ECHELON CORP
Form 10-Q
November 08, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark one)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005

OR

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

For the transition period from _______________ to _______________

000-29748
(Commission file number)

ECHELON CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

550 Meridian Avenue
San Jose, CA 95126
(Address of principal executive office and zip code)

(408) 938-5200
(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 filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes x No o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of October 31, 2005, 40,021,635 shares of the Registrant's common stock were outstanding.

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FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2005

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FORWARD-LOOKING INFORMATION

This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions, anticipations, commitments or strategies regarding the future that are forward-looking. These statements include those discussed in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, including "Liquidity and Capital Resources," "Recently Issued Accounting Standards" and "Factors That May Affect Future Results of Operations," and elsewhere in this report. These statements include statements concerning projected revenues, international revenues, expenses, gross profit, income, adoption of SFAS 154 on our results of operations, the interpretation of FIN 47, the requirements of SFAS 123R, the adoption of FAS 109-1, product development and market acceptance of our products. In this report, the words "may," "could," "would," "might," "will," "should," "plan," "forecast," "anticipate," "belie "intend," "estimate," "predict," "potential," "continue," "future," "moving toward" or the negative of these terms or oth expressions also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of risk factors including, but not limited to, those set forth in the section entitled "Factors That May Affect Future Results of Operations" and elsewhere in this report. You should carefully consider these risks, in addition to the other information in this report and in our other filings with the SEC. All forward-looking statements and reasons why results may differ included in this report are

made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.

PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ECHELON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

		September 30, 2005		December 31, 2004
ASSETS				
CURRENT ASSETS:				
Cash and cash equivalents	$	34,356	$	35,510
Short-term investments		127,477		124,854
Accounts receivable, net		9,423		17,261
Inventories		5,187		5,584
Other current assets		2,914		2,213
Total current assets		179,357		185,422
Property and equipment, net		15,320		16,983
Goodwill		8,060		8,344
Restricted investments		--		11,106
Other long-term assets		2,062		2,061
TOTAL ASSETS	$	204,799	$	223,916
LIABILITIES AND STOCKHOLDERS' EQUITY				
CURRENT LIABILITIES:				
Accounts payable	$	5,294	$	5,157
Accrued liabilities		11,510		5,452
Deferred revenues		1,262		1,422
Total current liabilities		18,066		12,031
LONG-TERM LIABILITIES:				
Deferred rent		1,026		823
Total long-term liabilities		1,026		823
STOCKHOLDERS’ EQUITY:				
Common stock		415		415
Additional paid-in capital		277,781		277,442
Treasury stock		(11,219)		(3,367)
Accumulated other comprehensive income		64		922
Accumulated deficit		(81,334)		(64,350)
Total stockholders’ equity		185,707		211,062
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$	204,799	$	223,916

See accompanying notes to condensed consolidated financial statements.

ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
REVENUES:	2005	2004	2005	2004
Product	$ 16,068	$ 22,556	$ 54,852	$ 77,467
Service	183	185	562	598
Total revenues	16,251	22,741	55,414	78,065
COST OF REVENUES:				
Cost of product	7,085	9,397	23,107	32,744
Cost of service	525	466	1,629	1,478
Total cost of revenues	7,610	9,863	24,736	34,222
GROSS PROFIT	8,641	12,878	30,678	43,843
OPERATING EXPENSES:				
Product development	6,170	6,227	18,747	18,623
Sales and marketing	5,164	4,572	15,585	14,660
General and administrative	8,550	3,123	16,597	9,855
Total operating expenses	19,884	13,922	50,929	43,138
INCOME (LOSS) FROM OPERATIONS	(11,243)	(1,044)	(20,251)	705
INTEREST AND OTHER INCOME, NET	1,225	609	3,567	1,755
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	(10,018)	(435)	(16,684)	2,460
INCOME TAX EXPENSE (BENEFIT)	100	(35)	300	197
NET INCOME (LOSS)	$ (10,118)	$ (400)	$ (16,984)	$ 2,263
NET INCOME (LOSS) PER SHARE:				
Basic	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06
Diluted	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06
SHARES USED IN COMPUTING NET INCOME (LOSS) PER SHARE:				
Basic	40,074	41,183	40,538	40,826
Diluted	40,074	41,183	40,538	40,963

See accompanying notes to condensed consolidated financial statements.

ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30,	
	2005	**2004**
CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income (loss)	$ (16,984)	$ 2,263
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,115	3,719
Loss on disposal of fixed assets	45	--
Increase in (reduction of) allowance for doubtful accounts provision	(1)	(37)
Stock-based compensation	356	--
Change in operating assets and liabilities:		
Accounts receivable	7,839	7,548
Inventories	397	(1,650)
Other current assets	(701)	578
Accounts payable	137	739
Accrued liabilities	6,058	(570)
Deferred revenues	(160)	847
Deferred rent	203	254
Net cash provided by operating activities	304	13,691
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchase of available-for-sale short-term investments	(92,408)	(111,622)
Proceeds from maturities and sales of available-for-sale short-term investments	89,794	111,129
Release (purchase) of restricted investments	11,106	(238)
Change in other long-term assets	250	(146)
Capital expenditures	(1,464)	(1,551)
Net cash provided by (used in) investing activities	7,278	(2,428)
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Repurchase of common stock	(7,869)	--
Proceeds from issuance of common stock	--	5,110
Net cash provided by (used in) financing activities	(7,869)	5,110
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(867)	(86)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,154)	16,287
CASH AND CASH EQUIVALENTS:		
Beginning of period	35,510	18,667
End of period	$ 34,356	$ 34,954
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$ 298	$ 725

See accompanying notes to condensed consolidated financial statements.

ECHELON CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The condensed consolidated financial statements include the accounts of Echelon Corporation (the “Company”), a Delaware corporation, and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements for the year ended December 31, 2004 included in its Annual Report on Form 10-K.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Foreign Currency Translation

For foreign subsidiaries using the local currency as their functional currency, assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expenses are translated at average exchange rates. The effects of these translation adjustments are reported as a separate component of stockholders’ equity. Remeasurement adjustments for non-functional currency monetary assets and liabilities are included in other income (expense) in the accompanying condensed consolidated statements of operations.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition

The Company’s revenues are derived from the sale and license of its products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Revenues from software licensing arrangements accounted for 8.0% of total revenues for the quarter ended September 30, 2005 and 5.7% for the same period in 2004; and 6.9% of total revenues for the nine months ended September 30, 2005 and 4.8% for the same period in 2004. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is probable and there are no post-delivery obligations. For hardware sales, including sales to distributors and third party manufacturers, these criteria are generally met at the time of shipment to the customer. For software licenses, these criteria are generally met upon shipment to the final end-user.

In accordance with Statement of Position 97-2, or SOP 97-2, *Software Revenue Recognition*, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence ("VSOE") of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of products that are considered multiple element arrangements under SOP 97-2. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support ("PCS"). The VSOE for this PCS is based on prices paid by the Company's customers for stand-alone purchases of these PCS packages. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*.

Service revenue is recognized as the training services are performed, or ratably over the term of the support period. In the case of custom software development services, revenue is recognized when the customer accepts the software.

Cash and Cash Equivalents

The Company considers bank deposits, money market investments and all debt and equity securities with an original maturity of three months or less as cash and cash equivalents.

Short-Term Investments

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. As of September 30, 2005, the Company's available-for-sale securities had contractual maturities from three to 24 months and an average maturity of eight months. The fair value of available-for-sale securities was determined based on quoted market prices at the reporting date for those instruments. As of September 30, 2005, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses by major security type were as follows (in thousands):

	Amortized Cost	**Aggregate Fair Value**	**Unrealized Holding Gains (Losses)**
U.S. corporate securities:			
Commercial paper	$ 12,510	$ 12,507	$ (3)
Certificate of deposit	1,506	1,507	1
Corporate notes and bonds	62,784	62,561	(223)
	76,800	76,575	(225)
Foreign corporate notes and bonds	3,022	3,019	(3)
U.S. government securities	48,076	47,883	(193)
Total investments in debt and equity securities	$ 127,898	$ 127,477	$ (421)

Computation of Net Income (Loss) Per Share

Net income (loss) per share has been calculated under Statement of Financial Accounting Standards No. 128, or SFAS 128, *Earnings per Share*. SFAS 128 requires companies to compute earnings per share under two different methods, basic and diluted. Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is calculated by adjusting the weighted average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the three months and nine months ended September 30, 2005 and September 30, 2004 (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss) (Numerator):				
Net income (loss), basic & diluted	$ (10,118)	$ (400)	$ (16,984)	$ 2,263
Shares (Denominator):				
Weighted average common shares outstanding	40,074	41,183	40,538	40,826
Shares used in basic computation	40,074	41,183	40,538	40,826
Common shares issuable upon exercise of stock options (treasury stock method)	--	--	--	137
Shares used in diluted computation	40,074	41,183	40,538	40,963
Net income (loss) per share:				
Basic	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06
Diluted	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06

In accordance with SFAS 128, for the three and nine month periods ended September 30, 2005, and for the three month period ended September 30, 2004, no diluted net loss per share calculations were performed due to the Company's net loss position. The number of potentially dilutive stock options excluded from these calculations for the three and nine months ended September 30, 2005, and the three months ended September 30, 2004, was 490,385, 184,791, and 3,415, respectively. For the nine months ended September 30, 2004, stock options in the amount of 9,157,651 were not included in the computation of diluted earnings per share. These options were excluded from the calculation because the options' exercise price was greater than the average market price of the common shares and therefore, the effect of their inclusion would be anti-dilutive.

Comprehensive Income

Comprehensive income for the Company consists of net income plus the effect of unrealized holding gains or losses on investments classified as available-for-sale, as well as foreign currency translation adjustments. Comprehensive income for the three and nine months ended September 30, 2005 and 2004 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income/(loss)	$ (10,118)	$ (400)	$ (16,984)	$ 2,263
Other comprehensive income/(loss), net of tax:				
Foreign currency translation adjustment	(89)	55	(867)	(78)
Unrealized holding gain/(loss) on available-for-sale securities	(83)	122	9	(418)
Comprehensive income/(loss)	$ (10,290)	$ (223)	$ (17,842)	$ 1,767

Valuation of Goodwill and Other Intangible Assets

In accordance with Statement of Financial Accounting Standards No. 142, or SFAS 142, *Goodwill and Other Intangible Assets,* we assess the impairment of goodwill and identifiable intangible assets on an annual basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The provisions of SFAS 142 require that a two-step test be performed to assess goodwill for impairment. First, the fair value of each reporting unit is compared to its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and no further testing is performed. The second step is performed if the carrying value exceeds the fair value. The

implied fair value of the reporting unit’s goodwill must be determined and compared to the carrying value of the goodwill. If the carrying value of a reporting unit’s goodwill exceeds its implied fair value, an impairment loss equal to the difference must be recorded.

When we adopted SFAS 142 in 2002, we ceased amortizing goodwill, which had a net unamortized balance of $1.7 million as of December 31, 2001. Since then, primarily as a result of acquisitions in 2002 and 2003, the net balance of goodwill has grown to $8.1 million as of September 30, 2005.

We review goodwill for impairment annually during the quarter ending March 31. Our review during the quarter ended March 31, 2005 indicated no impairment. If, as a result of an annual or any other impairment review that we perform in the future, we determine that there has been an impairment of our goodwill or other intangible assets, we would be required to take an impairment charge.

Stock-Based Employee Compensation Plans

The Company accounts for its stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock issued to Employees*, and related Interpretations. For stock options granted to employees, no stock-based employee compensation cost is reflected in net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. In 2005, the Company also began issuing restricted stock to certain of its employees. For these restricted stock awards, stock-based employee compensation is reflected in net income. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, or SFAS 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	2004	2005	2004
Net income (loss) as reported	$ (10,118)	$ (400)	$ (16,984)	$ 2,263
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	170	--	356	--
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,322)	(7,484)	(7,264)	(17,679)
Pro forma net loss	$ (12,270)	$ (7,884)	$ (23,892)	$ (15,416)
Basic net income/(loss) per share:				
As reported	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06
Pro forma	$ (0.31)	$ (0.19)	$ (0.59)	$ (0.38)
Diluted net income/(loss) per share:				
As reported	$ (0.25)	$ (0.01)	$ (0.42)	$ 0.06
Pro forma	$ (0.31)	$ (0.19)	$ (0.59)	$ (0.38)

The weighted-average grant date fair value of options granted during the three months ended September 30, 2005 and September 30, 2004 was $3.77 and $3.96, respectively. The weighted-average grant date fair value of options granted during the nine months ended September 30, 2005 and September 30, 2004 was $3.63 and $6.01, respectively. Under SFAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	2004	2005	2004
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	4.1%	3.1%	4.0%	2.4%
Expected volatility	57.5%	71.4%	57.7%	78.3%
Expected life (in years)	3.7	3.7	3.6	3.6

Restricted Investments

In July 2005, the Company renegotiated its line of credit with its primary bank. As part of the renegotiation, the requirement for restricted investments was eliminated. Prior to July 2005, restricted investments consisted of money market funds and certain United States government agency obligations. These investments were carried at fair value and were collateral for a $10.0 million line of credit issued to the Company by its primary bank. Because the Company's former agreement with the lender prevented the Company from withdrawing these invested funds, they were considered restricted. The line of credit is maintained primarily for the purpose of providing standby letters of credit for specified obligations under the Company's headquarter facility lease agreements.

As of September 30, 2005, the Company's primary bank has issued, against the line of credit, two standby letters of credit totaling $8.0 million as security for real estate lease commitments discussed in Note 4. As of September 30, 2005, no amounts had been drawn against the line of credit or the letters of credit.

Recently Issued Accounting Standards

In June 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for how an entity accounts for, and reports, a change in accounting principle. Previously, most voluntary changes in accounting principles were implemented by reflecting a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. Although the Company will continue to evaluate the application of SFAS 154, it does not currently believe adoption will have a material effect on its financial position, results of operations, or cash flows.

In March 2005, the FASB issued FASB Interpretation No. 47, or FIN 47, *Accounting for Conditional Asset Retirement Obligations*, which is an interpretation of SFAS 143, *Accounting for Asset Retirement Obligations*. FIN 47 requires that a liability for the fair value of a conditional asset retirement obligation be recognized if the fair value of the liability can be reasonably estimated. The interpretation must be adopted no later than the end of a company's fiscal year ending after December 15, 2005. The interpretation is not expected to have a material impact on the Company's financial position, results of operations, or cash flows.

