents and patents pending worldwide on wind turbine technology. The Company assumed no debt in this transaction. Prior to the acquisition of Windtec by the Company, Windtec was a customer of the Company s Power Electronic Systems business unit for which the Company recognized revenues on sales of its products to Windtec of $845,592 and $2,584,330 for the three and nine month periods ended December 31, 2006, respectively. Windtec s results of operations will be included in the Company s consolidated financial statements beginning on January 5, 2007.

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**AMERICAN SUPERCONDUCTOR CORPORA TION**

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

**Executive Overview**

American Superconductor Corporation was founded in 1987. We are focused on developing, manufacturing and selling products using two core technologies: high temperature superconductor (HTS) wires and power electronic converters for electric power applications. We also assemble superconductor wires and power electronic converters into fully integrated products, such as HTS ship propulsion motors and dynamic reactive compensation systems, which we sell or plan to sell to end users. Current or prospective customers for our products include electric utilities, electrical equipment manufacturers, wind farm developers, owners and operators, industrial power users and commercial and military shipbuilders.

Our HTS wire addresses constraints on the power by increasing the electric current carrying capacity of the transmission cables comprising these power grids and by providing for the manufacture of controllable alternating current power cables. In addition, our HTS wire, when incorporated into primary electrical equipment such as motors and generators, can provide increased manufacturing and operating savings due to a significant reduction in the size and weight of this equipment. Also, our power electronic converters increase the quantity, quality and reliability of electric power that is transmitted by electric utilities or consumed by large industrial entities.

Our products are in varying stages of commercialization. Our power electronic converters have been sold commercially, as part of an integrated system, to utilities, manufacturers and wind farm developers, owners and operators since 1999. Our HTS wire has been produced commercially since the beginning of 2003, although its principal applications (power cables, rotating machines, specialty magnets) are currently in the prototype stage. Some of these prototypes are funded by U.S. government contracts, primarily with the Department of Defense (DOD) and Department of Energy (DOE). One of our major contracts with the U.S. Navy was converted from cost-plus-incentive-fee contract to a firm-fixed-price contract on April 26, 2006. As such, it is subject to more financial risk in the event of unanticipated cost overruns. During the quarter ended December 31, 2006, a crack was discovered in a non-superconductor component of the 36.5 megawatt (MW) motor that required repair. This event caused an unanticipated cost overrun on the Navy 36.5 MW contract that resulted in an estimated loss of approximately $1,616,000 being recorded in the quarter ended December 31, 2006. The crack has been fully repaired and reassembly of the motor is nearly complete. The motor is expected to be delivered to the Navy in March 2007.

The site for the Long Island Power Authority (LIPA) 138,000 volt (138kV) HTS cable system in Hauppauge, New York has now been fully prepared, the cryogenics system has been completed and is operating, and the cables have been manufactured and will begin going into the ground in the spring of 2007. Commissioning is scheduled for the summer of 2007. Funding for the project from the DOE continues to be handled under Continuing Resolution. As a result, the DOE was unable to fully release the remaining incremental funding up to the current

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authorized contract ceiling of $23,455,000 during the period ended December 31, 2006. Our revenues on this contract are limited by the amount of authorized funding and therefore we were unable to recognize $2,721,000 of LIPA project revenues in the period ended December 31, 2006. These costs incurred in excess of funding received were deferred and recorded as inventory. There were additional program costs incurred during the quarter ended December 31, 2006 of $1,916,000 which were in excess of the current authorized contract ceiling. These costs incurred in excess of the contract ceiling were expensed as incurred as we have not yet received a contract modification from DOE to cover the cost growth associated with the LIPA project. We are currently negotiating with the DOE to obtain a contract modification to cover the cost growth on the LIPA project.

As discussed in our May 1, 2006 Form 8-K, our success in the development efforts related to our lower-cost, second generation (2G) HTS wire led to a management decision in March 2006 to complete the transition of our HTS wire manufacturing operation from first generation (1G) to 2G HTS wire. As a result, all 1G wire production has been indefinitely suspended with near-term market needs for HTS wire to be met from approximately 400,000 meters of 1G HTS wire inventory that is currently in stock. We expect this action will enable us to achieve our sales objectives for HTS wire while reducing operating losses and operating cash requirements for our AMSC Wires business unit.

Our cash requirements depend on numerous factors, including successful completion of our product development activities, ability to commercialize our product prototypes, rate of customer and market adoption of our products and the continued availability of U.S. government funding during the product development phase. Significant deviations to our business plan with regard to these factors, which are important drivers to our business, could have a material adverse effect on our operating performance, financial condition, and future business prospects. We expect to pursue the expansion of our operations through internal growth and potential strategic alliances and acquisitions. We are currently in the process of converting our 2G HTS wire pre-pilot production line into a full-scale manufacturing line, which we expect will have a gross production capacity in its initial pilot operation mode of approximately 720,000 meters per year in December 2007. This manufacturing line is expected to require approximately $12 million to $14 million in capital investment by December 2007, of which over $7 million has been spent to date.

On January 5, 2007, we completed the acquisition of Windtec Consulting GmbH (Windtec ). Windtec is an Austria-based designer and licensor of wind turbine systems and a provider of wind turbine electrical systems. Windtec is now a wholly-owned subsidiary of AMSC and will be operated by our Power Electronic Systems business unit. The Windtec purchase price was 1.3 million shares of our common stock, valued at approximately $13.1 million based on a five-day average stock price of $10.08 per share at the time of signing the definitive acquisition agreements on November 28, 2006. The shares are subject to a lockup whereby the former sole owner and founder of Windtec may sell only a certain number of shares per year through January 2010. The all-stock transaction also includes an earn-out opportunity with the potential for the issuance of up to an additional 1.4 million shares of our common stock to be granted to the former owner and founder based on the achievement by Windtec of certain revenue growth targets for the fiscal years ending March 31, 2008 through March 31, 2011. The

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transaction includes the acquisition of 27 patents and patents pending worldwide on wind turbine technology. We assumed no debt in this transaction. Prior to the acquisition of Windtec by AMSC, Windtec was a customer of our Power Electronic Systems business unit for which we reported revenues of approximately $846,000 and $2,584,000 for the three and nine month periods ended December 31, 2006, respectively. Beginning on January 5, 2007, Windtec s results of operations are being included in our consolidated financial statements.

**Critical Accounting Policies and Estimates**

The preparation of consolidated financial statements requires that we make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ under different assumptions or conditions.

Our accounting policies that involve the most significant judgments and estimates are as follows:

- Stock-based compensation;
- Revenue recognition and deferred revenue;
- Allowance for doubtful accounts;
- Long-lived assets;
- Inventory accounting;
- Deferred tax assets; and
- Goodwill.

*Stock-based compensation.* On April 1, 2006, the first day of our fiscal 2007, we adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, which requires us to account for stock-based payment transactions using a fair value-based method and recognize the related expense in the results of operations. We applied the provisions of Staff Accounting Bulletin No. 107 in our adoption of SFAS No. 123(R). Prior to our adoption of SFAS No. 123(R), we accounted for stock-based payments to employees using the Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, intrinsic value method and, therefore, we recognized compensation expense for restricted stock awards and did not recognize compensation cost for employee stock options where the exercise price of the stock option was equal to the market value of the underlying common stock on the date of grant. SFAS No. 123(R) allows companies to choose one of two transition methods: the modified prospective method or the modified retrospective transition method. Effective April 1, 2006, we elected the modified prospective method of transition and accordingly have not restated the results of prior periods. Stock-based compensation expense includes expense for the unvested awards outstanding at March 31, 2006 and all awards granted subsequent to March 31, 2006.

