

FUEL TECH, INC.
Form 10-Q
May 09, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

or

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

For the transition period from _____ to _____

Commission file number: 001-33059

FUEL TECH, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation of organization)

20-5657551
(I.R.S. Employer Identification Number)

Fuel Tech, Inc.
512 Kingsland Drive
Batavia, IL 60510-2299
630-845-4500
(Address and telephone number of principal executive offices)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in rule 12b-2 under the Securities Exchange Act of 1934)

Large Accelerated Filer Accelerated Filer Non-accelerated Filer

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

Yes No

As of April 20, 2007 there were outstanding 22,198,698 shares of Common Stock, par value \$0.01 per share, of the registrant.

FUEL TECH, INC.

Form 10-Q for the three-month period ended March 31, 2007

INDEX

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements (Unaudited)	
Condensed Consolidated Balance Sheets as of March 31, 2007 and December 31, 2006	1
Condensed Consolidated Statements of Income for the Three-Month Periods Ended March 31, 2007 and 2006	2
Condensed Consolidated Statements of Cash Flows for the Three-Month Periods Ended March 31, 2007 and 2006	3
Notes to Condensed Consolidated Financial Statements	4
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures about Market Risk	13
Item 4. Controls and Procedures	13
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	14
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	14
Item 3. Defaults upon Senior Securities	14
Item 4. Submission of Matters to a Vote of Security Holders	14
Item 5. Other Information	14
Item 6. Exhibits	14
SIGNATURES	15

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FUEL TECH, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per-share data)

	March 31, 2007 (Unaudited)	December 31, 2006 (Note B)
Assets		
Current assets:		
Cash and cash equivalents	\$ 31,602	\$ 24,405
Short-term investments	-	8,000
Accounts receivable, net of allowances for doubtful accounts of \$150	14,303	16,724
Inventories	208	203
Deferred income taxes	4,972	4,972
Prepaid expenses and other current assets	1,686	1,916
Total current assets	52,771	56,220
Equipment, net of accumulated depreciation of \$9,409 and \$8,845, respectively	4,169	4,051
Goodwill	2,119	2,119
Other intangible assets, net of accumulated amortization of \$1,233 and \$1,205, respectively	1,134	1,156
Deferred income taxes	1,214	885
Other assets	1,064	1,229
Total assets	\$ 62,471	\$ 65,660
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 5,212	\$ 7,632
Accrued liabilities	5,516	9,873
Total current liabilities	10,728	17,505
Other liabilities	1,252	500
Total liabilities	11,980	18,005
Shareholders' equity:		
Common stock, \$.01 par value, 40,000,000 shares authorized, 22,198,698 and 22,086,728 shares issued, respectively	222	221
Additional paid-in capital	105,248	103,122
Accumulated deficit	(55,333)	(56,044)
Accumulated other comprehensive loss	82	79
Nil coupon perpetual loan notes	272	277
Total shareholders' equity	50,491	47,655
Total liabilities and shareholders' equity	\$ 62,471	\$ 65,660

See notes to condensed consolidated financial statements.

FUEL TECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(in thousands, except share and per share-data)

	Three Months Ended March 31	
	2007	2006
Net sales	\$ 16,262	\$ 17,121
Costs and expenses:		
Cost of sales	8,957	9,056
Selling, general and administrative	5,906	5,424
Research and development	554	351
	15,417	14,831
Operating income	845	2,290
Interest income	417	150
Other (expense) income, net	(41)	(18)
Income before taxes	1,221	2,422
Income tax expense	(429)	(1,072)
Net income	\$ 792	\$ 1,350
Net income per Common Share:		
Basic	\$ 0.04	\$ 0.07
Diluted	\$ 0.03	\$ 0.06
Weighted-average number of Common Shares outstanding:		
Basic	22,107,000	20,613,000
Diluted	24,653,000	23,708,000

See notes to condensed consolidated financial statements.