In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*. SFAS 123R requires that an amount be calculated for all equity instruments granted to employees, including grants of employee stock options, using a fair-value-based method, and that these amounts be recorded as an expense in the Company's consolidated statements of income. The accounting provisions of SFAS 123R are effective for annual reporting periods beginning after June 15, 2005. The Company will be required to adopt SFAS 123R in its first fiscal quarter ending March 31, 2006. The pro forma disclosures previously permitted under SFAS 123, *Accounting for Stock-Based Compensation*, will no longer be an alternative to financial statement recognition. See "Stock-Based Employee Compensation Plans" above for the pro-forma net loss and net loss per share amounts that would have been reported for the quarters and nine months ended September 30, 2005 and September 30, 2004 had the Company used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Under SFAS 123R, beginning January 1, 2006, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include either a modified-prospective or a modified-retroactive adoption option. Under the modified-retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified-prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the modified-retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. Although the Company has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro-forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have a significant adverse impact on its results of operations and earnings per share.

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107, *Share-Based Payment*, which expresses views of the SEC staff regarding the application of SFAS 123R. Among other things, SAB 107 provides interpretive guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1, or FAS 109-1, *Application of FASB Statement No. 109, "Accounting for Income Taxes," to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* ("AJCA"). The AJCA introduces a special 9% tax deduction on qualified production activities. FAS 109-1 clarifies that this tax deduction should be accounted for as a special tax deduction in accordance with Statement No. 109. The Company does not currently expect the adoption of these new tax positions will have a material impact on its financial position, results of operations, or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2, or FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FAS 109-2 provides additional time to companies beyond the financial reporting period of enactment to evaluate the effects of the AJCA on their plans for repatriation of foreign earnings for purposes of applying SFAS 109, *Accounting for Income Taxes*. The Company is currently evaluating the repatriation provisions of AJCA, which if implemented by the Company, would affect the Company's tax provision and deferred tax assets and liabilities. However, given the uncertainties and complexities of the repatriation provision, as well as the Company's continuing evaluation, it is not possible at this time to determine the amount, if any, that may be repatriated or the related potential income tax effects of such repatriation.

3. Significant Customers

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. The Company currently has two customers that represent a majority of the Company's revenues: Enel S.p.A. ("Enel"), an Italian utility company (including Enel's third party meter manufacturers), and EBV Electronik GmbH ("EBV"), the

Company's sole distributor of its LONWORKS® Infrastructure products in Europe. For the three and nine months ended September 30, 2005 and 2004, the percentages of the Company's revenues attributable to sales made to these two customers were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Enel	27.0%	51.0%	37.1%	56.1%
EBV	22.7%	16.5%	20.5%	15.2%
Total	49.7%	67.5%	57.6%	71.3%

The Company's contract with Enel expired in June 2005, although the Company currently expects to continue shipping products during the remainder of 2005 that were ordered by Enel and its third party meter manufacturers prior to the expiration date. The Company's contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2005.

4. Commitments and Contingencies

Lease Commitments

The Company leases its facilities under operating leases that expire on various dates through 2013. In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. This agreement requires minimum rental payments for ten years totaling approximately $20.6 million and also required that the Company provide a $3.0 million security deposit. The Company satisfied the security deposit requirement by causing to have issued a standby letter of credit ("LOC") in July 2000, which has been renewed annually since then. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

In October 2000, the Company entered into another lease agreement with the same real estate developer for an additional building at its headquarters site. Construction on the second building was completed in May 2003, at which time monthly rental payments commenced. This second lease agreement also requires minimum rental payments for ten years totaling approximately $23.4 million. In addition, this second lease agreement also required a security deposit of $5.0 million. The Company satisfied this security deposit requirement by causing to have issued another LOC in October 2001, which is also subject to annual renewals. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

In addition to its corporate headquarters facility, the Company also leases facilities for its sales, marketing, distribution and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to three years, and in some instances are cancelable with advance notice.

Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain of its products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded under our cost of product revenues on our consolidated statements of income, was approximately $115,000 during the quarter ended September 30, 2005, and $125,000 for the same period in 2004. Royalty expense was approximately $363,000 for the nine months ended September 30, 2005, and $355,000 for the same period in 2004.

The Company will continue to be obligated for royalty payments in the future. The Company is currently unable to estimate the cumulative amount of these future royalties. However, such amounts will continue to be dependent on the

number of units shipped or the amount of revenue generated from these products.

Guarantees

In the normal course of business, the Company provides indemnifications of varying scope to its customers against claims of intellectual property infringement made by third parties arising from the use of its products. Historically, costs related to these indemnification provisions have not been significant. However, the Company is unable to estimate the maximum potential impact of these indemnification provisions on its future results of operations.

As permitted under Delaware law, the Company has entered into agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The indemnification period covers all pertinent events and occurrences during or related to the officer's or director's tenure with the Company. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has directors and officers insurance coverage that could enable it to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Legal Actions

On May 3, 2004, the Company announced that Enel filed a request for arbitration to resolve a dispute regarding the Company's marketing and supply obligations under the Research and Development and Technological Cooperation Agreement dated June 28, 2000. The arbitration took place in London in early March 2005 under the rules of arbitration of the International Court of Arbitration of the International Chamber of Commerce, or ICC. The Company received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million using exchange rates in effect as of September 30, 2005, have been accrued for and are included in the Company's results of operations for the quarter ended September 30, 2005. The arbitration tribunal refused Enel's request to extend the supply or marketing obligations of Echelon.

In addition to the matter described above, from time to time, in the ordinary course of business, the Company is also subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of September 30, 2005, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

5. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. Inventories consist of the following (in thousands):

	September 30, 2005	December 31, 2004
Purchased materials	$ 1,008	$ 1,320
Work-in-process	13	12
Finished goods	4,166	4,252
	$ 5,187	$ 5,584

6. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	September 30, 2005	December 31, 2004
Accrued payroll and related costs	$ 2,459	$ 2,482
Accrued taxes	1,384	1,398
Other accrued liabilities	7,667	1,572
	$ 11,510	$ 5,452

7. Segment Disclosure

In 1998, the Company adopted Statement of Financial Accounting Standards No. 131, or SFAS 131, *Disclosures about Segments of an Enterprise and Related Information.* Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer, the Chief Operating Officer, and their direct reports. SFAS 131 also requires disclosures about products and services, geographic areas, and major customers.

The Company operates its business as one reportable segment: the design, manufacture and sale of products for the control network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products are marketed under the LONWORKS brand name, which provides the infrastructure and support required to implement and deploy open, interoperable, control network solutions. All of the Company's products either incorporate, or interoperate with, products that incorporate the Neuron® Chip and/or the LONWORKS protocol. The Company also provides services to customers which consist of technical support and training courses covering its LONWORKS network technology and products. The Company offers about 90 products and services that together constitute the LONWORKS system. In general, any given customer purchases a subset of such products and services that are appropriate for that customer's application.

The Company manages its business primarily on a geographic basis. The Company's geographic areas are comprised of three main groups: the Americas; Europe, Middle East and Africa ("EMEA"); and Asia Pacific/ Japan ("APJ"). Each geographic area provides products and services as further described in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations. The Company evaluates the performance of its geographic areas based on profit or loss from operations. Profit or loss for each geographic area includes sales and marketing expenses and other charges directly attributable to the area and excludes certain expenses that are managed outside the geographic area. Costs excluded from area profit or loss primarily consist of unallocated corporate expenses, comprised of product development costs, corporate marketing costs and other general and administrative expenses, which are separately managed. The Company's long-lived assets include property and equipment, restricted investments, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of September 30, 2005, and December 31, 2004, long-lived assets of about $22.4 million and $35.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements. Assets and the related depreciation and amortization are not reported by geography because that information is not reviewed by the Executive Staff when making decisions about resource allocation to the geographic areas based on their performance.

In North America, the Company sells its products through a direct sales organization. Outside North America, direct sales, applications engineering and customer support are conducted through the Company's operations in EMEA and APJ. Revenues are attributed to geographic areas based on the country where the products are shipped. Summary information by geography for the three and nine months ended September 30, 2005 and 2004 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues from customers:				
Americas	$ 4,488	$ 4,164	$ 12,568	$ 12,406
EMEA	9,341	14,619	36,817	57,316
APJ	2,422	3,958	6,029	8,343
Total	$ 16,251	$ 22,741	$ 55,414	$ 78,065
Gross profit:				
Americas	$ 2,599	$ 2,767	$ 7,565	$ 8,130
EMEA	4,700	7,867	19,599	30,650
APJ	1,342	2,244	3,514	5,063
Total	$ 8,641	$ 12,878	$ 30,678	$ 43,843
Income (loss) from operations:				
Americas	$ 1,481	$ 1,767	$ 4,172	$ 4,916
EMEA	3,352	6,514	15,239	26,440
APJ	191	1,375	68	2,070
Unallocated	(16,267)	(10,700)	(39,730)	(32,721)
Total	$ (11,243)	$ (1,044)	$ (20,251)	$ 705

Products sold to Enel and its designated manufacturers accounted for approximately $4.4 million, or 27.0% of total revenues for the quarter ended September 30, 2005, and $11.6 million, or 51.0% for the same period in 2004; and $20.6 million, or 37.1% of total revenues for the nine months ended September 30, 2005, and $43.8 million, or 56.1% for the same period in 2004. For the quarter ended September 30, 2005, 91.5% of the revenues under the Enel program were derived from products shipped to customers in EMEA and the remaining 8.5% were derived from products shipped to customers in APJ. For the nine months ended September 30, 2005, 97.5% of the revenues derived from products shipped under the Enel program were from customers in EMEA and the remaining 2.5% from customers in APJ.

EBV, the sole independent distributor of the Company’s products in Europe, accounted for 22.7% of total revenues for the quarter ended September 30, 2005 and 16.5% for the same period in 2004; and 20.5% of total revenues for the nine months ended September 30, 2005 and 15.2% for the same period in 2004.

8. Income Taxes

The provision for income taxes for the three months and nine months ended September 30, 2005 and 2004 includes a provision for Federal, state, and foreign taxes based on the annual estimated effective tax rate applied to the Company and its subsidiaries for the year. The difference between the statutory rate and the Company’s effective tax rate is primarily due to the impact of foreign taxes and the utilization of net operating losses not previously benefited.

9. Related Party

During the quarter and nine months ended September 30, 2005, and the years ended December 31, 2004, 2003, and 2002, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In June 2000, the Company entered into a stock purchase agreement with Enel. At the same time, the Company also entered into a research and development agreement (the “R&D Agreement”) with an affiliate of Enel. Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LONWORKS technology into Enel’s remote metering management project in Italy. For the quarter and nine months ended September 30, 2005, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $4.4

million and $20.6 million, respectively. For the quarter and nine months ended September 30, 2004, the Company recognized revenue from products sold to Enel and its designated manufacturers of approximately $11.6 million and $43.8 million, respectively. As of September 30, 2005 and September 30, 2004, $5.3 million and $8.8 million, respectively, of the Company’s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

On May 3, 2004, the Company announced that Enel filed a request for arbitration to resolve a dispute regarding the Company's marketing and supply obligations under the R&D Agreement. The arbitration was resolved with the issuance of a decision on September 29, 2005, calling for the Company to pay Enel approximately $5.2 million in damages, interest, and legal and arbitration related costs. For additional information regarding the arbitration, please refer to the "Legal Actions" section of Note 4, Commitments and Contingencies.

10. Stock Repurchase Program

In March and August 2004, the Company's Board of Directors approved a stock repurchase program for up to 3.0 million shares of the Company's common stock. During the quarter ended September 30, 2005, the Company repurchased 96,644 shares under the program at a cost of approximately $773,000. During the nine months ended September 30, 2005, the Company repurchased 1,162,388 shares under the program at a cost of $7.9 million. Since the repurchase program's inception, the Company has repurchased 1,187,372 shares at a cost of $8.0 million. As of September 30, 2005, 1,812,628 shares are available for repurchase. The stock repurchase program will expire in March 2006.

11. Employee Stock Option Exchange Program

On September 21, 2004, the Company announced a voluntary employee stock option exchange program (the "Exchange Program") whereby eligible employees had an opportunity to exchange some or all of their outstanding options for a predetermined number of new stock options. The Company's Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President and Chief Financial Officer, along with members of the Board of Directors, were not eligible to participate in the Exchange Program.

On October 21, 2004, in accordance with the Exchange Program, the Company accepted and cancelled options to purchase 3,816,812 shares of its common stock. On April 22, 2005, which was the first business day that was nine months and one day after cancellation of the exchanged options, the Company granted new stock options totaling 2,159,327 shares. With the exception of new options granted to participating executive officers and certain foreign employees, the new options were granted at an exercise price of $6.11, the closing price of the Company's stock on that date.

In accordance with the terms of the Exchange Program, the exercise price for new options granted to participating executive officers was $8.52, which is the greater of the fair market value of the Company's stock on the date of grant, or 115% of the closing price of the Company's stock on the date the exchanged options were cancelled. No impact to the Company's financial position, results of operations, or cash flows during 2005 or 2004 was associated with this transaction.

12. Warranty Reserves

When evaluating the reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are recorded at the time of shipment. The reserve for warranty costs was $356,000 as of September 30, 2005 and $148,000 as of December 31, 2004.

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business, including but not limited to: our belief that control networks based on our products can reduce life-cycle costs, save energy, are more flexible than centralized systems and permit control systems to be comprised of products and services from a variety of vendors; our belief that the NES system brings cost savings in a wide range of a utility’s functions, from metering and customer services to distribution operations and value-added services; our belief that new products and product enhancements, such as our NES offering and Panoramix platform, will make it easier for our customers to aggregate and process information from remote LonWorks networks, thereby increasing overall network management capabilities; our belief that the benefits derived from our NES system deliver a more compelling return on investment than “traditional” automatic meter reading (“AMR”) systems; our belief that our Enel Project revenue will decline sharply in 2005 as compared to 2004 and our belief that we will not be able to find one or more replacements for this Enel project revenue reduction in 2005; our belief that we will not receive any material revenues from Enel in 2006 and beyond; our belief that, in general, as long as the current worldwide economic recovery continues to gain momentum, overall revenues from our LonWorks Infrastructure business will continue to improve during 2005 as compared to 2004; our expectation that our LonWorks Infrastructure revenues from Europe will continue growing in 2005; our belief that market conditions in Asia, particularly Japan, will continue to be challenging in 2005; our belief that, during the remainder of 2005, the portion of our revenues conducted in Japanese Yen (or other foreign currencies) will rise slightly from that experienced in 2004; our expectation that we will begin shipping our RoHS compliant products in volume quantities later in 2005; our expectation that, for full year 2005, our overall gross margin will be reduced by one to two percentage points from that generated in 2004; our expectation that our service revenues will decrease over prior year levels; our expectation that, for full year 2005, product development expenses will increase marginally over 2004 levels; our expectation that, for full year 2005, general and administrative costs will increase substantially over levels incurred in 2004; our expectation that our anticipated operating losses for the remainder of 2005 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations; our expectation that the average amount of our invested cash will decrease during the remainder of 2005; our belief that, during 2005, our sales and marketing expenses will increase over 2004 levels; our belief that many of our customers will continue to refrain from purchasing our customer support and training offerings during 2005 in an effort to minimize their operating expenses; our belief that we have adequately provided for legal proceedings as of September 30, 2005; our belief that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months; our belief that we will incur a substantial loss in 2005; our belief that stock option expensing will materially reduce our financial results in future years; and our belief that estimates and judgments made regarding future events in connection with the preparation of our financial statements are reasonable. These statements may be identified by the use of such words as “may,” “could,” “would,” “might,” “will,” “should,” “plan,” “forecast,” “anticipate,” “ believe,” “expect,” “intend,” “estimate,” “predict,” “potential,” “continue,” “future,” “moving toward” or the negative of these other similar expressions. In addition, forward-looking statements include, but are not limited to, statements about our beliefs, estimates, or plans about our ability to maintain low manufacturing and operating costs and costs per unit, our ability to estimate revenues, pricing pressures, returns, reserves, demand for our products, selling, general, and administrative expenses, taxes, research, development, and engineering expenses, spending on property, plant, and equipment, expected sales of our products, the market for our products generally and certain customers specifically, our beliefs regarding our liquidity needs, and our beliefs regarding the material weakness identified in internal controls at our Japanese subsidiary.