Under the fair value recognition provisions of SFAS No. 123(R), stock-based compensation is estimated at the grant date based on the fair value of the award and is recognized as expense over the requisite service period of the award. The fair value of restricted stock awards is determined by reference to the fair market value of our common stock on the date of grant. Consistent with the valuation method we used for disclosure-only purposes under the provisions of SFAS No. 123(R), we use the Black-Scholes model to value service condition and performance condition awards under SFAS No. 123(R). For awards with service conditions, we recognize compensation cost on a straight-line basis over the requisite service/vesting period. For awards with service and performance conditions and graded-vesting features (a certain percentage of stock awards vest each period), we recognize compensation costs on an accelerated, graded-vesting basis over the requisite service/vesting period. We use the lattice model to value market condition awards. For awards with market conditions with a single cliff vest feature, we recognize compensation costs on a straight-line basis over the requisite service period.

Determining the appropriate fair value model and related assumptions requires judgment, including estimating stock price volatilities of our common stock, forfeiture rates and expected terms. The expected volatility rates are estimated based on historical and implied volatilities of our common stock. The expected term represents the average time that the options that vest are expected to be outstanding based on the vesting provisions and our historical exercise, cancellation and expiration patterns. We estimate pre-vesting forfeitures when recognizing compensation expense based on historical and forward-looking factors. Changes in estimated forfeiture rates and differences between estimated forfeiture rates and actual experience may result in significant, unanticipated increases or decreases in stock-based compensation expense from period to period. The termination of employment by certain employees who hold large numbers of stock-based compensation instruments may also have a significant, unanticipated impact on forfeiture experience and, therefore, on stock-based compensation expense. We will update these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are warranted.

*Revenue recognition and deferred revenue.* For certain arrangements, such as prototype development contracts and certain product sales, we record revenues using the percentage of completion method, measured by the relationship of costs incurred to total estimated contract costs. We use the percentage of completion revenue recognition method when a purchase arrangement meets all of the criteria in Statement of Position 81-1. Percentage of completion revenue recognition accounting is predominantly used on long-term prototype development contracts with the U.S. government, such as the 36.5 MW motor contract with the U.S. Navy. We follow this method since reasonably dependable estimates of the revenues and costs applicable to various stages of a contract can be made. However, the ability to reliably estimate total costs at completion is challenging, especially on long-term prototype development contracts, and could result in future changes in contract estimates. Since many contracts extend

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over a long period of time, revisions in cost and funding estimates during the progress of work have the effect of adjusting earnings applicable to prior-period performance in the current period. Recognized revenues and profit or loss are subject to revisions as the contract progresses to completion. Revisions in profit or loss estimates are charged to income in the period in which the facts that give rise to the revision become known. During the quarter ended December 31, 2006, as a result of cost overruns and changes in estimates, we recorded an estimated loss of $1,616,000 related to the Navy 36.5 MW motor program.

We recognize revenue from other product sales upon customer acceptance, which can occur at the time of delivery, installation, or post-installation, where applicable, provided persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and the collectibility is reasonably assured. For multiple-element arrangements, we use the residual method to allocate value to each undelivered item. Under the residual method, each undelivered item is allocated value based on verifiable objective evidence of fair value for that item and the remainder of the total arrangement price is allocated to the delivered items. For a delivered item to be considered a separate unit, the delivered item must have value to the customer on a standalone basis, there must be objective and reliable evidence of fair value of the undelivered items in the arrangement and the delivery or performance of the undelivered items must be considered probable and substantially within our control. We do not provide our customers with contractual rights of return for any of our products. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. The determination of what constitutes a significant post-delivery performance obligation (if any post-delivery performance obligations exist) is the primary subjective consideration we systemically evaluate in the context of each product shipment in order to determine whether to recognize revenue on the order or to defer the revenue until all post-delivery performance obligations have been completed. Customer deposits received in advance of revenue recognition are recorded as deferred revenue until customer acceptance is received. Deferred revenue also represents the amount billed to and/or collected from commercial and government customers on contracts which permit billings to occur in advance of contract performance/revenue recognition.

*Allowance for doubtful accounts.* If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional provisions for bad debt allowances may be required. The allowance for doubtful accounts was $0 as of December 31, 2006 and March 31, 2006, respectively.

Over 75% of our total revenues in fiscal 2006 and over 50% of our total revenues in the first nine months of fiscal 2007 were from two customers we consider to be financially stable the U.S. government (various agencies thereof) and General Electric. For other customers, allowances for doubtful accounts are evaluated on a case-by-case basis, as necessary, considering several factors such as the age of the accounts receivable, the financial stability of the customer, discussions that may have occurred with the customer, and our judgment as to the overall collectibility of the receivable.

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*Long-Lived Assets.* We periodically evaluate our long-lived assets for potential impairment under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. We perform these evaluations whenever events or circumstances suggest that the carrying amount of an asset or group of assets is not recoverable. Our judgments regarding the existence of impairment indicators are based on market and operational performance. Indicators of potential impairment include:

- a significant change in the manner in which an asset is used;
- a significant decrease in the market value of an asset;
- a significant adverse change in its business or the industry in which it is sold;
- a current period operating cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the asset; and
- significant advances in our technologies that require changes in our manufacturing process.

If we believe an indicator of potential impairment exists, we test to determine whether impairment recognition criteria in SFAS No. 144 have been met. To analyze a potential impairment, we project undiscounted future cash flows expected to result from the use and eventual disposition of the asset or primary asset in the asset group over its remaining useful life, If these projected cash flows are less than the carrying amount, an impairment loss is recognized in the Consolidated Statements of Operations based on the difference between the carrying value of the asset or asset group and its fair value, less any disposition costs. Evaluating the impairment requires judgment by our management to estimate future operating results and cash flows. If different estimates were used, the amount and timing of asset impairments could be affected.

In the fourth quarter of fiscal 2006, we recorded a $4,960,000 impairment charge to write down the value of our 1G asset group (consisting of equipment, patents and licenses), related to our decision to complete the transition of our wire manufacturing operations from 1G to 2G HTS wire, and to indefinitely suspend 1G HTS wire manufacturing. No impairment charges were recorded in fiscal 2004 or fiscal 2005. In the fourth quarter of fiscal 2003, we recorded a $39,231,000 impairment charge to write down our 1G asset group, primarily comprised of the Devens, Massachusetts manufacturing facility and capital equipment, to an estimated fair value in connection with our transition plans from 1G to 2G HTS wire.

*Inventory accounting*. We write down inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of the inventory and the estimated realizable value based upon assumptions of future demand and market conditions. If actual market conditions are less favorable than those projected, additional inventory write-downs may be required. Program costs may be deferred and recorded as inventory on contracts on which costs are incurred in excess of funding, if future funding is deemed probable.

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During the fiscal year ended March 31, 2006, we wrote down $1,591,000 of 1G HTS wire inventory to its estimated net realizable value based on analysis of existing backlog and anticipated demand for our 1G wire. Any future sales of previously written-down inventory will result in the recognition of revenue with no corresponding costs of revenue, which when sold will have a positive impact on our gross margin. We anticipate that during the fourth quarter of fiscal 2007, we will begin to realize sales of 1G HTS wire on previously written-down inventory. As of December 31, 2006 we had 1G HTS wire inventory with an original cost basis of $3,568,000 that has been written down to zero value.

*Deferred tax assets.* We have recorded a full valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we consider future taxable income and tax planning strategies in assessing the need for the valuation allowance, if management were to determine that we would be able to realize deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

*Goodwill.* Goodwill represents the excess of cost over net assets of acquired businesses that are consolidated. Pursuant to SFAS No. 142 Goodwill and Other Intangible Assets, goodwill is not amortized. In lieu of amortization, we perform an impairment review of our goodwill at least annually or when events and changes in circumstances indicate the need for such a detailed impairment analysis, as prescribed by SFAS No. 142. Goodwill is considered impaired when the carrying value of a reporting unit exceeds its estimated fair value. In assessing the recoverability of goodwill, we make assumptions regarding estimated future cash flows and other factors to determine the fair value of the reporting unit. To date, we have determined that goodwill is not impaired, but we could in the future determine that goodwill is impaired, which would result in a charge to earnings.