FUEL TECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Three Months Ended March 31	
	2007	2006
Operating activities		
Net cash used in operating activities	\$ (1,342)	\$ (582)
Investing activities		
Sales (purchases) of short-term investments	8,000	(8,000)
Purchases of equipment and patents	(697)	(730)
Net cash provided by (used in) investing activities	7,303	(8,730)
Financing activities		
Proceeds from exercise of stock options	506	2,763
Income tax benefit from exercise of stock options	727	1,068
Net cash provided by financing activities	1,233	3,831
Effect of exchange rate fluctuations on cash	3	23
Net increase (decrease) in cash and cash equivalents	7,197	(5,458)
Cash and cash equivalents at beginning of period	24,405	10,375
Cash and cash equivalents at end of period	\$ 31,602	\$ 4,917

See notes to condensed consolidated financial statements.

FUEL TECH, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)
(in thousands, except share and per share data)

Note A: Nature of Business

Fuel Tech, Inc. (“Fuel Tech”) is a technology company that provides advanced engineering solutions for the optimization of combustion systems in utility and industrial applications. Fuel Tech, Inc., originally incorporated in 1987 under the laws of the Netherlands Antilles as Fuel-Tech N.V., became domesticated in the United States on September 30, 2006, and continues as a Delaware corporation with its corporate headquarters at 512 Kingsland Drive, Batavia Illinois 60510-2299.

Note B: Basis of Presentation

The accompanying unaudited, condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results of operations for the periods covered have been included. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in Fuel Tech, Inc.’s Annual Report on Form 10-K for the year ended December 31, 2006.

Effective September 30, 2006, Fuel Tech, Inc. changed its place of incorporation from the Netherlands Antilles to the State of Delaware in a tax-free reorganization. In the reorganization, each outstanding share of Fuel-Tech N.V. Common Stock held by our stockholders was converted into one share of Fuel Tech, Inc. Common Stock. The shares exchanged were all of Fuel Tech, Inc.’s issued and outstanding shares immediately after the reorganization. The number of shares of Fuel Tech, Inc.’s Common Stock outstanding immediately after the reorganization was the same as the number of shares of Fuel-Tech N.V. Common Stock outstanding immediately prior to the reorganization. In connection with this reorganization, all option agreements and warrant rights to purchase shares of Fuel-Tech N.V. Common Stock were converted into option agreements and warrant rights to purchase shares of Fuel Tech, Inc. Common Stock.

In addition to the reorganization, Fuel Tech, Inc. adopted a tax-free plan of merger whereby two of Fuel Tech, Inc.’s wholly owned United States subsidiaries were merged with and into Fuel Tech, Inc. on December 31, 2006.

Note C: Earnings per Share Data

Basic earnings per share excludes the dilutive effects of stock options and warrants and of the nil coupon non-redeemable convertible unsecured loan notes. Diluted earnings per share includes the dilutive effect of stock options and warrants and of the nil coupon non-redeemable convertible unsecured loan notes. The following table sets forth the weighted-average shares used in calculating the earnings per share for the three-month periods ended March 31, 2007 and 2006:

	Three Months Ended March 31	
	2007	2006
Basic weighted-average shares	22,107,000	20,613,000
Conversion of unsecured loan notes	45,000	46,000
Unexercised options and warrants	2,501,000	3,049,000
Diluted weighted-average shares	24,653,000	23,708,000

Note D: Total Comprehensive Income

Total comprehensive income for Fuel Tech is comprised of net income and the impact of foreign currency translation as follows:

	Three Months Ended March 31	
	2007	2006
Comprehensive income:		
Net income	\$ 792	\$ 1,350
Foreign currency translation	3	23
	\$ 795	\$ 1,373

Note E: Stock-Based Compensation

Fuel Tech has one stock based employee compensation plan, referred to as the 1993 Incentive Plan (1993 Plan), under which awards may be granted to participants in the form of Non-Qualified Stock Options, Incentive Stock Options, Stock Appreciation Rights, Restricted Stock, Performance Awards, Bonuses or other forms of share-based or non-share-based awards or combinations thereof. Participants in the 1993 Plan may be Fuel Tech's directors, officers, employees, consultants or advisors (except consultants or advisors in capital-raising transactions) as the directors determine are key to the success of Fuel Tech's business. The amount of shares that may be issued or reserved for awards to participants under a 2004 amendment to the 1993 Plan is 12.5% of outstanding shares calculated on a diluted basis. At March 31, 2007, Fuel Tech has 988,000 stock options available for issuance under the 1993 Plan.