Forward-looking statements are estimates reflecting the best judgment of our senior management, and they involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. Our business is subject to a number of risks and uncertainties. While this discussion represents our current judgment on the future direction of our business, these risks and uncertainties could cause

actual results to differ materially from any future performance suggested herein. Some of the important factors that may influence possible differences are continued competitive factors, technological developments, pricing pressures, changes in customer demand, and general economic conditions, as well as those discussed above in "Factors That May Affect Future Results of Operations." We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of such statements. Readers should review the "Factors That May Affect Future Results of Operations," as well as other documents filed from time to time by us with the SEC.

OVERVIEW

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We are based in San Jose, California, and maintain offices in nine foreign countries throughout Europe and Asia. We develop, market and support a wide array of products and services based on our LONWORKS technology that enable OEMs and systems integrators to design and implement open, interoperable, distributed control networks. We offer these hardware and software products to OEMs and systems integrators in the building, industrial, transportation, utility/home and other automation markets.

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We sell certain of our products to Enel and certain suppliers of Enel for use in Enel's electricity meter management project in Italy known as the Contatore Elettronico. We refer to Echelon's revenue derived from sales to Enel and Enel's designated manufacturers as Enel Project revenue. We have been investing in products for use by electricity utilities for use in management of electricity distribution. We began to receive modest amounts of revenue resulting from these investments in 2004. We refer to this revenue as networked energy services, or NES, revenue. We refer to all other revenue as LONWORKS Infrastructure revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

We have a history of losses and, although we achieved profitability in past fiscal periods, we have incurred a loss in each of the quarters to date in 2005, and expect to incur substantial operating losses for the remainder of 2005, due primarily to the significant reduction in the amount of Enel Project revenue. Enel has stated that it intends to complete the installation of the Contatore Elettronico during 2005, after which we do not expect any material revenues from Enel or its meter manufacturers.

CRITICAL ACCOUNTING ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, allowance for doubtful accounts, inventories, commitments and contingencies, income taxes, and asset impairments. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective and complex judgments.

Sales Returns and Allowances. We sell our products and services to OEMs, systems integrators, and our other customers directly through our sales force and indirectly through distributors located in the geographic markets that we serve. Net revenues consist of product and service revenues reduced by estimated sales returns and allowances. Provisions for estimated sales returns and allowances are recorded at the time of sale, and are based on management’s estimates of potential future product returns related to product revenues in the current period. In evaluating the adequacy of our sales returns and other allowances, management analyzes historical returns, current and historical economic trends, contractual terms, and changes in customer demand and acceptance of our products.

Sales to certain distributors are made under terms allowing limited rights of return. Sales to EBV, our largest distributor, accounted for 22.7% of total net revenues for the quarter ended September 30, 2005 and 16.5% for the same period in 2004; and 20.5% of total net revenues for the nine months ended September 30, 2005 and 15.2% for the same period in 2004. Worldwide sales to distributors, including those to EBV, accounted for approximately 32.3% of total net revenues for the quarter ended September 30, 2005 and 17.0% of total net revenues for the same period in 2004; and 28.2% of total net revenues for the nine months ended September 30, 2005 and 21.4% for the same period in 2004.

To estimate potential product returns from distributors other than EBV, management analyzes historical returns and the specific contractual return rights of each distributor. In the case of EBV, we further refine this analysis by reviewing month-end inventory levels at EBV, shipments in transit to EBV, EBV’s historical sales volume by product, and forecasted sales volumes for some of EBV’s larger customers. Significant management judgments and estimates must be made and used in connection with establishing these distributor-related sales returns and other allowances in any accounting period. Material differences may result in the amount and timing of our revenues for any period if management revises its judgments or estimates.

In addition, if we were to modify the contractual return rights, or otherwise change the terms of our agreement with EBV or any of our other distributors, we could be required to defer the revenue on sales made to these distributors until such time as the distributors sold the products to their end-user customers. Such a change in our revenue recognition for these sales could result in a material reduction in our revenues in the period when we modify the

distributor agreement(s).

Other than standard warranty repair work, Enel and its designated contract meter manufacturers do not have rights to return products we ship to them. However, our agreement with Enel contains an “acceptance” provision, whereby Enel is entitled to inspect products we ship to them to ensure the products conform, in all material respects, to the product’s specifications. Once the product has been inspected and approved by Enel, or if the acceptance period lapses before Enel inspects or approves the products, the goods are considered accepted. Prior to shipping our products to Enel, we perform detailed reviews and tests to ensure the products will meet Enel’s acceptance criteria. We do not ship products unless they have passed these reviews and tests. As a result, we record revenue for these products upon shipment to Enel. If Enel were to subsequently properly reject any material portion of a shipment for not meeting the agreed upon specifications, we would defer the revenue on that portion of the transaction until such time as Enel and we were able to resolve the discrepancy. Such a deferral could have a material impact on the amount and timing of our Enel related revenues.

We also provide for an allowance for sales discounts and rebates that we identify and reserve for at the time of sale. This reserve is primarily related to estimated future point of sale, or POS, credits to be issued to EBV. Under our arrangement with EBV, we have agreed to issue POS credits on sales they make to certain volume customers. We base this estimate on EBV’s historical and forecasted sales volumes to those customers. Significant management judgments and estimates must be made and used in connection with establishing these reserves for POS credits in any accounting period. Material differences may result in the amount and timing of our revenues for any period if management revises its judgments or estimates.

Our allowances for sales returns and other sales-related reserves were approximately $1.9 million as of September 30, 2005, and $1.3 million as of December 31, 2004.

Allowance for Doubtful Accounts. We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as many as net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer’s payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit-worthiness of our overall customer base, changes in our customers’ payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions worsened, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was $300,000 as of both September 30, 2005 and December 31, 2004.

Inventory Valuation. At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand. Inventories on hand, in excess of one year’s forecasted demand, are not valued. In addition, we write off inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete. We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

Warranty Reserves. We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was $356,000 as of September 30, 2005 and $148,000 as of December 31, 2004.

Deferred Income Taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on our historical net operating losses, and the uncertainty of our future operating results, we have recorded a valuation allowance that fully reserves our deferred tax assets. If we later determine that, more likely than not, some or all of the net deferred tax assets will be realized, we would then need to reverse some or all of the previously provided valuation allowance. Our deferred tax asset valuation allowance was $45.6 million as of December 31, 2004.

Valuation of Goodwill and Other Intangible Assets. We assess the impairment of goodwill and identifiable intangible assets on an annual basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner or use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends; and
- significant changes in the composition of the intangible assets acquired.

When we determine that the carrying value of goodwill and other intangible assets may not be recoverable based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net goodwill and other intangible assets amounted to $8.1 million as of September 30, 2005.

When we adopted Statement of Financial Accounting Standards (SFAS) No. 142 in 2002, we ceased amortizing goodwill, which had a net unamortized balance of $1.7 million as of December 31, 2001. Since then, primarily as a result of acquisitions in 2002 and 2003, the net balance of goodwill has grown to $8.1 million as of September 30, 2005. We review goodwill for impairment annually during the quarter ending March 31. Our review during the quarter ended March 31, 2005 indicated no impairment. If, as a result of an annual or any other impairment review that we perform in the future, we determine that there has been an impairment of our goodwill or other intangible assets, we would be required to take an impairment charge. Such a charge could have a material adverse impact on our financial position and/or operating results.

RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the three and nine-month periods ended September 30, 2005 and September 30, 2004:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	**2004**	**2005**	**2004**
Revenues:				
Product	98.9%	99.2%	99.0%	99.2%
Service	1.1	0.8	1.0	0.8
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product	43.6	41.4	41.7	41.9
Cost of service	3.2	2.0	2.9	1.9
Total cost of revenues	46.8	43.4	44.6	43.8
Gross profit	53.2	56.6	55.4	56.2
Operating expenses:				
Product development	38.0	27.4	33.8	23.9
Sales and marketing	31.8	20.1	28.1	18.8
General and administrative	52.6	13.7	30.0	12.6
Total operating expenses	122.4	61.2	91.9	55.3
Income (loss) from operations	(69.2)	(4.6)	(36.5)	0.9
Interest and other income, net	7.5	2.7	6.4	2.2
	(61.7)	(1.9)	(30.1)	3.1

Income (loss) before provision for income taxes				
Income tax expense (benefit)	0.6	(0.2)	0.5	0.3
Net income (loss)	(62.3)%	(1.7)%	(30.6)%	2.8%

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Revenues

Total Revenues

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Total Revenues	$ 16,251	$ 22,741	$ (6,490)	(28.5%)

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Total Revenues	$ 55,414	$ 78,065	$ (22,651)	(29.0%)

The $6.5 million decrease in total revenues for the quarter ended September 30, 2005 as compared to the same period in 2004 was primarily the result of a $7.2 million reduction in Enel Project revenues, partially offset by a $573,000 increase in LONWORKS Infrastructure revenues and a $156,000 increase in NES revenues. The $22.7 million decrease in total revenues for the nine months ended September 30, 2005 as compared to the same period in 2004 was primarily the result of a $23.2 million reduction in Enel Project revenues, partially offset by a $513,000 increase in NES revenues.

Enel Project revenues

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Total Revenues	$ 4,388	$ 11,605	$ (7,217)	(62.2%)

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Total Revenues	$ 20,580	$ 43,796	$ (23,216)	(53.0%)

Revenues from the Enel Project will typically fluctuate from quarter to quarter, and from year to year, for reasons such as those described in more detail in the section entitled “Factors That May Affect Future Results of Operations.” The $7.2 million decrease in Enel Project revenues for the quarter ended September 30, 2005, as compared to the same period in 2004, was attributable to a reduction in the number of electricity meter components (also referred to as metering kit products) sold during the period. To a lesser extent, a slight reduction in the average selling prices for metering kits also contributed to the decline in revenues. Under the terms of our agreement with Enel, prices for the products we sell for the Enel Project are reduced based on the cumulative number of units shipped. The $23.2 million decrease in Enel Project revenues for the nine months ended September 30, 2005 as compared to the same period in 2004 was primarily attributable to a reduction in the number of metering kits and data concentrator products sold. To a lesser extent, reductions in the average selling prices for metering kits and data concentrators, as well as revenue recognized during the second quarter of 2004 associated with a one-time licensing fee for custom software we developed for Enel, also contributed to the year-over-year decline.

We sell our products to Enel and its designated contract meter manufacturers in U.S. Dollars. Therefore, the associated revenues are not subject to foreign currency risks.

Enel has stated that it intends to complete the installation of the Contatore Elettronico during 2005. We expect that 2005 revenues from the Enel project will decline from 2004 levels by roughly $37.8 million to approximately $26.3 million, or slightly more than 35% of our total revenues for 2005. We do not currently anticipate any material revenues from Enel in 2006 and beyond.

From time to time, we have interpreted the contracts between our companies differently from Enel, which has led to disagreements. For example, as a result of a dispute regarding the compensation owed to us for the transition from the second version of metering kit to the third generation of metering kit, which dispute has since been resolved, we deferred approximately $2.7 million of revenue from the second quarter to the third quarter of 2003. More recently, in May 2004, we announced that Enel filed a request for arbitration to resolve a dispute regarding our marketing and supply obligations under the R&D Agreement. Under the arbitration, Enel sought to compel our company to sell to Enel an unspecified amount of additional products, to jointly market the Contatore Elettronico system with Enel outside of Italy, to pay damages of approximately €42 million, and to reimburse them for certain legal and arbitration related fees. The arbitration took place in early March 2005 in London. We received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million using exchange rates in effect as of September 30, 2005, have been accrued for and are included in our results of operations for the quarter ended September 30, 2005. The arbitration tribunal refused Enel's request to extend the supply or marketing obligations of Echelon. Once the project is completed in 2005, we will experience a significant drop in our overall revenue, which will have a material negative impact on our financial position and results of operations.

Given our expectation that revenues from the Enel Project will cease in late 2005, we have created the NES system and continue to seek market opportunities with other utilities to expand our customer base. In 2002, we formed a new sales and marketing organization that has been tasked with identifying other customers for our NES system products. However, we can give no assurance that our efforts in the NES area will be successful.

LONWORKS Infrastructure revenues

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
LONWORKS Infrastructure Revenues	$ 11,702	$ 11,129	$ 573	5.1%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
LONWORKS Infrastructure Revenues	$ 34,291	$ 34,238	$ 53	0.0%

Our LONWORKS Infrastructure revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. The $573,000 increase in LONWORKS Infrastructure revenues for the quarter ended September 30, 2005 as compared to the same period in 2004 was primarily attributable to improved economic conditions and business opportunities in the various markets that we serve. Partially offsetting this increase was the impact of exchange rates on sales made in foreign currencies, principally the Japanese Yen, which resulted in an approximately $7,000 year-over-year decrease. The $53,000 increase in LONWORKS Infrastructure revenue for the nine months ended September 30, 2005 as compared to the same period in 2004 was primarily due to the favorable impact of exchange rates on sales made in foreign currencies, which resulted in a $21,000 increase between the two periods.