**Results of Operations**

The Company has three reportable business segments Power Electronic Systems, SuperMachines, and AMSC Wires.

The Power Electronic Systems business segment develops and sells power electronic converters and designs, manufactures and sells integrated systems based on those converters for power quality and reliability solutions and for wind farm applications.

The SuperMachines business segment develops and commercializes electric motors, generators, and synchronous condensers based on HTS wire. Its primary focus for motors and generators is on ship propulsion.

The AMSC Wires business segment develops, manufactures and sells HTS wire, including intercompany sales of wire to SuperMachines. The focus of this segment s current development, manufacturing and sales efforts is on HTS wire for power transmission cables, motors, generators, synchronous condensers and specialty electromagnets.

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*Revenues*

Total consolidated revenues decreased to $9,452,000 in the quarter ended December 31, 2006 from $13,496,000 for the same prior-year quarter, a decrease of $4,044,000. For the nine months ended December 31, 2006, total revenues were, $33,098,000, a $3,481,000 decrease compared to the $36,579,000 of revenues recorded in the comparable period of the prior year.

| Revenues | For the three months ended December 31, 2006 | For the three months ended December 31, 2005 | For the nine months ended December 31, 2006 | For the nine months ended December 31, 2005 |
|---|---|---|---|---|
| Power Electronic Systems | $ 7,118,000 | $ 1,426,000 | $ 17,139,000 | $ 9,428,000 |
| SuperMachines | 991,000 | 8,863,000 | 11,720,000 | 17,136,000 |
| AMSC Wires | 1,343,000 | 3,207,000 | 4,239,000 | 10,015,000 |
| Total | $ 9,452,000 | $ 13,496,000 | $ 33,098,000 | $ 36,579,000 |

The $4,044,000 decrease in consolidated revenues for the quarter ended December 31, 2006 was the result of decreases of $7,872,000 in the SuperMachines business unit and $1,864,000 in the AMSC Wires business unit, partially offset by a $5,692,000 increase in revenues at Power Electronics Systems.

Revenues in our Power Electronic Systems business unit increased to $7,118,000 for the quarter ended December 31, 2006 from $1,426,000 for the same prior-year quarter, primarily as a result of a higher level of D-VAR® and PowerModule system sales due to the growing demand for wind energy solutions, and higher PQ-IVR sales to industrial customers. Revenues in the fourth quarter of fiscal 2007 at Power Electronic Systems are expected to be higher than the third quarter of fiscal 2007 on the basis of existing backlog expected to be recognized as revenue in the fourth quarter. We also expect Power Electronic Systems revenue to increase during the fourth quarter as a result of the Windtec acquisition completed on January 5, 2007.

Revenues in our SuperMachines business unit decreased to $991,000 for the quarter ended December 31, 2006 from $8,863,000 for the quarter ended December 31, 2005. Prototype development contract revenues relating to work performed on the firm-fixed-price contract for the U.S. Navy s 36.5 MW motor were $771,000 in the quarter ended December 31, 2006 and $8,727,000 in the prior-year quarter. On April 26, 2006, a contract modification from the Navy was received that provided $13,344,000 in additional funding, thereby increasing the contract value to $90,150,000 and converting it from a cost-plus-incentive-fee contract to a firm-fixed-price contract. The revenue decrease related to the 36.5 MW motor program is due to a lower level of work performed on the motor program in the current fiscal year as compared to the prior fiscal year. In addition, delays in the completion of the motor resulted in an increase in estimated costs as well as a delay in revenue recognition from the third quarter to the fourth quarter of fiscal 2007. A crack was discovered in a non-superconductor component in the third quarter of fiscal 2007 that required repair. This resulted in an estimated loss of approximately $1,616,000 being recorded in the third quarter. The crack has been fully repaired and reassembly of the motor is nearly complete. The 36.5 MW motor is scheduled to be delivered to the Navy by the end of fiscal 2007. Revenues on this program are recognized on a percentage of completion measure and, as such, are subject to adjustments when estimates to complete the program are revised. Of the $13,344,000 of additional funding received in April 2006, $11,013,000 has been recognized as revenue in the nine months ended December 31, 2006 and $2,331,000 is expected to be recognized as revenue in the fourth quarter of fiscal 2007 as we deliver the motor to the Navy.

On October 13, 2006, we signed a cost-plus-fixed fee contract valued at $5,254,000 with the U.S. Naval Sea Systems Command (NAVSEA) for the design and optimization of HTS ship propulsion motors and power electronic drives. The first $1,900,000 of incremental funding has been allotted for the initial stage of this contract which is expected to be completed in the next six months. We are pursuing additional contracts for HTS motors and generators for fiscal 2007 and beyond with the U.S. Navy and our strategic business alliance partner, Northrop Grumman Marine Systems, among others. However, we expect SuperMachines revenues to be lower in fiscal 2007 compared to fiscal 2006 as we deliver the 36.5 MW motor near the end of fiscal 2007 and complete this final phase of the $90,150,000 Navy contract.

Revenues in our AMSC Wires business unit, which consist of contract revenues and product sales from HTS wire sales and the DOE-sponsored project to install an HTS power cable in the transmission grid of the LIPA, decreased to $1,343,000 for the quarter ended December 31, 2006 from $3,207,000 for the prior-year quarter. The decrease in AMSC Wires revenues in the third quarter of fiscal 2007, compared to the same prior-year quarter, was primarily attributable to a $1,863,000 decrease in LIPA-related revenues. LIPA project revenues were limited by the amount of authorized funding received from DOE as of December 31, 2006 as a result of delays in the receipt of incremental funding while DOE operates under Continuing Resolution until the U.S. Congress passes the Energy and Water appropriations bill. We received incremental funding from the DOE of $397,000 and recognized revenues in that amount during the third quarter of fiscal 2007. This compares to $2,260,000 in LIPA-related revenues in the third quarter of the prior year.

Due to the DOE funding limitation, $2,721,000 of program costs incurred in excess of funding received were recorded as inventory as of December 31, 2006, as receipt of future funding sufficient to cover these deferred costs was deemed probable. The deferred program costs consisted primarily of materials, labor, overhead, and subcontractor costs. Additional incremental funding was received from DOE in January 2007 in the amount of approximately $800,000, which will enable us to recognize that amount as revenue in our fourth fiscal quarter ending March 31, 2007. We expect the remaining $1,921,000 of deferred program costs to be relieved from inventory over the next several months as DOE continues to release incremental funding as it becomes available. There were additional program costs incurred during the quarter ended December 31, 2006 of $1,916,000 which were in excess of the current authorized contract ceiling. These excess costs were expensed as incurred as we have not yet received a contract modification from DOE to cover the cost growth associated with the LIPA project. We are currently negotiating with the DOE to obtain a contract modification to cover the cost growth on the LIPA project.

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Wire sales to other customers increased by $3,000 to $622,000 in the quarter ended December 31, 2006 as a result of slightly higher HTS wire shipments, as compared to $619,000 in the third quarter of fiscal 2006. This increase was offset by a $4,000 decrease in AMSC Wires contract revenues, which were $324,000 in the third quarter of fiscal 2007, compared to $328,000 in the prior-year quarter.