Prior to January 1, 2006, Fuel Tech accounted for the stock options granted under the 1993 Plan under the recognition and measurement provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" (Opinion 25) and related Interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock Based Compensation" (Statement 123). No stock based employee compensation cost was recognized in Fuel Tech's historical Statements of Income prior to January 1, 2006 as all options granted under the 1993 Plan had an exercise price equal to the market value of the underlying common stock on the date of grant.

Effective January 1, 2006, Fuel Tech adopted the fair value recognition provisions of FASB Statement No. 123(R), "Share Based Payment" (Statement 123(R)) using the modified-prospective transition method. Under that transition method, compensation cost recognized for the quarter ended March 31, 2007 includes: (a) compensation cost for all share based payments granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Accordingly, results for prior periods have not been restated.

As a result of adopting Statement 123(R) on January 1, 2006, Fuel Tech recorded stock-based compensation expense of \$890 (\$583 after-tax) for the quarter ended March 31, 2007. Fuel Tech recorded \$227 (there was no tax impact) in stock-based compensation expense for the quarter ended March 31, 2006.

Prior to the adoption of Statement 123(R), Fuel Tech presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. Statement 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$727 excess tax benefit classified as a financing cash inflow on the Statement of Cash Flows for the three months ended March 31, 2007 would have been classified as an operating cash inflow if Fuel Tech had not adopted Statement 123(R).

The awards granted under the 1993 Plan have a 10-year life and they vest as follows: 50% after the second anniversary of the award date, 25% after the third anniversary, and the final 25% after the fourth anniversary of the award date. Fuel Tech calculates stock compensation expense based on the grant date fair value of the award and recognizes expense on a straight-line basis over the four-year service period of the award.

Prior to January 1, 2006, Fuel Tech used the Black-Scholes option-pricing model to estimate the fair value of employee stock options for the required pro forma disclosure under Statement 123. This model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. With the adoption of Statement 123(R) as of January 1, 2006, Fuel Tech has continued to use the Black-Scholes option-pricing model to estimate the fair value of stock option grants.

The principal variable assumptions utilized in valuing options and the methodology for estimating such model inputs include: (1) risk-free interest rate - an estimate based on the yield of zero-coupon treasury securities with a maturity

equal to the expected life of the option; (2) expected volatility - an estimate based on the historical volatility of Fuel Tech's Common Stock for a period equal to the expected life of the option; and (3) expected life of the option - an estimate based on historical experience including the effect of employee terminations.

Edgar Filing: FUEL TECH, INC. - Form 10-Q

Based on the results of the model, the weighted-average fair value of the stock options granted during the three-month period ended March 31, 2007 was \$13.35 per share using the following assumptions:

	2007	2006
Expected dividend yield	0.00%	0.00%
Risk-free interest rate	4.46%	4.70%
Expected volatility	56.8%	65.6%
Expected life of option	5.2 years	5.3 years

Stock option activity for Fuel Tech's 1993 Plan for the three months ended March 31, 2007 was as follows:

	Number of Options	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding on January 1, 2007	2,414,200	\$ 13.02		
Granted	22,000	24.66		
Exercised	(102,250)	4.95		\$ 2,162
Expired or forfeited	(44,000)	19.10		
Outstanding on March 31, 2007	2,289,950	\$ 13.37	8.15 years	\$ 30,618
Exercisable on March 31, 2007	633,700	\$ 5.31	5.92 years	\$ 3,365
Weighted-average fair value of options granted during first three months of 2007		\$ 13.35		

The weighted-average exercise price per nonvested stock award at grant date was \$24.66 per share for the nonvested stock awards granted in 2007. Nonvested stock award activity for all plans for the three months ended March 31, 2007 was as follows:

	Nonvested Stock Outstanding
Outstanding on January 1, 2007	1,702,750
Granted	22,000
Released	(24,500)
Expired or forfeited	(44,000)
Outstanding on March 31	1,656,250

As of March 31, 2007, there was \$11.4 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 1993 Plan. That cost is expected to be recognized over a period of four years.