Although we have experienced relatively small growth in our LONWORKS Infrastructure revenues for the nine months ended September 30, 2005 as compared to the same period in 2004, we continue to believe that, as long as current worldwide economic conditions do not deteriorate, full year 2005 revenues from our LONWORKS Infrastructure business will improve slightly from the $45.7 million recorded in 2004. This expected improvement, however, will be subject to further fluctuations in the exchange rates between the U.S. Dollar and the Japanese Yen. If

the U.S. Dollar were to strengthen against the Japanese Yen, our revenues would decrease. Conversely, if the U.S. Dollar were to weaken against the Japanese Yen, our revenues would increase. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in Japanese Yen (or other foreign currencies) and the magnitude of the exchange rate fluctuation from year to year. The portion of our revenues conducted in currencies other than the U.S. Dollar, principally the Japanese Yen, was about 5.3% for the quarter ended September 30, 2005 and 3.9% for the same period in 2004. We currently expect that, during the remainder of 2005, the portion of our revenues conducted in these foreign currencies will rise slightly from that experienced in 2004, primarily due to the reduction in Enel project revenues. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

NES revenues

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
NES Revenues	$ 162	$ 6	$ 156	2,600.0%

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
NES Revenues	$ 543	$ 30	$ 513	1,710.0%

For both the quarter and nine-months ended September 30, 2005, NES revenues have been generated primarily from the completion of customer trials. For the quarter and nine-months ended September 30, 2004, NES revenues were generated primarily from the sale of NES products and services.

We expect that, for full year 2005, total NES revenues will increase from the $85,000 reported in 2004 to approximately $800,000, and that the primary source of these revenues in 2005 will be the completion of customer trials.

EBV revenues

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
EBV Revenues	$ 3,686	$ 3,743	$ (57)	(1.5%)

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
EBV Revenues	$ 11,375	$ 11,849	$ (474)	(4.0%)

Sales to EBV, our largest distributor and the sole independent distributor of our products in Europe, accounted for 22.7% of our total revenues for the quarter ended September 30, 2005 and 16.5% of our total revenues for the same period in 2004; and 20.5% of our total revenues for the nine months ended September 30, 2005 and 15.2% for the same period in 2004. We believe the reduction in revenues for both the quarter and nine months ended September 30, 2005 as compared to the same periods in 2004 is primarily due to the impact of the new Restriction of Hazardous Substances, or RoHS, regulations. Under these new rules, which become effective in the European Union (and elsewhere) in 2006, manufacturers such as Echelon will be required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into the region. We believe that, in an effort to minimize any excess inventories of non-RoHS compliant products, EBV is reducing its existing inventory balances from historical levels. This, in turn, results in reduced shipments to EBV until the RoHS compliant products become available. Consequently, we believe that full year 2005 revenues from EBV will be reduced from the $15.9 million reported in 2004. We currently expect to begin shipping the RoHS compliant versions of some of our products in volume quantities later in 2005.

Our contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2005. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our future financial position could be harmed. We currently sell our products to EBV in

U.S. Dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Product revenues

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Product Revenues	$ 16,068	$ 22,556	$ (6,488)	(28.8%)

	Nine Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Product Revenues	$ 54,852	$ 77,467	$ (22,615)	(29.2%)

The $6.5 million decrease in product revenues for the quarter ended September 30, 2005 as compared to the same period in 2004 was primarily the result of a $7.2 million reduction in Enel Project revenues, partially offset by increases in our LONWORKS Infrastructure and NES product revenues. The $22.6 million decrease in product revenues for the nine months ended September 30, 2005 as compared to the same period in 2004 was primarily the result of a $23.2 million reduction in Enel Project revenues, partially offset by a $513,000 increase in NES revenues and an $84,000 increase in LONWORKS Infrastructure product revenues. The NES revenues recognized during the first nine months of 2005 were primarily attributable to the completion of customer trials.

Service revenues

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Service Revenues	$ 183	$ 185	$ (2)	(1.1%)

	Nine Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Service Revenues	$ 562	$ 598	$ (36)	(6.0%)

The $2,000 decrease in LONWORKS Infrastructure service revenues during the quarter ended September 30, 2005 as compared to the same period in 2004, and the $36,000 decrease during the nine months ended September 30, 2005 as compared to the same period in 2004, was the result of a continued decrease in our customers' use of our support and training services. We believe that the worldwide economic recession in 2002 and 2003 forced many of our customers to curtail spending for training and support. Although worldwide economic conditions improved during the latter part of 2003 and have continued through the first half of 2005, we do not expect our service revenues to increase over prior year levels. In fact, we believe that many of our customers will continue to refrain from purchasing our customer support and training offerings during 2005 in an effort to minimize their operating expenses.

Gross Profit and Gross Margin

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Gross Profit	$ 8,641	$ 12,878	$ (4,237)	(32.9%)
Gross Margin	53.2%	56.6%	--	(3.4)

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Gross Profit	$ 30,678	$ 43,843	$ (13,165)	(30.0%)
Gross Margin	55.4%	56.2%	--	(0.8)

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of goods sold for service revenues consists of employee-related costs such as salaries and fringe benefits as well as other direct costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

For both the quarter and nine months ended September 30, 2005 as compared to the same periods in 2004, gross margins were favorably affected by a change in the mix of Enel Project and LONWORKS Infrastructure revenues. During the quarter ended September 30, 2005, approximately 27.0% of our revenues were attributable to the Enel Project and 72.0% were attributable to sales of our LONWORKS Infrastructure products and services. For the quarter ended September 30, 2004, approximately 51.0% of our revenues were attributable to the Enel Project, while 48.9% resulted from sales of our LONWORKS Infrastructure products and services. For the nine months ended September 30, 2005, approximately 37.1% of our revenues were attributable to the Enel Project and 61.9% were attributable to sales of our LONWORKS Infrastructure products and services. For the nine months ended September 30, 2004, approximately 56.1% of our revenues were attributable to the Enel Project, while 43.9% resulted from sales of our LONWORKS Infrastructure products and services. In general, gross margins on Enel Project revenues tend to be lower than those generated from sales of our LONWORKS Infrastructure products and services. As a result, when Enel Project revenues are lower as a percentage of overall revenues, as they were during the quarter and nine months ended September 30, 2005, overall gross margins tend to be higher. Conversely, when Enel Project revenues comprise a higher percentage of overall revenues, as they were during the quarter and nine months ended September 30, 2004, overall gross margins tend to be lower.

Completely offsetting these improvements for the quarter and nine-months ended September 30, 2005 as compared to the same periods in 2004 was the impact of lower overall revenues on gross margins. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when revenues decrease, as they did in the quarter and nine months ended September 30, 2005 as compared to the same periods in 2004, gross margins decrease.

We expect that, for full year 2005, our overall gross margin will be reduced by one to two percentage points from the 56.2% generated in 2004.

Operating Expenses

Product Development

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Product Development	$ 6,170	$ 6,227	$ (57)	(0.9%)

Nine Months Ended

(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Product Development	$ 18,747	$ 18,623	$ 124	0.7%

Product development expenses consist primarily of payroll and related expenses for development personnel, facility costs, fees paid to third party consultants, equipment and supplies, depreciation and amortization, and other costs associated with the development of new technologies and products.

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The primary factors contributing to the marginal decrease in product development expenses for the quarter ended September 30, 2005, as compared to the same period in 2004, were decreases in consultant and other third party service provider expenses as well as a decrease in depreciation and amortization expenses associated with purchased technology that became fully amortized during the first quarter of 2005. Partially offsetting these reductions in product development expenses between the two periods were increased expenses for equipment and supplies used in development activities as well as increased compensation and other employee related expenses.

The primary factors contributing to the slight increase in product development expenses for the nine-months ended September 30, 2005, as compared to the same period in 2004, were increases in compensation and related costs for our development personnel (including costs paid to third party consultants), as well as costs associated with prototype material and other supplies used in the development process. Offsetting these increases was a decrease in depreciation and amortization expense associated with purchased technology that became fully amortized during the first quarter of 2005.

We expect that, for full year 2005, product development expenses will increase marginally over 2004 levels.

Sales and Marketing

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Sales and Marketing	$ 5,164	$ 4,572	$ 592	12.9%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Sales and Marketing	$ 15,585	$ 14,660	$ 925	6.3%

Sales and marketing expenses consist primarily of payroll and related expenses for sales and marketing personnel, including commissions to sales personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and support offices.

For both the quarter and nine months ended September 30, 2005, as compared to the same periods in 2004, the increases in sales and marketing expenses were primarily the result of increased costs associated with tradeshows and other marketing communications related expenses, travel and entertainment expenses, compensation and other employee related expenses, fees paid to consultants and other third party service providers, and equipment and other supplies used in the sales process.

In addition, approximately $122,000 of the $925,000 increase between the two nine month periods was attributable to the impact of foreign currency exchange rate fluctuations between the U.S. Dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the Pound Sterling, and the Japanese Yen. The impact of foreign currency exchange rate fluctuations between the two quarterly periods was negligible.

We expect that, for full year 2005, our sales and marketing expenses will increase over 2004 levels. We believe that this increase will be attributable to increases in sales incentive compensation plans as well as the relative weakness of the U.S. Dollar. If, however, the U.S. Dollar were to continue strengthening against the foreign currencies where we do business, our sales and marketing expenses would be favorably impacted. Conversely, if the U.S. Dollar were to weaken further against these currencies, our expenses would rise.

General and Administrative

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
General and Administrative	$ 8,550	$ 3,123	$ 5,427	173.8%

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
General and Administrative	$ 16,597	$ 9,855	$ 6,742	68.4%

General and administrative expenses consist primarily of payroll and related expenses for executive, accounting and administrative personnel, professional fees for legal and accounting services rendered to the company, facility costs, insurance, and other general corporate expenses.

For both the quarter and nine months ended September 30, 2005, the increase in general and administrative expenses, as compared to the same periods in 2004, was primarily attributable to the impact of the Enel arbitration award. As previously discussed, in late September 2005 we received the arbitration panel's ruling, which awarded Enel approximately $5.2 million. Of that amount, approximately $5.1 million was accounted for as a general and administrative cost in the third quarter of 2005, while the remaining $96,000 was reflected as interest expense.

Excluding the impact of the Enel arbitration award, general and administrative expenses increased by approximately $346,000 for the quarter ended September 30, 2005, as compared to the same period in 2004. This increase is primarily attributable to increased compensation and related costs for our general and administrative personnel as well as increased costs for service contracts and other maintenance agreements, offset by a reduction in travel and entertainment expenses.

Excluding the impact of the Enel arbitration award, general and administrative expenses increased by approximately $1.7 million for the nine months ended September 30, 2005, as compared to the same period in 2004. This increase is primarily attributable to increased legal fees and other related costs incurred in connection with our arbitration with Enel, increased fees paid to our external auditors resulting from increased Sarbanes-Oxley compliance requirements, and, to a lesser extent, increased compensation and related costs for our general and administrative personnel.

We expect that, for full year 2005, general and administrative costs will increase substantially over levels incurred in 2004. This higher level of spending will be primarily due to the $5.1 million impact of the Enel arbitration award, legal fees associated with the Enel arbitration, and additional compliance requirements imposed by Sarbanes-Oxley.

Interest and Other Income, Net

(Dollars in thousands)	Three Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Interest and Other Income, Net	$ 1,225	$ 609	$ 616	101.1%

(Dollars in thousands)	Nine Months Ended September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Interest and Other Income, Net	$ 3,567	$ 1,755	$ 1,812	103.2%

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances. In addition, foreign exchange translation gains and losses related to short-term intercompany balances are also reflected in this amount.

For both the quarter and nine months ended September 30, 2005, interest and other income, net was negatively impacted by the Enel arbitration award. As previously discussed, of the total $5.2 million charge associated with the

award, approximately $96,000 was reflected as interest expense. Excluding the impact of the Enel arbitration award, interest and other income, net increased by $712,000 and $1.9 million for the quarter and nine months ended September 30, 2005, respectively, as compared to the same periods in 2004.

Of the $616,000 increase in interest and other income, net during the quarter ended September 30, 2005 as compared to the same period in 2004, approximately $583,000 was attributable to increased interest income. Similarly, of the $1.8 million increase in interest and other income, net during the nine months ended September 30, 2005 as compared to the same period in 2004, approximately $1.5 million was attributable to increased interest income. These increases are primarily attributable to an overall improvement in the average yield on our investment portfolio. Yields have increased recently as a result of the Federal Reserve's interest rate increases over the last several months. As short-term investments we purchased in 2003 and 2004 have come to maturity, the proceeds have been re-invested in instruments with higher effective yields, thus increasing interest income. Also contributing to the increase between the two quarterly and nine month periods was the favorable impact of foreign exchange gains on our short-term intercompany balances.

Although interest rates have increased modestly over the last several months, we expect that our anticipated operating losses for the remainder of 2005 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations. In addition, we may decide to continue repurchasing our common stock in accordance with our Board of Directors approved stock repurchase program, which expires in March 2006. As a result, we expect that the average amount of our invested cash will decrease during the remainder of 2005, which could result in reduced interest income. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

Provision for Income Taxes

	Three Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Provision for Income Taxes	$ 100	$ (35)	$ 135	385.7%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2005	September 30, 2004	2005 over 2004 $ Change	2005 over 2004 % Change
Provision for Income Taxes	$ 300	$ 197	$ 103	52.3%

The provision for income taxes for 2005 includes a provision for federal, state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes and the beneficial impact of deferred taxes resulting from the utilization of net operating losses. Income taxes of $100,000 for the quarter ended September 30, 2005, and $300,000 for the nine months ended September 30, 2005, primarily consist of taxes related to profitable foreign subsidiaries and various state minimum taxes. Income taxes of $(35,000) for the quarter ended September 30, 2004, and $197,000 for the nine months ended September 30, 2004, primarily consist of taxes related to profitable foreign subsidiaries, federal alternative minimum taxes, and various state minimum and regular income taxes.

Although we expect to generate a loss before provision for income taxes in 2005, we will be required to book income tax expense to cover, at a minimum, the foreign taxes owed on income generated by our profitable foreign subsidiaries. We expect this 2005 provision for income taxes will be slightly below the amounts provided for in 2004.

OFF-BALANCE SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS

Off-Balance-Sheet Arrangements. We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose Echelon to material continuing risks, contingent liabilities, or any other obligation under a variable interest

in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

Operating Lease Commitments. We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable operating leases. The first lease agreement expires in 2011 and the second lease agreement expires in 2013. Upon expiration, both lease agreements provide for extensions of up to ten years. As part of these lease transactions, we provided the lessor security deposits in the form of two standby letters of credit totaling $8.0 million. Prior to July 2005, these letters of credit were secured with a cash deposit at the bank that issued the letters of credit. The cash on deposit was restricted as to withdrawal and was managed by a third party subject to certain limitations under our investment policy. The letters of credit are now unsecured.

In addition to our corporate headquarters facility, we also lease facilities for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to two years, and in some instances are cancelable with advance notice.