We expect revenues in AMSC Wires to be lower in fiscal 2007 than fiscal 2006 as a result of a lower level of work performed and materials supplied on the LIPA contract compared to the prior fiscal year. We expect to complete the installation of the cable in the summer of 2007. We are also in the process of installing, testing, and qualifying capital equipment for manufacturing our 2G HTS wire, the sales of which are currently constrained by limited manufacturing capacity. We expect to sell limited quantities of 2G HTS wire while we complete the conversion of our pre-pilot line to a full-scale manufacturing line, which we expect to be operating in initial pilot mode at the end of calendar year 2007. We expect to continue to meet near-term customer demand for HTS wire from the approximately 400,000 meters of 1G HTS wire we have in inventory.

For the nine-month period ended December 31, 2006, total consolidated revenues decreased to $33,098,000 from $36,579,000 for the same prior-year period, a decrease of $3,481,000.

Revenues in Power Electronic Systems increased to $17,139,000 for the nine-month period ended December 31, 2006 from $9,428,000 for the same period of the prior year primarily as a result of the higher level of D-VAR and PQ-IVR system shipments to wind farm operators, utilities, and industrial customers.

SuperMachines revenues decreased by $5,416,000 to $11,720,000 in the nine-month period ended December 31, 2006 from $17,136,000 for the same period last year as a result of the substantial completion of engineering design work and HTS coil fabrication on the 36.5 MW motor program in the prior fiscal year and as a result of the delay in the delivery of the 36.5 MW motor as discussed above.

AMSC Wires revenues decreased by $5,776,000 to $4,239,000 for the nine-month period ended December 31, 2006 from $10,015,000 for the same prior-year period, due to a $4,537,000 decrease in LIPA-related revenues, a $1,176,000 decrease in HTS wire sales, and a $63,000 decrease in contract revenues. LIPA project revenues decreased to $1,423,000 in the nine months ended December 31, 2006 from $5,960,000 in the same period of the prior year as a result of the delivery of substantially all of the 1G HTS wire required for the project in the second and third quarters of fiscal 2006 and as a result of the funding limitation as of December 31, 2006 which resulted in $2,721,000 of program costs being deferred and recorded in inventory. Wire sales to other customers decreased to $1,679,000 in the nine months ended December 31, 2006 from $2,855,000 in the same prior-year period due primarily to lower 1G HTS wire sales. Contract revenues decreased to $1,137,000 in the nine months ended December

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31, 2006 compared to $1,200,000 in the same prior-year period as a result of a higher percentage of government funded contracts awarded as cost-share contracts during fiscal 2007 as compared to fiscal 2006. Cost-share contract funding is recorded as an offset to research and development and selling, general and administrative expenses, rather than as revenue as noted below.

*Cost-sharing funding*

In addition to reported revenues, we also received funding of $746,000 for the quarter ended December 31, 2006 under U.S. government cost-sharing agreements with the U.S. Air Force and DOE, compared to $553,000 for the quarter ended December 31, 2005, an increase of $193,000. For the nine months ended December 31, 2006, we received cost-sharing funding of $2,290,000, compared to $862,000 for the same period of the prior year. These increases in funding were due to the $5,350,000 Title III contract awarded by the Air Force in December 2005. Under the Title III contract, we recognized cost-sharing funding of $611,000 and $1,743,000 as an offset to operating expenses for the third quarter and nine-month period ended December 31, 2006, respectively. As required by government contract accounting guidelines, funding from government cost-sharing agreements is recorded as an offset to research and development and selling, general and administrative expenses, rather than as revenue. All of our cost-sharing agreements provide funding in support of 2G wire development work being done in the AMSC Wires business unit. We anticipate that a portion of our funding in the future will continue to come from cost-sharing agreements as we continue to develop joint programs with government agencies. Backlog as of December 31, 2006 relating to cost-sharing agreements was $3,293,000.

*Costs and expenses*

Total costs and expenses for the quarter ended December 31, 2006 were, $19,662,000 compared to $21,774,000 for the same quarter last year. Total costs and expenses for the nine-month period ended December 31, 2006 were $58,223,000 compared to $58,402,000 for the same period last year.

Costs of revenue product sales and prototype development contracts decreased by $3,449,000 to $11,070,00 for the quarter ended December 31, 2006, compared to $14,519,000 for the same quarter of the prior year. This decrease was the result of lower costs associated with the decreased level of product sales in the AMSC Wires business unit, primarily as a result of the deferral of $2,721,000 in LIPA contract costs incurred in excess of funding received as of December 31, 2006. The recovery of the inventoried costs on the LIPA project is deemed probable and will be recorded as costs of revenue upon the receipt of incremental funding from the DOE.

For the quarter ended December 31, 2006, costs of revenue included $1,916,000 in costs on the LIPA project that have been incurred through December 31, 2006 in excess of the current contract ceiling. These costs incurred in excess of the contract ceiling of $23,455,000 as of December 31, 2006 were expensed as incurred into costs of revenue in the third quarter of fiscal 2007 because the funding necessary to recover these costs was not deemed probable as of December 31, 2006. We are currently negotiating with the DOE to obtain a contract

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modification to cover the cost growth on the LIPA project. If we receive a contract amendment and additional funding from the DOE, we will be in a position to recover some or all of the $1,916,000 of costs in a subsequent quarter.

In addition to the AMSC Wires business unit, SuperMachines business unit costs of revenue - product sales and prototype development contracts decreased due to a lower level of work associated with the 36.5 MW motor program in the third quarter of fiscal 2007 compared to the third quarter of fiscal 2006. This decrease in SuperMachines costs of revenue as a result of a lower level of work performed was partially offset by the recognition of additional cost growth on the program in the third quarter of fiscal 2007 associated with the technical delay in the delivery of the motor to the Navy. A crack was discovered in a non-superconductor component that required repair. This resulted in a loss of approximately $1,616,000 being recorded in the quarter ended December 31, 2006. The crack has been fully repaired and reassembly of the motor is nearly complete. The 36.5 MW motor is expected to be delivered to the Navy in March 2007.

The decrease in Costs of revenue product sales and prototype development contracts from the AMSC Wires and SuperMachines business units was partially offset by an increase in these costs for the Power Electronic Systems business unit due to a higher level of sales of D-VAR, PQ-IVR and PowerModule systems.

Costs of revenue product sales and prototype development contracts decreased by $4,095,000 to $33,232,000 in the nine-month period ended December 31, 2006 from $37,327,000 for the same period of the prior year in connection with the lower levels of revenue in the AMSC Wires and SuperMachines business units, partially offset by $1,916,000 of LIPA project costs expensed as incurred in excess of the current LIPA contract ceiling and the higher costs of revenue in Power Electronics Systems compared to the prior-year nine-month period.

Costs of revenue contract revenue increased by $27,000 to $381,000 for the quarter ended December 31, 2006 from $354,000 for the same quarter of the prior year as a result of higher costs incurred in the third quarter to complete firm-fixed-price contracts than in the same prior-year quarter. For the nine months ended December 31, 2006, Costs of revenue contract revenue increased by $9,000 to $1,264,000 from $1,255,000 for the same period of the prior year as a result of higher contract revenues for the nine-month period ended December 31, 2006.