Note F: Debt

Fuel Tech has a \$25.0 million revolving credit facility expiring July 31, 2009. The facility is unsecured and bears interest at a rate of LIBOR plus 75 basis points. Fuel Tech can use this facility for cash advances and standby letters of credit. As of March 31, 2007, there were no outstanding borrowings on this facility.

Note G: Business Segment and Geographic Disclosures

Fuel Tech segregates its financial results into two reportable segments representing two broad technology segments as follows:

- The NO_x reduction technology segment, which includes the NO_xOUT[®], NO_xOUT CASCADE[®], NO_xOUT ULTRA[®] and NO_xOUT-SCR[®] processes for the reduction of NO_x emissions in flue gas from boilers, incinerators, furnaces and other stationary combustion sources, and
- The fuel treatment chemicals technology segment, which uses chemical processes for the control of slagging, fouling, and corrosion and for plume abatement in furnaces and boilers through the addition of chemicals into the fuel using TIFI[™] Targeted In-Furnace Injection[™] technology.

The “Other” classification includes those profit and loss items not allocated by Fuel Tech to each reportable segment. Further, there are no intersegment sales that require elimination.

Fuel Tech evaluates performance and allocates resources based on reviewing gross margin by reportable segment. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Fuel Tech does not review assets by reportable segment, but rather, in aggregate for Fuel Tech as a whole.

Edgar Filing: FUEL TECH, INC. - Form 10-Q

Reporting segment net sales and gross margin are provided below.

Three months ended March 31, 2007	Nitrogen Oxide Reduction	Fuel Treatment Chemical	Other	Total
Net sales from external customers	\$ 8,609	\$ 7,653	\$ -	\$ 16,262
Cost of sales	5,027	3,895	35	8,957
Gross margin	3,582	3,758	(35)	7,305
Selling, general and administrative			5,906	5,906
Research and development			554	554
Operating income (loss)	\$ 3,582	\$ 3,758	\$ (6,495)	\$ 845

Three months ended March 31, 2006	Nitrogen Oxide Reduction	Fuel Treatment Chemical	Other	Total
Net sales from external customers	\$ 12,365	\$ 4,756	\$ -	\$ 17,121
Cost of sales	6,888	2,118	50	9,056
Gross margin	5,477	2,638	(50)	8,065
Selling, general and administrative			5,424	5,424
Research and development			351	351
Operating income (loss)	\$ 5,477	\$ 2,638	\$ (5,825)	\$ 2,290

Information concerning Fuel Tech's operations by geographic area is provided below. Revenues are attributed to countries based on the location of the customer. Assets are those directly associated with operations of the geographic area.

	Three months ended March 31	
	2007	2006
Net sales:		
United States	\$ 14,007	\$ 12,906
Foreign	2,255	4,215
	\$ 16,262	\$ 17,121

	March 31, 2007	December 31, 2006
Assets:		
United States	\$ 58,650	\$ 62,190
Foreign	3,821	3,470
	\$ 62,471	\$ 65,660

Note H: Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109," (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. On January 17, 2007, the FASB affirmed its previous decision to make FIN 48 effective for fiscal years beginning after December 15, 2006. Accordingly, Fuel Tech adopted the provisions of FIN 48 on January 1, 2007.

Previously, Fuel Tech had accounted for tax contingencies in accordance with Statement of Financial Accounting Standards 5, *Accounting for Contingencies*. As required by FIN 48, which clarifies Statement 109, *Accounting for Income Taxes*, Fuel Tech recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, Fuel Tech applied FIN 48 to all tax positions for which the statute of limitations remained open. As a result of the implementation of FIN 48, Fuel Tech recognized an increase of approximately \$86,000 in the liability for unrecognized tax benefits, of which, \$81,000 was accounted for as a reduction to the January 1, 2007, balance of retained earnings.

The amount of unrecognized tax benefits as of January 1, 2007, was \$783,000. This amount includes \$741,000 of unrecognized tax benefits which, if ultimately recognized, will reduce Fuel Tech's annual effective tax rate. There have been no material changes in unrecognized tax benefits since January 1, 2007.