Purchase Commitments. We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods that range from one to nine months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

Indemnifications. In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during or related to the officer's or director's tenure with our company. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that could enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded under our cost of products revenue on our consolidated statements of income, was approximately $115,000 during the quarter ended September 30, 2005, and $125,000 for the same period in 2004. Royalty expense was approximately $363,000 for the nine months ended September 30, 2005, and $355,000 for the same period in 2004.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

Legal Actions. On May 3, 2004, we announced that Enel had filed a request for arbitration to resolve a dispute regarding our marketing and supply obligations under the R&D Agreement. The arbitration took place in London in early March 2005. We received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million using exchange rates in effect as of September 30, 2005, have been accrued for and are included in our results of operations for the quarter ended September 30, 2005. The arbitration tribunal refused Enel's request to extend the supply or marketing obligations of Echelon.

In addition to the matter described above, from time to time, in the ordinary course of business, we are also subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable

that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of September 30, 2005, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

As of September 30, 2005, our contractual obligations were as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating leases	$ 32,499	$ 5,025	$ 9,481	$ 9,294	$ 8,699
Purchase commitments	6,366	6,199	167	--	--
Total	$ 38,865	$ 11,224	$ 9,648	$ 9,294	$ 8,699

LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although recently we have also been able to finance our operations through operating cash flow. From inception through September 30, 2005, we raised approximately $277.9 million from the sale of preferred stock and common stock, including exercises of stock options and warrants granted to our employees and members of our Board of Directors.

In July 1998, we consummated an initial public offering of 5,000,000 shares of our common stock at a price to the public of $7.00 per share. The net proceeds from the offering were about $31.7 million. Concurrent with the closing of our initial public offering, 7,887,381 shares of convertible preferred stock were converted into an equivalent number of shares of common stock. The net proceeds received upon the consummation of the offering were invested in short-term, investment-grade, interest-bearing instruments.

In September 2000, we consummated a sale of 3.0 million shares of our common stock to Enel. The net proceeds of the sale were approximately $130.7 million.

In September 2001, our Board of Directors approved a stock repurchase program which authorized us to repurchase up to 2.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. In September 2001, we repurchased 265,000 shares under the program at a cost of $3.2 million. No additional repurchases were made subsequent to September 2001. The stock repurchase program expired in September 2003.

In March and August 2004, our Board of Directors approved a second stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we have repurchased a total of 1,187,372 shares under the program at a cost of $8.0 million. As of September 30, 2005, 1,812,628 shares are available for repurchase. The stock repurchase program will expire in March 2006.

The following table presents selected financial information as of September 30, 2005 and for each of the last three fiscal years (dollars in thousands):

	September 30, 2005	2004	December 31, 2003	2002
Cash, cash equivalents, and short-term investments	$ 161,833	$ 160,364	$ 144,923	$ 134,489
Trade accounts receivable, net	9,423	17,261	20,110	22,930
Working capital	161,291	173,391	160,745	156,320
Stockholders' equity	185,707	211,062	200,924	195,018

As of September 30, 2005, we had $161.8 million in cash, cash equivalents, and short-term investments, an increase of $1.5 million as compared to December 31, 2004. Historically, our primary source of cash, other than stock sales

and exercises of stock options and warrants as discussed above, has been receipts from revenue. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase program.

Net cash provided by operating activities. Net cash provided by operating activities has historically been driven by net income (loss) levels, adjustments for non-cash charges such as depreciation, amortization, and in-process research and development charges, and fluctuations in operating asset and liability balances. Net cash provided by operating activities was $304,000 for the nine months ended September 30, 2005, a $13.4 million decrease over the same period in 2004. During the nine months ended September 30, 2005, net cash provided by operating activities was primarily the result of changes in our operating assets and liabilities of $13.8 million, depreciation and amortization expense of $3.1 million, and stock-based compensation expense of $356,000, offset by our net loss of $17.0 million. Cash provided by operating activities for the nine months ended September 30, 2004 was generated primarily from changes in our operating assets and liabilities of $7.7 million, net income of $2.3 million, and $3.7 million of depreciation and amortization.

Net cash provided by (used for) investing activities. Net cash provided by (used for) investing activities has historically been driven by transactions involving our short-term investment portfolio, purchases and sales of restricted investments, capital expenditures, changes in our long-term assets, and acquisitions. Net cash provided by investing activities was $7.3 million for the nine months ended September 30, 2005, a $9.7 million increase from the same period in 2004. During the nine months ended September 30, 2005, net cash provided by investing activities was primarily the result of by proceeds from sales and maturities of available-for-sale short-term investments of $89.8 million, an $11.1 million reduction in our restricted investments, and changes in our other long-term assets of $250,000, offset by purchases of $92.4 million of available-for-sale short-term investments and capital expenditures of $1.5 million. During the nine months ended September 30, 2004, net cash used for investing activities was primarily the result of purchases of $111.6 million of available-for-sale short-term investments, capital expenditures of $1.6 million, purchases of restricted investments of $238,000, and changes in our other long-term assets of $146,000, offset by proceeds from sales and maturities of available-for-sale short-term investments of $111.1 million.

Net cash provided by (used in) financing activities. Net cash provided by (used in) financing activities has historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs. Net cash used in financing activities was $7.9 million for the nine months ended September 30, 2005, a $13.0 million increase as compared to net cash provided by financing activities of $5.1 million during the same period in 2004. During the nine months ended September 30, 2005, net cash used in financing activities was attributable to open-market purchases of our common stock under our stock repurchase program. For the nine months ended September 30, 2004, net cash provided by financing activities of $5.1 million was comprised of proceeds from the exercise of stock options by employees and directors.

We use well-regarded investment management firms to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated United States corporate obligations, United States government securities, and to a lesser extent, money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We expect that cash requirements for our payroll and other operating costs will continue at or slightly above existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. Furthermore, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business.

Our existing cash, cash equivalents, and investment balances will likely decline during 2005 as a result of our anticipated operating losses and purchases under our board of directors approved stock repurchase program. In addition, any weakening of current economic conditions, or changes in our planned cash outlay, could also negatively affect our existing cash, cash equivalents, and investment balances. However, based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to, the risks detailed later in this discussion in

the section titled "*Factors That May Affect Future Results of Operations*." In the unlikely event that we would require additional financing within this period, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

RELATED PARTY TRANSACTIONS

During the quarter and nine months ended September 30, 2005, and the years ended December 31, 2004, 2003, and 2002, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, M. Kenneth Oshman, our Chairman of the Board and Chief Executive Officer, uses private air travel services for business trips for himself and for any employees accompanying him. Prior to January 1, 2005, a company controlled by Armas Clifford Markkula, a director of our company, provided these private air travel services. Our net expense with respect to such private air travel services is no greater than comparable first class commercial air travel services. Such net outlays were not material.

In September 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million (see Note 9 to our accompanying condensed consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. As of October 31, 2005, to our knowledge Enel had not disposed of any of its 3.0 million shares.

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. Enel appointed Mr. Francesco Tatò as its representative to our board of directors in September 2000. As a consequence of the expiration of Mr. Tatò's mandate as Enel's Chief Executive Officer, Mr. Tatò resigned his board memberships in all of Enel's subsidiaries and affiliates, including Echelon. His resignation from our board of directors was effective in June 2002. Enel has reserved its right to nominate a new member of our board of directors, although as of October 31, 2005, Enel has not done so. During the term of service of Enel's representative on our board of directors from September 2000 to September 2002, Enel's representative abstained from resolutions on any matter relating to Enel.

At the time we entered into the stock purchase agreement with Enel, we also entered into the R&D Agreement with an affiliate of Enel. The R&D Agreement expired in June 2005. Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy. For the quarter and nine months ended September 30, 2005, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $4.4 million and $20.6 million, respectively. As of September 30, 2005, $5.3 million of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. Of the $5.3 million accounts receivable balance, approximately $2.1 million was due from Enel and was past due at September 30, 2005. As of October 31, 2005, Enel and we agreed to offset this past due balance against the $5.2 million arbitration settlement award, which is discussed in more detail below. For the quarter and nine months ended September 30, 2004, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $11.6 million and $43.8 million, respectively, $8.8 million of which was included in accounts receivable at September 30, 2004. We expect that 2005 revenue relating to the Enel program will decline significantly as compared to the $64.1 million recognized in 2004. In addition, we expect that we will complete our Enel program related deliveries during 2005, after which revenue, if any, from Enel and its designated manufacturers will be reduced to an immaterial amount.

As described in the "Legal Actions" section of our discussion of "Off-Balance-Sheet Arrangements and Other Contractual Obligations", during the second quarter of 2004, Enel began arbitration proceedings against our company. The arbitration was held in early March 2005 in London. We received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million using exchange rates in effect as of September 30, 2005, have been accrued for and are included in our results of operations for the quarter ended September 30, 2005.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for how an entity accounts for, and reports, a change in accounting

principle. Previously, most voluntary changes in accounting principles were implemented by reflecting a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. Although we are continuing to evaluate the application of SFAS 154, we do not currently believe its adoption will have a material effect on our financial position, results of operations, or cash flows.

In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, or FIN 47, *Accounting for Conditional Asset Retirement Obligations*, which is an interpretation of SFAS 143, *Accounting for Asset Retirement Obligations*. FIN 47 requires that a liability for the fair value of a conditional asset retirement obligation be recognized if the fair value of the liability can be reasonably estimated. The interpretation must be adopted no later than the end of a company's fiscal year ending after December 15, 2005. The interpretation is not expected to have a material impact on our financial position, results of operations, or cash flows.

In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*. SFAS 123R requires that an amount be calculated for all equity instruments granted to employees, including grants of employee stock options, using a fair-value-based method, and that these amounts be recorded as an expense in our consolidated statements of income. The accounting provisions of SFAS 123R are effective for annual reporting periods beginning after June 15, 2005. We will be required to adopt SFAS 123R in our first fiscal quarter ending March 31, 2006. The pro forma disclosures previously permitted under SFAS 123, *Accounting for Stock-Based Compensation*, will no longer be an alternative to financial statement recognition. See "Stock-Based Employee Compensation Plans" in Note 2 to our accompanying consolidated financial statements later in this report for the pro-forma net loss and net loss per share amounts that would have been reported for the years ended December 31, 2004, 2003, and 2002 had we used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Under SFAS 123R, beginning January 1, 2006, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include either a modified-prospective or a modified-retroactive option. Under the modified-retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified-prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the modified-retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro-forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a significant adverse impact on our results of operations and earnings per share.

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107, *Share-Based Payment*, which expresses views of the SEC staff regarding the application of SFAS 123R. Among other things, SAB 107 provides interpretive guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1, or FAS 109-1, *Application of FASB Statement No. 109, "Accounting for Income Taxes," to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* ("AJCA"). The AJCA introduces a special 9% tax deduction on qualified production activities. FAS 109-1 clarifies that this tax deduction should be accounted for as a special tax deduction in accordance with Statement No. 109. We do not currently expect the adoption of these new tax positions will have a material impact on our financial position, results of operations, or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2, or FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FAS 109-2 provides additional time to companies beyond the financial reporting period of enactment to evaluate the effects of the AJCA on their plans for repatriation of foreign earnings for purposes of applying SFAS 109, *Accounting for Income Taxes*. We are currently evaluating the repatriation provisions of AJCA, which if implemented, would affect our tax provision and deferred tax assets and liabilities. However, given the uncertainties and complexities of the repatriation provision, as well as our continuing evaluation, it is not possible at this time to determine the amount, if any, that may be repatriated or the related potential income tax effects of such repatriation.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock could decline.

After the Enel project is completed, our overall revenue will decline significantly.

We expect that revenues from the Enel project will decline by approximately $37.8 million in 2005 from the $64.1 million of revenue that we received in 2004. Such revenues will account for slightly more than 35% of our overall revenues through 2005. We currently expect that our revenues from Enel and its meter manufacturers will become immaterial in 2006 and thereafter. Accordingly, we continue to seek new revenue opportunities with other utility companies around the world.

We believe that utility companies generally require a lengthier sales cycle than do most of our other customers. In most instances, one or more field trials of our NES system products may be required before a final decision is made by the utility. For example, a subsidiary of Nuon, a utility grid operator located in the Netherlands, completed a limited field trial of our NES system within its service territory in early 2005. Nuon has recently issued a public tender for a mass deployment, but has not yet announced a winner for the tender. We may not win the tender. In addition, there is generally an extended development and integration effort required in order to incorporate the new technology into the utility's existing infrastructure.

Once a utility decides to move forward with a mass deployment of our NES system, the timing of our revenues will depend on a variety of factors, including, among others, contractual acceptance provisions and shipping terms. Due to the extended sales cycle and the additional development and integration time required, as well as the uncertainty of the timing of our revenues, we have not found any replacements for the Enel project revenue reduction in 2005. Because we do not expect to be able to immediately replace the revenues generated by the Enel project, our overall 2005 and 2006 revenues and results of operations will be harmed.

Although we have invested substantial amounts of time and money into our NES system, our utility market product offerings may not be accepted by our targeted customers, or may fail to meet our financial targets. If we incur penalties and/or damages with respect to sales of the NES system, such penalties and/or damages could have an adverse effect on our financial condition, revenues, and operating results.

To be successful in our efforts to sell our NES system, we have invested and intend to continue to invest significant resources in the development of the NES system. For example, in April 2003 we acquired certain assets of Metering Technology Corporation, or MTC, for $11.0 million in cash and the assumption of certain liabilities. Among the assets acquired was the right to use MTC's developed electricity meter technology. As we have integrated their technology into our NES system, we have incurred and expect to continue to incur significant development costs.

We cannot assure you that our NES system will be accepted in the utility market place. For example, in order to realize all of the benefits of the NES system, a utility must replace a significant portion of its metering infrastructure with a homogenous population of intelligent, networked meters. In addition, even if the NES system meets a utility's technical specifications, we may not be able to meet all of the utility's contractual requirements. We also cannot assure you that, if accepted by the utilities, our NES system will generate economic returns that meet our financial targets. For example, revenues from our NES system offering may be lower than we anticipate, as was the case for actual versus targeted NES system revenues for the second, third and fourth quarters of 2004. Also, our current annual revenue targets for our NES business for 2005 are less than the levels originally forecast earlier in the year. The timing of these revenues could also fluctuate from our business plan for a variety of reasons, including the contractual acceptance provisions we agree to when negotiating our NES system sales agreements. Additionally, the gross margins we receive from our NES system offering will not be as high as for most of our other products.

Even if we are successful in penetrating the utility market with our NES system offering, we face competition from many companies. For example, Enel, our largest customer, has designed a system that it intends to use to compete with our NES system using third party products instead of our products. Enel has significantly greater experience and financial, technical, and other resources than we have. Enel previously announced an alliance with IBM to market and sell metering systems worldwide. We do not believe that our company will contribute to that alliance. Other competitors, including Actaris, Atos Origin, DCSI, Elster, Hexagram, Hunt Technologies, Itron, Iskraemeco, Nexus, and Ramar, as well as our own customers such as Enermet, Horstmann Controls, Kamstrup, and Metrima, could also develop and market their own multi-service metering systems that will compete with our NES system offering. We believe that our NES system will compete with other offerings both in terms of technical capabilities as well as in terms of price, warranties, indemnities, penalties, and other contractual provisions.