*Research and development*

A portion of our R&D expenditures related to externally funded development contracts has been classified as costs of revenue (rather than as R&D expenses). Additionally, a portion of R&D expenses was offset by cost-sharing funding. Our R&D expenditures are summarized as follows:

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| | Three Months Ended December 31, 2006 | 2005 | Nine Months Ended December 31, 2006 | 2005 |
|---|---|---|---|---|
| R&D expenses per Consolidated Statements of Operations | $ 4,099,000 | $ 4,039,000 | $ 11,700,000 | $ 11,198,000 |
| R&D expenditures classified as Costs of revenue | 5,181,000 | 9,433,000 | 17,231,000 | 22,216,000 |
| R&D expenditures offset by cost-sharing funding | 385,000 | 289,000 | 1,180,000 | 464,000 |
| Aggregated R&D expenses | $ 9,665,000 | $ 13,761,000 | $ 30,111,000 | $ 33,878,000 |

R&D expenses (exclusive of amounts classified as costs of revenue and amounts offset by cost-sharing funding) increased to $4,099,000 and $11,700,000 in the three and nine months ended December 31, 2006, respectively, from $4,039,000 and $11,198,000 for the same periods last year primarily as a result of two factors: a lower percentage of the R&D cost was classified as costs of revenue due to the lower level of funded prototype development contract work in SuperMachines related to the Navy 36.5 MW motor program, and a higher level of internally-funded R&D spending was incurred in AMSC Wires, primarily focused on 2G wire scale-up efforts. Aggregated R&D expenses, which include amounts classified as costs of revenue and amounts offset by cost-sharing funding, were $9,665,000 and $30,111,000 in the three and nine months ended December 31, 2006, respectively, compared to $13,761,000 and $33,878,000 for the same periods of the prior year. The decease in third-quarter aggregated R&D spending compared to the prior year was due primarily to a lower level of externally-funded R&D spending at SuperMachines. On a nine-month basis, the decrease in aggregated R&D spending, compared to prior year, reflected the aforementioned higher levels of internal R&D expenditures in AMSC Wires offset by a lower level of externally-funded R&D spending at SuperMachines.

*Selling, general, and administrative*

A portion of the SG&A expenditures related to externally funded development contracts has been classified as costs of revenue (rather than as SG&A expenses). Additionally, a portion of SG&A expenses was offset by cost-sharing funding. Our SG&A expenditures are summarized as follows:

| | Three Months Ended December 31, 2006 | 2005 | Nine Months Ended December 31, 2006 | 2005 |
|---|---|---|---|---|
| SG&A expenses per Consolidated Statements of Operations | $ 4,112,000 | $ 2,862,000 | $ 12,027,000 | $ 8,622,000 |
| SG&A expenditures classified as Costs of revenue | 770,000 | 1,986,000 | 3,304,000 | 3,935,000 |
| SG&A expenditures offset by cost-sharing funding | 361,000 | 265,000 | 1,109,000 | 398,000 |
| Aggregated SG&A expenses | $ 5,243,000 | $ 5,113,000 | $ 16,440,000 | $ 12,955,000 |

SG&A expenses (exclusive of amounts classified as costs of revenue and amounts offset by cost-sharing funding) increased to $4,112,000 and $12,027,000 in the three and nine months

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ended December 31, 2006, respectively, from $2,862,000 and $8,622,000 for the same periods last year primarily as a result of a lower percentage of the SG&A cost being classified as costs of revenue due to the lower level of funded prototype development contract work in SuperMachines. Aggregated SG&A expenses, which include amounts classified as costs of revenue and amounts offset by cost-sharing funding, increased to $5,243,000 and $16,440,000 for the three and nine months ended December 31, 2006, respectively, from $5,113,000 and $12,955,000 for the same periods last year. The higher level of aggregated SG&A expenses in the three and nine-month periods ended December 31, 2006, compared to the same prior-year periods, was primarily the result of the higher level of stock compensation expense recorded in fiscal 2007 in connection with our adoption of SFAS No. 123(R).

We present Aggregated R&D and Aggregated SG&A expenses, which are non-GAAP measures, because we believe this presentation provides useful information on our aggregate R&D and SG&A spending and because R&D and SG&A expenses as reported on the Consolidated Statements of Operations have been and may in the future be subject to significant fluctuations solely as a result of changes in the level of externally funded contract development work, resulting in significant changes in the amount of the costs recorded as costs of revenue rather than as R&D and SG&A expenses, as discussed above.

*Operating income (loss)*

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|---|---|---|---|
| **Operating income (loss)** | **2006** | **2005** | **2006** | **2005** |
| Power Electronic Systems | $ 439,000 | $ (1,940,000) | $ (56,000) | $ (3,160,000) |
| SuperMachines | (4,525,000) | (249,000) | (8,106,000) | (673,000) |
| AMSC Wires | (4,797,000) | (5,526,000) | (12,830,000) | (16,238,000) |
| Unallocated corporate expense | (1,328,000) | (563,000) | (4,134,000) | (1,752,000) |
| Total | $ (10,211,000) | $ (8,278,000) | $ (25,126,000) | $ (21,823,000) |

The operating income at Power Electronic Systems was $439,000 and the operating loss was $56,000 in the three and nine months ended December 31, 2006, respectively, compared to operating losses of $1,940,000 and $3,160,000 in the same prior-year periods, respectively, primarily as a result of higher gross margins in fiscal 2007 in connection with the increased level of product sales. Based on the higher level of product sales to date and the current backlog related to our D-VAR, PQ-IVR and PowerModule, we expect this business unit to achieve operating profitability for the full fiscal year.

The operating loss at SuperMachines was $4,525,000 and $8,106,000 in the three and nine months ended December 31, 2006, respectively, compared to operating losses of $249,000 and $673,000 in the same prior-year periods as a result of lower revenues and margins related to the 36.5 MW Navy contract during the three and nine months ended December 31, 2006. The margin decrease was primarily the result of higher than planned subcontractor spending and an increase in costs related to a delay in the projected completion date for the final assembly, factory testing, and delivery of our 36.5 MW ship propulsion motor into the fourth quarter of fiscal 2007. The 36.5 MW motor program was converted from a cost-plus-incentive-fee contract to a firm-fixed-price contract on April 26, 2006. During the third quarter of fiscal 2007, a crack was discovered in a non-superconductor component that required repair. This resulted in a loss of approximately $1,616,000 being recorded in the quarter ended December 31, 2006. The crack has been fully repaired and reassembly of the motor is nearly complete. As a result, cost overruns incurred have directly impacted the profitability of this business unit. We expect this business unit to continue to incur operating losses during the remainder of fiscal 2007.

The operating loss at AMSC Wires decreased to $4,797,000 and $12,830,000 in the three and nine months ended December 31, 2006, respectively, compared to $5,526,000 and $16,238,000 in the same prior-year periods, due to lower depreciation and amortization expense as a result of the $4,960,000 impairment charge on the 1G asset group (consisting of equipment, patents and licenses) that was recorded during the fourth quarter of fiscal 2006, partially offset by the LIPA project costs of $1,916,000 expensed as incurred in excess of the contract ceiling and higher internally-funded R&D spending on 2G wire development and scale-up activities. We continue to invest in capital equipment for the scale-up of our 2G wire full scale manufacturing line. Through December 31, 2006 we have invested over $7,000,000 and expect to spend an additional $5,000,000 to $7,000,000 by December 2007 for the 2G production line, which will be capable of producing approximately 720,000 meters per year on a gross capacity basis in its initial pilot mode of operation. We expect depreciation expense to increase as we place into service this 2G manufacturing equipment over the next 12 months. We expect this business unit to continue to incur operating losses during the remainder of fiscal 2007.

*Non-operating expenses/Interest income*

Interest income decreased to $510,000 in the quarter ended December 31, 2006 from $676,000 in the prior-year quarter, primarily as a result of the lower cash balances available for investment. Interest income decreased to $1,779,000 in the nine-month period ended December 31, 2006 from $1,910,000 in the same prior-year period as a result of lower cash balances available for investment.