Fuel Tech is subject to income taxes in the U.S. federal jurisdiction, and various states and foreign jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few exceptions, Fuel Tech is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for the years before 2003.

Fuel Tech recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense for all periods presented. Fuel Tech had accrued approximately \$39,000 for the payment of interest and penalties at January 1, 2007. Subsequent changes to accrued interest and penalties have not been significant.

FUEL TECH, INC.

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

Results of Operations

Net sales for the first quarter ended March 31, 2007 and 2006 were \$16,262,000 and \$17,121,000, respectively. The 5% percent decline versus prior year is due to a \$3,756,000 reduction in revenues derived from the nitrogen oxide (NOx) reduction technology segment, which was partially offset by a \$2,897,000 million increase in revenues derived from the fuel treatment chemical technology segment.

The NOx reduction technology segment generated revenues of \$8,609,000 for the three months ended March 31, 2007, a reduction of \$3,756,000 from the prior year, due primarily to the winding down of two NOx reduction projects in the People's Republic of China which had been signed in 2005, and contributed significantly to revenues in 2006. While revenues are down from the prior year, this segment is positioned well to capitalize on the next phase of increasingly stringent U.S. air quality standards, and interest in Fuel Tech's retrofittable suite of technologies, both domestically and abroad, has never been greater. With the compliance for the Environmental Protection Agency's (EPA) State Implementation Plan (SIP) Call regulation beginning to wind down, utilities and industrial facilities across the country are planning for compliance with the Clean Air Interstate Rule (CAIR) and the Clean Air Visibility Rule (CAVR), which take effect in 2009 and 2013, respectively. Thousands of utility and industrial boilers will be impacted by these regulations and Fuel Tech's technologies will serve as an important element in enabling utility and industrial boiler unit owners to attain compliance.

The fuel treatment chemical technology segment generated revenues of \$7,653,000 for the three months ended March 31, 2007, an increase of \$2,897,000, or 61%, over the prior year. This segment's growth is indicative of the continued market acceptance of Fuel Tech's patented TIFI™ Targeted In-Furnace Injection™ technology, particularly on coal-fired units, which represent the largest market opportunity for the technology, both domestically and abroad. While the year on year growth is substantial, growth in this segment was hampered by utility maintenance outages in the first quarter of 2007. Thus far in 2007, Fuel Tech has added six new coal-fired units to its customer base.

The FUEL CHEM technology segment revolves around the unique application of specialty chemicals to improve the efficiency, reliability and environmental status of plants operating in the electric utility, industrial, pulp and paper, and waste-to-energy markets. FUEL CHEM programs are currently in place on over 50 combustion units, treating a wide variety of solid and liquid fuels, including coal, heavy oil, biomass and municipal waste.

Central to the FUEL CHEM® approach is the introduction of chemical reagents, such as magnesium hydroxide, to combustion units via in-body fuel application (pre-combustion) or via direct injection (post-combustion) utilizing Fuel Tech's proprietary TIFI technology. By attacking performance-hindering problems, such as slagging, fouling, corrosion, opacity, acid plume and loss on ignition (LOI), as well as the formation of sulfur trioxide (SO₃), ammonium bisulfate (ABS), particulate matter (PM_{2.5}), carbon dioxide (CO₂) and NOx, Fuel Tech's programs offer numerous operational, financial and environmental benefits to owners of boilers, furnaces and other combustion units.

The principal markets for this product line are electric power plants burning coals with slag-forming constituents such as sodium and iron. Sodium is typically found in the Powder River Basin coals of Wyoming and Montana, while iron is typically found in coals produced in the Illinois Basin (IB) region. In addition, higher sulfur content is typical of IB coals and certain Appalachian coals and these can give rise to unacceptable levels of SO₃ formation in plants with Selective Catalytic Reduction (SCR) systems and flue gas desulfurization units (scrubbers).

The combination of slagging coals and SO₃-related issues, such as "blue plume" formation, air pre-heater fouling and corrosion, SCR fouling and the proclivity to suppress certain mercury removal processes, represents attractive market

potential for Fuel Tech.

Cost of sales as a percentage of net sales for Fuel Tech for the three months ended March 31, 2007 and 2006 was 55% and 53%, respectively. The cost of sales percentage for the first quarter for the NOx reduction business increased to 58% from 56% in the comparable prior-year period, resulting from the mix of project business. For the fuel treatment chemical business, the cost of sales percentage increased to 51% in the first quarter of 2007 from 45% in 2006. The increase is due to the timing of revenue recognition on cost-share demonstrations and to the loss of leverage on fixed costs related to utility outages noted above.

Selling, general and administrative expenses for the three months ended March 31, 2007 and 2006 were \$5,906,000 and \$5,424,000, respectively. The \$482,000 increase was partially attributable to the recording of \$890,000 in stock compensation expense in accordance with Statement 123(R), as discussed in Note E above, in the first quarter of 2007. This amount was an increase of \$663,000 over the prior year.

Research and development expenses for the three months ended March 31, 2007 and 2006 were \$554,000 and \$351,000, respectively. Fuel Tech has established a more focused approach in the pursuit of commercial applications for its technologies outside of its traditional markets, and in the development and analysis of new technologies that could represent incremental market opportunities.

The \$267,000 increase in interest income is driven by higher average cash and short-term investment balances versus those experienced in the prior year.

For the three months ended March 31, 2007, Fuel Tech recorded tax expense of \$429,000. This amount represents deferred tax expense related to taxable income recognized in the first quarter of 2007. For the three months ended March 31, 2006, Fuel Tech recorded tax expense of \$1,072,000.

Liquidity and Sources of Capital

At March 31, 2007, Fuel Tech had cash and cash equivalents and short-term investments of \$31,602,000 and working capital of \$42,043,000 versus \$32,405,000 and \$38,715,000 at the end of 2006, respectively. Operating activities used \$1,342,000 of cash during the three-month period ended March 31, 2007, primarily due to the change in working capital from year end. Investing activities generated cash of \$7,303,000 during the quarter ended March 31, 2007 as the decrease in short-term investments provided cash of \$8,000,000 of which \$697,000 was utilized to support and enhance the operations of the business, principally for equipment related to the fuel treatment chemical technology segment. Fuel Tech generated cash related to the exercise of stock options in the amount of \$1,233,000. Of this amount, \$506,000 represents proceeds derived from the exercise price of options exercised in the first three months of 2007, while \$727,000 represents the excess tax benefits realized from the exercise of stock options in the first three months of 2007.

Forward-Looking Statements

Statements in this Form 10-Q that are not historical facts, so-called “forward-looking statements,” are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that all forward-looking statements involve risks and uncertainties, including those detailed in Fuel Tech’s filings with the Securities and Exchange Commission. See “Risk Factors of the Business” in Item 1A, and also Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Fuel Tech’s Form 10-K for the year ended December 31, 2006.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk Management

Fuel Tech's earnings and cash flow are subject to fluctuations due to changes in foreign currency exchange rates. Fuel Tech does not enter into foreign currency forward contracts or into foreign currency option contracts to manage this risk due to the immaterial nature of the transactions involved.

Item 4. Controls and Procedures

Fuel Tech maintains disclosure controls and procedures and internal controls designed to ensure that information required to be disclosed in Fuel Tech's filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Fuel Tech's management, with the participation of its principal executive and financial officers, has evaluated the effectiveness of Fuel Tech's disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Fuel Tech's principal executive and financial officers have concluded, based on such evaluation, that such disclosure controls and procedures were effective as of the end of such period.

There was no change in Fuel Tech's internal control over financial reporting that was identified in connection with such evaluation that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, Fuel Tech's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

None

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

None

Item 3. Defaults upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

a. Exhibits

Exhibit 31.1 and 31.2 are filed herewith

Exhibit 32 is furnished herewith

14

FUEL TECH, INC.

Signatures

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

Date: May 8, 2007

By: /s/ John F. Norris Jr.

John F. Norris Jr.
Director, President and Chief Executive Officer

Date: May 8, 2007

By: /s/ Vincent J. Arnone

Vincent J. Arnone
Chief Financial Officer,
Sr. Vice President and
Treasurer