In addition, we presently plan to sell our NES products to utilities either directly or through resellers or other partners. If we sell the NES system directly to a utility, the utility may require us to assume responsibility for installing the NES

system in the utility's territory, integrating the NES system into the utility's operating and billing system, overseeing management of the combined system, and undertaking other activities. These are services that we generally would not be responsible for if we sold our NES products through a reseller or other partner, or if we sold directly to a utility that managed those activities on its own. To date, we do not have any significant experience with those services. As a result, if we sold directly to a utility that required us to provide those services, we may be required to contract with third parties to satisfy those obligations. We cannot assure you that we would find appropriate third parties to provide those services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

Lastly, sales of the NES system may expose us to penalties, damages and other liabilities relating to late deliveries, late or improper installations or operations, failure to meet product specifications, failure to achieve performance specifications, indemnities or otherwise. If we are unsuccessful in deploying the NES system, or otherwise fail to meet our financial targets for the NES system, our revenues, results of operations, and financial position will be harmed.

Compliance with new rules and regulations concerning hazardous materials may be costly and time-consuming, and may result in increased costs and a reduction in, or changes in the timing of, our expected revenues.

We are in the process of implementing programs to comply with newly enacted Restrictions on Hazardous Substances, or RoHS, regulations that require certain manufacturers, such as Echelon, to eliminate hazardous substances (e.g., lead, cadmium, mercury, etc.) from the commercial products that are sold to customers in the European Union and Japan. These new rules become effective in 2006. Transitioning our products from non-compliant to RoHS-compliant is a complex, costly, and time-consuming process. During the transition, we face several risks, including, but not limited to, risks that we will be unable to successfully develop RoHS compliant alternatives for our existing non-RoHS compliant products, that we will be unable to complete the transition in a timely manner, and that the costs associated with this development effort will be higher than originally anticipated. In addition, we face the risk that, in order to minimize any exposure to excess non-RoHS compliant inventories, our customers, including our distributors such as EBV, may reduce their inventory levels significantly from historical levels. While we expect that, once the transition is complete, our customers would restore their inventories back to historical levels, such action by our customers and/or distributors could result in a reduction in expected revenue in the fourth quarter of 2005 and early 2006 due to the timing of these inventory level adjustments. Lastly, we also face the risk that, in transitioning our products to comply with these new regulations, we could ourselves be left with excess quantities of non-RoHS compliant inventory for which an excess and obsolete inventory reserve would be required. If any of these risks materialize, our revenues, results of operations, and financial position could be harmed.

When we are required to take a compensation expense for the value of stock options or other compensatory awards that we issue to our employees, our results of operations will be harmed.

We believe that stock options are a key element in our ability to attract and retain employees in the markets in which we operate. In December 2004, the Financial Accounting Standards Board issued SFAS 123R, *Share-Based Payment: an amendment of FASB Statements No. 123 and 95*. SFAS 123R requires a company to recognize, as an expense, the fair value of stock options and other stock-based compensation granted to employees and other service providers. The Securities and Exchange Commission recently postponed the effective date of SFAS 123R to fiscal years beginning after June 15, 2005. For Echelon, the new rules will become effective in the first quarter of 2006.

We currently use the intrinsic value method to measure compensation expense for stock-based awards to our employees. Under this standard, we generally do not consider stock option grants issued under our employee stock option plans to be compensation when the exercise price of the stock option is equal to or greater than the fair market value on the date of grant. Beginning in 2006, we will be required to take a compensation charge as stock options or other stock-based compensation awards are issued or as they vest, including the unvested portion of options that were granted on or before December 31, 2005. This compensation charge will be based on a calculated value of the option or other stock-based award using a complex methodology, and which may not correlate to the current market price of our stock. We believe that the effect of such compensation expense will be to materially reduce our reported gross margins from historical levels and to materially increase our operating expenses from historical levels, resulting in reduced earnings and earnings per share.

Our results for the balance of 2005 will be harmed if we do not achieve our expected revenues from the Enel project.

The R&D Agreement with Enel expired in June 2005, but we will continue to ship products during the remainder of 2005 that were ordered prior to its expiration. We expect the Contatore Elettronico project will account for slightly more than 35% of our forecasted revenue for 2005. We continue to face a number of risks as we complete this project. For example, a dispute could develop between Enel and our company with respect to product suitability, quality, specifications, quantities, or other issues. In addition, as a result of any dispute, Enel or its meter manufacturers could attempt to cancel all or some of their remaining order backlog prior to shipment. Even if we should prevail in such a dispute, the costs incurred by Echelon, the diversion of time by key employees, and/or any delay in payments due from Enel or its meter manufacturers could adversely affect our company. If any dispute is not resolved in our favor or in a timely manner, revenue generated from the project could be delayed or could become less profitable to us, or could result in damages or losses. Any of these factors would cause our revenues and income to suffer, which would significantly and adversely affect our financial condition and operating results.

Our markets are highly competitive. Many of our competitors have longer operating histories and greater resources than we do. If we are unable to effectively compete in the industry, our operating results would be harmed.

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and rapid changes in customer requirements. To maintain and improve our competitive position, we must continue to develop and introduce, on a timely and cost-effective basis, new products, features and services that keep pace with the evolving needs of our customers. The principal competitive factors that affect the markets for our control network products include the following:

- our ability to develop and introduce new products on a timely basis;
- our product reputation, quality, and performance;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our customer service and support; and
- warranties, indemnities, and other contractual terms.

In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses. For our LONWORKS Infrastructure products, our competitors include some of the largest companies in the electronics industry, such as Siemens in the building and industrial automation industries, and Allen-Bradley (a subsidiary of Rockwell) and Groupe Schneider in the industrial automation industry. Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. In addition, those competitors that manufacture and promote closed, proprietary control systems may enjoy a captive customer base dependent on such competitors for service, maintenance, upgrades and enhancements. Products from other companies such as Digi International, emWare, Ipsil, JumpTec, Lantronix, Microsoft, and Wind River Systems, as well as certain micro-controller manufacturers including Freescale (formerly Motorola), Texas Instruments, Micro Chip, and Philips, all of which promote directly connecting devices to the Internet, could also compete with our products. In addition, in the utilities market, products from companies such as Actaris, Atos Origin, DCSI, Elster, Hexagram, Hunt Technologies, Itron, Iskraemeco, Nexus, and Ramar, each of which offers automatic meter reading products for the utility industry, as well as metering systems from our customers such as Enel, Enermet, Horstmann Controls, Kamstrup, and Milab, could compete with our NES system. For example, Enel, our largest customer, working with IBM, competes with our NES system using third party products instead of our products. Enel and IBM, as well as several other named competitors, have significantly greater experience and financial, technical, and other resources than we have. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position could be harmed.

The performance of the contract equipment manufacturers that Enel has selected to manufacture electricity meters could affect our remaining expected revenues from the Enel project.

Enel has selected several contract equipment manufacturers, or meter manufacturers, to manufacture electricity meters for the Contatore Elettronico project. We sell a product called a metering kit to these meter manufacturers as part of this project. Our shipments of metering kits depend, to a large extent, on the production of electricity meters. Our success under the Contatore Elettronico project could be affected by the meter manufacturers for many reasons, including:

- the meter manufacturers may not maintain sufficient net working capital to fund production of electricity meters or may fail to provide letters of credit that we mandate;
-

disputes may arise with us regarding product quality or responsibility for costs incurred by the meter manufacturers relating to metering kits;

- if the meter manufacturers fail to meet their intended production or quality levels, fail to pay us in accordance with agreed-upon payment terms for products we ship to them, or breach any of their agreements with us, we could elect to cancel orders for products from meter manufacturers, delay shipment of products to meter manufacturers, or otherwise fail to achieve our revenue targets for the Contatore Elettronico project;
- the meter manufacturers may not achieve their intended production levels; and
- we may be prohibited by government trade sanctions from selling metering kits to one or more meter manufacturers.

Additionally, if any of Enel's meter manufacturers were to experience cash flow problems resulting from one or more of the above listed failures, or any other factor, we could be forced to provide a bad debt reserve for some or all of the unpaid balances that meter manufacturer owed us for products we previously shipped to them. Given the volume of products that Enel's meter manufacturers purchase from us, any bad debt provision we would be required to make would most likely be a material amount, and therefore, would have an adverse effect on our financial condition and operating results.

As a result of our lengthy sales cycle, we have limited ability to forecast the amount and timing of specific sales. If we fail to complete or are delayed in completing transactions, our revenues could vary significantly from period to period.

The sales cycle between initial customer contact and execution of a contract or license agreement with a customer can vary widely. For example, OEMs, as well as utilities that may be interested in our NES system, typically conduct extensive and lengthy product evaluations before making initial purchases of our products. They may further delay subsequent purchases of our products due to their own prolonged product development, system integration, and product introduction periods. Delays in our sales cycle can also result from, among other things:

- changes in our customers' budgets;
- changes in the priority our customers assign to control network development;
- the time it takes for us to educate our customers about the potential applications of and cost savings associated with our products;
- the deployment schedule for projects undertaken by our utility or systems integrator customers;
- the actions of utility regulators or management boards regarding investments in metering systems;
- delays in installing, operating, and evaluating the results of NES system field trials; and
- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments

We generally have little or no control over these factors, which may cause a potential customer to favor a competitor's products, or to delay or forgo purchases altogether. If any of these factors prevent or substantially delay our ability to complete a transaction, our revenues and results of operations could be harmed.

If we do not maintain adequate distribution channels for our LONWORKS Infrastructure products, or establish adequate distribution channels for our NES system products, our revenues will be harmed significantly.

Currently, significant portions of our revenues are derived from sales to distributors, including EBV, the sole independent distributor of our products to OEMs in Europe. Sales to EBV, our largest distributor, accounted for 22.7% of our total net revenues for the quarter ended September 30, 2005, and 16.5% of our total net revenues for the same period in 2004; and 20.5% of our total net revenues for the nine months ended September 30, 2005 and 15.2% for the same period in 2004. Worldwide sales to distributors, including those to EBV, accounted for approximately 32.3% of total net revenues for the quarter ended September 30, 2005, and 17.0% of our total net revenues for the same period in 2004; and 28.2% of total net revenues for the nine months ended September 30, 2005 and 21.4% for the same period in 2004.

Our current agreement with EBV, which has been in effect since 1997, expires in December 2005. If EBV, or any other existing or future distributor, fails to dedicate sufficient resources and efforts to marketing and selling our products, our revenues could decrease. If EBV significantly reduces its inventory levels for our products, both our revenues and customer service levels would decrease. If we do not maintain our agreement with EBV, we would be required to locate another distributor or add our own pan-European distribution capability to meet the needs of our customers. In that event, our business could be harmed during the transition period as EBV's inventory of our products was sold but not replaced. Moreover, any replacement distribution channel could prove less effective than EBV.

In addition, if we were to modify the contractual return rights, or otherwise change the terms of our agreement with EBV or any of our other distributors, we could be required to defer the revenue on sales made to these distributors until such time as the distributors sold the products to their end-user customers. Such a change in our revenue recognition for these sales could result in a material reduction in our revenues in the period when we modify the distributor agreement(s).

We market our NES system products directly, as well as through selected value added resellers, or VARs, and integration partners. We believe that a significant portion of our NES system sales, if any, will be made through our VARs and integration partners, rather than directly by our company, since to date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES system business with other companies, our NES system business may not be successful, which will harm our revenues and operating results.

The undetermined market acceptance of our products makes it difficult to evaluate our future prospects.

We face a number of risks as a company in a rapidly changing and developing market, and you must consider our prospects in light of the associated risks. This is true of both our LONWORKS Infrastructure products and our NES system products. Our future operating results are difficult to predict due to many factors, including the following:

- our targeted markets have not yet accepted many of our products and technologies;
- many of our customers do not fully support open, interoperable networks, and this reduces the market for our products;
- we may not anticipate changes in customer requirements and, even if we do so, we may not be able to develop new or improved products that meet these requirements in a timely manner, or at all;
- the markets in which we operate require rapid and continuous development of new products, and we have failed to meet some of our product development schedules in the past;
- potential changes in voluntary product standards around the world can significantly influence the markets in which we operate; and
- our industry is very competitive and many of our competitors have far greater resources and may be prepared to provide financial support from their other businesses in order to compete with us.

Compliance with new rules and regulations concerning corporate governance may be costly, time-consuming, and difficult to achieve, which could harm our operating results and business.

The Sarbanes-Oxley Act, or the Act, which was signed into law in 2002, mandates, among other things, that companies adopt new corporate governance measures and imposes comprehensive reporting and disclosure requirements. The Act also imposes increased civil and criminal penalties on a corporation, its chief executive and chief financial officers, and members of its Board of Directors, for securities law violations. In addition, the Nasdaq National Market, on which our common stock is traded, has adopted and is considering the adoption of additional comprehensive rules and regulations relating to corporate governance. These rules, laws, and regulations have increased the scope, complexity, and cost of our corporate governance, reporting, and disclosure practices. Because compliance with these new rules, laws, and regulations will be costly and time-consuming, our management’s attention could be diverted from managing our day-to-day business operations, and our operating expenses could increase. In addition, because of the inherent limitations in all financial control systems, it is possible that a material weakness may be found in our internal controls over financial reporting, which could affect our ability to insure proper financial reporting. For example, as described more fully in Item 4 - Controls and Procedures, in October 2005 we identified a material weakness in our internal controls over revenue recognition at our Japanese subsidiary.

In the future, these developments could make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, our board members, Chief Executive Officer, and Chief Financial Officer face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which could harm our business.

We depend on a limited number of key manufacturers and use contract electronic manufacturers for most of our products requiring assembly. If any of these manufacturers terminates or decreases its relationships with

us, we may not be able to supply our products and our revenues would suffer.

The Neuron Chip is an important component that our customers use in control network devices. In addition, the Neuron Chip is an important device that we use in many of our products. Neuron Chips are currently manufactured and distributed by Toshiba and Cypress Semiconductor under license agreements we maintain with them. These agreements, among other things, grant Toshiba and Cypress the worldwide right to manufacture and distribute Neuron Chips using technology licensed from us, and require us to provide support, as well as unspecified updates to the licensed technology, over the terms of the agreements. The Cypress agreement expires in April 2009 and the Toshiba agreement expires in January 2010. However, we cannot be certain that these manufacturers will continue to supply Neuron Chips until these contracts expire, and we currently have no other source of supply for Neuron Chips. If either Toshiba or Cypress were to cease designing, manufacturing, and distributing Neuron Chips, we could be forced to rely on a sole supplier for Neuron Chips. If both Toshiba and Cypress were to exit this business, we would attempt to find a replacement. This would be an expensive and time-consuming process, with no guarantee that we would be able to find an acceptable alternative source.

We also maintain manufacturing agreements with other semiconductor manufacturers for the production of key products, including those used in the Enel Project and our NES system. For example, in 2003 we announced a new product family that we refer to as Power Line Smart Transceivers. A sole source supplier, STMicroelectronics, manufactures these products. We currently have no other source of supply for Power Line Smart Transceivers or the components manufactured by Cypress and AMI Semiconductor.

Our future success will also depend significantly on our ability to manufacture our products cost-effectively, in sufficient volumes and in accordance with quality standards. For most of our products requiring assembly, we use contract electronic manufacturers, including WKK Technology, TYCO TEPC/Transpower, and World Fair International. These contract electronic manufacturers procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks. By using third parties to manufacture our products, we have reduced control over quality, costs, delivery schedules, product availability, and manufacturing yields. For instance, quality problems at a contract equipment manufacturer could result in missed shipments to our customers and unusable inventory. Such delays could, among other things, reduce our revenues, increase our costs by increasing our inventory reserves, and cause us to incur penalties. In addition, contract electronic manufacturers can themselves experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We will also face risks if and when we transition between contract electronic manufacturers. For example, in late 2004 we began to transfer certain manufacturing capacity to World Fair, so our experience with that company is limited. When we transition, we may have to move raw material and in-process inventory between locations in different parts of the world. Also, we would be required to reestablish acceptable manufacturing processes with a new work force. We could also be liable for excess or unused inventory held by contract manufacturers for use in our products. This inventory may become obsolete as a result of engineering changes that we make. In addition, we may no longer need this inventory because of factors such as changes in our production build plans, miscommunication between us and a contract manufacturer, or errors made by a contract manufacturer in ordering material for use in our products. Under our contracts with these contract electronic manufacturers, we would become liable for all or some of these excess or obsolete inventories.

The failure of any key manufacturer to produce products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could adversely affect our revenues and gross profit, and could result in claims against us by our customers.

Since we depend on sole or a limited number of suppliers, any price increases, shortages, or interruptions of supply would adversely affect our revenues and/or gross profits.

As previously discussed, we currently purchase several key products and components only from sole or limited sources. For some of these suppliers, we do not maintain signed agreements that would obligate them to supply to us

on negotiated terms. As a result, we may be vulnerable to price increases for products or components. In addition, in the past, we have occasionally experienced shortages or interruptions in supply for certain of these items, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities. If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure these products or components from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.

Although we attempt to avoid infringing known proprietary rights of third parties in our product development efforts, from time to time we may receive notice that a third party believes that our products may be infringing certain patents or other intellectual property rights of that third party. We may also be contractually obligated to indemnify our customers or other third parties that use our products in the event they are alleged to infringe a third party's intellectual property rights. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources and cause us to incur significant expenses. Thus, even if our products do not infringe, we may elect to take a license or settle to avoid incurring such costs. In the event our products are infringing upon the intellectual property rights of others, we may elect or be required to redesign our products so that they do not incorporate any intellectual property to which the third party has or claims rights. As a result, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license for the third party's intellectual property, but it is possible that we would not be able to obtain such a license on reasonable terms, or at all. Any delays that we might then suffer or additional expenses that we might then incur could adversely affect our revenues, operating results and financial condition.

Our customers may not pursue product opportunities based on their concerns regarding third party intellectual property rights, particularly patents, and this could reduce the market opportunity for the sale of our products and services.

We have a history of losses and, although we achieved profitability in prior years, we expect to incur substantial losses again in 2005.

For the nine months ended September 30, 2005, we generated a loss of $17.0 million. As of September 30, 2005, we had an accumulated deficit of $81.3 million. We have invested and expect to continue investing significant financial resources in product development, marketing and sales. We believe we will incur a substantial loss in 2005. Consequently, we currently expect our cash and short-term investment balances to decline as a result of such losses.

Our future operating results will depend on many factors, including:

- adoption of our NES solution and other products by service providers for use in utility and/or other home automation projects;
- revenue growth of our LONWORKS Infrastructure products;
- timely installation of Enel's Contatore Elettronico project;
- continuation of worldwide economic growth, particularly in certain industries such as semiconductor manufacturing equipment;
- the ability of our contract electronic manufacturers to provide quality products on a timely basis, especially during periods where excess capacity in the contract electronic manufacturing market is reduced;
- growth in acceptance of our products by OEMs, systems integrators, service providers and end-users;
- the effect of expensing stock option grants or other compensatory awards to our employees, when such requirements become effective in 2006;
- our ability to attract new customers in light of increased competition;
- our ability to develop and market, in a timely and cost-effective way, new products that perform as designed;
- costs associated with business acquisitions, including up-front in-process research and development charges and ongoing amortization expenses related to other identified intangible assets;
- ongoing operational expenses associated with any future business acquisitions;
- results of impairment tests that we will perform from time to time in the future, in accordance with SFAS 142, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future. If the results of these impairment tests indicate that an impairment event has taken place, we will be required to take an asset impairment charge that could have a material adverse effect on our operating results; and
- general economic conditions.

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As of December 31, 2004, we had net operating loss carry forwards for federal income tax reporting purposes of approximately $68.3 million and for state income tax reporting purposes of approximately $8.9 million, which expire at various dates through 2022. In addition, as of December 31, 2004, we had tax credit carry forwards of approximately $13.1 million, $6.7 million of which expire at various dates through 2022. The Internal Revenue Code of 1986, as amended, contains provisions that limit the use in future periods of net operating loss and credit carry forwards upon the occurrence of certain events, including significant changes in ownership interests. We have performed an analysis of our ownership changes and have reported the net operating loss and credit carry forwards considering such limitations. As of December 31, 2004, our deferred tax assets, including our net operating loss carry forwards and tax credits, totaled approximately $45.6 million. The Internal Revenue Code of 1986 also contains provisions requiring companies to fully utilize net operating losses before utilizing tax credits. As a practical matter, this provision may cause many of our tax credits to expire unused, even if we return to profitability. We have recorded a valuation allowance for the entire deferred tax asset as a result of uncertainties regarding the realization of the asset balance, our history of losses and the variability of our operating results.

We face operational and financial risks associated with international operations.

Our international sales and marketing operations are located in nine countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 72.4% of our total net revenues for the quarter ended September 30, 2005, and 81.7% of our total net revenues for the same period in 2004; and 77.3% of our total revenues for the nine months ended September 30, 2005 and 84.1% for the same period in 2004. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Our operations and the market price of our products may be directly affected by economic and political conditions in the countries where we do business. In addition, we may not be able to maintain or increase the international demand for our products. Additional risks inherent in our international business activities generally include the following:

- international terrorism and anti-American sentiment;
- currency fluctuations;
- unexpected changes in regulatory requirements, tariffs and other trade barriers;
- costs of localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- longer accounts receivable payment cycles;
- difficulties in managing international operations;
- labor actions generally affecting individual countries, regions, or any of our customers which could result in reduced demand for our products;
- potentially adverse tax consequences, including restrictions on repatriation of earnings; and
- the burdens of complying with a wide variety of foreign laws.

Differing vacation and holiday patterns in other countries, particularly in Europe, may also affect the amount of business that we transact in other countries in any given quarter, the timing of our revenues, and our ability to forecast projected operating results for such quarter.

Fluctuations in the value of currencies in which we conduct our business relative to the U.S. dollar could cause currency translation adjustments. The portion of our revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was approximately 5.3% for the quarter ended September 30, 2005, and 3.9% for the same period in 2004; and 4.6% for the nine months ended September 30, 2005 and 3.2% for the same period in 2004. In addition, much of our sales and marketing expenses, as well as certain other costs, are incurred in currencies other than the U.S. dollar. For example, China recently revalued its currency, the Chinese Renminbi, against the U.S. dollar. Although the initial adjustment did not result in a material change to the costs for goods and services we obtain from our suppliers and contractors in China, any future revaluations of the Chinese currency against the U.S. dollar could

result in significant cost increases. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

The use of the Euro as the standard currency in participating European countries may also impact our ability to transact sales in U.S. dollars. We have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. We do not know when or if EBV will give such notice. If fewer of our sales in Europe are transacted in U.S. dollars, we may experience an increase in currency translation adjustments, particularly as a result of general economic conditions in Europe as a whole. We do not currently engage in currency hedging transactions or otherwise cover our foreign currency exposure.

In addition, our utility customers and value added reseller partners may insist that we price our NES system products in local currencies. In that case, we could face additional currency risk and if we chose to hedge that risk, we would incur additional costs.

The outbreak of severe acute respiratory syndrome, or SARS, that began in China, Hong Kong, Singapore, and Vietnam in 2003 also had a negative impact on our business. Any future outbreak of SARS, or other widespread communicable diseases such as avian influenza, more commonly know as bird flu, could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future SARS or other health-related disruptions at our third-party contract manufacturers or other key suppliers, many of whom are located in China and other parts of southeast Asia, could affect our ability to supply our customers with products in a timely manner.

Fluctuations in our operating results may cause our stock price to decline.

Our quarterly and annual results have varied significantly from period to period, and we have, on occasion, failed to meet securities analysts' expectations. For example, in the fourth quarter of 2004, we generated net income of $3.0 million, whereas in the first, second, and third quarters of 2005, we generated net losses of $2.3 million, $4.6 million, and $10.1 million, respectively. We expect to incur substantial losses for the remainder of 2005, and our future results may continue to fluctuate and may not meet analysts' expectations in some future period. As a result, the price of our common stock could fluctuate or decline. Some factors that could cause this variability, many of which are outside of our control, including the following:

- transitioning from non-RoHS compliant to RoHS compliant products could cause our customers to reduce their historical inventory levels, which could reduce our revenues;
- revenues from the Enel project may fail to meet analysts' expectations or our revenue and earnings guidance;
- we may fail to meet analysts' expectations relating to our NES system and additional utility customers and applications;
- we may fail to meet analysts' expectations for revenue growth in our sales of LONWORKS Infrastructure products to OEMs and systems integrators;
- our future operating results will be materially adversely effected by the expense required to be recorded under SFAS 123R, Share-Based Payment;
- the rates at which OEMs purchase our products and services may fluctuate;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- we may fail to introduce new products on a timely basis or before the end of an existing product's life cycle;
- downturns in any customer's or potential customer's business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- we may face increased competition for both our LONWORKS Infrastructure products and our NES products;
- market acceptance of our products may decrease;
- our customers may delay or cancel their orders;
- the mix of products and services that we sell may change to a less profitable mix;
- shipment and payment schedules may be delayed;
- revenue recognition for sales of our NES system products may be dependent on acceptance criteria determined by our NES system customers;
- our pricing policies or those of our competitors may change;
- we could incur costs associated with business acquisitions, including up-front in-process research and development charges and ongoing amortization expenses related to other identified intangible assets;
- we could incur ongoing operational expenses associated with future business acquisitions;
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the results of impairment tests that we will perform from time to time in the future, in accordance with SFAS 142, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may indicate that an impairment event has taken place. If so, we will be required to take an asset impairment charge that could have a material adverse effect on our operating results;

- our product distribution may change; and
- product ratings by industry analysts and endorsements of competing products by industry groups could hurt the market acceptance of our products.

In addition, our expense levels are based, in significant part, on the future revenues that we expect. Consequently, if our revenues are less than we expect, our expense levels could be disproportionately high as a percentage of total revenues, which would negatively affect our profitability and cause our stock price to decline.

Many of our competitors develop, support, and promote alternative control systems. If we are unable to promote and expand acceptance of our open, interoperable control system, our revenues and operating results may be harmed.

Many of our current and prospective competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. In some cases, companies have established associations or cooperative relationships to enhance the competitiveness and popularity of their products, or to promote these different or incompatible technologies, protocols and standards. For example, in the building automation market, we face widespread reluctance by vendors of traditional closed or proprietary control systems, who enjoy a captive market for servicing and replacing equipment, to use our interoperable technologies. We also face strong competition by large trade associations that promote alternative technologies and standards in their native countries, such as the Konnex Association in Belgium, and the European Installation Bus Association in Germany, each of which has over 100 members and licensees. Other examples include various industry groups who promote alternative open standards such as BACnet in the building market, DALI in the lighting controls market, Echonet in the home control market, and a group comprised of Asea Brown Boveri, Adtranz/Bombardier, Siemens, GEC Alstrom and other manufacturers that support an alternative rail transportation protocol to our LONWORKS protocol. Our technologies, protocols, or standards may not be successful in any of our markets, and we may not be able to compete with new or enhanced products or standards introduced by existing or future competitors.

Defects in or misuse of our products or other liabilities not covered by insurance may delay our ability to generate revenues and may increase our liabilities and expenses.

Our products may contain undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing process. For example, in NES trials, undetected errors may hinder our ability to win a subsequent tender. In addition, our customers or their installation partners may improperly install or implement our products. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. As a result, errors or failures in our products, or the improper installation or implementation of our products by third parties, could harm our reputation, reduce our revenues, increase our expenses, and negatively impact our operating results and financial condition.

To address these issues, the agreements we maintain with our customers typically contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. In certain very limited instances, these agreements require that we be named as an additional insured on our customers' insurance policies. However, our customer contracts and additional insured coverage may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products. For example, utility customers purchasing our NES system may require that we agree to indemnities or penalties in excess of the provisions we typically employ with our LONWORKS Infrastructure products, or that are not limited at all. Also, local laws may impose liability for NES system or other product failures, including liability for harm to property or persons. Such failures could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

We may also experience losses or potential losses in the event of property damage, liability for harm to a third party's property or person, claims against our directors or officers, and the like. To help reduce our exposure to these types of claims, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. For example, during 2000, the total limit for claims under our errors and omissions insurance policy was $17.0 million. Since then, we have reduced the total limit for this line of coverage to $10.0 million because we believed the premiums our insurers requested were excessive. We believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. In times of significant cost increases, this could result in increased costs or reduced limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we may face increased exposure to these types of claims. If liability for a claim exceeds our policy limits, our operating results and our financial position would be negatively affected.

We promote an open technology platform that could increase our competition.

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our customers are capable of developing hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, all of the network management commands required to develop software that competes with our LNS software are published. This could decrease the demand for our products and increase the competition that we face.

Downturns in the control network technology market and related markets may decrease our revenues and margins.

The market for our products depends on economic conditions affecting the broader control network technology and related markets. Downturns in these markets may cause our OEMs and system integrators to delay or cancel projects, reduce their production or reduce or cancel orders for our products. In this environment, customers may experience financial difficulty, cease operations or fail to budget for the purchase of our products. This, in turn, may lead to longer sales cycles, delays in payment and collection, and price pressures, causing us to realize lower revenues and margins. In particular, capital spending in the technology sector has decreased in past years, and many of our customers and potential customers have experienced declines in their revenues and operations. In addition, concerns with respect to terrorism and geopolitical issues in the Middle East and Asia have added more uncertainty to the current economic environment. We cannot predict the impact of these events, or of any related military action, on our customers or business. We believe that, in light of these events, some businesses may further curtail or may eliminate capital spending on control network technology altogether. If capital spending in our markets declines, or does not increase, it may be necessary for us to gain significant market share from our competitors in order to achieve our financial goals and return to profitability.

If our OEMs do not employ our products and technologies our revenues could decrease significantly.

To date, a substantial portion of our product sales has been to OEMs. The product and marketing decisions made by OEMs significantly affect the rate at which our products are used in control networks. We believe that because OEMs in certain industries receive a large portion of their revenues from sales of products and services to their installed base, these OEMs have tended to moderate the rate at which they incorporate LONWORKS technology into their products. They may believe that a more rapid transition to LONWORKS technology could harm their installed base business. Furthermore, OEMs that manufacture and promote products and technologies that compete or may compete with us may be particularly reluctant to employ our products and technologies to any significant extent, if at all. We may not be able to maintain or improve the current rate at which our products are accepted by OEMs and others, which could decrease our revenues.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. As of October 31, 2005, we have 95 issued U.S. patents, 10 pending U.S. patent applications, and various foreign counterparts. It is possible that patents will not issue from these pending applications or from any future applications or that, if issued, any claims allowed will not be sufficiently broad to protect our technology. In addition, we may not apply for or obtain patents in each country in which our technology may be used. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology. We have registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we

fail to take all necessary steps to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

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Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or to obtain and use information that we regard as proprietary. Any of the patents, trademarks, copyrights or intellectual property rights that have been or may be issued or granted to us could be challenged, invalidated or circumvented, and any of the rights granted may not provide protection for our proprietary rights. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. We have licensed in the past and may license in the future our key technologies to third parties. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. For example, certain of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result of this litigation, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights; or to prevent an unauthorized third party from copying or otherwise obtaining and using our products or technology.

If OEMs fail to develop interoperable products or if our targeted markets do not accept our interoperable products, we may be unable to generate sales of our products.

Our future operating success will depend, in significant part, on the successful development of interoperable products by OEMs and us, and the acceptance of interoperable products by systems integrators and end-users. We have expended considerable resources to develop, market and sell interoperable products, and have made these products a cornerstone of our sales and marketing strategy. We have widely promoted interoperable products as offering benefits such as lower life-cycle costs and improved flexibility to owners and users of control networks. However, OEMs that manufacture and market closed systems may not accept, promote or employ interoperable products, since doing so may expose their businesses to increased competition. In addition, OEMs might not, in fact, successfully develop interoperable products, or their customers might not accept their interoperable products. If OEMs fail to develop interoperable products, or our markets do not accept interoperable products, our revenues and operating results will suffer.

Our executive officers and technical personnel are critical to our business, and if we lose or fail to attract key personnel, we may not be able to successfully operate our business.

Our performance depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer, our Chief Operating Officer, and our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations and managerial personnel. Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain qualified executive officers and key personnel necessary to enable our business to succeed. Our product development and marketing functions are largely based in Silicon Valley, which is typically a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are prohibited from making loans to executive officers under recent legislation, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

The markets for our products are rapidly evolving. If we are not able to develop or enhance products to respond to changing market conditions, our revenues will suffer.

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Customer requirements for control network products can change as a result of innovations or changes within the building, industrial, transportation, utility/home and other industries. For example, our NES system offering to utilities is new. Also, new or different standards within industry segments may be adopted, giving rise to new customer requirements. These customer requirements may or may not be compatible with our current or future product offerings. Our future success depends in large part on our ability to continually enhance our existing product offerings, lower the market price for our products, and develop new products that maintain technological competitiveness. We may not be successful in modifying our products and services to address these requirements and standards. For example, certain of our competitors may develop competing technologies based on Internet Protocols (IP) that could have, or could be perceived to have, advantages over our products in remote monitoring or other applications. As another example, many competitors promote media types, such as radio frequency (wireless) and fiber optics that, even if used with LONWORKS technology, could displace sales of certain of our transceiver products. If we are not able to develop or enhance our products to respond to these changing market conditions, our revenues and results of operations will suffer.

In addition, due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including:

- transitioning from non-RoHS compliant to RoHS compliant products could cause our customers to reduce their historical inventory levels, which could reduce our revenues;
- significant stockholders may sell some or all of their holdings of our stock. For example, Enel presently owns 3,000,000 shares, or approximately 7.5% of our outstanding common stock. Enel is generally free to sell these shares at its discretion. In the event Enel, or any other significant stockholder, elects to sell all or a portion of their holdings in our shares, such sale or sales could depress the market price of our stock during the period in which such sales are made;
- investors may be concerned about our ability to develop new customers for our NES system products, the success of our project with Enel, and the success we have selling our LONWORKS Infrastructure products and services to OEMs and systems integrators;
- investors may be concerned about the expense that we will be required to record for stock options and other stock-based incentives provided to our employees;
- competitors may announce new products or technologies;
- our quarterly operating results may vary widely;
- we or our customers may announce technological innovations or new products;
- securities analysts may change their estimates of our financial results; and
- increases in market interest rates, which generally have a negative impact on stock prices.

In addition, the market price of securities of technology companies, especially those in rapidly evolving industries such as ours, has been very volatile in the past. This volatility in any given technology company’s stock price has often been unrelated or disproportionate to the operating performance of that particular company.

Voluntary standards that are established in our markets could limit our ability to sell our products and reduce our revenues.

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. Some of our competitors have attempted to use voluntary standards to reduce the market opportunity for our products, or to increase the market opportunity for their own products, by lobbying for the adoption of voluntary standards that would exclude or limit the use of products that incorporate our technology. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets. The adoption of voluntary standards that are incompatible with our products or technology could limit the market opportunity for our products. If the markets we target were to adopt voluntary standards that are incompatible with our products or technology, either inadvertently or by design, our revenues, operating results, and financial condition would be adversely affected.

Regulatory actions could limit our ability to market and sell our products.

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation. Government regulatory action could greatly reduce the market for our products. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

Our existing stockholders control a significant percentage of our stock, which will limit other stockholders' ability to influence corporate matters.

As of October 31, 2005, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our Board of Directors), beneficially owned 35.0% of our outstanding stock.

Under the stock purchase agreement with Enel, which transaction was completed September 11, 2000, Enel purchased 3.0 million newly issued shares of our common stock and was granted the right to nominate a director to our Board of Directors. As a condition to the closing of the stock purchase agreement, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote the shares of our company's common stock that they beneficially owned or controlled in favor of Enel's nominee to our Board of Directors. In addition, under the terms of the stock purchase agreement, Enel has agreed to (i) vote (and cause any of its affiliates that own shares of our common stock to vote) all of its shares in favor of the slate of director nominees recommended by the Board of Directors, and (ii) vote (and endeavor to cause any of its affiliates that own shares of our common stock to vote) a number of shares equal to at least that percentage of shares voted by all other stockholders for or against any specified matter, as recommended by the Board of Directors. The specified matters are the election of accountants, the approval of company option plans, and any proposal by any of our stockholders (unless the proposal could be prejudicial to Enel or the required voting would interfere with Enel's fiduciary duties to its own shareholders).

As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

Potential conflicts of interest could limit our ability to act on opportunities that are adverse to a significant stockholder or its affiliates.

From time to time, we may enter into a material contract with a person or company that owns a significant amount of our company's stock. As circumstances change, we may develop conflicting priorities or other conflicts of interest with the significant stockholder with regard to the contract, or the significant stockholder may exert or attempt to exert a significant degree of influence over our management and affairs. The significant stockholder might exert or attempt to exert this influence in its capacity as a significant stockholder or, if the significant stockholder has a representative on our Board of Directors, through that Board member.

For example, we entered into the Contatore Elettronico project with an affiliate of Enel. Enel currently owns 3.0 million shares of our common stock, representing approximately 7.5% of our outstanding common stock. Enel also has the right to nominate a member of our Board of Directors as long as Enel owns at least 2.0 million shares of our common stock. As a consequence of the expiration of his mandate as Enel's Chief Executive Officer, Mr. Francesco Tatò resigned his board membership in all of Enel's subsidiaries and affiliates, including Echelon. Mr. Tatò served on our Board of Directors as a representative of Enel from September 2000 until September 2002. Enel has reserved its right to nominate a new member of our Board of Directors, who must be approved by us, to fill the vacancy created by the resignation of Enel's former board representative to our Board of Directors. During the term of service of Enel's

former board representative from September 2000 to September 2002, Enel's representative on our Board abstained from resolutions on any matter relating to Enel. A member of our Board of Directors who is also an officer of or is otherwise affiliated with Enel may decline to take action in a manner that might be favorable to us but adverse to Enel. Conflicts that could arise might concern the Contatore Elettronico project with Enel and other matters where Enel's interest may not always coincide with our interests or the interests of our other stockholders. Any of those conflicts could lead to litigation and could otherwise significantly and adversely affect our financial condition and results of operations.

Natural disasters or power outages could disrupt our business.

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. Many of our operations are subject to these risks, particularly our operations located in California. In past years, we experienced temporary power losses in our California facilities due to power shortages that have disrupted our operations, and we may in the future experience additional power losses that could disrupt our operations. While the impact to our business and operating results has not been material, it is possible that power losses will adversely affect our business in the future, or that the cost of acquiring sufficient power to run our business will increase significantly. Similarly, a natural disaster or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters including, earthquakes.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2004.

Market Risk Disclosures. The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10 percent from levels at September 30, 2005 and September 30, 2004, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. If necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at September 30, 2005, and September 30, 2004, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

ITEM 4. CONTROLS AND PROCEDURES

Our review of our internal controls over financial reporting was made within the context of the relevant professional auditing standards defining “internal controls over financial reporting,”“significant deficiencies,” and “material weaknesses.” As part of our evaluation of internal controls over financial reporting, we also address other, less significant control matters that we or our auditors identify, and we determine what revision or improvement to make, if any, in accordance with our on-going procedures.

Conclusions Regarding Disclosure Controls and Procedures

In conjunction with management, our CEO and our CFO evaluated the effectiveness of our “disclosure controls and procedures” (as defined in the Securities Exchange Act of 1934, or the Exchange Act, Rules 13a-14(c) and 15-d-14(c)) as of September 30, 2005. During this review, management identified a material weakness in internal controls over

financial reporting related to revenue recognition at our Japanese subsidiary, which is described more fully below. Based upon this finding, the CEO and CFO concluded that our disclosure controls and procedures were not effective as of September 30, 2005. Once identified, management immediately began remediation efforts to address this control deficiency and performed additional procedures to ensure the unaudited quarterly condensed financial statements for the first three quarters of 2005 were prepared in accordance with generally accepted accounting principles in the United States ("US GAAP"). Accordingly, management believes that the unaudited consolidated financial statements included in this Quarterly Report on Form 10-Q, fairly present, in all material respects, our financial condition, results of operations, and cash flows for the periods presented. Management has also concluded that the identified material weakness did not cause any material errors in the unaudited consolidated financial statements included in the Quarterly Reports on Form 10-Q for the periods ending March 31, 2005 and June 30, 2005. Management believes the remediation efforts to correct this control deficiency, which are more fully described below, will be completed before December 31, 2005.

Management's assessment identified the following material weakness in our internal controls over financial reporting as of September 30, 2005:

Revenue Recognition at our Japanese Subsidiary

Management has concluded that a material weakness existed in the procedures for reviewing and accepting customer orders at our Japanese subsidiary that could result in more than a remote likelihood that a material misstatement of the financial statements would not be prevented or detected. More specifically, management found that personnel at the Japanese subsidiary were not adequately trained to determine whether or not customer orders they received met the requirements for revenue recognition under US GAAP. As a result of this control deficiency, management recorded adjustments to revenue, cost of goods sold, accounts receivable, and inventory for the quarter ended September 30, 2005. Although the amounts adjusted were not considered "material", as that term is defined under standards established by the Public Company Accounting Oversight Board, management concluded that this control deficiency should be considered a "material weakness", as the deficiency could have resulted in a material misstatement.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Subsequent to September 30, 2005, and in conjunction with the identification of the material weakness discussed above, we made the following changes to our internal controls over revenue recognition at our Japanese subsidiary:

- Effective October 1, 2005, management added a control to require an additional review of all orders received by the Japanese subsidiary to ensure compliance with revenue recognition criteria under US GAAP. This review will be performed by finance personnel whom management has deemed are properly and adequately trained for such purpose prior to the recognition of revenue with respect to the order.
- All sales personnel, including order processors, will receive detailed training with periodic updates in revenue recognition criteria required under US GAAP.

Limitations on the Effectiveness of Controls

Since we began reviewing our internal controls over financial reporting, we identified a number of processes where an opportunity to improve our internal controls existed. As part of our ongoing effort to maximize our internal controls over financial reporting, each of these control improvement opportunities has been, or is in the process of being, remediated by management.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On May 3, 2004, we announced that Enel had filed a request for arbitration to resolve a dispute regarding our marketing and supply obligations under the R&D Agreement. The arbitration took place in London in early March 2005. We received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million using exchange rates in effect as of September 30, 2005, have been accrued for and are included in our results of operations for the quarter ended September 30, 2005. The arbitration tribunal refused Enel's request to extend the supply or marketing obligations of Echelon.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information about the repurchase of our common stock during the quarter ended September 30, 2005:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1- July 31	--(1)	$ --	1,090,728(1)	1,909,272
August 1 - August 31	96,644	$ 8.00	1,187,372	1,812,628
September 1- September 30	--	$ --	1,187,372	1,812,628
Total	96,644	$ 8.00	1,187,372	1,812,628

(1) Shares repurchased in open-market transactions under the current stock repurchase program approved by our Board of Directors in March 2004 and August 2004. The program authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. During the quarter ended September 30, 2005, we repurchased 96,644 shares under the program at a cost of approximately $773,000. Since inception, we have repurchased a total of 1,187,372 shares under the program at a cost of $8.0 million. The stock repurchase program will expire in March 2006.

ITEM 6. EXHIBITS

Exhibit No.	Description of Document
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	

	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

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SIGNATURE

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.

	ECHELON CORPORATION
Date: November 8, 2005	By:/s/ Oliver R. Stanfield
	Oliver R. Stanfield,
	Executive Vice President and Chief Financial Officer (Duly Authorized Officer and Principal Financial and Accounting Officer)

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