Other income (expense), net was $154,000 in the quarter ended December 31, 2006 compared to $149,000 in the same quarter of the prior year and consisted primarily of a gain on the revaluation of the warrant issued in April 2005 to TM Capital Corp., a past financial advisor to us, related to a litigation settlement. The litigation settlement amount of $2,653,000, consisting of a $1,700,000 cash payment made in April 2005 and a $953,000 accrued liability relating to the warrant issued for 200,000 shares of our common stock, was accrued in the fourth quarter of fiscal 2005. The accrued warrant cost will continue to be classified as a current liability in accordance with Emerging Issues Task Force (EITF) Issue No. 00-19 until such time as the warrant is exercised, and will be marked to market based primarily on the current price and expected volatility of our common stock as of the end of each reporting period. The warrant was valued at $836,000 as of December 31, 2006 and $999,000 as of September 30, 2006, as compared to the March 31, 2006 warrant valuation of $946,000, resulting in a reduction of expense of $163,000 in the quarter ended December 31, 2006 and a reduction of expense of $111,000 in the nine-month period ended December 31, 2006.

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Based on our latest operating plan, we expect to continue to incur operating losses until at least the end of fiscal year 2009 as we continue to devote significant financial resources to our commercialization efforts and to our ongoing research and development activities. We anticipate an increase in depreciation associated with the scale-up of our 2G manufacturing line as equipment is placed into service, as well as intangible asset amortization associated with the Windtec acquisition.

Please refer to the Risk Factors in Part 2 section 1A below for a discussion of certain factors that may affect our future results of operations and financial condition.

**Liquidity and Capital Resources**

At December 31, 2006, we had cash, cash equivalents and marketable securities of $41,614,000 compared to $65,669,000 at March 31, 2006, a decrease of $24,055,000.

| | December 31, 2006 | March 31, 2006 |
|---|---|---|
| Cash and cash equivalents | $ 12,848,000 | $ 35,171,000 |
| Marketable securities | 28,766,000 | 30,498,000 |
| Total cash, cash equivalents, and marketable securities | $ 41,614,000 | $ 65,669,000 |

The decrease in cash and cash equivalents to $12,848,000 at December 31, 2006 from $35,171,000 at March 31, 2006 was primarily the result of net cash used in operating activities of $16,738,000 and $7,927,000 for the purchase of capital equipment, partially offset by $1,854,000 net proceeds from the sale of marketable securities and $1,133,000 proceeds from the issuance of common stock. The $24,055,000 decrease in cash, cash equivalents, and marketable securities to $41,614,000 at December 31, 2006 from $65,669,000 at March 31, 2006 was primarily the result of net cash used in operating activities of $16,738,000 and purchases of capital equipment of $7,927,000, partially offset by the proceeds from the sale of common stock of $1,133,000.

The principal uses of cash during the nine months ended December 31, 2006 were a net loss of $23,246,000, a $2,361,000 increase in accounts receivable, a $781,000 increase in inventory and $7,927,000 in capital expenditures, primarily related to the 2G pilot production line. This was partially offset by depreciation and amortization expense of $3,058,000, non-cash stock-based compensation expense of $2,878,000, an increase in accounts payable of $2,730,000, and an increase of $1,084,000 in deferred revenue. The increase in accounts receivable was the result of delays in milestone payments on the 36.5 MW motor program and a higher accounts receivable balance at Power Electronic Systems due in part to higher system sales in the month of December. The increase in inventory relates to the deferred program costs inventoried on the LIPA project as of the end of December 31, 2006 (due to the funding limitation). We expect the rate of cash use to decline significantly in the fourth quarter of fiscal 2007, compared to the average rate of cash use in the first three quarters of fiscal 2007, as we collect receivables from certain customers (particularly the 36.5 MW motor milestone payments coming due from the Navy).

We have generated operating losses since our inception in 1987 and expect to continue incurring losses until at least the end of fiscal 2009. Operating losses for the fiscal years ended March 31, 2006, 2005 and 2004 contributed to net cash used by operating activities of $19,589,000, $9,283,000 and $17,422,000, respectively, for these periods. For the nine months ended December 31, 2006, net cash used by operating activities was $16,738,000.

Although our cash requirements fluctuate based on a variety of factors, including customer adoption of our products and our research and development efforts to commercialize our products, we believe that our available cash will be sufficient to fund our working capital, capital expenditures, and other cash requirements through at least the end of fiscal 2009.

The cost for the full-scale manufacturing equipment, which we expect to operate in a pilot mode beginning in December 2007, will have a gross production capacity of approximately 720,000 meters per year in December 2007. The cost of the equipment is expected to be $12,000,000 to $14,000,000 through December 2007, of which over $7,000,000 has been spent to date. The additional capital equipment needed for full commercial production is expected to cost approximately $25,000,000 to $30,000,000, and should result in a commercial manufacturing operation with a gross capacity of approximately 8 million meters of wire per year. Our current plan is to have a commercial manufacturing operation that can produce over 2 million meters per year in place by approximately December 2009. We believe we can increase the manufacturing output of our 2G HTS wire if the market demand for our 2G HTS wire accelerates during this period.

We have backlog (excluding amounts included in accounts receivable) of approximately $43,237,000 to be received after December 31, 2006 from government and commercial customers, compared to $23,761,000 at March 31, 2006. The $19,485,000 increase in backlog from March 31, 2006 to December 31, 2006 was a result of $54,861,000 in new orders and contracts booked during the first nine months of fiscal 2007 associated mainly with $32,183,000 in new system and power converter orders in our Power Electronic Systems business unit. Also contributing was the government contract modification, which provided $13,344,000 in additional funding on the Navy 36.5 MW motor program, thereby increasing the contract value of the program to $90,150,000 and converting it from a cost-plus-incentive-fee contract to a firm-fixed-price contract on April 26, 2006. The Navy 36.5 MW contract modification specifies a milestone payment plan. We received cash payments of $5,000,000 during the nine months ended December 31, 2006. We anticipate that we will receive the remaining $8,344,000 over the next two quarters as we complete the re-assembly, testing and delivery of the motor to the Navy. The additional new orders added into our backlog during the first nine months of fiscal 2007 were partially offset by revenues recognized in the nine-month period ended December 31, 2006 on the 36.5 MW motor program and LIPA cable project, as work continues to progress on these multi-year contracts, which were originally awarded in February and April of 2003, respectively. The current backlog, including $14,780,000 on U.S. government contracts, is subject to certain standard cancellation provisions. Additionally, several of our government contracts are being funded incrementally, and as such, are subject to the future authorization and appropriation of government funding on an annual basis. We have a history of successful performance under incrementally-funded contracts with the government. The backlog as of December 31, 2006 does not include the incremental backlog from the Windtec acquisition completed in January 2007.

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Of the backlog amount of $43,237,000 as of December 31, 2006, approximately 87% is billable to and potentially collectable from our customers within the next 12 months.

The possibility exists that we may pursue acquisition and joint venture opportunities in the future that may affect liquidity and capital resource requirements.

To date, inflation and foreign exchange have not had a material impact on our financial results.

***New Accounting Pronouncements***

A discussion of recent accounting pronoucements is included in Note 17 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended March 31, 2006.

In June 2006, the Financial Accounting Standards Board (FASB) ratified the consensus reached by the EITF on Issue no. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) ( EITF 06-3 ). EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, and some excise taxes. EITF 06-3 concluded that the presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed. In addition, for any such taxes that are reported on a gross basis, EITF 06-3 prescribes that a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The provisions of EITF 06-3 should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006 with earlier adoption permitted. We are currently evaluating the provisions of EITF 06-3.

In July 2006, the FASB issued Interpretation No. 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. FIN 48 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 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. We are currently evaluating the provisions of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 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 157 does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier adoption permitted. The provisions of SFAS 157 should be applied prospectively as of the beginning of the fiscal year in which it is initially applied, with limited exceptions. We are currently evaluating the provisions of SFAS 157.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements expressing the Staff s views regarding the process of quantifying financial statement misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement errors: the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement including the reversing effect of prior year misstatements but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of the error on each financial statement and the related financial statement disclosure. This model is commonly referred to as a dual approach because it essentially requires quantification of errors under both the iron-curtain and the roll-over methods. The provisions of SAB 108 should be applied to annual financial statements covering the first fiscal year ending after November 15, 2006. We are currently evaluating the provisions of SAB 108.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to market risk through financial instruments, such as investments in marketable securities, is limited to interest rate risk and is not material. Our investments in marketable securities consist primarily of corporate debt instruments and are designed, in order of priority, to preserve principal, provide liquidity, and maximize income. Interest rates are variable and fluctuate with current market conditions. We do not believe that a 10% change in interest rates would have a material impact on our financial position or results of operation.

Item 4. Controls and Procedures

**Evaluation of Disclosure Controls and Procedures**

The Company s management, with the participation of the Company s chief executive officer and chief financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of December 31, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act ), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the

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time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company s disclosure controls and procedures as of December 31, 2006, the Company s chief executive officer and chief financial officer concluded that, as of such date, the Company s disclosure controls and procedures were effective at the reasonable assurance level.

**Changes in Internal Control Over Financial Reporting**

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the third quarter of fiscal 2007 that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

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## PART II

## OTHER INFORMATION

Item 1. Legal Proceedings
Not Applicable

Item 1A. Risk Factors
Various statements included herein, as well as other statements made from time to time by our representatives, which relate to future matters (including but not limited to statements concerning our future operating results or future commercial success) constitute forward looking statements and are made under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. There are a number of important factors which could cause our actual results of operations and financial condition in the future to vary from that indicated in such forward looking statements. Factors that may cause such differences include, without limitation, the risks, uncertainties and other information set forth below.

While the following risk factors have been updated to reflect developments subsequent to the filing of our Annual Report on Form 10-K for the fiscal year ended March 31, 2006, there have been no material changes to the risk factors included in that report.

**We have a history of operating losses, and we expect to incur losses in the future.**

We have been principally engaged in research and development activities. We have incurred net losses in each year since our inception. Our net loss for the nine months ended December 31, 2006 was $23,246,000 and for the fiscal years ended March 31, 2006, March 31, 2005, and March 31, 2004 was $30,876,000, $19,660,000, and $26,733,000, respectively. Our accumulated deficit as of December 31, 2006 was $373,625,000. We expect to continue to incur operating losses until at least the end of fiscal 2009, and there can be no assurance that we will ever achieve profitability.

We had cash, cash equivalents and marketable securities totaling $41,614,000 at December 31, 2006. We believe our available cash will be sufficient to fund our working capital, capital expenditures, and other cash requirements through at least the end of fiscal 2009. However, we may need additional funds if our performance deviates significantly from our current business plan, if there are significant changes in competitive or other market factors, or if unforeseen circumstances arise. Such funds may not be available, or may not be available under terms acceptable to us.

**There are a number of technological challenges that must be successfully addressed before our superconductor products can gain widespread commercial acceptance, and our inability to address such technological challenges could adversely affect our ability to acquire customers for our products.**

Many of our products are in the early stages of commercialization, while others are still under development. There are a number of technological challenges that we must successfully address to complete our development and commercialization efforts. We also believe that several years of further development in the cable and motor industries will be necessary before a substantial number of additional commercial applications for our HTS wire in these industries can be developed and proven. We will also need to improve the performance and/or reduce the cost of our HTS wire to expand the number of commercial applications for it. We may be unable to meet such technological challenges. Delays in development, as a result of technological challenges or other factors, may result in the introduction or commercial acceptance of our products later than anticipated.

**The commercial uses of superconductor products are limited today, and a widespread commercial market for our products may not develop.**

To date, there has been no widespread commercial use of HTS products. Commercial acceptance of low temperature superconductor (LTS) products, other than for medical magnetic resonance imaging and superconductor magnetic energy storage (SMES) products, has been significantly limited by the cooling requirements of LTS materials. Even if the technological hurdles currently limiting commercial uses of HTS and LTS products are overcome, it is uncertain whether a robust commercial market for those new and unproven products will ever develop. It is possible that the market demands we currently anticipate for our HTS and LTS products will not develop and that superconductor products will never achieve widespread commercial acceptance.

**We have limited experience manufacturing our HTS products in commercial quantities, and failure to manufacture our HTS products in commercial quantities at acceptable cost and quality levels would impair our ability to meet customer delivery requirements.**

To be financially successful, we will have to manufacture our products in commercial quantities at acceptable costs while also preserving the necessary performance and quality levels. We cannot make assurances that we will be successful in developing product designs and manufacturing processes that permit us to manufacture our HTS products in commercial quantities at acceptable costs while preserving the necessary performance and quality. In addition, we may incur significant unforeseen expenses in our product design and manufacturing efforts.

**We have never manufactured our 2G HTS wire in commercial quantities, and failure to manufacture our 2G HTS wire in commercial quantities at acceptable cost and quality levels would substantially limit our future revenue and profit potential.**

We are in the early stages of developing our commercial-scale 2G HTS wire manufacturing processes, which, while very different from our 1G HTS wire manufacturing processes, are also extremely complex and challenging. We may not be able to manufacture satisfactory commercial quantities of 2G HTS wire of consistent quality, yield and cost. Failure to successfully scale up manufacturing of our 2G HTS wire would result in a significant limitation of the broad market acceptance of our HTS products and of our future revenue and profit potential.

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**We have limited experience in marketing and selling our products, and our failure to effectively market and sell our products could adversely affect our revenue and cash flow.**

To date, we have limited experience marketing and selling our products, and there are few people who have significant experience marketing or selling superconductor products. Once our products are ready for widespread commercial use, we will have to develop a marketing and sales organization that will effectively demonstrate the advantages of our products over both more traditional products and competing superconductor products or other technologies. We may not be successful in our efforts to market this new technology, and we may not be able to establish an effective sales and distribution organization.

We may decide to enter into arrangements with third parties for the marketing or distribution of our products, including arrangements in which our products, such as HTS wire, are included as a component of a larger product, such as a motor. By entering into marketing and sales alliances, the financial benefits to us of commercializing our products are dependent on the efforts of others. We may not be able to enter into marketing or distribution arrangements with third parties on financially acceptable terms, and third parties may not be successful in selling our products or applications incorporating our products.

**Many of our revenue opportunities are dependent upon subcontractors and other business partners.**

Many of the revenue opportunities for our AMSC Wires business unit involve projects, such as the installation of HTS cables in power grids, on which we partner with other companies, including suppliers of cryogenic systems and manufacturers of electric power cables. In addition, a key element of our SuperMachines business strategy is the formation of business alliances with motor manufacturers and/or marine propulsion system integrators. As a result, most of our current and planned revenue-generating projects involve business partners on whose performance our revenue is dependent. If these business partners fail to deliver their products or perform their obligations on a timely basis, our revenue from the project may be delayed or decreased.

**Our contracts with the U.S. government are subject to audit, modification or termination by the U.S. government, and the continued funding of such contracts remains subject to annual congressional appropriation which, if not approved, could adversely affect our results of operations and financial condition.**

As a company that contracts with the U.S. government, we are subject to financial audits and other reviews by the U.S. government of our costs and performance, accounting and general business practices relating to these contracts. Based on the results of its audits, the U.S. government may adjust our contract-related costs and fees. No assurances can be given that adjustments arising from government audits and reviews would not have a material adverse effect on our results of operations. Some of our contracts with the U.S. government are on a firm fixed price basis and, as such, are subject to more financial risk in the event of unanticipated cost overruns.

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All of our U.S. government contracts can be terminated by the U.S. government for its convenience. Termination for convenience provisions provide only for our recovery of costs incurred or committed, settlement expenses and profit on work completed prior to termination. In addition to the right of the U.S. government to terminate its contracts with us, U.S. government contracts are conditioned upon the continuing approval by Congress of the necessary spending to honor such contracts. Congress often appropriates funds for a program on a fiscal-year basis even though contract performance may take more than one year. Consequently, at the beginning of many major governmental programs, contracts often may not be fully funded, and additional monies are then committed to the contract only if, as and when appropriations are made by Congress for future fiscal years. There can be no assurance that our U.S. government contracts will not be terminated or suspended in the future. The U.S. government s termination of, or failure to fully fund, one or more of our contracts would have a negative impact on our operating results and financial condition. Further, in the event that any of our government contracts are terminated for cause, it could affect our ability to obtain future government contracts which could, in turn, seriously harm our ability to develop our technologies and products.

**Our products face intense competition both from superconductor products developed by others and from traditional, non-superconductor products and alternative technologies, which could limit our ability to acquire or retain customers.**

As we begin to market and sell our superconductor products, we will face intense competition both from competitors in the superconductor field and from vendors of traditional products and new technologies. There are many companies in the United States, Europe, Japan and China engaged in the development of HTS wire, including Sumitomo Electric Industries, Intermagnetics General, European High Temperature Superconductors, Nexans, Zenergy, Fujikura, Furukawa Electric, Showa, THEVA, and Innova Superconductor Technology. The superconductor industry is characterized by rapidly changing and advancing technology. Our future success will depend in large part upon our ability to keep pace with advancing HTS and LTS technology and developing industry standards. Our SMES products and integrated power electronic products, such as D-VAR , compete with a variety of other products such as dynamic voltage restorers (DVRs), static VAR compensators (SVCs), static compensators (STATCOMS), flywheels, power electronic converters and battery-based power supply systems. Competition for our PowerModules includes products from ABB, Alstom, Siemens, Mitsubishi Electric, Ecostar, Inverpower, SatCon, Semikron and Xantrex. The HTS motor and generator products that we are developing face competition from copper wire-based motors and generators, from permanent magnet motors that are being developed, and from companies developing HTS rotating machinery including Converteam (formerly Alstom Power Conversion), Doosan Heavy Industries & Construction, GE, Ishikawajima-Harima Heavy Industries Co., Rockwell, and Siemens. Research efforts and technological advances made by others in the superconductor field or in other areas with applications to the power quality and reliability markets may render our development efforts obsolete. Many of our competitors have substantially greater financial resources, research and development, manufacturing and marketing capabilities than we have. In addition, as the HTS wire, HTS electric motors and generators, and power electronic systems markets develop, other large industrial companies may enter those fields and compete with us. If we are unable to compete successfully, it may harm our business, which in turn may limit our ability to acquire or retain customers.

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**Third parties have or may acquire patents that cover the HTS materials we use or may use in the future to manufacture our products, and our success depends on our ability to license such patents or other proprietary rights.**

We expect that some or all of the HTS materials and technologies we use in designing and manufacturing our products are or will become covered by patents issued to other parties, including our competitors. If that is the case, we will need either to acquire licenses to these patents or to successfully contest the validity of these patents. The owners of these patents may refuse to grant licenses to us, or may be willing to do so only on terms that we find commercially unreasonable. If we are unable to obtain these licenses, we may have to contest the validity or scope of those patents to avoid infringement claims by the owners of these patents. It is possible that we will not be successful in contesting the validity or scope of a patent, or that we will not prevail in a patent infringement claim brought against us. Even if we are successful in such a proceeding, we could incur substantial costs and diversion of management resources in prosecuting or defending such a proceeding.

**Our patents may not provide meaningful protection for our technology, which could result in us losing some or all of our market position.**

We own or have licensing rights under many patents and pending patent applications. However, the patents that we own or license may not provide us with meaningful protection of our technologies and may not prevent our competitors from using similar technologies, for a variety of reasons, such as:

- the patent applications that we or our licensors file may not result in patents being issued;
- any patents issued may be challenged by third parties; and
- others may independently develop similar technologies not protected by our patents or design around the patented aspects of any technologies we develop.

Moreover, we could incur substantial litigation costs in defending the validity of our own patents. We also rely on trade secrets and proprietary know-how to protect our intellectual property. However, our non-disclosure agreements and other safeguards may not provide meaningful protection for our trade secrets and other proprietary information. If the patents that we own or license or our trade secrets and proprietary know-how fail to protect our technologies, our market position may be adversely affected.

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**Our success is dependent upon attracting and retaining qualified personnel, and our inability to do so could significantly damage our business and prospects.**

Our success will depend in large part upon our ability to attract and retain highly qualified research and development, management, manufacturing, marketing and sales personnel. Hiring those persons may be especially difficult due to the specialized nature of our business.

**We may acquire additional complementary businesses or technologies, which may require us to incur substantial costs for which we may never realize the anticipated benefits.**

We acquired Windtec on January 5, 2007 and may in the future acquire additional complementary businesses or technologies, although we currently have no commitments or agreements. If we do pursue additional acquisitions, management s attention and resources may be diverted from other business concerns. An acquisition may also involve significant purchase price and significant transaction-related expenses.

Achieving the benefits of any acquisition involves additional risks, including:

- difficulty assimilating acquired operations, technologies and personnel;
- inability to retain management and other key personnel of the acquired business;
- changes in management or other key personnel that may harm relationships with the acquired business s customers and employees; and
- diversion of management attention as a result of the integration process.

We cannot ensure that we will realize any of the anticipated benefits of any acquisition, and if we fail to realize these anticipated benefits, our operating performance could suffer.

**Our international operations are subject to risks that we do not face in the U.S., which could have an adverse effect on our operating results.**

We completed our acqusition of Windtec, an Austrian-based company, on January 5, 2007 and we are expanding our sales and service operations in Austria and the Asia-Pacific region. We expect our revenue and operations outside the United States will continue to expand in the future. Our international operations are subject to a variety of risks that we do not face in the U.S., including:

- difficulties in staffing and managing our foreign offices and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- potentially longer payment cycles for sales in foreign countries and difficulties in collecting accounts receivable;
- additional withholding taxes or other taxes on our foreign income, and tariffs or other restrictions on foreign trade or investment, including export duties and quotas, trade and employment restrictions;
- imposition of, or unexpected adverse changes in, foreign laws or regulatory requirements;

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increased exposure to foreign currency exchange rate risk;

reduced protection for intellectual property rights in some countries; and

political unrest, war or acts of terrorism.

Our overall success in international markets depends, in part, upon our ability to succeed in differing legal, regulatory, economic, social and political conditions. We may not be successful in developing and implementing policies and strategies that will be effective in managing these risks in each country where we do business. Our failure to manage these risks successfully could harm our international operations and reduce our international sales, thus adversely affecting our business, operating results and financial condition.

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

Not Applicable

Item 3. Defaults Upon Senior Securities

Not Applicable

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

Not Applicable

Item 5. Other Information

Not Applicable

Item 6. Exhibits

See the Exhibit Index on the page immediately preceding the exhibits for a list of exhibits filed as part of this quarterly report, which Exhibit Index is incorporated herein by this reference.

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## 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.

AMERICAN SUPERCONDUCTOR CORPORATION

| | |
|---|---|
| February 9, 2006 | */s/ Gregory J. Yurek* |
| Date | Gregory J. Yurek |
| | Director, Chairman of the Board and |
| | Chief Executive Officer |
| | (Principal Executive Officer) |
| February 9, 2006 | */s/ Thomas M. Rosa* |
| Date | Thomas M. Rosa |
| | Vice President and Chief Financial Officer |
| | (Principal Financial and Accounting Officer) |

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**Exhibit Index**

| Exhibit No. | Description |
|---|---|
| 31.1 | Chief Executive Officer - Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Chief Financial Officer - Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Chief Executive Officer - Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Chief Financial Officer - Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |