

COVANTA HOLDING CORP

Form 10-Q

July 25, 2007

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

**Form 10-Q**

- ☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended June 30, 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 1-6732**

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

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*  
**40 Lane Road, Fairfield, NJ**  
*(Address of Principal Executive Office)*

**95-6021257**  
*(I.R.S. Employer  
Identification Number)*  
**07004**  
*(Zip code)*

**(973) 882-9000**  
*(Registrant's telephone number including area code)*

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.  
Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

The number of shares of the registrant's Common Stock outstanding as of the last practicable date.

**Class**

**Outstanding at July 18, 2007**

Common Stock, \$0.10 par value

153,825,304 shares

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

**FORM 10-Q QUARTERLY REPORT  
For the Quarter Ended June 30, 2007**

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**Cautionary Note Regarding Forward-Looking Statements**

Certain statements in this Quarterly Report on Form 10-Q may constitute forward-looking statements as defined in Section 27A of the Securities Act of 1933 (the Securities Act ), Section 21E of the Securities Exchange Act of 1934 (the Exchange Act ), the Private Securities Litigation Reform Act of 1995 (the PSLRA ) or in releases made by the Securities and Exchange Commission ( SEC ), all as may be amended from time to time. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of Covanta Holding Corporation and its subsidiaries ( Covanta ) or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Statements that are not historical fact are forward-looking statements. Forward-looking statements can be identified by, among other things, the use of forward-looking language, such as the words plan, believe, expect, anticipate, intend, estimate, project, may, will, would, could, should, seeks, similar words, or the negative of these terms or other variations of these terms or comparable language, or by discussion of strategy or intentions. These cautionary statements are being made pursuant to the Securities Act, the Exchange Act and the PSLRA with the intention of obtaining the benefits of the safe harbor provisions of such laws. Covanta cautions investors that any forward-looking statements made by Covanta are not guarantees or indicative of future performance. Important assumptions and other important factors that could cause actual results to differ materially from those forward-looking statements with respect to Covanta, include, but are not limited to, the risks and uncertainties affecting their businesses described in Item 1A. Risk Factors of Covanta s Annual Report on Form 10-K for the year ended December 31, 2006 and in other filings by Covanta with the SEC.

Although Covanta believes that its plans, intentions and expectations reflected in or suggested by such forward-looking statements are reasonable, actual results could differ materially from a projection or assumption in any of its forward-looking statements. Covanta s future financial condition and results of operations, as well as any forward-looking statements, are subject to change and inherent risks and uncertainties. The forward-looking statements contained in this Quarterly Report on Form 10-Q are made only as of the date hereof and Covanta does not have or undertake any obligation to update or revise any forward-looking statements whether as a result of new information, subsequent events or otherwise, unless otherwise required by law.

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Unaudited)			
	(In thousands, except per share amounts)			
<b>OPERATING REVENUES:</b>				
Waste and service revenues	\$ 218,040	\$ 213,501	\$ 416,951	\$ 404,870
Electricity and steam sales	126,815	116,413	240,481	225,591
Other operating revenues	10,285	4,222	27,917	9,031
Total operating revenues	355,140	334,136	685,349	639,492
<b>OPERATING EXPENSES:</b>				
Plant operating expenses	199,561	175,696	401,568	362,245
Depreciation and amortization expense	48,436	48,838	96,479	95,235
Net interest expense on project debt	13,886	15,293	28,491	31,291
General and administrative expenses	20,029	16,101	42,221	34,305
Write-down of assets, net of insurance recoveries	(13,341)		4,925	
Other operating expenses	9,357	1,520	26,173	4,210
Total operating expenses	277,928	257,448	599,857	527,286
<b>Operating income</b>	77,212	76,688	85,492	112,206
<b>Other income (expense):</b>				
Investment income	1,819	2,915	7,003	5,318
Interest expense	(14,718)	(27,361)	(35,978)	(55,844)
Loss on extinguishment of debt		(6,795)	(32,006)	(6,795)
Total other expenses	(12,899)	(31,241)	(60,981)	(57,321)
Income before income tax expense, minority interests and equity in net income from unconsolidated investments	64,313	45,447	24,511	54,885
Income tax expense	(28,822)	(6,662)	(10,646)	(10,925)
Minority interests	(2,091)	(2,279)	(3,489)	(2,879)

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Equity in net income from unconsolidated investments	4,316	14,672	9,422	21,515
<b>NET INCOME</b>	<b>\$ 37,716</b>	<b>\$ 51,178</b>	<b>\$ 19,798</b>	<b>\$ 62,596</b>
<b>Earnings Per Share:</b>				
Basic	\$ 0.25	\$ 0.35	\$ 0.13	\$ 0.43
Diluted	\$ 0.24	\$ 0.35	\$ 0.13	\$ 0.43

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



Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	As of	
	June 30, 2007	December 31, 2006
	(Unaudited)	
	(In thousands, except per share amounts)	
ASSETS		
Current:		
Cash and cash equivalents	\$ 154,862	\$ 233,442
Marketable securities available for sale	3,100	7,080
Restricted funds held in trust	188,833	178,054
Receivables (less allowances of \$3,650 and \$4,469)	219,640	209,306
Unbilled service receivables	58,763	56,868
Deferred income taxes	39,249	24,146
Prepaid expenses and other current assets	99,516	94,690
Total Current Assets	763,963	803,586
Property, plant and equipment, net	2,581,805	2,637,923
Investments in fixed maturities at market (cost: \$30,185 and \$35,833)	29,483	35,007
Restricted funds held in trust	214,473	229,867
Unbilled service receivables	64,643	73,067
Intangible assets, net	359,140	383,574
Goodwill	91,282	91,282
Investments in investees and joint ventures	85,757	73,717
Other assets	108,718	109,797
Total Assets	\$ 4,299,264	\$ 4,437,820

**LIABILITIES AND STOCKHOLDERS EQUITY**

<b>Current:</b>		
Current portion of long-term debt	\$ 14,462	\$ 36,434
Current portion of project debt	193,591	190,242
Accounts payable	39,376	20,151
Deferred revenue	19,872	16,457
Accrued expenses and other current liabilities	187,815	197,468
<b>Total Current Liabilities</b>	<b>455,116</b>	<b>460,752</b>
Long-term debt	1,015,634	1,223,689
Project debt	1,177,935	1,245,705
Deferred income taxes	383,646	420,263
Other liabilities	328,100	305,578

<b>Total Liabilities</b>	3,360,431	3,655,987
<b>Commitments and Contingencies (Note 16)</b>		
<b>Minority Interests</b>	43,580	42,681
<b>Stockholders' Equity:</b>		
Preferred stock (\$0.10 par value; authorized 10,000 shares; none issued and outstanding)		
Common stock (\$0.10 par value; authorized 250,000 shares; issued 154,179 and 147,657 shares; outstanding 153,827 and 147,500 shares)	15,418	14,766
Additional paid-in capital	757,355	619,685
Accumulated other comprehensive income	4,740	3,942
Accumulated earnings	117,775	100,775
Treasury stock, at par	(35)	(16)
<b>Total Stockholders' Equity</b>	895,253	739,152
<b>Total Liabilities and Stockholders' Equity</b>	\$ 4,299,264	\$ 4,437,820

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

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Six Months Ended June 30,	
	2007	2006
	(Unaudited)	
	(In thousands)	
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 19,798	\$ 62,596
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	96,479	95,235
Amortization of long-term debt deferred financing costs	1,704	1,503
Write-down of assets, net of insurance recoveries	4,925	
Loss on extinguishment of debt	32,006	6,795
Amortization of debt premium and discount	(7,689)	(11,540)
Stock-based compensation expense	6,407	3,368
Equity in net income from unconsolidated investments	(9,422)	(21,515)
Dividends from unconsolidated investments	7,194	5,762
Minority interests	3,489	2,879
Deferred income taxes	(1,789)	736
Other, net	784	2,593
Change in operating assets and liabilities, net of effects of acquisition:		
Receivables	(13,336)	(3,023)
Unbilled service receivables	10,191	8,262
Accounts payable and accrued expenses	(4,617)	(13,342)
Deferred revenue	(321)	(1,257)
Unpaid losses and loss adjustment expenses	(779)	(4,991)
Other, net	(2,486)	(17,396)
Net cash provided by operating activities	142,538	116,665
<b>INVESTING ACTIVITIES:</b>		
Purchase of equity interest	(10,253)	
Proceeds from the sale of investment securities	9,575	5,096
Purchase of property, plant and equipment	(43,016)	(26,797)
Property insurance proceeds	7,341	
Acquisition of business	(7,439)	
Other, net	233	2,835
Net cash used in investing activities	(43,559)	(18,866)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from the issuance of common stock, net	135,757	
Proceeds from rights offering, net		20,498

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Proceeds from the exercise of options for common stock, net	111	558
Proceeds from borrowings on long-term debt	949,907	97,577
Proceeds from borrowings on project debt	3,389	5,149
Principal payments on long-term debt	(1,160,385)	(120,039)
Principal payments on project debt	(65,489)	(69,009)
Payments of long-term debt deferred financing costs	(18,324)	(2,129)
Payments of tender premiums on debt extinguishment	(32,759)	(1,952)
Decrease in holding company restricted funds	6,660	
Decrease in restricted funds held in trust	7,815	14,722
Distributions to minority partners	(4,578)	(5,346)
Net cash used in financing activities	(177,896)	(59,971)
Effect of exchange rate changes on cash and cash equivalents	337	97
Net (decrease) increase in cash and cash equivalents	(78,580)	37,925
Cash and cash equivalents at beginning of period	233,442	128,556
Cash and cash equivalents at end of period	\$ 154,862	\$ 166,481

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

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY****For The Six Months Ended June 30, 2007**

	<b>Common Stock</b>		<b>Additional Paid-In Capital</b>		<b>Accumulated Other Comprehensive Income</b>	<b>Accumulated Earnings</b>	<b>Treasury Stock</b>		<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Capital</b>		<b>Income</b>	<b>Earnings</b>	<b>Shares</b>	<b>Amount</b>	
	<b>(Unaudited, In thousands)</b>								
Balance as of December 31, 2006	147,657	\$ 14,766	\$ 619,685	\$ 3,942	\$ 100,775		157	\$ (16)	\$ 739,152
Shares issued in equity offering, net of costs	6,118	612	135,145						135,757
Stock-based compensation expense			6,407						6,407
Effect of FIN 48 adoption						(2,798)			(2,798)
Shares cancelled for terminated employees			1				20	(1)	
Shares cancelled for tax withholdings for vested stock awards			(3,954)				175	(18)	(3,972)
Exercise of options to purchase common stock	15	1	110						111
Shares issued in restricted stock award	389	39	(39)						
Comprehensive income, net of income taxes:									
Net income						19,798			19,798
Foreign currency translation					2,633				2,633
Amortization of actuarial loss for benefit obligation					53				53
					237				237

Net unrealized loss on available-for-sale securities									
Net realized gain on derivative instruments				(2,125)					(2,125)
Total comprehensive income				798		19,798			20,596
Balance as of June 30, 2007	154,179	\$ 15,418	\$ 757,355	\$ 4,740	\$ 117,775	352	\$ (35)	\$ 895,253	

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

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Note 1. Organization and Basis of Presentation**

***Organization***

The financial statements in this report represent the consolidation of Covanta Holding Corporation and its wholly-owned and majority-owned subsidiaries. Covanta Holding Corporation conducts all of its operations through subsidiaries which are predominantly engaged in the businesses of waste and energy services.

The terms we, our, ours, us, Covanta and Company refer to Covanta Holding Corporation and its subsidiaries; the term Covanta Energy refers to our subsidiary Covanta Energy Corporation and its subsidiaries; the term ARC Holdings refers to our subsidiary Covanta ARC Holdings, Inc. and its subsidiaries; the term CPIH refers to our subsidiary Covanta Power International Holdings, Inc. and its subsidiaries.

We are a leading developer, owner and operator of infrastructure for the conversion of energy-from-waste, waste disposal and renewable energy production businesses in the United States and abroad. We also engage in the independent power production business outside the United States. We own, have equity investments in, and/or operate 55 energy generation facilities, 44 of which are in the United States and 11 of which are located outside the United States. Our energy generation facilities use a variety of fuels, including municipal solid waste, water (hydroelectric), natural gas, coal, wood waste, landfill gas and heavy fuel-oil. We also own or operate several businesses that are associated with our energy-from-waste business, including a waste procurement business, two landfills, and several waste transfer stations. We also operate one domestic water treatment facility.

Given our increased focus on developing our international waste and energy business, during the first quarter of 2007, we segregated what we previously reported as our Waste and Energy Services segment into two new segments: Domestic and International. Our remaining operations, which we previously reported as our Other Services segment and was comprised of the holding company and insurance subsidiaries operations, do not meet the quantitative thresholds which require separate disclosure as a reportable segment. Therefore, we currently have two reportable segments, Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q. As permitted by the rules and regulations of the Securities and Exchange Commission ( SEC ), the financial statements contain certain condensed financial information and exclude certain footnote disclosures normally included in audited consolidated financial statements prepared in accordance with United States generally accepted accounting principles ( GAAP ). In presenting the unaudited condensed consolidated financial statements, our management makes estimates and assumptions that affect the amounts reported and related disclosures. Estimates, by their nature, are based on judgments and available information. Accordingly, actual results could differ from those estimates. In the opinion of our management, the accompanying financial statements contain all adjustments, including normal recurring accruals, necessary to fairly present the accompanying financial statements. Operating results for the interim period are not necessarily indicative of the results that may be expected for the fiscal year ended December 31, 2007. For further information, refer to the Audited Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006.

The unaudited condensed consolidated financial statements reflect the results of our operations, cash flows and financial position and of our majority-owned or controlled subsidiaries. Investments in companies that are not majority-owned or controlled, but in which we have significant influence are accounted for under the equity method. Significant influence is generally deemed to exist if we have an ownership interest in the voting stock of the investee of between 20% and 50%, although other factors, such as representation on the investee's board of directors, are considered in determining whether the equity method of accounting is appropriate. Investments in



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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

companies in which we do not have the ability to exercise significant influence are carried at the lower of cost or estimated realizable value.

Certain prior period amounts have been reclassified in the unaudited condensed consolidated financial statements to conform to the current period presentation. All intercompany accounts and transactions have been eliminated.

**Note 2. Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 will be applied under other accounting principles that require or permit fair value measurements, as this is a relevant measurement attribute. This statement does not require any new fair value measurements. We will adopt the provisions of SFAS 157 beginning January 1, 2008. We are currently evaluating the impact of the adoption of this statement on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 ( SFAS 159 ). SFAS 159 provides companies with the option to report selected financial assets and liabilities at fair value that are not currently required to be measured at fair value. The objective of this statement is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The decision about whether to elect the fair value option is applied on an instrument by instrument basis, with a few exceptions; the decision is irrevocable; and it is applied only to entire instruments and not to portions of instruments. Upon implementation, an entity will report the effect of the first remeasurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. An entity would recognize unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. We are currently evaluating whether we will elect to apply the fair value option to any of our assets and liabilities and the impact of the election on our consolidated financial statements.

**Note 3. Acquisitions**

***Holliston Transfer Station***

On April 30, 2007, we acquired a waste transfer station in Holliston, Massachusetts from Casella Waste Systems Inc. for a cash payment of \$7.4 million. This acquisition was not material to our unaudited condensed consolidated financial statements. Therefore, disclosures of pro forma financial information have not been presented.

**Note 4. Stock-Based Compensation**

We recognize stock-based compensation expense in accordance with the provisions of SFAS No. 123 (revised 2004), Share-Based Payments ( SFAS 123R ). Stock-based compensation expense for all stock-based compensation awards granted after December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. For stock-based compensation awards granted prior to, but not yet vested as of December 31, 2005, stock-based compensation expense is based on the grant date fair value estimated in accordance with the original

provisions of SFAS No. 123, Accounting for Stock-Based Compensation.

We recognize compensation expense based on the number of stock options and restricted stock awards expected to vest by using an estimate of expected forfeitures. The estimate of the expected forfeitures was initially determined based on historical turnover experience from the Covanta Energy pension plan. This initial estimate was

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

subsequently adjusted during the year ended December 31, 2006, and again in the second quarter of 2007, as discussed below, to reflect a revised forfeiture rate. We recognize compensation costs using the graded vesting attribution method over the requisite service period of the award, which is generally a vesting term of three to five years. Prior to the second quarter of 2007, we recognized compensation expense based on an overall forfeiture rate of 8%. In order to better reflect compensation expense by type of award, i.e. stock options versus restricted stock, we reevaluated the forfeiture rate during the second quarter of 2007. The new forfeiture rates range from 8% to 15% depending on the type of award and the vesting period. The cumulative effect of the change in the forfeiture rate to compensation expense did not have a material impact on the financial statements.

The amount received from the exercise of non-qualified stock options was \$0.1 million and \$0.6 million in the six months ended June 30, 2007 and 2006, respectively. The tax benefits related to the exercise of the non-qualified stock options and the vesting of restricted stock awards were not recognized during the six months ended June 30, 2007 and 2006 due to our net operating loss carryforwards ( NOLs ). When the NOLs have been fully utilized by us, we will recognize a tax benefit and an increase in additional paid-in capital for the excess tax deductions received on the exercised non-qualified stock options and vested restricted stock. Future realization of the tax benefit will be presented in cash flows from financing activities in the condensed consolidated statements of cash flows in the period the tax benefit is recognized.

**Stock-Based Awards**

We adopted the Covanta Holding Corporation Equity Award Plan for Employees and Officers (the Employees Plan ) and the Covanta Holding Corporation Equity Award Plan for Directors (the Directors Plan ) (collectively, the Award Plans ), effective with stockholder approval on October 5, 2004. On July 25, 2005, our Board of Directors approved and on September 19, 2005, our stockholders approved the amendment to the Employees Plan to authorize the issuance of an additional 2,000,000 shares. The 1995 Stock and Incentive Plan (the 1995 Plan ) was terminated with respect to any future awards under such plan on October 5, 2004 upon stockholder approval of the Award Plans. The 1995 Plan will remain in effect until all awards have been satisfied or expired.

***Restricted Stock Awards***

Restricted stock awards that have been issued to employees typically vest over a three-year period. Restricted stock awards are stock-based awards for which the employee or director does not have a vested right to the stock ( nonvested ) until the requisite service period has been rendered or the required financial performance factor has been reached for each pre-determined vesting date. A percentage of each employee restricted stock awards granted have financial performance factors. Stock-based compensation expense for each financial performance factor is recognized beginning in the period when management has determined it is probable the financial performance factor will be achieved for the respective vesting period.

Restricted stock awards to employees are subject to forfeiture if the employee is not employed on the vesting date. Restricted stock awards issued to directors prior to 2006 were subject to the same forfeiture restrictions as are applicable to employees. Restricted stock awards issued to directors in 2006 and thereafter are not subject to forfeiture in the event a director ceases to be a member of the Board of Directors, except in limited circumstances. Restricted stock awards will be expensed over the requisite service period, subject to an assumed eight percent forfeiture rate.

On March 19, 2007, March 26, 2007 and June 6, 2007, we awarded certain employees 350,249 shares, 876 shares and 1,592 shares, respectively, of restricted stock under the Employees Plan. On May 30, 2007, in accordance with our existing program for annual director compensation, we awarded 36,000 shares of restricted stock under the Directors Plan. We determined that the service vesting condition of the restricted stock awards granted to the directors on May 30, 2007 to be non-substantive and, in accordance with SFAS 123R, recorded the entire fair value of the awards as compensation expense in the three months ended June 30, 2007.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Changes in nonvested restricted stock awards during the six months ended June 30, 2007 were as follows:

	<b>Number of Shares</b>	<b>Weighted- Average Grant Date Fair Value</b>
Nonvested as of December 31, 2006	935,533	\$ 13.85
Granted	388,717	\$ 22.28
Vested	(481,707)	\$ 12.46
Forfeited	(18,604)	\$ 15.71
Nonvested as of June 30, 2007	823,939	\$ 18.64

As of June 30, 2007, there was \$11.9 million unrecognized stock-based compensation expense related to nonvested restricted stock awards. This expense is expected to be recognized over a period of up to three years. Total compensation expense for restricted stock awards was \$2.6 million and \$2.3 million for the three months ended June 30, 2007 and 2006, respectively and \$4.2 million and \$2.8 million for the six months ended June 30, 2007 and 2006, respectively.

***Stock Options***

On March 19, 2007 and May 7, 2007, we granted stock options to purchase an aggregate of 1,755,000 shares and 30,000 shares, respectively, of common stock under the Employees Plan. The stock options have an exercise price of \$22.02 per share and \$24.80 per share, respectively, and both grants expire 10 years from the date of grant. The stock options vest in equal installments over five years commencing on March 17, 2008 and May 17, 2008, respectively. The stock option grants will be expensed over the requisite service period, subject to a 15% forfeiture rate.

The fair value of the stock option awards granted during the six months ended June 30, 2007 was calculated using the Black-Scholes option pricing model with the following assumptions:

<b>Stock Option Award</b>	<b>Risk-Free Interest Rate</b>	<b>Dividend Yield</b>	<b>Volatility Expected (A)</b>	<b>Expected Life</b>
<b>Grant Date</b>				
March 19, 2007	4.58%	0%	31%	8 years
May 7, 2007	4.627%	0%	29%	8 years

(A) Expected volatility is based on implied volatility.



Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Stock option activity for all outstanding options, vested and nonvested, during the six months ended June 30, 2007 was as follows:

	<b>Shares</b>	<b>Weighted-Average Exercise Price</b>	<b>Weighted-Average Remaining Contractual Life (In years)</b>	<b>Aggregate Intrinsic Value (In thousands)</b>
Outstanding at December 31, 2006	1,029,664	\$ 8.22		
Granted	1,785,000	22.07		
Exercised	(15,027)	7.43		
Forfeited and cancelled				
Outstanding at June 30, 2007	2,799,637	17.05	8.6	\$ 21,267
Vested and expected to vest in the future at June 30, 2007	2,632,211	16.86	8.6	\$ 20,500
Exercisable at June 30, 2007	706,811	8.13	6.4	\$ 11,678

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between \$24.65 per share, the closing stock price on the last trading day of the second quarter of 2007, and the exercise price, multiplied by the number of in-the-money stock options) that would have been received by the stock option holders had all holders of vested stock options exercised their stock options on the last trading day of the second quarter of 2007 (June 29, 2007). The intrinsic value changes based on the fair market value of our common stock. Total intrinsic value of stock options exercised for the six months ended June 30, 2007 was \$0.2 million. The total fair value of stock options expensed was \$1.8 million and \$0.3 million for the three months ended June 30, 2007 and 2006, respectively and \$2.2 million and \$0.6 million for the six months ended June 30, 2007 and 2006, respectively.

As of June 30, 2007, there was \$14.3 million of total unrecognized compensation expense related to stock options which is expected to be recognized over a weighted-average period of five years.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5. Earnings Per Share**

Per share data is based on the weighted average outstanding number of shares of our common stock, par value \$0.10 per share, during the relevant period. Basic earnings per share are calculated using only the weighted average number of outstanding shares of common stock. Diluted earnings per share computations, as calculated under the treasury stock method, include the weighted average number of shares of additional outstanding common stock issuable for stock options, restricted stock, convertible debt and rights whether or not currently exercisable. Diluted earnings per share for the periods presented do not include securities if their effect was anti-dilutive (in thousands, except per share amounts).

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net income	\$ 37,716	\$ 51,178	\$ 19,798	\$ 62,596
<b>Basic earnings per share:</b>				
Weighted average basic common shares outstanding	152,983	146,343	152,234	144,872
Basic earnings per share	\$ 0.25	\$ 0.35	\$ 0.13	\$ 0.43
<b>Diluted earnings per share:</b>				
Weighted average basic common shares outstanding	152,983	146,343	152,234	144,872
Stock options	651	519	636	539
Restricted stock	673	225	733	196
Rights				816
Convertible debentures				
Weighted average diluted common shares outstanding	154,307	147,087	153,603	146,423
Diluted earnings per share	\$ 0.24	\$ 0.35	\$ 0.13	\$ 0.43

There were 1,785,000 stock options excluded from the weighted average diluted common shares calculation for the three and six months ended June 30, 2007 because their inclusion would have been anti-dilutive.

On January 31, 2007, we issued 1.00% Senior Convertible Debentures due 2027 (the "Debentures"). The debentures are convertible if, after March 31, 2007 and before February 1, 2025, the closing sale price of our common stock for at least twenty trading days in the period of the 30 consecutive trading days ending on the last trading day of the previous quarter is more than 130% of \$28.20 (the conversion price). When this market condition is met, the debentures are convertible at the conversion rate of 35.4610 (initial rate with no change made during the period) shares of stock per \$1,000 principal of debt. The closing stock price on the last trading day of the second quarter of



2007 (June 29, 2007) was \$24.65 which is less than the conversion price thus the convertible bonds conversion feature is not dilutive.

**Note 6. Pass Through Costs**

Pass through costs are costs for which we receive a direct contractually committed reimbursement from the municipal client which sponsors an energy-from-waste project. These costs generally include utility charges, insurance premiums, ash residue transportation and disposal and certain chemical costs. These costs are recorded net of municipal client reimbursements in our condensed consolidated financial statements. Total pass through costs

**Table of Contents****COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

were \$13.3 million and \$13.7 million for the three months ended June 30, 2007 and 2006, respectively, and \$29.1 million and \$28.4 million for the six months ended June 30, 2007 and 2006, respectively.

**Note 7. Revenues and Unbilled Service Receivables**

The following table summarizes the components of waste and service revenues for the periods presented below (in thousands of dollars):

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Waste and service revenues unrelated to project debt	\$ 193,186	\$ 186,871	\$ 366,572	\$ 351,545
Revenue earned explicitly to service project debt-principal	17,290	17,274	34,580	34,548
Revenue earned explicitly to service project debt-interest	7,564	9,356	15,799	18,777
Total waste and service revenues	\$ 218,040	\$ 213,501	\$ 416,951	\$ 404,870

Unbilled service receivables include fees related to the principal portion of debt service earned to service project debt principal where such fees are expressly included as a component of the service fee paid by the municipality pursuant to applicable energy-from-waste service agreements. Regardless of the timing of amounts paid by municipalities relating to project debt principal, we record service revenue with respect to this principal component on a levelized basis over the term of the service agreement. Long-term unbilled service receivables related to energy-from-waste operations are recorded at their discounted amounts.

Electricity and steam sales included lease income from our international business of \$42.2 million and \$33.3 million for the three months ended June 30, 2007 and 2006, respectively, and \$72.4 million and \$60.7 million for the six months ended June 30, 2007 and 2006, respectively.

On May 29, 2007, we entered into a ten year agreement with the Harrisburg Authority (the Authority) to maintain and operate the Authority's 800 tons per day (tpd) energy-from-waste facility located in Harrisburg, Pennsylvania. Under the agreement, we will earn a base annual service fee of approximately \$10.5 million, which is subject to annual escalation and certain performance-based adjustments. The agreement also covers providing construction management services and advancing up to \$28 million in funding for certain facility improvements required to enhance facility performance. The agreement will become effective when certain conditions precedent occur which is expected later this year. In the meantime, a subsidiary of Covanta Energy has entered into an interim agreement to operate and maintain the facility as the Authority's contractor.

**Note 8. Equity Method Investments**

Equity in net income from unconsolidated investments was \$4.3 million and \$14.7 million for the three months ended June 30, 2007 and 2006, respectively, and \$9.4 million and \$21.5 million for the six months ended June 30, 2007 and 2006, respectively.

Equity in net income from unconsolidated investments primarily relates to our 26% investment in Quezon Power, Inc. ( Quezon ) in the Philippines. For the six years prior to May 2006, Quezon had benefited from Philippine tax regulations which were designed to promote investments in certain industries (including power generation). Equity in net income from unconsolidated investments for the three months and six months ended June 30, 2007 included approximately \$1.4 million and \$3.4 million, respectively, of increased tax expense for Quezon related to the conclusion of this six-year income tax holiday in May 2006.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Equity in net income from unconsolidated investments for the three months and six months ended June 30, 2006 included approximately \$7.0 million of cumulative deferred income tax benefits related to unrealized foreign exchange losses that are expected to be tax deductible for Philippine tax purposes in future years. Quezon recorded this cumulative deferred income tax benefit in the period ended June 30, 2006 on the basis of rulings which were issued by the Philippine tax authorities in June 2006 clarifying the tax deductibility of such losses upon realization. The realization of this deferred tax benefit is subject to fluctuations in the value of the Philippine peso versus the US dollar. During the last six months of 2006 and during the six months ended June 30, 2007, we reduced the cumulative deferred income tax benefit by approximately \$2.1 million and \$1.5 million, respectively, as a result of the strengthening of the Philippine peso versus the US dollar.

The unaudited results of operations from Quezon were as follows (in thousands of dollars):

	<b>Quezon</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Operating revenues	\$ 68,238	\$ 64,667	\$ 138,471	\$ 132,573
Operating income	29,498	21,505	62,061	50,063
Net income	9,462	43,336	21,911	63,316

***China Joint Venture***

On April 25, 2007, we closed on agreements relating to the subscription for a 40% equity interest in Chongqing Sanfeng Environmental Industry Co., Ltd. ( Sanfeng ). Sanfeng, a company located in Chongqing Municipality, China, currently owns minority equity interests in two 1,200 metric tpd 24 megawatts ( MW ) mass-burn energy-from-waste projects. As a result of this investment, Sanfeng was converted to a Sino-foreign equity joint venture under Chinese law in which we hold a 40% equity interest and Chongqing Iron & Steel Company (Group) Limited, holds the remaining 60% equity interest. We made an initial cash payment of approximately \$10 million in connection with our investment in Sanfeng.

**Note 9. Intangible Assets and Goodwill*****Intangible Assets***

Intangible assets consisted of the following (in thousands of dollars):

	<b>As of June 30, 2007</b>				<b>As of December 31, 2006</b>			
	<b>Remaining Useful Life</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>	

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Waste and energy contracts	2 - 22 years	\$ 388,378	\$ 114,431	\$ 273,947	\$ 388,378	\$ 91,850	\$ 296,528
Lease interest and other	12 - 23 years	72,186	6,072	66,114	72,154	4,555	67,599
Landfill	7 years	17,985	3,616	14,369	17,985	3,066	14,919
Total amortizable intangible assets		\$ 478,549	\$ 124,119	\$ 354,430	\$ 478,517	\$ 99,471	\$ 379,046
Other intangibles	Indefinite	4,710		4,710	4,528		4,528
Intangible assets, net		\$ 483,259	\$ 124,119	\$ 359,140	\$ 483,045	\$ 99,471	\$ 383,574

Amortization expense related to waste and energy contracts and other intangible assets was \$11.6 million and \$11.0 million for the three months ended June 30, 2007 and 2006, respectively, and \$23.1 million and \$24.1 million

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for the six months ended June 30, 2007 and 2006, respectively. The lease interest asset is amortized to rent expense in plant operating expenses and was \$0.7 million for both the three months ended June 30, 2007 and 2006 and \$1.5 million for both the six months ended June 30, 2007 and 2006.

The following table details the amount of the actual/estimated amortization expense associated with intangible assets as of June 30, 2007 included or expected to be included in our statement of operations for each of the years indicated (in thousands of dollars):

	<b>Waste and Energy Contracts</b>	<b>Landfill, Lease Interest and Other Contracts</b>	<b>Totals</b>
Six Months ended June 30, 2007	\$ 22,581	\$ 2,067	\$ 24,648
Remainder of 2007	\$ 22,272	\$ 3,091	\$ 25,363
2008	43,180	5,149	48,329
2009	39,635	5,149	44,784
2010	27,317	5,149	32,466
2011	24,228	5,149	29,377
Thereafter	117,315	56,796	174,111
Total	\$ 273,947	\$ 80,483	\$ 354,430

***Goodwill***

Goodwill was \$91.3 million as of both June 30, 2007 and December 31, 2006. Goodwill represents the total consideration paid in excess of the fair value of the net tangible and identifiable intangible assets acquired and the liabilities assumed in the ARC Holdings acquisition in accordance with the provisions of SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ). Goodwill has an indefinite life and is not amortized but is reviewed annually for impairment under the provisions of SFAS 142. Goodwill is not deductible for federal income tax purposes.

**Note 10. Other Noncurrent Liabilities**

Other noncurrent liabilities consisted of the following (in thousands of dollars):

	<b>June 30, 2007</b>	<b>As of December 31, 2006</b>
Waste and service contracts	\$ 129,992	\$ 135,607

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Tax liabilities for uncertain tax positions	65,384	26,622
Interest rate swap	8,345	9,855
Benefit obligations	38,606	38,979
Asset retirement obligations	23,916	23,740
Insurance loss and loss adjustment reserves	37,241	38,020
Service contract obligations		9,607
Other	24,616	23,148
	\$ 328,100	\$ 305,578

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table details the amount of the actual/estimated amortization contra-expense associated with the below market waste and service contracts liability as of June 30, 2007 included or expected to be included in our statement of operations for each of the years indicated (in thousands of dollars):

	<b>Waste and Service Contracts</b>
Six Months ended June 30, 2007	\$ 6,038
Remainder of 2007	\$ 6,032
2008	12,053
2009	12,104
2010	12,136
2011	12,195
Thereafter	75,472
Total	\$ 129,992

**Note 11. Income Taxes**

We record our interim tax provision based upon our estimated annual effective tax rate and account for the tax effects of discrete events in the period in which they occur. We currently estimate our annual effective tax rate, including discrete items, for the year ended December 31, 2007 to be approximately 43.8%. We review the annual effective tax rate on a quarterly basis as projections are revised. The effective income tax rate was 43.4% and 19.9% for the six months ended June 30, 2007 and 2006, respectively. Excluding the cumulative adjustment of \$10 million due to the adoption of Accounting Principles Board ( APB ) Opinion No. 23, Accounting for Income Taxes Special Areas ( APB 23 ), the effective income tax rate was 38.2% for the six months ended June 30, 2006. The increase in the effective tax rate for the six months ended June 30, 2007 compared to the six months ended June 30, 2006 is primarily the result of the release of valuation allowance on federal net operating losses during the second quarter of 2006.

Beginning in the second quarter of 2006, we adopted the permanent reinvestment exception under APB 23 whereby we will no longer provide deferred taxes on the undistributed earnings of our international subsidiaries. We intend to permanently reinvest our international earnings outside of the United States in our existing international operations and in any new international business we may develop or acquire. As a result of the adoption of APB 23, we recognized a one-time benefit of \$10 million during the three months ended June 30, 2006 associated with the reversal of deferred taxes accrued on unremitted earnings of international affiliates in prior periods.

We file a federal consolidated income tax return with our eligible subsidiaries. Covanta Lake II, Inc. files outside of the consolidated return group. Our federal consolidated income tax return also includes the taxable results of certain grantor trusts described below.



We adopted the provisions of FASB Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, ( FIN 48 ) effective January 1, 2007. The cumulative effect of applying the provisions of this interpretation was a \$2.8 million decrease to our opening balance retained earnings in 2007, which was comprised of an increase of \$6.1 million to the liability for uncertain tax positions, a \$16.4 million increase to deferred tax assets, a \$13.1 million decrease to property, plant and equipment and a reclassification of \$32.7 million between deferred tax liabilities and the liability for uncertain tax positions. The liability for uncertain tax positions, exclusive of interest and penalties, was \$57.2 million as of June 30 and January 1, 2007, respectively. No material additional liabilities were recorded for uncertain tax positions during the six months ended June 30, 2007.

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

There are no uncertain tax positions both individually and in the aggregate, that if recognized, would materially affect our effective tax rate.

We continue to reflect interest accrued on uncertain tax positions and penalties as part of the tax provision under FIN 48. For the three months ended June 30, 2007 and 2006, we recognized \$0.3 million and zero, respectively and for the six months ended June 30, 2007 and 2006, we recognized \$0.5 million and zero, respectively of interest and penalties on uncertain tax positions. As of June 30, and January 1, 2007, we had accrued interest and penalties associated with uncertain tax positions of \$8.1 million and \$7.3 million, respectively.

As issues are examined by the Internal Revenue Service ( IRS ) and state auditors, we may decide to adjust the existing FIN 48 liability for issues that were not deemed an exposure at the time we adopted FIN 48. Accordingly, we will continue to monitor the results of these audits and adjust the liability as needed.

State income tax returns are generally subject to examination for a period of three to five years after the filing of the respective return. The state impact of any federal changes remains subject to examination by various states for a period of up to one year after formal notification to the states. We have various state income tax returns in the process of examination, administrative appeals or litigation.

Federal income tax returns for Covanta Energy are closed for the years through 2002. However, to the extent NOLs are utilized from earlier years, this will allow the IRS to re-examine closed years. ARC Holdings' tax returns are open for federal audit for the tax return years of 2001 and forward, and are currently the subject of an IRS examination. This examination is related to ARC Holdings' refund requests related to NOL carryback claims from tax years prior to our acquisition of ARC Holdings in 2005 that require Joint Committee approval.

Our NOLs predominantly arose from our predecessor insurance entities (which were subsidiaries of our predecessor, formerly named Mission Insurance Group, Inc., Mission ). These Mission insurance entities have been in state insolvency proceedings in California and Missouri since the late 1980 s. The amount of NOLs available to us will be reduced by any taxable income generated by current members of our consolidated tax group, which include grantor trusts associated with the Mission insurance entities.

In January 2006, we executed agreements with the California Commissioner of Insurance (the California Commissioner ), who administers the majority of the grantor trusts, regarding the final administration and conclusion of such trusts. The agreements, which were approved by the California state court overseeing the Mission insolvency proceedings (the Mission Court ), settle matters that had been in dispute regarding the historic rights and obligations relating to the conclusion of the grantor trusts.

We have discussed with the Director of the Division of Insurance of the State of Missouri (the Missouri Director ), who administers the balance of the grantor trusts relating to the Mission Insurance entities, similar arrangements for claimants of the Missouri grantor trusts. Given the claims activity relating to the Missouri grantor trusts, and the lack of disputed matters with the Missouri Director, we do not expect to enter into additional or amended contractual arrangements with the Missouri Director with respect to the final administration of the Missouri grantor trusts.

While we cannot predict with certainty what amounts, if any, may be includable in taxable income as a result of the final administration of these grantor trusts, we believe that neither arrangements with the California Commissioner nor the final administration by the Missouri Director will result in a material reduction in available NOLs.

We had consolidated federal NOLs estimated to be approximately \$410 million for federal income tax purposes as of December 31, 2006. The NOLs will expire in various amounts from December 31, 2007 through December 31, 2025, if not used. In addition to the consolidated federal NOLs, as of December 31, 2006, we had additional federal credits and loss carryforwards of \$46 million and state credits and loss carryforwards of \$13 million that will expire between 2007 and 2026. These deferred tax assets are offset by a valuation allowance of \$37 million.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Our provision for income taxes in the condensed consolidated statements of operations also includes certain state and other taxes. Tax filings for these jurisdictions do not consolidate the activity of the grantor trusts referred to above and in certain states reflect preparation on a separate-company basis. For further information, refer to Note 21. Income Taxes of the Notes to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Note 12. Changes in Capitalization*****Long-Term Debt***

Long-term debt is comprised of credit facilities and intermediate debt as follows (in thousands of dollars):

	<b>June 30, 2007</b>	<b>As of December 31, 2006</b>
<b>Covanta</b>		
1.00% Senior Convertible Debentures due 2027	\$ 373,750	\$
<b>Covanta Energy Senior Secured Credit Facilities</b>		
First Lien Term Loan Facility		368,389
Second Lien Term Loan Facility		260,000
Term Loan Facility due 2014	650,000	
	650,000	628,389
<b>Covanta Energy Intermediate Subsidiary Debt</b>		
6.26% Senior ARC Notes due 2015		192,000
8.50% Senior Secured MSW Notes due 2010	5,610	195,785
7.375% Senior Secured MSW II Notes due 2010	500	224,100
	6,110	611,885
Unamortized debt premium	198	19,748
Total intermediate subsidiary debt	6,308	631,633
<b>Other Covanta Energy long-term debt</b>	38	101
Total	1,030,096	1,260,123
Less: current portion (includes \$198 and \$4,732 of unamortized premium)	(14,462)	(36,434)
Total long-term debt	\$ 1,015,634	\$ 1,223,689

***2007 Recapitalization Plan***

On January 19, 2007, we announced a comprehensive recapitalization plan utilizing a series of equity and debt financings. Subsequent to this announcement, we completed the following transactions:

the refinancing of Covanta Energy's debt facilities with new Covanta Energy debt facilities, comprised of a \$300 million revolving credit facility, a \$320 million funded letter of credit facility, and a \$650 million term loan (collectively referred to as the "New Credit Facilities");

an underwritten public offering of 6.118 million shares of our common stock, in which we received proceeds of approximately \$136.6 million, net of underwriting discounts and commissions;

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

an underwritten public offering of approximately \$373.8 million aggregate principal amount of Debentures issued by us, from which we received proceeds of approximately \$364.4 million, net of underwriting discounts and commissions; and

the repayment, by means of a tender offer, of approximately \$604.4 million in aggregate principal amount of outstanding notes previously issued by certain intermediate subsidiaries of Covanta Energy.

We completed our public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, and we closed on the New Credit Facilities on February 9, 2007. We completed our tender offer for approximately \$604.4 million in aggregate principal amount of outstanding notes on February 22, 2007. As a result of the recapitalization plan, in the first quarter of 2007 we recognized a loss on extinguishment of debt of approximately \$32.0 million, pre-tax, which is comprised of the write-down of deferred financing costs, tender premiums paid for the intermediate subsidiary debt, and a call premium paid in connection with previously existing financing arrangements. These amounts were partially offset by the write-down of unamortized premiums relating to the intermediate subsidiary debt and a gain associated with the settlement of our interest rate swap agreements.

***New Credit Facilities***

The New Credit Facilities are comprised of:

a \$300 million revolving loan facility due 2013, which includes a \$200 million sub-facility for the issuance of letters of credit (the Revolving Loan Facility );

a \$320 million funded letter of credit facility, due 2014 (the Funded L/C Facility ); and

a \$650 million term loan facility, due 2014 (the Term Loan Facility ).

***Amortization Terms***

The New Credit Facilities include mandatory annual amortization of the Term Loan Facility to be paid in quarterly installments beginning June 30, 2007, through the date of maturity as follows (in thousands of dollars):

	<b>Annual Remaining Amortization</b>
2007	\$ 4,875
2008	6,500
2009	6,500
2010	6,500
2011	6,500

2012	6,500
2013	6,500
2014	606,125
Total	\$ 650,000

The June 30, 2007 scheduled principal payment on the Term Loan Facility was made on July 2, 2007 (the next business day). Under the New Credit Facilities, Covanta Energy is obligated to apply a portion of excess cash from operations on an annual basis (calculated pursuant to the credit agreement), as well as specified other sources, to repay borrowings under the Term Loan Facility. The portion of excess cash to be used for this purpose is 50%, 25%, or 0%, based on measurement of the leverage ratio under the financial covenants.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Interest and Fee Terms*

Loans under the New Credit Facilities are designated, at our election, as Eurodollar rate loans or base rate loans. Eurodollar loans bear interest at a reserve adjusted British Bankers Association Interest Settlement Rate, commonly referred to as LIBOR, for deposits in dollars plus a borrowing margin as described below. Interest on Eurodollar rate loans is payable at the end of the applicable interest period of one, two, three or six months (and at the end of every three months in the case of six month Eurodollar loans). Base rate loans bear interest at (a) a rate per annum equal to the greater of (1) the prime rate designated in the relevant facility or (2) the federal funds rate plus 0.5% per annum, plus (b) a borrowing margin as described below.

Letters of credit that may be issued in the future under the Revolving Loan Facility will accrue fees at the then effective borrowing margins on Eurodollar rate loans (described below), plus a fee on each issued letter of credit payable to the issuing bank. Letter of credit availability under the Funded L/C Facility accrues fees (whether or not letters of credit are issued thereunder) at the then effective borrowing margin for Eurodollar rate loans times the total availability under letters of credit (whether or not then utilized), plus a fee on each issued letter of credit payable to the issuing bank. In addition, Covanta Energy has agreed to pay to the participants under the Funded L/C Facility a fee equal to 0.10% times the average daily amount of the credit linked deposit paid by such participants for their participation under the Funded L/C Facility.

The borrowing margins referred to above for the Revolving Loan Facility, the Term Loan Facility and the Funded L/C Facility are as follows:

	<b>Borrowing Margin for Revolving Loans (Eurodollar Loans)</b>	<b>Borrowing Margin for Revolving Loans (Base Rate Loans)</b>	<b>Borrowing Margin for Term Loans, Funded Letters of Credit and Credit-Linked Deposits (Eurodollar Loans)</b>	<b>Borrowing Margin for Term Loans, Funded Letters of Credit and Credit-Linked Deposits (Base Rate Loans)</b>
<b>Leverage Ratio</b>				
≥ 4.00:1.00	2.00%	1.00%	1.75%	0.75%
< 4.00:1.00 and ≥ 3.25:1.00	1.75%	0.75%	1.50%	0.50%
< 3.25:1.00 and ≥ 2.75:1.00	1.50%	0.50%	1.50%	0.50%
< 2.75:1.00	1.25%	0.25%	1.50%	0.50%

*Guarantees and Securitization*



The New Credit Facilities are guaranteed by us and by certain Covanta Energy subsidiaries. Covanta Energy and certain of its subsidiaries that are party to the New Credit Facilities agreed to secure all of Covanta Energy's obligations under the New Credit Facilities by granting, for the benefit of secured parties, a first priority lien on substantially all of their assets, to the extent permitted by existing contractual obligations, a pledge of substantially all of the capital stock of each of Covanta Energy's domestic subsidiaries owned by it and 65% of substantially all the capital stock of each of Covanta Energy's foreign subsidiaries directly owned by it, in each case to the extent not otherwise pledged.

*Debt Covenants and Defaults*

The loan documentation under the New Credit Facilities contains customary affirmative and negative covenants and financial covenants. During the term of the New Credit Facilities, we expect that the negative covenants will place limitations on Covanta Energy, but be materially less restrictive than the restrictions in effect prior to February 9, 2007. We were in compliance with all required covenants as of June 30, 2007.

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

The financial covenants of the New Credit Facilities, which are measured on a trailing four quarter period basis, include the following:

maximum Covanta Energy leverage ratio of 4.50 to 1.00 for the four quarter period ended June 30, 2007, which measures Covanta Energy's principal amount of consolidated debt less certain restricted funds dedicated to repayment of project debt principal and construction costs ( Consolidated Adjusted Debt ) to its adjusted earnings before interest, taxes, depreciation and amortization, as calculated under the New Credit Facilities ( Adjusted EBITDA ). The definition of Adjusted EBITDA in the New Credit Facilities excludes certain non-cash charges. The maximum Covanta Energy leverage ratio allowed under the New Credit Facilities adjusts in future periods as follows:

4.50 to 1.00 for the four quarter period ended September 30, 2007;

4.25 to 1.00 for each of the four quarter periods ended December 31, 2007, March 31, June 30 and September 30, 2008;

4.00 to 1.00 for each of the four quarter periods ended December 31, 2008, March 31, June 30 and September 30, 2009;

3.75 to 1.00 for each of the four quarter periods ended December 31, 2009, March 31, June 30 and September 30, 2010;

3.50 to 1.00 for each four quarter period thereafter;

maximum Covanta Energy capital expenditures incurred to maintain existing operating businesses of \$100 million, subject to adjustment due to an acquisition by Covanta Energy; and

minimum Covanta Energy interest coverage ratio of 3.00 to 1.00, which measures Covanta Energy's Adjusted EBITDA to its consolidated interest expense plus certain interest expense of ours, to the extent paid by Covanta Energy.

***Debentures***

On January 31, 2007, we completed an underwritten public offering of \$373.8 million aggregate principal amount of Debentures. This offering included Debentures sold pursuant to an over-allotment option which was exercised by the underwriters. The Debentures constitute our general unsecured senior obligations and will rank equally in right of payment with any future senior unsecured indebtedness. The Debentures are effectively junior to our existing and future secured indebtedness, including the New Credit Facilities, to the extent of the value of the assets securing such indebtedness. The Debentures are not guaranteed by any of our subsidiaries and are effectively subordinated to all existing and future indebtedness and liabilities (including trade payables) of our subsidiaries.

The Debentures bear interest at a rate of 1.00% per year, payable semi-annually in arrears, on February 1 and August 1 of each year, commencing on August 1, 2007 and will mature on February 1, 2027. Beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures during any six-month

interest period in which the trading price of the Debentures measured over a specified number of trading days is 120% or more of the principal amount of the Debentures. When applicable, the contingent interest payable per \$1,000 principal amount of Debentures will equal 0.25% of the average trading price of \$1,000 principal amount of Debentures during the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period. The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and as such, the fair market value for the embedded derivative was zero as of June 30, 2007.

Under limited circumstances, the Debentures are convertible by the holders thereof, at any time, into cash and shares of our common stock, if any, initially based on a conversion rate of 35.4610 shares of our common stock per \$1,000 principal amount of Debentures, (which represents an initial conversion price of approximately \$28.20 per

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

share). The terms of the Debentures require that under certain circumstances, such as an acquisition of us by a third party, the payment by us of a cash dividend on our common stock, or where a cash tender offer is made for our common stock, we are obligated to adjust the conversion rate applicable to the Debentures. This adjustment requirement constitutes a contingent beneficial conversion feature that is part of the Debentures. If such an adjustment were to occur, (i) the amount of the contingent beneficial feature would be bifurcated from the Debentures, (ii) the liability recorded in our financial statements with respect to the Debentures would be reduced by the amount bifurcated, and (iii) the amount bifurcated would be recorded as a charge to interest expense and accreted to the Debenture liability over the remaining term of Debentures, or the conversion date of the Debentures, if earlier.

At our option, the Debentures are subject to redemption at any time on or after February 1, 2012, in whole or in part, at a redemption price equal to 100% of the principal amount of the Debentures being redeemed, plus accrued and unpaid interest (including contingent interest, if any). In addition, holders may require us to repurchase their Debentures on February 1, 2012, February 1, 2017 and February 1, 2022, in whole or in part, for cash at a repurchase price equal to 100% of the principal amount of the Debentures being repurchased, plus accrued and unpaid interest (including contingent interest, if any). The Debentures are also subject to repurchase by us, at the holder's option, if a fundamental change occurs, for cash at a repurchase price equal to 100% of the principal amount of the Debentures, plus accrued and unpaid interest (including contingent interest, if any).

***Intermediate Subsidiary Debt***

On March 16, 2007, we issued a Notice of Redemption for the remaining ARC Notes. All outstanding ARC Notes were redeemed on April 16, 2007 at a total redemption price of \$743.50 per \$1,000 in original principal amount of the ARC Notes, which includes principal outstanding, premium and accrued interest up to the redemption date.

As of June 30, 2007, the remaining outstanding debt for the MSW I Notes and MSW II Notes was \$5.6 million and \$0.5 million, respectively. On July 23, 2007, we issued a Notice of Redemption for the remaining MSW I Notes and MSW II Notes for redemption within 45 days. We intend to redeem the MSW I Notes and MSW II Notes at \$1,042.50 and \$1,036.88, respectively, per \$1,000 principal amount (plus accrued and unpaid interest to the date of redemption).

***2006 Refinancing***

As a result of amendments to Covanta Energy's financing arrangements in May 2006, in the three months ended June 30, 2006, we recognized a loss on extinguishment of debt of \$6.8 million, pre-tax, which was comprised of the write-down of deferred financing costs and a call premium paid on extinguishment.

***Short-Term Liquidity***

As of June 30, 2007, Covanta Energy had available credit for liquidity as follows (in thousands of dollars):

Total Available Under Facility	Maturing	Available As of June 30, 2007
--------------------------------------	----------	--

Revolving Loan Facility(1)	\$	300,000	2013	\$	300,000
Funded L/C Facility	\$	320,000	2014	\$	4,429

(1) Up to \$200 million of which may be utilized for letters of credit.

As of June 30, 2007, Covanta Energy had not drawn any loans from the Revolving Loan Facility. As of June 30, 2007, Covanta Energy had approximately \$315.6 million outstanding letters of credit under the Funded L/C Facility.

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

***Stockholders' Equity***

On January 31, 2007, we completed an underwritten public offering of 5.32 million shares of our common stock. The shares were sold to the public at a price of \$23.50 per share. We granted the underwriters an option to purchase up to an additional 798,000 shares of common stock at \$22.325 per share for a period of 30 days beginning on and including the date of original issuance of the shares in connection with this offering, solely to cover over-allotments. The option was exercised and such additional shares were sold on February 6, 2007. Proceeds received in these offerings were approximately \$136.6 million, net of underwriting discounts and commissions.

During the six months ended June 30, 2007, we awarded certain employees a total of 352,717 shares of restricted stock under the Employees Plan and we awarded 36,000 shares of restricted stock under the Directors Plan. During the six months ended June 30, 2007, we granted stock options to purchase an aggregate of 1,785,000 shares of common stock under the Employees Plan. See Note 4. Stock-Based Compensation.

We adopted the provisions of FIN 48 effective January 1, 2007. The cumulative effect of applying the provisions of this interpretation was a \$2.8 million decrease to our opening balance retained earnings in 2007. See Note 11. Income Taxes for additional information.

On February 24, 2006, we completed a rights offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds. See Note 17. Related-Party Transactions.

**Note 13. Business Segments**

We develop, own and operate infrastructure for the conversion of energy-from-waste, waste disposal and renewable energy production in the United States and abroad. We also engage in the independent power production business outside the United States. Given our increased focus on developing our international waste and energy business, during the first quarter of 2007, we segregated what we previously reported as our Waste and Energy Services segment into two new segments: Domestic and International. Our remaining operations, which we previously reported as our Other Services segment and was comprised of the holding company and insurance subsidiaries' operations, does not meet the quantitative thresholds which require separate disclosure as a reportable segment. Therefore, we currently have two reportable segments, Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Results of our reportable segments are shown below (in thousands of dollars):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Operating Revenues:				
Domestic	\$ 300,604	\$ 286,021	\$ 588,359	\$ 548,592
International	52,008	44,600	91,809	83,445
All other(1)	2,528	3,515	5,181	7,455
Total operating revenues	\$ 355,140	\$ 334,136	\$ 685,349	\$ 639,492
Operating Income:				
Domestic	\$ 73,080	\$ 68,691	\$ 78,315	\$ 98,480
International	4,820	7,915	8,323	13,443
All other(1)	(688)	82	(1,146)	283
Total operating income	77,212	76,688	85,492	112,206
Other Income (Expense):				
Investment income	1,819	2,915	7,003	5,318
Interest expense	(14,718)	(27,361)	(35,978)	(55,844)
Loss on extinguishment of debt(2)		(6,795)	(32,006)	(6,795)
Income before income tax expense, minority interests and equity in net income from unconsolidated investments	\$ 64,313	\$ 45,447	\$ 24,511	\$ 54,885

(1) All other is comprised of our insurance subsidiaries' operations.

(2) See Note 12. Changes in Capitalization for additional information.

**Note 14. Benefit Obligations**

The components of net periodic benefit costs are as follows (in thousands of dollars):

<b>Pension Benefits</b>		<b>Other Post-Retirement Benefits</b>	
<b>For the Three Months Ended June 30,</b>	<b>For the Six Months Ended June 30,</b>	<b>For the Three Months Ended June 30,</b>	<b>For the Six Months Ended June 30,</b>

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	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Service cost	\$	\$	\$	\$	\$	\$	\$	\$
Interest cost	1,145	1,075	2,291	2,150	192	155	384	309
Expected return on plan assets	(1,107)	(922)	(2,215)	(1,844)				
Amortization of actuarial (gain) loss		(16)		(32)	27		53	
Net periodic benefit cost	\$ 38	\$ 137	\$ 76	\$ 274	\$ 219	\$ 155	\$ 437	\$ 309

Costs related to the Covanta Energy Savings Plan were \$2.5 million and \$2.6 million for the three months ended June 30, 2007 and 2006, respectively and \$6.5 million and \$5.8 million for the six months ended June 30, 2007 and 2006, respectively.



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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

**Note 15. Financial Instruments**

***Interest Rate Swaps***

Covanta Energy was required, under financing arrangements in effect from June 24, 2005 to February 9, 2007, to enter into hedging arrangements with respect to a portion of its exposure to interest rate changes with respect to its borrowing under the credit facilities which were in effect prior to the New Credit Facilities. On July 8, 2005, Covanta Energy entered into two separate pay fixed, receive floating interest rate swap agreements with a total notional amount of \$300 million. On March 21, 2006, we entered into one additional pay fixed, receive floating interest rate swap agreement with a notional amount of \$37.5 million. On December 27, 2006, the notional amount of the original interest rate swap agreements were reduced to \$250 million from \$300 million. These interest rate swaps were designated as cash flow hedges in accordance with SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities. Accordingly, unrealized gains or losses were deferred in other comprehensive income until the hedged cash flows affect earnings. The impact of the interest rate swaps was a decrease to interest expense for the three months and six months ended June 30, 2006 by \$0.5 million and \$0.7 million, respectively. In connection with the refinancing of Covanta Energy's debt facilities, the interest rate swap agreements described above were settled on February 9, 2007. We recognized a gain associated with the settlement of our interest rate swap agreements of \$3.4 million, pre-tax. The New Credit Facilities do not require us to enter into interest rate swap agreements. For additional information related to the New Credit Facilities, see Note 12. Changes in Capitalization.

***Contingent Interest***

The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and as such, the fair market value for the embedded derivative was zero as of June 30, 2007. See Note 12. Changes in Capitalization for specific criteria related to contingent interest of the Debentures.

**Note 16. Commitments and Contingencies**

We and/or our subsidiaries are party to a number of claims, lawsuits and pending actions, most of which are routine and all of which are incidental to our business. We assess the likelihood of potential losses on an ongoing basis and when losses are considered probable and reasonably estimable, record as a loss an estimate of the ultimate outcome. If we can only estimate the range of a possible loss, an amount representing the low end of the range of possible outcomes is recorded. The final consequences of these proceedings are not presently determinable with certainty.

***Environmental Matters***

Covanta Energy's operations are subject to environmental regulatory laws and environmental remediation laws. Although Covanta Energy's operations are occasionally subject to proceedings and orders pertaining to emissions into the environment and other environmental violations, which may result in fines, penalties, damages or other sanctions, we believe that Covanta Energy is in substantial compliance with existing environmental laws and regulations.

Covanta Energy may be identified, along with other entities, as being among parties potentially responsible for contribution to costs associated with the correction and remediation of environmental conditions at disposal sites subject to federal and/or analogous state laws. In certain instances, Covanta Energy may be exposed to joint and several liabilities for remedial action or damages. Covanta Energy's ultimate liability in connection with such environmental claims will depend on many factors, including its volumetric share of waste, the total cost of remediation, and the financial viability of other companies that also sent waste to a given site and, in the case of divested operations, its contractual arrangement with the purchaser of such operations. Generally, such claims arising prior to April 1, 2002 were resolved in and discharged by Covanta Energy's Chapter 11 cases.

Table of Contents**COVANTA HOLDING CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The potential costs related to the matters described below and the possible impact on future operations are uncertain due in part to the complexity of governmental laws and regulations and their interpretations, the varying costs and effectiveness of cleanup technologies, the uncertain level of insurance or other types of recovery and the questionable level of Covanta Energy's responsibility. Although the ultimate outcome and expense of any litigation, including environmental remediation, is uncertain, Covanta Energy believes that the following proceedings will not have a material adverse effect on our consolidated financial position or results of operations.

In June 2001, the Environmental Protection Agency (EPA) named Covanta Haverhill, Inc. (Haverhill), as a potentially responsible party (PRP) at the Beede Waste Oil Superfund Site, Plaistow, New Hampshire (Beede site). On December 15, 2006, Haverhill together with numerous other PRPs, signed the Beede Waste Oil Superfund Site RD/RA Consent Decree with respect to remediation of the Beede site. The Consent Decree becomes effective upon approval and entry by the U.S. District Court in New Hampshire. We currently believe that based on the amount of waste oil Haverhill is alleged to have sent to the Beede site in comparison to other similarly-situated settling PRPs, its ultimate liability will not be material to its financial position and results of operations although it is not possible at this time to predict that outcome with certainty.

In August 2004, EPA notified Covanta Essex Company (Essex) that it was potentially liable for Superfund response actions in the Lower Passaic River Study Area, referred to as LPRSA, a 17 mile stretch of river in northern New Jersey. Essex is one of at least 73 PRPs named thus far that have joined the LPRSA PRP group. On May 8, 2007, EPA and the PRP group entered into an Administrative Order on Consent by which the PRP group will complete a Remedial Investigation/Feasibility Study of the LPRSA under EPA oversight. The cost to complete the Study is estimated at \$37 million, in addition to EPA oversight costs. Considering the history of industrial and other discharges into the LPRSA from other sources, including named PRPs, Essex believes any releases to the LPRSA from its facility to be de minimis in comparison; however, it is not possible at this time to predict that outcome with certainty or to estimate Essex's ultimate liability in the matter, including for natural resource damages.

***Other Matters***

Other commitments as of June 30, 2007 were as follows (in thousands of dollars):

	<b>Commitments Expiring by Period</b>		
	<b>Total</b>	<b>Less Than One Year</b>	<b>More Than One Year</b>
Letters of credit	\$ 321,011	\$ 34,400	\$ 286,611
Surety bonds	58,691		58,691
Total other commitments net	\$ 379,702	\$ 34,400	\$ 345,302

The letters of credit were issued to secure our performance under various contractual undertakings related to our domestic and international projects, or to secure obligations under our insurance program. Each letter of credit relating to a project is required to be maintained in effect for the period specified in related project contracts, and generally

may be drawn if it is not renewed prior to expiration of that period.

As of June 30, 2007, Covanta Energy had approximately \$4.4 million in available capacity for additional letters of credit under its Funded L/C Facility and \$200 million available capacity for letters of credit under its Revolving Loan Facility. As of July 16, 2007, Covanta Energy caused to be issued an additional letter of credit in the approximate amount of \$7.2 million, following which it had fully utilized the available capacity under the Funded L/C Facility, and had approximately \$197.0 million in available capacity for additional letters of credit under the Revolving Loan Facility. As of July 16, 2007, Covanta Energy had \$320.0 million outstanding letters of credit under the Funded L/C Facility. See Note 18. Subsequent Events. We believe that we will be able to fully perform under our contracts to which these existing letters of credit relate, and that it is unlikely that letters of credit would be drawn because of a default of our performance obligations. If any of these letters of credit were to be drawn under the current debt facilities, the amount drawn would be immediately repayable to the issuing bank. If we were unable to

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

immediately repay such amounts drawn under these letters of credit, unreimbursed amounts would be treated under the New Credit Facilities as additional term loans issued under the Term Loan Facility.

The surety bonds listed on the table above relate primarily to performance obligations (\$49.7 million) and support for closure obligations of various energy projects when such projects cease operating (\$9.0 million). Were these bonds to be drawn upon, Covanta Energy would have a contractual obligation to indemnify the surety company.

We have certain contingent obligations related to the Debentures. These are:

holders may require us to repurchase their Debentures on February 1, 2012, February 1, 2017 and February 1, 2022;

holders may require us to repurchase their Debentures, if a fundamental change occurs; and

holders may exercise their conversion rights upon the occurrence of certain events, which would require us to pay the conversion settlement amount in cash and/or our common stock.

See Note 12. Changes in Capitalization for specific criteria related to contingent interest, conversion or redemption features of the Debentures.

Covanta Energy and certain of its subsidiaries have issued or are party to performance guarantees and related contractual support obligations undertaken mainly pursuant to agreements to construct and operate certain energy-from-waste facilities and a water facility. With respect to its domestic businesses, Covanta Energy and certain of its subsidiaries have issued guarantees to municipal clients and other parties that Covanta Energy's subsidiaries will perform in accordance with contractual terms, including, where required, the payment of damages or other obligations. Such contractual damages or other obligations could be material, and in circumstances where one or more subsidiary's contract has been terminated for its default, such damages could include amounts sufficient to repay project debt. For facilities owned by municipal clients and operated by Covanta Energy, Covanta Energy's potential maximum liability as of June 30, 2007 associated with the repayment of the municipalities' project debt on such facilities was approximately \$1 billion. This amount was not recorded as a liability in Covanta Energy's consolidated balance sheet as of June 30, 2007 as Covanta Energy believes that it had not incurred such liability at the date of the financial statements. Additionally, damages payable under such guarantees on Covanta Energy-owned energy-from-waste facilities could expose Covanta Energy to recourse liability on project debt. Covanta Energy also believes that it has not incurred such damages at the date of the financial statements. If Covanta Energy is asked to perform under one or more of such guarantees, its liability for damages upon contract termination would be reduced by funds held in trust and proceeds from sales of the facilities securing the project debt, which is presently not estimable.

With respect to our international businesses, Covanta Energy and certain of its subsidiaries have issued guarantees on behalf of our international operating subsidiaries with respect to contractual obligations to operate certain international power projects and one energy-from-waste project. The potential damages owed under such arrangements for international projects may be material.

Depending upon the circumstances giving rise to such domestic and international damages, the contractual terms of the applicable contracts, and the contract counterparty's choice of remedy at the time a claim against a guarantee is made, the amounts owed pursuant to one or more of such guarantees could be greater than Covanta Energy's then-available sources of funds. To date, Covanta Energy has not incurred material liabilities under its guarantees, either on domestic or international projects.

On March 31, 2007, our SEMASS energy-from-waste facility located in Rochester, Massachusetts experienced a fire in the front-end receiving portion of the facility. Damage was extensive to this portion of the facility and operations at the facility were suspended completely for approximately 20 days. As a result of this loss, we recorded an asset impairment of \$18.3 million, pre-tax, in the first quarter of 2007, which represented a

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**COVANTA HOLDING CORPORATION AND SUBSIDIARIES**

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

preliminary estimate of the net book value of the assets destroyed. Based upon additional analysis as the facility is fully restored, we may increase the impairment recorded. The cost of repair or replacement, and business interruption losses, are insured under the terms of applicable insurance policies, subject to deductibles. We cannot predict the timing of when we would receive the proceeds under such policies. During the second quarter of 2007, we recorded insurance recoveries of \$13.3 million related to repair and reconstruction and \$2.7 million related to clean-up costs. Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction costs, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses. We expect the cost of repair or replacement and business interruption losses we do not recover, representing deductibles under such policies, will not be material.

**Note 17. Related-Party Transactions**

As described in Note 8. Equity Method Investments, Covanta Energy holds a 26% investment in Quezon. Covanta Energy and Quezon are both party to an agreement in which Covanta Energy assumed responsibility for the operation and maintenance of Quezon's coal-fired electricity generation facility. For the three months ended June 30, 2007 and 2006, Covanta Energy collected \$10.7 million and \$7.8 million, respectively, and for the six months ended June 30, 2007 and 2006, Covanta Energy collected \$18.0 million and \$16.9 million, respectively, for the operation and maintenance of the facility. As of June 30, 2007 and December 31, 2006, the net amount due to Quezon was \$3.9 million and \$2.2 million, respectively.

On February 24, 2006, we completed a rights offering to the holders of Covanta Energy's 9.25% debentures prior to its emergence from bankruptcy proceedings, in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds, including 633,380 shares purchased by D. E. Shaw Laminar Portfolios, L.L.C. (Laminar), one of our largest stockholders, pursuant to the exercise of rights held by Laminar as a holder of such 9.25% debentures.

**Note 18. Subsequent Events**

***Biomass Energy Facilities***

On July 16, 2007, we completed the acquisition of two biomass energy facilities and a biomass energy fuel management business, all located in California's Central Valley, from The AES Corporation, for approximately \$51 million in cash, subject to certain customary post-closing adjustments, which are not expected to be material. Covanta Energy borrowed \$30.0 million from the Revolving Loan Facility to partially fund the acquisition. In addition, we expect to invest between \$15 million and \$20 million in capital improvements to increase the facilities productivity and environmental performance.

***MSW I Notes and MSW II Notes***

On July 23, 2007, we issued a Notice of Redemption for the remaining MSW I Notes and MSW II Notes for redemption within 45 days. We intend to redeem the MSW I Notes and MSW II Notes, at \$1,042.50 and \$1,036.88, respectively, per \$1,000 principal amount (plus accrued and unpaid interest to the date of redemption).

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

The terms we, our, ours, us, Covanta and Company refer to Covanta Holding Corporation and its subsidiaries; the term Covanta Energy refers to our subsidiary Covanta Energy Corporation and its subsidiaries; the term ARC Holdings refers to our subsidiary Covanta ARC Holdings, Inc. and its subsidiaries; the term CPIH refers to our subsidiary Covanta Power International Holdings, Inc. and its subsidiaries.

The following discussion addresses our financial condition as of June 30, 2007 and our results of operations for the three and six months ended June 30, 2007, compared with the same periods last year. It should be read in conjunction with our Audited Consolidated Financial Statements and Notes thereto for the year ended December 31, 2006 and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2006 and in the interim unaudited financial statements and notes included in our Quarterly Report on Form 10-Q for the period ended March 31, 2007, to which the reader is directed for additional information.

The preparation of interim financial statements necessarily relies heavily on estimates. Due to the use of estimates and certain other factors, such as the seasonal nature of our waste and energy services business, as well as competitive and other market conditions, we do not believe that interim results of operations are indicative of full year results of operations. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts and classification of assets and liabilities and disclosure 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 materially from those estimates.

**OVERVIEW**

We are organized as a holding company and conduct all of our operations through subsidiaries which are engaged predominantly in the businesses of waste and energy services. We are a leading developer, owner and operator of infrastructure for the conversion of energy-from-waste, waste disposal and renewable energy production businesses in the United States and abroad. We also engage in the independent power production business outside the United States. We own, have equity investments in, and/or operate 55 energy generation facilities, 44 of which are in the United States and 11 of which are located outside the United States. Our energy generation facilities use a variety of fuels, including municipal solid waste, water (hydroelectric), natural gas, coal, wood waste, landfill gas and heavy fuel-oil. We also own or operate several businesses that are associated with our energy-from-waste business, including a waste procurement business, two landfills, and several waste transfer stations. We also operate one domestic water treatment facility.

We believe our business offers solutions to public sector leaders around the world in two related elements of critical infrastructure: post-recycling waste disposal and energy generation. We believe the environmental benefits of energy-from-waste, as an alternative to landfilling, are clear and compelling: utilizing energy-from-waste reduces greenhouse gas emissions, lowers the risk of groundwater contamination, and conserves land. At the same time, energy-from-waste generates clean, reliable energy from a renewable fuel source, thus reducing dependence on fossil fuels, the combustion of which is itself a major contributor to greenhouse gas emissions. As public planners address their needs for more environmentally sensitive waste disposal and energy generation in the years ahead, we believe energy-from-waste will be an increasingly attractive alternative.



In March 2007, we announced that we have developed and successfully tested two new and cost-effective technologies that represented major advances in controlling nitrogen oxide (NOx) emissions. Both technologies, for which patents are pending, have been tested at existing facilities and are now ready for full scale commercial application. We expect to pursue additional technical improvements to our services and processes that will add value to our business in the years ahead.

We are focused on:

providing customers with superior service by operating our existing businesses to historic high standards;

generating sufficient cash to meet our liquidity needs;

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paying down Covanta Energy's project debt;

investing in and growing our business in order to create additional value for stockholders; and

seeking acquisition opportunities to expand our operations in the United States and abroad.

Maintaining historic facility production levels while effectively managing operating and maintenance expense is important to optimize Covanta Energy's long-term cash generation. We do not expect to make any cash contributions to Covanta Energy except in conjunction with certain acquisitions and investments permitted under Covanta Energy's new credit facilities as described below. Covanta Energy may make limited cash distributions to us under the new credit facilities.

On January 19, 2007, we announced a comprehensive recapitalization plan utilizing a series of equity and debt financings. Subsequent to this announcement, we completed the following transactions:

the refinancing of Covanta Energy's debt facilities with new Covanta Energy debt facilities, comprised of a \$300 million revolving credit facility, a \$320 million funded letter of credit facility, and a \$650 million term loan (collectively referred to as the "New Credit Facilities");

an underwritten public offering of 6.118 million shares of our common stock, in which we received proceeds of approximately \$136.6 million, net of underwriting discounts and commissions;

an underwritten public offering of approximately \$373.8 million aggregate principal amount of 1.00% Senior Convertible Debentures due 2027 (the "Debentures") issued by us, from which we received proceeds of approximately \$364.4 million, net of underwriting discounts and commissions; and

the repayment, by means of a tender offer, of approximately \$604.4 million in aggregate principal amount of outstanding notes previously issued by Covanta Energy's intermediate subsidiaries.

We completed our public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, and we closed on the New Credit Facilities on February 9, 2007. We completed our tender offer for approximately \$604.4 million in aggregate principal amount of outstanding notes on February 22, 2007. Additional information, including material terms and financial statement impacts related to our recapitalization plan, is contained in *Liquidity and Capital Resources* below. Under the New Credit Facilities, we will have substantially greater, but not unrestricted, ability to make investments in our business and to take advantage of opportunities to grow our business through investments and acquisitions, both domestically and internationally.

Our liquidity is enhanced by the existence of net operating loss carryforwards ("NOLs"), which predominantly arose from our predecessor insurance entities ("Mission Insurance Entities", formerly named Mission Insurance Group, Inc.), which have been in state insolvency proceedings in California and Missouri since the late 1980s. As described below, certain grantor trusts associated with these predecessor insurance entities (and the taxable income and loss they generate) continue to be included in our consolidated tax group. Our ability to utilize the NOLs to offset taxable income generated by operations in our Domestic segment could have a material effect on our consolidated financial condition and results of operations. We had NOLs estimated to be approximately \$410 million for federal income tax purposes as of December 31, 2006. The NOLs will expire in various amounts from December 31, 2007 through December 31, 2025, if not used. The amount of NOLs available to us will be reduced by any taxable income generated by current members of our consolidated tax group, which include the grantor trusts described above. During or at the

conclusion of the administration of these grantor trusts by state insurance regulatory agencies, taxable income or loss could result, which could accelerate or delay the date on which we may be otherwise obligated to pay incremental cash taxes. While we cannot predict with certainty what amounts, if any, may be includable in our taxable income as a result of the final administration of the trusts, we believe that any such taxable income will not result in a material reduction in available NOLs. For additional detail relating to our NOLs and risks attendant thereto, see Note 11. Income Taxes of the Notes to the Condensed Consolidated Financial Statements ( Notes ) and *Item 1A. Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2006.

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### **Business Development and Acquisitions**

In our domestic and international business development efforts, we encounter competition from other companies in pursuing opportunities in the waste disposal and energy markets. With the New Credit Facilities, we will have greater flexibility to pursue such opportunities by investing in the business, and making acquisitions.

Our business is capital intensive because it is based upon building and operating municipal solid waste processing and energy generating projects. In order to provide meaningful growth through development, we must be able to invest our funds, obtain equity and/or debt financing, and provide support to our operating subsidiaries. Our domestic project development has recently concentrated on working with our client communities to expand existing energy-from-waste project capacities and, as a result, we have two expansion projects under construction. We are pursuing additional project expansion opportunities, contract extension opportunities, acquisition opportunities, and opportunities in businesses ancillary to our existing business, such as additional waste transfer, transportation, processing and landfill businesses.

As with our domestic business, the New Credit Facilities afford greater flexibility to invest in and grow our international business. We are pursuing international waste and/or energy business opportunities, particularly in markets where the market demand, regulatory environment or other factors encourage technologies such as energy-from-waste in order to reduce dependence on landfilling, such as in selected countries in the European Union (in particular the United Kingdom, Ireland and Italy), China or island nations where landfilling is a less desirable disposal option.

During the six months ended June 30, 2007, our initiatives to grow our business included the following:

On May 29, 2007, we entered into a ten year agreement with the Harrisburg Authority to maintain and operate the Authority's 800 tons per day ( tpd ) energy-from-waste facility located in Harrisburg, Pennsylvania. Under the agreement, we will earn a base annual service fee of approximately \$10.5 million, which is subject to annual escalation and certain performance-based adjustments. The agreement also covers providing construction management services and advancing up to \$28 million in funding for certain facility improvements required to enhance facility performance. The agreement will become effective when certain conditions precedent occur which is expected later this year. In the meantime, a subsidiary of Covanta Energy has entered into an interim agreement to operate and maintain the facility as the Authority's contractor.

On May 25, 2007, we entered an agreement to purchase two biomass energy facilities and a biomass energy fuel management business, all located in California's Central Valley, from The AES Corporation. On July 16, 2007 we completed the acquisition of these businesses for a purchase price of \$51 million, subject to certain customary post-closing adjustments, which are not expected to be material. These facilities will add 75 megawatts ( MW ) to our portfolio of renewable energy plants, which currently includes four biomass facilities. In addition, we expect to invest between \$15 million and \$20 million in capital improvements to increase the facilities' productivity and environmental performance. See Note 18. Subsequent Events of the Notes for additional information.

On April 30, 2007, we acquired a waste transfer station in Holliston, Massachusetts from Casella Waste Systems Inc. for a cash payment of \$7.4 million. This facility will increase our total waste disposal capacity by approximately 700 tpd and will enhance our portfolio of five transfer stations.

On February 12, 2007, we entered into agreements relating to the subscription for a 40% equity interest in Chongqing Sanfeng Environmental Industry Co., Ltd. ( Sanfeng ). Sanfeng, a company located in Chongqing Municipality, China, is engaged in the business of owning and operating energy-from-waste projects and

providing design and engineering, procurement and construction services for energy-from-waste facilities in China. Sanfeng currently owns minority equity interests in two 1,200 metric tpd 24 MW mass-burn energy-from-waste projects. On April 25, 2007, we closed on this investment and Sanfeng was converted to a Sino-foreign equity joint venture under Chinese law in which we hold a 40% equity interest and Chongqing Iron & Steel Company (Group) Limited holds the remaining 60% equity interest. We made an initial cash payment of approximately \$10 million in connection with our investment in Sanfeng. We expect to utilize Sanfeng, which has been renamed Chongqing Sanfeng Covanta Environmental Industry

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Co., Ltd., as the principal platform through which we will grow our energy-from-waste business in China, and that we will make additional investments as and when Sanfeng is successful in developing additional projects.

**Business Segments**

Prior to January 1, 2007, we had two reportable business segments – Waste and Energy Services and Other Services. Given our increased focus on developing our international waste and energy business, during the first quarter of 2007, we segregated what we previously reported as our Waste and Energy Services segment into two new segments: Domestic and International. Our remaining operations, which we previously reported as our Other Services segment and was comprised of the holding company and insurance subsidiaries' operations, do not meet the quantitative thresholds which required separate disclosure as a reportable segment. Therefore, our reportable segments are now Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

***Domestic***

For all energy-from-waste projects, we receive revenue from two primary sources: fees charged for operating projects or processing waste received and payments for electricity and steam sales. We also operate, and in some cases have ownership interests in, transfer stations and landfills which generate revenue from waste disposal fees or operating fees. In addition, we own and in some cases operate, other renewable energy projects in the United States which generate electricity from wood waste, landfill gas, and hydroelectric resources. The electricity from these projects is sold to utilities. For these projects, we receive revenue from electricity sales, and in some cases cash from equity distributions.

***International***

Our subsidiary, CPIH, engages in the independent power production and energy-from-waste businesses outside the United States. Through CPIH, we have ownership interests in, and/or operate facilities in the Philippines, China, Bangladesh, India, Costa Rica, and Italy. The Costa Rica facilities generate electricity from hydroelectric resources while the other independent power production facilities generate electricity and steam by combusting coal, natural gas, or heavy fuel oil. In addition, two facilities in China and one facility in Italy generate electricity by processing waste received. For these projects, CPIH receives revenue from operating fees, electricity and steam sales, and in some cases cash from equity distributions.

**Contract Structures**

We have 24 domestic energy-from-waste projects where we charge a fixed fee (which escalates over time pursuant to contractual indices we believe are appropriate to reflect price inflation) for operation and maintenance services. We refer to these projects as having a Service Fee structure. Our contracts at Service Fee projects provide revenue that does not materially vary based on the amount of waste processed or energy generated and as such is relatively stable for the contract term. In addition, at most of our Service Fee projects, the operating subsidiary retains only a fraction of the energy revenues generated, with the balance used to provide a credit to the municipal client against its disposal costs. Therefore, in these projects, the municipal client derives most of the benefit and risk of energy production and changing energy prices.

We also have 8 domestic energy-from-waste projects where we receive a per-ton fee under contracts for processing waste. We refer to these projects as having a Tip Fee structure. At Tip Fee projects, we generally enter into long-term waste disposal contracts for a substantial portion of project disposal capacity and retain all of the energy revenue generated. The waste disposal and energy revenue from these projects is more dependent upon operating performance

and, as such, is subject to greater revenue fluctuation to the extent performance levels fluctuate.

Under both structures, our returns are expected to be stable if we do not incur material unexpected operation and maintenance costs or other expenses. In addition, most of our energy-from-waste project contracts are structured so that contract counterparties generally bear, or share in, the costs associated with events or

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circumstances not within our control, such as uninsured force majeure events and changes in legal requirements. The stability of our domestic revenues and returns could be affected by our ability to continue to enforce these obligations. Also, at some of our energy-from-waste facilities, commodity price risk is mitigated by passing through commodity costs to contract counterparties. With respect to domestic and international independent power projects, such structural features generally do not exist because either we operate and maintain such facilities for our own account or we do so on a cost-plus basis rather than a fixed-fee basis.

At some of our domestic and international independent power projects, our operating subsidiaries purchase fuel in the open markets which exposes us to fuel price risk. At other plants, fuel costs are contractually included in our electricity revenues, or fuel is provided by our customers. In some of our international projects, the project entity (which in some cases is not our subsidiary) has entered into long-term fuel purchase contracts that protect the project from changes in fuel prices, provided counterparties to such contracts perform their commitments.

## **Seasonal Effects**

Our quarterly operating income from domestic and international operations within the same fiscal year typically differs substantially due to seasonal factors, primarily as a result of the timing of scheduled plant maintenance.

We typically conduct scheduled maintenance periodically each year, which requires that individual boiler units temporarily cease operations. During these scheduled maintenance periods, we incur material repair and maintenance expenses and receive less revenue, until the boiler units resume operations. This scheduled maintenance typically occurs during periods of off-peak electric demand in the spring and fall. The spring scheduled maintenance period is typically more extensive than scheduled maintenance conducted during the fall. As a result, we typically incur the highest maintenance expense in the first half of the year. Given these factors, we typically experience lower operating income from our projects during the first six months of each year, and higher operating income during the second six months of each year.

## **Contract Duration**

We operate energy-from-waste projects under long-term agreements. For those projects we own, our contract to sell the project's energy output (either electricity or steam) generally expires at or after the date when the initial term of our contract to operate or receive waste also expires. Expiration of these contracts will subject us to greater market risk in maintaining and enhancing revenues as we enter into new contracts. We intend to enter into replacement or additional contracts for waste supplies and will sell our energy output either into the regional electricity grid or pursuant to new contracts. Because project debt on these facilities will be paid off at such time, we believe we will be able to offer disposal services at rates that will attract sufficient quantities of waste and provide acceptable revenues. For those projects we operate but do not own, prior to the expiration of the initial term of our operating contract, we will seek to enter into renewal or replacement contracts to continue operating such projects. We will seek to bid competitively in the market for additional contracts to operate other facilities as similar contracts of other vendors expire. There can be no assurance that we will be able to enter into such renewals, replacement or additional contracts, or that the terms available in the market at the time will be favorable.

## **RESULTS OF OPERATIONS**

Prior to January 1, 2007, we had two reportable business segments—Waste and Energy Services and Other Services. Given our increased focus on developing our international waste and energy business, during the first quarter of 2007, we segregated what we previously reported as our Waste and Energy Services segment into two new segments: Domestic and International. Our remaining operations, which we previously reported as our Other Services segment, which was comprised of the holding company and insurance subsidiaries' operations, do not meet the quantitative



thresholds which required separate disclosure as a reportable segment. Therefore, our reportable segments are now Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

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The following general discussions should be read in conjunction with the condensed consolidated financial statements and the Notes thereto and other financial information appearing and referred to elsewhere in this report. Additional detail on comparable revenues, costs and expenses, and operating income is provided in the reported Domestic and International segment discussions below.

**Consolidated Results**

	For the Three Months Ended June 30, 2007		For the Six Months Ended June 30, 2007	
	2007	2006	2007	2006
	(Unaudited, in thousands)			
<b>CONSOLIDATED RESULTS OF OPERATIONS:</b>				
Total operating revenues	\$ 355,140	\$ 334,136	\$ 685,349	\$ 639,492
Total operating expenses	277,928	257,448	599,857	527,286
<b>Operating income</b>	77,212	76,688	85,492	112,206
<b>OTHER INCOME (EXPENSE):</b>				
Investment income	1,819	2,915	7,003	5,318
Interest expense	(14,718)	(27,361)	(35,978)	(55,844)
Loss on extinguishment of debt		(6,795)	(32,006)	(6,795)
Total other expense	(12,899)	(31,241)	(60,981)	(57,321)
<b>Income before income tax expense, minority interests and equity in net income from unconsolidated investments</b>				
	64,313	45,447	24,511	54,885
Income tax expense	(28,822)	(6,662)	(10,646)	(10,925)
Minority interests	(2,091)	(2,279)	(3,489)	(2,879)
Equity in net income from unconsolidated investments	4,316	14,672	9,422	21,515
<b>NET INCOME</b>	\$ 37,716	\$ 51,178	\$ 19,798	\$ 62,596
<b>EARNINGS PER SHARE:</b>				
Basic	\$ 0.25	\$ 0.35	\$ 0.13	\$ 0.43
Diluted	\$ 0.24	\$ 0.35	\$ 0.13	\$ 0.43

**Consolidated Results of Operations Comparison of Results for the Three Months Ended June 30, 2007 vs. Results for the Three Months Ended June 30, 2006**

Operating revenues increased by \$21.0 million primarily due to increased waste and service revenues at our energy-from-waste facilities and increased construction revenues at our Hillsborough County facility in the Domestic segment. Operating revenues also increased due to higher electricity generation at our Indian facilities in the International segment. Operating expenses increased by \$20.5 million primarily due to increased plant operating

expenses due to normal cost escalations such as wages, additional costs related to operations at the Harrisburg facility and the Holliston transfer station and increased construction expenses at our Hillsborough County facility. Operating expenses also increased as a result of increased plant operating expenses due to higher generation at our Indian facilities.

On March 31, 2007, our SEMASS energy-from-waste facility experienced a fire in the front-end receiving portion of the facility. Damage was extensive to this portion of the facility and operations at the facility were suspended completely for approximately 20 days. As a result of this loss, we recorded an asset impairment of \$18.3 million, pre-tax, in the first quarter of 2007, which represented a preliminary estimate of the net book value of the assets destroyed. Based upon additional analysis as the facility is fully restored, we may increase the impairment recorded. The cost of repair or replacement, and business interruption losses, are insured under the terms of

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applicable insurance policies, subject to deductibles. We cannot predict the timing of when we would receive the proceeds under such policies. During the second quarter of 2007, we recorded insurance recoveries of \$13.3 million related to repair and reconstruction and \$2.7 million related to clean-up costs. Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses.

Total investment income decreased by \$1.1 million primarily due to lower invested cash balances. Interest expense decreased by \$12.6 million primarily due to lower loan balances and lower interest rates resulting from the May 2006 refinancing and the 2007 recapitalization. As a result of amendments to our financing arrangements in May 2006, we recognized a loss on extinguishment of debt of \$6.8 million for the three months ended June 30, 2006. See Note 12. Changes in Capitalization of the Notes for additional information.

Equity in net income from unconsolidated investments decreased by \$10.4 million. Quezon recorded a \$7.0 million cumulative deferred income tax benefit during the three months ended June 30, 2006 related to unrealized foreign exchange losses that are expected to be tax deductible for Philippine tax purposes in future years. The realization of this deferred tax benefit is subject to fluctuations in the value of the Philippine peso versus the US dollar. During the three months ended June 30, 2007, we reduced the cumulative deferred income tax benefit by approximately \$1.1 million as a result of the strengthening of the Philippine peso versus the US dollar. Equity in net income from unconsolidated investments for the three months ended June 30, 2007 also included approximately \$1.4 million of increased tax expense for Quezon related to the conclusion of a six-year income tax holiday in May 2006. See Note 8. Equity Method Investments of the Notes for additional information.

Income tax expense increased by \$22.2 million primarily due to a one-time tax benefit of \$10 million recorded during the three months ended June 30, 2006, associated with the adoption of the permanent reinvestment exception under Accounting Principles Board ( APB ) Opinion No. 23, Accounting for Income Taxes Special Areas ( APB 23 ) as discussed in Note 11. Income Taxes of the Notes. Additionally, tax expense increased due to higher taxable income.

Net income and diluted earnings per share was \$37.7 million and \$0.24, respectively, for the quarter ended June 30, 2007 compared to net income and diluted earnings per share of \$51.2 million and \$0.35, respectively, for the quarter ended June 30, 2006.

Additional detail on comparable revenues, costs and expenses, and operating income is provided in the Domestic and International segment discussions below.

## **Consolidated Results of Operations Comparison of Results for the Six Months Ended June 30, 2007 vs. Results for the Six Months Ended June 30, 2006**

Operating revenues increased by \$45.9 million primarily due to increased waste and service revenues at our energy-from-waste facilities and increased construction revenues at our Hillsborough County facility in the Domestic segment. Operating revenues also increased due to higher electricity generation at our Indian facilities in the International segment. Operating expenses increased by \$72.6 million primarily due to increased plant operating expenses due to normal cost escalations such as wages, additional costs related to operations at the Harrisburg facility and the Holliston transfer station, increased construction expenses at our Hillsborough County facility and a write-down of assets related to a fire at our SEMASS energy-from-waste facility in our Domestic segment as discussed below. Operating expenses also increased as a result of increased plant operating expenses due to higher generation at our Indian facilities.

Following the fire at our SEMASS energy-from-waste facility, during the second quarter of 2007, we recorded insurance recoveries of \$13.3 million related to repair and reconstruction and \$2.7 million related to clean-up costs.

Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses.

Total investment income increased by \$1.7 million primarily due to higher invested cash balances and higher interest rates on invested funds. Interest expense decreased by \$19.9 million primarily due to lower loan balances and lower interest rates resulting from the May 2006 refinancing and the 2007 recapitalization plan. As a result of

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the recapitalization plan in the first quarter of 2007, we recognized a loss on extinguishment of debt charge of approximately \$32.0 million, pre-tax, which is comprised of the write-down of deferred financing costs, tender premiums paid for the intermediate subsidiary debt, and a call premium paid in connection with previously existing financing arrangements. These amounts were partially offset by the write-down of unamortized premiums relating to the intermediate subsidiary debt and a gain associated with the settlement of our interest rate swap agreements in February 2007. As a result of amendments to our financing arrangements in May 2006, we recognized a loss on extinguishment of debt of \$6.8 million for the six months ended June 30, 2006. See Note 12. Changes in Capitalization of the Notes for additional information.

Equity in net income from unconsolidated investments decreased by \$12.1 million. Quezon recorded a \$7.0 million cumulative deferred income tax benefit during the six months ended June 30, 2006 related to unrealized foreign exchange losses that are expected to be tax deductible for Philippine tax purposes in future years. The realization of this deferred tax benefit is subject to fluctuations in the value of the Philippine peso versus the US dollar. During the six months ended June 30, 2007, we reduced the cumulative deferred income tax benefit by approximately \$1.5 million as a result of the strengthening of the Philippine peso versus the US dollar. Equity in net income from unconsolidated investments for the six months ended June 30, 2007 also included approximately \$3.4 million of increased tax expense for Quezon related to the conclusion of a six-year income tax holiday in May 2006. See Note 8. Equity Method Investments of the Notes for additional information.

Income tax expense decreased by \$0.3 million primarily due to lower taxable income for the six months ended June 30, 2007 resulting primarily from the write-down of assets related to SEMASS and the loss on extinguishment of debt. The reduction in income tax expense was primarily offset by a one-time tax benefit of \$10 million recorded during the six months ended June 30, 2006, associated with the adoption of the permanent reinvestment exception under APB 23 as discussed in Note 11. Income Taxes of the Notes.

Net income and diluted earnings per share was \$19.8 million and \$0.13, respectively, for the six months ended June 30, 2007 compared to net income and diluted earnings per share of \$62.6 million and \$0.43, respectively, for the six months ended June 30, 2006.

Additional detail on comparable revenues, costs and expenses, and operating income is provided in the Domestic and International segment discussions below.

**Domestic Business**

	<b>For the Three Months Ended June 30, 2007                  2006</b>		<b>For the Six Months Ended June 30, 2007                  2006</b>	
	<b>(Unaudited, in thousands)</b>			
Waste and service revenues	\$ 216,997	\$ 212,642	\$ 414,879	\$ 402,580
Electricity and steam sales	75,850	72,672	150,744	144,436
Other operating revenues	7,757	707	22,736	1,576
Total operating revenues	300,604	286,021	588,359	548,592
Plant operating expenses	157,567	142,365	328,028	300,535
Depreciation and amortization expense	46,155	46,693	92,160	90,916

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Net interest expense on project debt	12,292	13,606	25,377	27,530
General and administrative expenses	17,047	14,441	36,978	30,780
Write-down of assets, net of insurance recoveries	(13,341)		4,925	
Other operating expense	7,804	225	22,576	351
Total operating expenses	227,524	217,330	510,044	450,112
Operating income	\$ 73,080	\$ 68,691	\$ 78,315	\$ 98,480

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**Domestic Results of Operations Comparison of Results for the Three Months Ended June 30, 2007 vs. Results for the Three Months Ended June 30, 2006**

Total Domestic revenues increased by \$14.6 million primarily due to contractual escalations and revenues related to construction activity as described below.

Waste and service revenues increased by \$4.4 million or 2% as a result of the following factors:

Revenues from energy-from-waste projects structured with Service Fee arrangements increased by \$3.8 million. Such revenues increased due to contractual escalations and operations at the Harrisburg facility, partially offset by a reduction related to lower revenues earned explicitly to service debt;

Revenues from energy-from-waste projects structured with Tip Fee arrangements decreased by \$0.6 million primarily driven by a decrease at the SEMASS facility following its fire during the first quarter of 2007, partially offset by contractual escalations, improved pricing and revenues from the Holliston transfer station following its acquisition; and

Other waste and service fee revenues increased by \$1.2 million primarily due to higher pricing for scrap metal.

Electricity and steam sales increased \$3.2 million or 4% primarily due to higher energy rates offset by lower volumes due to the partial suspension of operations at the SEMASS facility following its fire during the first quarter of 2007.

Other operating revenues increased by \$7.1 million primarily related to construction revenues at our Hillsborough County facility.

Plant operating expenses increased by \$15.2 million primarily due to normal cost escalations such as wages, costs related to the SEMASS fire, operations at the Harrisburg facility and the Holliston transfer station.

Net interest expense on project debt decreased by \$1.3 million primarily due to lower project debt balances.

General and administrative expenses increased by \$2.6 million primarily due to stock-based compensation expense and normal wage and benefit escalations.

Following the fire at our SEMASS energy-from-waste facility, during the second quarter of 2007, we recorded insurance recoveries of \$13.3 million related to repair and reconstruction and \$2.7 million related to clean-up costs. Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses.

Other operating expense increased by \$7.6 million primarily due to costs related to construction at the Hillsborough County facility.

**Domestic Results of Operations Comparison of Results for the Six Months Ended June 30, 2007 vs. Results for the Six Months Ended June 30, 2006**

Total Domestic revenues increased by \$39.8 million primarily due to contractual escalations and revenues related to construction activity as described below.

Waste and service revenues increased by \$12.3 million or 3% as a result of the following factors:



Revenues from energy-from-waste projects structured with Service Fee arrangements increased by \$8.3 million. Such revenues increased due to contractual escalations and operations at the Harrisburg facility offset by a reduction related to lower revenues earned explicitly to service debt;

Revenues from energy-from-waste projects structured Tip Fee arrangements increased by \$1.1 million primarily driven by higher pricing and operations at the Holliston transfer station following its acquisition, partially offset by a decrease at the SEMASS facility following its fire during the first quarter of 2007; and

Other waste and service fee revenues increased by \$2.9 million primarily due to higher pricing for scrap metal.

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Electricity and steam sales increased \$6.3 million or 4% primarily due to higher energy rates along with revenues received related to energy rate settlements related to prior years partially offset by lower volumes related to the SEMASS fire.

Other operating revenues increased by \$21.2 million primarily related to construction revenues at our Hillsborough County facility.

Plant operating expenses increased by \$27.5 million primarily due to normal cost escalations such as wages, costs related to the SEMASS fire, operations at the Harrisburg facility and the Holliston transfer station.

Depreciation and amortization expense increased by \$1.2 million primarily due to additions of property, plant and equipment.

Net interest expense on project debt decreased by \$2.2 million primarily due to lower project debt balances.

General and administrative expenses increased by \$6.2 million primarily due to stock-based compensation expense, additional business development spending and normal wage and benefit escalations.

Following the fire at our SEMASS energy-from-waste facility, during the second quarter of 2007, we recorded insurance recoveries of \$13.3 million related to repair and reconstruction and \$2.7 million related to clean-up costs. Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses.

Other operating expense increased by \$22.2 million primarily due to costs related to construction at the Hillsborough County facility.

**International Business**

	<b>For the Three Months Ended June 30, 2007</b>		<b>For the Six Months Ended June 30, 2007</b>	
	<b>2006</b>		<b>2006</b>	
	<b>(Unaudited, in thousands)</b>			
Waste and service revenues	\$ 1,043	\$ 859	\$ 2,072	\$ 2,290
Electricity and steam sales	50,965	43,741	89,737	81,155
Total operating revenues	52,008	44,600	91,809	83,445
Plant operating expenses	41,994	33,331	73,540	61,710
Depreciation and amortization expense	2,255	2,127	4,282	4,284
Net interest expense on project debt	1,594	1,687	3,114	3,761
General and administrative expenses	2,219	893	3,590	1,984
Other operating income	(874)	(1,353)	(1,040)	(1,737)
Total operating expenses	47,188	36,685	83,486	70,002

Operating income	\$ 4,820	\$ 7,915	\$ 8,323	\$ 13,443
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**International Results of Operations Comparison of Results for the Three Months Ended June 30, 2007 vs. Results for the Three Months Ended June 30, 2006**

Total International revenues increased by approximately \$7.4 million primarily due to a \$10.0 million increase in revenues under energy contracts at both Indian facilities resulting from higher electricity generation. This increase was partially offset by a \$1.3 million decrease in revenues from the Yanjiang facility in China resulting from lower steam sales, and a \$1.1 million decrease in revenues resulting from the sale of the Huantai facility in China during the second quarter of 2006.

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Plant operating expenses increased by \$8.7 million primarily due to a \$10.0 million increase resulting from higher generation at both Indian facilities, partially offset by a \$0.9 million decrease due to lower generation at the Yanjiang facility in China and a \$0.8 million decrease in plant operating costs due to the sale of the Huantai facility in China during the second quarter of 2006.

General and administrative expenses increased by \$1.3 million primarily due to normal wage and benefit escalations and additional business development spending.

Other operating income decreased by \$0.5 million primarily due to a \$1.2 million gain on the sale of the Huantai facility in China recorded during the second quarter of 2006 and a \$0.4 million gain on the sale of inventory that was previously written off at a facility in the Philippines during the second quarter of 2006, partially offset by a \$1.1 million re-measurement gain on the foreign currency denominated debt at one of the Indian facilities.

## **International Results of Operations Comparison of Results for the Six Months Ended June 30, 2007 vs. Results for the Six Months Ended June 30, 2006**

Total International revenues increased by approximately \$8.4 million primarily due to a \$15.2 million increase in revenues under energy contracts at both Indian facilities resulting from higher electricity generation. This increase was partially offset by a \$2.8 million decrease in revenues from the Yanjiang facility in China resulting from lower steam sales, and a \$2.9 million decrease in revenues resulting from the sale of the Huantai facility in China during the second quarter of 2006.

Plant operating expenses increased by \$11.8 million primarily due to a \$15.9 million increase resulting from higher generation at both Indian facilities, partially offset by a \$2.0 million decrease due to lower generation at the Yanjiang facility in China and a \$2.6 million decrease in plant operating costs due to the sale of the Huantai facility in China during the second quarter of 2006.

Net interest expense on project debt decreased by \$0.6 million primarily due to the scheduled quarterly pay down of project debt at both Indian facilities.

General and administrative expenses increased by \$1.6 million primarily due to normal wage and benefit escalations and additional business development spending.

Other operating income decreased by \$0.7 million primarily due to a \$1.2 million gain on the sale of the Huantai facility in China recorded during the second quarter of 2006 and a \$0.4 million gain on the sale of inventory that was previously written off at a facility in the Philippines during the second quarter of 2006, partially offset by a \$0.9 million re-measurement gain on the foreign currency denominated debt at one of the Indian facilities.

## **LIQUIDITY AND CAPITAL RESOURCES**

On January 19, 2007, we announced a comprehensive recapitalization plan utilizing a series of equity and debt financings. We completed public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, and we closed on the New Credit Facilities on February 9, 2007. We completed the tender offer of intermediate debt for approximately \$604.4 million in aggregate principal amount of outstanding notes on February 22, 2007 and on April 16, 2007 redeemed additional notes of approximately \$1.4 million. Under the New Credit Facilities, we will have substantially greater, but not unrestricted, ability to make investments in our business and to take advantage of opportunities to grow our business through investments and acquisitions, both domestically and internationally. Additional information, including material terms related to our recapitalization plan, is contained below under *2007 Recapitalization Plan*.

Generating sufficient cash to meet our liquidity needs, pay down debt and to invest in our business remains an important objective of management. Maintaining historic facility production levels while effectively managing operating and maintenance expenses is important to optimize long-term cash generation. We do not expect to make any cash contributions to Covanta Energy, except in connection with certain acquisitions and investments permitted under Covanta Energy's New Credit Facilities (described below under *2007 Recapitalization Plan*). Covanta Energy may make limited cash distributions to us under the New Credit Facilities.

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Covanta Energy derives its cash flows principally from its domestic and international project operations and businesses. The frequency and predictability of Covanta Energy's receipt of cash from projects differs, depending upon various factors, including whether restrictions on distributions exist in applicable project debt arrangements, whether a project is domestic or international, and whether a project has been able to operate at historical levels of production.

Covanta Energy's receipt of cash from its international projects is also subject to satisfaction of financial tests and other covenants contained in applicable project debt arrangements. A material portion of cash from Covanta Energy's international projects are received semi-annually, during the second and fourth quarters.

As of June 30, 2007, Covanta Energy was in compliance with the covenants under the New Credit Facilities. We believe that when combined with its other sources of liquidity, including the revolving loan facility that is a component of the New Credit Facilities, Covanta will generate sufficient cash over at least the next twelve months to meet operational needs, make capital expenditures, invest in the business and service debt due prior to maturity.

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**Capital Resources and Commitments**

The following chart summarizes the various debt facilities and cash resources as of June 30, 2007 (in millions of dollars):

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**Table of Contents****Cash Flow and Liquidity**

The information set forth below regarding liquidity and capital resources as of June 30, 2007 is presented according to our consolidated operations and our current segments of Domestic and International.

**Cash Flow**

Our sources of funds are our investments and financing activities (including offerings of equity and/or debt securities), as well as dividends, if any, and other payments received from our subsidiaries. Under the financing arrangements existing during 2006 and prior to the New Credit Facilities, Covanta Energy's ability to pay dividends to us was limited, except in certain circumstances. Under the New Credit Facilities, Covanta Energy has greater flexibility to distribute cash to us. Proceeds of approximately \$364.4 million and \$136.6 million, each net of underwriting discounts and commissions, were received during the six months ended June 30, 2007 related to underwritten public offerings of Debentures and common stock, respectively. On February 24, 2006, we completed a rights offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds.

Summarized cash flow information for our current business segments reconciled to the condensed consolidated statements of cash flows is as follows (in thousands of dollars):

**For the Six Months Ended June 30, 2007**

	<b>Domestic</b>	<b>International</b>	<b>All Other(1)</b>	<b>Total</b>
Net cash provided by operating activities	\$ 114,794	\$ 26,794	\$ 950	\$ 142,538
Net cash (used in) provided by investing activities	(38,615)	(10,434)	5,490	(43,559)
Net cash (used in) provided by financing activities	(175,192)	(13,477)	10,773	(177,896)
Effect of exchange rate changes on cash and cash equivalents		337		337
Net (decrease) increase in cash and cash equivalents	\$ (99,013)	\$ 3,220	\$ 17,213	\$ (78,580)

**For the Six Months Ended June 30, 2006**

	<b>Domestic</b>	<b>International</b>	<b>All Other(1)</b>	<b>Total</b>
Net cash provided by (used in) operating activities	\$ 106,208	\$ 11,752	\$ (1,295)	\$ 116,665
Net cash (used in) provided by investing activities	(26,019)	3,389	3,764	(18,866)
Net cash (used in) provided by financing activities	(78,666)	(2,296)	20,991	(59,971)
Effect of exchange rate changes on cash and cash equivalents		97		97
Net increase in cash and cash equivalents	\$ 1,523	\$ 12,942	\$ 23,460	\$ 37,925



- (1) All other is comprised of the holding company and insurance subsidiaries' operations.

*Domestic Segment*

Cash provided by operating activities was \$114.8 million and \$106.2 million for the six months ended June 30, 2007 and 2006, respectively. The increase in cash flow from operating activities was primarily due to working capital improvements and a \$10.3 million payment from Domestic to All Other in the three months ended March 31, 2006, relating to the California Grantor Trust settlement. Net cash used in investing activities was \$38.6 million and \$26.0 million for the six months ended June 30, 2007 and 2006, respectively, and was primarily due to the purchase of property, plant and equipment and the acquisition of the Holliston Transfer Station in April 2007 offset by property insurance proceeds of \$7.3 million received related to the SEMASS fire. Net cash used in financing activities was \$175.2 million for the six months ended June 30, 2007 primarily due to the 2007 recapitalization plan. The net proceeds from refinancing the New Credit Facilities was \$5.6 million, net of transaction fees. The combination of the proceeds from the public offerings of Debentures and common stock noted above and approximately \$130 million in cash and restricted cash (available for use as a result of the recapitalization plan) were utilized for the repayment, by means of a tender offer, of approximately \$604.4 million in principal.

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amount of outstanding notes previously issued by certain intermediate subsidiaries of Covanta Energy. Net cash used in financing activities was \$78.7 million for the six months ended June 30, 2006 and was primarily driven by the refinancing in May 2006 and the repayment of debt partially offset by a decrease in restricted funds held in trust.

Restricted funds held in trust were \$358.0 million as of June 30, 2007. Restricted funds held in trust are primarily amounts received and held by third party trustees relating to projects owned by Covanta Energy, and which may be used only for specified purposes. We do not have access to these funds.

### *International Segment*

Cash provided by operating activities was \$26.8 million and \$11.8 million for the six months ended June 30, 2007 and 2006, respectively. Net cash used in investing activities was \$10.4 million for the six months ended June 30, 2007 primarily due to our \$10 million investment in Chongqing Sanfeng Environmental Industry Co., Ltd. in April 2007. Net cash provided by investing activities was \$3.4 million for the six months ended June 30, 2006 primarily due to the sale of the Huantai facility in China during the second quarter of 2006. Net cash used in financing activities was \$13.5 million and \$2.3 million for the six months ended June 30, 2007 and 2006, respectively, primarily due to an increase in restricted funds held in trust. Restricted funds held in trust were \$45.3 million as of June 30, 2007.

### **2007 Recapitalization Plan**

On January 19, 2007, we announced a comprehensive recapitalization plan utilizing a series of equity and debt financings. Subsequent to this announcement, we completed the following transactions:

the refinancing of Covanta Energy's debt facilities with the New Credit Facilities, comprised of a \$300 million revolving credit facility, a \$320 million funded letter of credit facility and a \$650 million term loan;

an underwritten public offering of 6.118 million shares of our common stock, in which we received proceeds of approximately \$136.6 million, net of underwriting discounts and commissions;

an underwritten public offering of approximately \$373.8 million aggregate principal amount of Debentures issued by us, from which we received proceeds of approximately \$364.4 million, net of underwriting discounts and commissions; and

the repayment, by means of a tender offer, of approximately \$604.4 million in aggregate principal amount of outstanding notes previously issued by Covanta Energy's intermediate subsidiaries.

We completed our public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, and we closed on the New Credit Facilities on February 9, 2007. We completed our tender offer for approximately \$604.4 million in aggregate principal amount of outstanding notes on February 22, 2007. As a result of the recapitalization plan in the first quarter of 2007, we recognized a loss on extinguishment of debt of approximately \$32.0 million, pre-tax, which is comprised of the write-down of deferred financing costs, tender premiums paid for the intermediate subsidiary debt, and a call premium paid in connection with previously-existing financing arrangements. These amounts were partially offset by the write-down of unamortized premiums relating to the intermediate subsidiary debt and a gain associated with the settlement of our interest rate swap agreements. The following discussion details the material terms of each of these transactions.

### ***New Credit Facilities***

The New Credit Facilities are comprised of:

a \$300 million revolving loan facility due 2013, which includes a \$200 million sub-facility for the issuance of letters of credit (the Revolving Loan Facility );

a \$320 million funded letter of credit facility, due 2014 (the Funded L/C Facility ); and

a \$650 million term loan facility, due 2014 (the Term Loan Facility ).

**Table of Contents***Amortization Terms*

The New Credit Facilities include mandatory annual amortization of the Term Loan Facility to be paid in quarterly installments beginning June 30, 2007, through the date of maturity as follows (in thousands of dollars):

	<b>Annual Remaining Amortization</b>
2007	\$ 4,875
2008	6,500
2009	6,500
2010	6,500
2011	6,500
2012	6,500
2013	6,500
2014	606,125
Total	\$ 650,000

The June 30, 2007 scheduled principal payment on the Term Loan Facility was made on July 2, 2007 (the next business day). Under the New Credit Facilities, Covanta Energy is obligated to apply a portion of excess cash from operations on an annual basis (calculated pursuant to the credit agreement), as well as specified other sources, to repay borrowings under the Term Loan Facility. The portion of excess cash to be used for this purpose is 50%, 25%, or 0%, based on measurement of the leverage ratio under the financial covenants.

*Interest and Fee Terms*

Loans under the New Credit Facilities are designated, at our election, as Eurodollar rate loans or base rate loans. Eurodollar loans bear interest at a reserve adjusted British Bankers Association Interest Settlement Rate, commonly referred to as LIBOR, for deposits in dollars plus a borrowing margin as described below. Interest on Eurodollar rate loans is payable at the end of the applicable interest period of one, two, three or six months (and at the end of every three months in the case of six month Eurodollar loans). Base rate loans bear interest at (a) a rate per annum equal to the greater of (1) the prime rate designated in the relevant facility or (2) the federal funds rate plus 0.5% per annum, plus (b) a borrowing margin as described below.

Letters of credit that may be issued in the future under the Revolving Loan Facility will accrue fees at the then effective borrowing margins on Eurodollar rate loans (described below), plus a fee on each issued letter of credit payable to the issuing bank. Letter of credit availability under the Funded L/C Facility accrues fees (whether or not letters of credit are issued thereunder) at the then effective borrowing margin for Eurodollar rate loans times the total availability under letters of credit (whether or not then utilized), plus a fee on each issued letter of credit payable to the issuing bank. In addition, Covanta Energy has agreed to pay to the participants under the Funded L/C Facility a fee equal to 0.10% times the average daily amount of the credit linked deposit paid by such participants for their participation under the Funded L/C Facility.



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The borrowing margins referred to above for the Revolving Loan Facility, the Term Loan Facility and the Funded L/C Facility are as follows:

			<b>Borrowing Margin for Term Loans, Funded Letters of Credit and</b>	<b>Borrowing Margin for Term Loans, Funded Letters of Credit and</b>
	<b>Borrowing Margin for Revolving Loans (Eurodollar Loans)</b>	<b>Borrowing Margin for Revolving Loans (Base Rate Loans)</b>	<b>Credit-Linked  Deposits (Eurodollar Loans)</b>	<b>Credit-Linked  Deposits (Base Rate Loans)</b>
<b>Leverage Ratio</b>				
≥ 4.00:1.00	2.00%	1.00%	1.75%	0.75%
< 4.00:1.00 and ≥ 3.25:1.00	1.75%	0.75%	1.50%	0.50%
< 3.25:1.00 and ≥ 2.75:1.00	1.50%	0.50%	1.50%	0.50%
< 2.75:1.00	1.25%	0.25%	1.50%	0.50%

*Guarantees and Securitization*

The New Credit Facilities are guaranteed by us and by certain Covanta Energy subsidiaries. Covanta Energy and certain of its subsidiaries that are party to the New Credit Facilities agreed to secure all of Covanta Energy's obligations under the New Credit Facilities by granting, for the benefit of secured parties, a first priority lien on substantially all of their assets, to the extent permitted by existing contractual obligations, a pledge of substantially all of the capital stock of each of Covanta Energy's domestic subsidiaries owned by it and 65% of substantially all the capital stock of each of Covanta Energy's foreign subsidiaries directly owned by it, in each case to the extent not otherwise pledged.

*Debt Covenants and Defaults*

The loan documentation under the New Credit Facilities contains customary affirmative and negative covenants and financial covenants. During the term of the New Credit Facilities, we expect that the negative covenants will place limitations on Covanta Energy, but be materially less restrictive than the restrictions in effect prior to February 9, 2007. We were in compliance with all required covenants as of June 30, 2007.

The financial covenants of the New Credit Facilities, which are measured on a trailing four quarter period basis, include the following:

maximum Covanta Energy leverage ratio of 4.50 to 1.00 for the four quarter period ended June 30, 2007, which measures Covanta Energy's principal amount of consolidated debt less certain restricted funds dedicated to repayment of project debt principal and construction costs ( Consolidated Adjusted Debt ) to its adjusted earnings before interest, taxes, depreciation and amortization, as calculated under the New Credit Facilities ( Adjusted EBITDA ). The definition of Adjusted EBITDA in the New Credit Facilities excludes certain non-cash charges. The maximum Covanta Energy leverage ratio allowed under the New Credit Facilities

adjusts in future periods as follows:

4.50 to 1.00 for the four quarter period ended September 30, 2007;

4.25 to 1.00 for each of the four quarter periods ended December 31, 2007, March 31, June 30 and September 30, 2008;

4.00 to 1.00 for each of the four quarter periods ended December 31, 2008, March 31, June 30 and September 30, 2009;

3.75 to 1.00 for each of the four quarter periods ended December 31, 2009, March 31, June 30 and September 30, 2010;

3.50 to 1.00 for each four quarter period thereafter;

maximum Covanta Energy capital expenditures incurred to maintain existing operating businesses of \$100 million, subject to adjustment due to an acquisition by Covanta Energy; and

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minimum Covanta Energy interest coverage ratio of 3.00 to 1.00, which measures Covanta Energy's Adjusted EBITDA to its consolidated interest expense plus certain interest expense of ours, to the extent paid by Covanta Energy.

### ***Material Terms of the Debentures***

On January 31, 2007, we also completed an underwritten public offering of \$373.8 million aggregate principal amount of Debentures. This offering included Debentures sold pursuant to an over-allotment option which was exercised by the underwriters. The Debentures constitute our general unsecured senior obligations and will rank equally in right of payment with any future senior unsecured indebtedness. The Debentures are effectively junior to our existing and future secured indebtedness, including the New Credit Facilities, to the extent of the value of the assets securing such indebtedness. The Debentures are not guaranteed by any of our subsidiaries and are effectively subordinated to all existing and future indebtedness and liabilities (including trade payables) of our subsidiaries.

The Debentures bear interest at a rate of 1.00% per year, payable semi-annually in arrears, on February 1 and August 1 of each year, commencing on August 1, 2007 and will mature on February 1, 2027. Beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures during any six-month interest period in which the trading price of the Debentures measured over a specified number of trading days is 120% or more of the principal amount of the Debentures. When applicable, the contingent interest payable per \$1,000 principal amount of Debentures will equal 0.25% of the average trading price of \$1,000 principal amount of Debentures during the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period. The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and as such, the fair market value for the embedded derivative was zero as of June 30, 2007.

Under limited circumstances, the Debentures are convertible by the holders thereof, at any time, into cash and shares of our common stock, if any, initially based on a conversion rate of 35.4610 shares of our common stock per \$1,000 principal amount of Debentures, (which represents an initial conversion price of approximately \$28.20 per share). The terms of the Debentures require that under certain circumstances, such as an acquisition of us by a third party, the payment by us of a cash dividend on our common stock, or where a cash tender offer is made for our common stock, we are obligated to adjust the conversion rate applicable to the Debentures. This adjustment requirement constitutes a contingent beneficial conversion feature that is part of the Debentures. If such an adjustment were to occur, (i) the amount of the contingent beneficial feature would be bifurcated from the Debentures, (ii) the liability recorded in our financial statements with respect to the Debentures would be reduced by the amount bifurcated, and (iii) the amount bifurcated would be recorded as a charge to interest expense and accreted to the Debenture liability over the remaining term of Debentures, or the conversion date of the Debentures, if earlier.

At our option, the Debentures are subject to redemption at any time on or after February 1, 2012, in whole or in part, at a redemption price equal to 100% of the principal amount of the Debentures being redeemed, plus accrued and unpaid interest (including contingent interest, if any). In addition, holders may require us to repurchase their Debentures on February 1, 2012, February 1, 2017 and February 1, 2022, in whole or in part, for cash at a repurchase price equal to 100% of the principal amount of the Debentures being repurchased, plus accrued and unpaid interest (including contingent interest, if any). The Debentures are also subject to repurchase by us, at the holder's option, if a fundamental change occurs, for cash at a repurchase price equal to 100% of the principal amount of the Debentures, plus accrued and unpaid interest (including contingent interest, if any).

### ***Equity Offering***



On January 31, 2007, we completed an underwritten public offering of 5.32 million shares of our common stock. The shares were sold to the public at a price of \$23.50 per share. We granted the underwriters an option to purchase up to an additional 798,000 shares of common stock at \$22.325 per share for a period of 30 days beginning on and including the date of original issuance of the shares in connection with this offering, solely to cover over-allotments. The option was exercised and such additional shares were sold on February 6, 2007. Proceeds received in these offerings were approximately \$136.6 million, net of underwriting discounts and commissions.

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***Intermediate Subsidiary Debt***

On January 23, 2007, we commenced cash tender offers for (a) any and all of the outstanding 8 1/2% Senior Secured Notes due 2010 (the MSW I Notes ) issued by MSW Energy Holdings LLC and its wholly owned subsidiary, MSW Energy Finance Co., Inc. (collectively referred to as MSW I ), (b) any and all of the outstanding 7 3/8% Senior Secured Notes due 2010 (the MSW II Notes ) issued by MSW Energy Holdings II LLC and its wholly owned subsidiary, MSW Energy Finance Co. II, Inc. (collectively referred to as MSW II ) and (c) any and all of the outstanding 6.26% Senior Notes due 2015 (the ARC Notes ) of Covanta ARC LLC.

In connection with each of the tender offers, we solicited the consents of the holders of each of the Notes to certain proposed amendments to the indentures governing such Notes. The primary purpose of the solicitations and the proposed amendments was to eliminate from the indentures substantially all of the restrictive covenants and certain events of default provisions contained therein.

Under the terms of the tender offer for the MSW I Notes and MSW II Notes, we offered to purchase the outstanding MSW I Notes and MSW II Notes for a total consideration, for each \$1,000 principal amount of MSW I Notes and MSW II Notes validly tendered and accepted for payment, equal to \$1,096.46 and \$1,079.92, respectively, which included a consent fee of \$30 for each \$1,000 principal amount of MSW I Notes and MSW II Notes validly tendered and accepted for payment.

Under the terms of the tender offer for the ARC Notes, we offered to purchase the outstanding ARC Notes for total consideration, for each \$1,000 original principal amount of ARC Notes validly tendered and accepted for payment, equal to \$729.82, which included a consent fee of \$30 for each \$1,000 principal amount of ARC Notes validly tendered and accepted for payment.

The solicitations for each of the Notes expired on February 5, 2007. At that time, we had received consents from the requisite number of holders of each of the outstanding MSW I Notes, MSW II Notes and ARC Notes, to amend the applicable indentures governing each of the Notes to eliminate substantially all of the restrictive covenants and certain events of default provisions. Each of the issuers entered into a supplemental indenture with the respective trustee for the applicable Notes. The supplemental indentures became operative on February 22, 2007.

On March 16, 2007, we issued a Notice of Redemption for the remaining ARC Notes. All outstanding ARC Notes were redeemed on April 16, 2007 at a total redemption price of \$743.50 per \$1,000 in original principal amount of the ARC Notes, which includes principal outstanding, premium and accrued interest up to the redemption date.

As of June 30, 2007, the remaining outstanding debt for the MSW I Notes and MSW II Notes was \$5.6 million and \$0.5 million, respectively. On July 23, 2007, we issued a Notice of Redemption for the remaining MSW I Notes and MSW II Notes for redemption within 45 days. We intend to redeem the MSW I Notes and MSW II Notes at \$1,042.50 and \$1,036.88, respectively, per \$1,000 principal amount (plus accrued and unpaid interest to the date of redemption).

**2006 Refinancing**

As a result of amendments to Covanta Energy's financing arrangements in May 2006, in the three months ended June 30, 2006 we recognized a loss on extinguishment of debt of \$6.8 million, pre-tax, which was comprised of the write-down of deferred financing costs and a call premium on extinguishment.

**Table of Contents*****Long-Term Debt***

Long-term debt is comprised of credit facilities and intermediate debt as follows (in thousands of dollars):

	<b>June 30, 2007</b>	<b>As of December 31, 2006</b>
<b>Covanta</b>		
1.00% Senior Convertible Debentures due 2027	\$ 373,750	\$
<b>Covanta Energy Senior Secured Credit Facilities</b>		
First Lien Term Loan Facility		368,389
Second Lien Term Loan Facility		260,000
Term Loan Facility due 2014	650,000	
	650,000	628,389
<b>Covanta Energy Intermediate Subsidiary Debt</b>		
6.26% Senior ARC Notes due 2015		192,000
8.50% Senior Secured MSW Notes due 2010	5,610	195,785
7.375% Senior Secured MSW II Notes due 2010	500	224,100
	6,110	611,885
Unamortized debt premium	198	19,748
Total intermediate subsidiary debt	6,308	631,633
<b>Other Covanta Energy long-term debt</b>	38	101
Total	1,030,096	1,260,123
Less: current portion (includes \$198 and \$4,732 of unamortized premium)	(14,462)	(36,434)
Total long-term debt	\$ 1,015,634	\$ 1,223,689

***Short-Term Liquidity***

As of June 30, 2007, Covanta Energy had available credit for liquidity as follows (in thousands of dollars):

	<b>Total Available Under Facility</b>	<b>Maturing</b>	<b>Available As of June 30, 2007</b>
Revolving Loan Facility(1)	\$ 300,000	2013	\$ 300,000
Funded L/C Facility	\$ 320,000	2014	\$ 4,429

(1) Up to \$200 million of which may be utilized for letters of credit.

As of June 30, 2007, Covanta Energy had not drawn any loans from the Revolving Loan Facility. As of June 30, 2007, Covanta Energy had approximately \$315.6 million outstanding letters of credit under the Funded L/C Facility. As of July 16, 2007, Covanta Energy caused to be issued an additional \$7.2 million in letters of credit and borrowed \$30.0 million under the Revolving Loan Facility. As of July 16, 2007, Covanta Energy had fully utilized the available capacity under the Funded L/C Facility, and had approximately \$197.0 million in available capacity for additional letters of credit under the Revolving Loan Facility. See Note 18. Subsequent Events of the Notes.

***Covanta Energy Project Debt***

***Domestic Project Debt***

Financing for Covanta Energy's energy-from-waste projects is generally accomplished through tax-exempt and taxable municipal revenue bonds issued by or on behalf of the municipal client. For such facilities that are

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owned by Covanta Energy's subsidiary, the issuers of the bond loans the bond proceeds to Covanta Energy's subsidiary to pay for facility construction. For such facilities, project-related debt is included as Project debt (short- and long-term) in our condensed consolidated financial statements. Generally, such project debt is secured by the revenues generated by the project and other project assets including the related facility. Such project debt of Covanta Energy's subsidiaries is described in the chart below under *Capital Requirements* as non-recourse project debt. The only potential recourse to Covanta Energy with respect to project debt arises under the operating performance guarantees described below under *Other Commitments and Contingencies*.

Certain subsidiaries had recourse liability for project debt which is recourse to Covanta ARC LLC, but is non-recourse to Covanta Energy, which as of June 30, 2007 was as follows (in thousands of dollars):

Covanta Niagara, L.P. Series 2001 Bonds	\$ 165,010
Covanta Southeastern Connecticut Company Corporate Credit Bonds	\$ 43,500
Covanta Hempstead Company Corporate Credit Bonds	\$ 42,670

***International Project Debt***

Financing for projects in which we have an ownership or operating interest is generally accomplished through commercial loans from local lenders or financing arranged through international banks, bonds issued to institutional investors and from multilateral lending institutions based in the United States. Such debt is generally secured by the revenues generated by the project and other project assets and is without recourse to CPIH or Covanta Energy. Project debt relating to two CPIH projects in India is included as Project debt (short- and long-term) in our consolidated financial statements. In most projects, the instruments defining the rights of debt holders generally provide that the project subsidiary may not make distributions to its parent until periodic debt service obligations are satisfied and other financial covenants are complied with.

**CAPITAL REQUIREMENTS**

We believe that when combined with our other sources of liquidity, our operations generate sufficient cash to meet operational needs, capital expenditures, and debt service due prior to maturity. We will also seek to enhance our cash flow from renewals or replacement of existing contracts, from new contracts to expand existing facilities or operate additional facilities and by investing in new projects. Our projected contractual obligations are consistent with amounts disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Other Commitments and Contingencies**

Other commitments as of June 30, 2007 were as follows (in thousands of dollars):

	<b>Commitments Expiring by Period</b>		
	<b>Total</b>	<b>Less Than One Year</b>	<b>More Than One Year</b>
Letters of credit	\$ 321,011	\$ 34,400	\$ 286,611
Surety bonds	58,691		58,691
Total other commitments net	\$ 379,702	\$ 34,400	\$ 345,302

The letters of credit were issued pursuant to the facilities to secure our performance under various contractual undertakings related to our domestic and international projects, or to secure obligations under our insurance program. Each letter of credit relating to a project is required to be maintained in effect for the period specified in related project contracts, and generally may be drawn if it is not renewed prior to expiration of that period.

As of June 30, 2007, Covanta Energy had approximately \$4.4 million in available capacity for additional letters of credit under its Funded L/C Facility and \$200 million available capacity for letters of credit under its Revolving Loan Facility. As of July 16, 2007, Covanta Energy caused to be issued an additional \$7.2 million in letters of credit and borrowed \$30.0 million under the Revolving Loan Facility. As of July 16, 2007, Covanta Energy had fully utilized the available capacity under the Funded L/C Facility, and had approximately \$197.0 million in available capacity for additional letters of credit under the Revolving Loan Facility. We believe that we will be able

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to fully perform under our contracts to which these existing letters of credit relate, and that it is unlikely that letters of credit would be drawn because of a default of our performance obligations. If any of these letters of credit were to be drawn under the current debt facilities, the amount drawn would be immediately repayable to the issuing bank. If we were unable to immediately repay such amounts drawn under these letters of credit, unreimbursed amounts would be treated under the New Credit Facilities as additional term loans issued under the Term Loan Facility.

The surety bonds listed on the table above relate primarily to performance obligations (\$49.7 million) and support for closure obligations of various energy projects when such projects cease operating (\$9.0 million). Were these bonds to be drawn upon, Covanta Energy would have a contractual obligation to indemnify the surety company.

We have certain contingent obligations related to the Debentures. These are:

holders may require us to repurchase their Debentures on February 1, 2012, February 1, 2017 and February 1, 2022;

holders may require us to repurchase their Debentures, if a fundamental change occurs; and

holders may exercise their conversion rights upon the occurrence of certain events, which would require us to pay the conversion settlement amount in cash and/or our common stock.

See *Liquidity and Capital Resources*, *2007 Recapitalization Plan*, *Material Terms of the Debentures* for specific criteria related to contingent interest, conversion or redemption features of the Debentures.

Covanta Energy and certain of its subsidiaries have issued or are party to performance guarantees and related contractual support obligations undertaken mainly pursuant to agreements to construct and operate certain energy-from-waste facilities and a water facility. With respect to its domestic businesses, Covanta Energy and certain of its subsidiaries have issued guarantees to municipal clients and other parties that Covanta Energy's subsidiaries will perform in accordance with contractual terms, including, where required, the payment of damages or other obligations. Such contractual damages or other obligations could be material, and in circumstances where one or more subsidiary's contract has been terminated for its default, such damages could include amounts sufficient to repay project debt. For facilities owned by municipal clients and operated by Covanta Energy, Covanta Energy's potential maximum liability as of June 30, 2007 associated with the repayment of the municipalities' project debt on such facilities was approximately \$1 billion. This amount was not recorded as a liability in our condensed consolidated balance sheet as of June 30, 2007 as we believe that Covanta Energy had not incurred such liability as of the date of the financial statements. Additionally, damages payable under such guarantees on Covanta Energy-owned energy-from-waste facilities could expose Covanta Energy to recourse liability on project debt. We also believe that Covanta Energy has not incurred such damages as of the date of the financial statements. If Covanta Energy is asked to perform under one or more of such guarantees, its liability for damages upon contract termination would be reduced by funds held in trust and proceeds from sales of the facilities securing the project debt, which is presently not estimable.

With respect to our international businesses, Covanta Energy and certain of its subsidiaries have issued guarantees on behalf of our international operating subsidiaries with respect to contractual obligations to operate certain international power projects and one energy-from-waste project. The potential damages owed under such arrangements for international projects may be material.

Depending upon the circumstances giving rise to such domestic and international damages, the contractual terms of the applicable contracts, and the contract counterparty's choice of remedy at the time a claim against a guarantee is made, the amounts owed pursuant to one or more of such guarantees could be greater than Covanta Energy's

then-available sources of funds. To date, Covanta Energy has not incurred material liabilities under its guarantees, either on domestic or international projects.

Our SEMASS energy-from-waste facility experienced a fire in the front-end receiving portion of the facility during the first quarter of 2007. Damage was extensive to this portion of the facility and operations at the facility were suspended completely for approximately 20 days. The cost of repair or replacement, and business interruption losses, are insured, subject to applicable deductibles. We cannot predict the timing of when we would receive the proceeds under such policies. We expect the cost of repair or replacement, and business interruption losses we do



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not recover, representing deductibles under such policies, will not be material. See Note 16. Commitments and Contingencies of the Notes to the Condensed Consolidated Financial Statements.

**Discussion of Critical Accounting Policies**

In preparing our condensed consolidated financial statements in accordance with United States generally accepted accounting principles, we are required to use judgment in making estimates and assumptions that affect the amounts reported in our financial statements and related notes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. These estimates form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Many of our critical accounting policies are subject to significant judgments and uncertainties which could potentially result in materially different results under different conditions and assumptions. Future events rarely develop exactly as forecast, and the best estimates routinely require adjustment. Except as described below, management believes there have been no material changes during the six months ended June 30, 2007 to the items discussed in Discussion of Critical Accounting Policies in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the year ended December 31, 2006.

***Stock-Based Compensation***

We recognized compensation expense based on the number of stock options and restricted stock awards expected to vest by using an estimate of expected forfeitures. The estimate of the expected forfeitures was initially determined based on historical turnover experience from the Covanta Energy pension plan. This initial estimate was subsequently adjusted during the year ended December 31, 2006, and again in the second quarter of 2007, as discussed below, to reflect a revised forfeiture rate. We recognize compensation costs using the graded vesting attribution method over the requisite service period of the award, which is generally a vesting term of three to five years. Prior to the second quarter of 2007, we recognized compensation expense based on an overall forfeiture rate of 8%. In order to better reflect compensation expense by type of award, i.e. options versus restricted stock, we reevaluated the forfeiture rate during the second quarter of 2007. The new forfeiture rates range from 8% to 15% depending on the type of award and the vesting period. The cumulative effect of the change in the forfeiture rate to compensation expense is immaterial.

***Recent Accounting Pronouncements***

See Note 2. Recent Accounting Pronouncements of the Notes for information related to new accounting pronouncements.

**ITEM 3. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

In the normal course of business, our subsidiaries are party to financial instruments that are subject to market risks arising from changes in interest rates, foreign currency exchange rates, and commodity prices. Our use of derivative instruments is very limited and we do not enter into derivative instruments for trading purposes.

Except as described below, management believes there have been no material changes during the six months ended June 30, 2007 to the items discussed in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2006.

***Interest Rate Swaps***

Covanta Energy was required, under financing arrangements in effect from June 24, 2005 to February 9, 2007, to enter into hedging arrangements with respect to a portion of its exposure to interest rate changes with respect to its borrowing under the Credit Facilities. On July 8, 2005, Covanta Energy entered into two separate pay fixed, receive floating interest rate swap agreements with a total notional amount of \$300 million. On March 21, 2006, we entered into one additional pay fixed, receive floating interest rate swap agreement with a notional amount of \$37.5 million. On December 27, 2006, the notional amount of the original interest rate swap agreements reduced to \$250 million from \$300 million. These interest rate swaps were designated as cash flow hedges in accordance with SFAS No. 133

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Accounting for Derivative Instruments and Hedging Activities . Accordingly, unrealized gains or losses were deferred in other comprehensive income until the hedged cash flows affect earnings. The impact of the swaps was to decrease interest expense for the three months and six months ended June 30, 2006 by \$0.5 million and \$0.7 million, respectively. In connection with the refinancing of Covanta Energy's debt facilities, the interest rate swap agreements described above were settled on February 9, 2007. We recognized a gain associated with the settlement of our interest rate swap agreements of \$3.4 million, pre-tax. The New Credit Facilities do not require us to enter into interest rate swap agreements. For additional information related to the New Credit Facilities, see Note 12. Changes in Capitalization of the Notes and *Liquidity and Capital Resources - 2007 Recapitalization Plan*.

### ***Contingent Interest***

On January 31, 2007, we completed an underwritten public offering of \$373.8 million aggregate principal amount of 1.00% Senior Convertible Debentures due 2027 (the Debentures ). The Debentures bear interest at a rate of 1.00% per year, payable semi-annually in arrears, on February 1 and August 1 of each year, commencing on August 1, 2007 and will mature on February 1, 2027. Beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures during any six-month interest period in which the trading price of the Debentures measured over a specified number of trading days is 120% or more of the principal amount of the Debentures. When applicable, the contingent interest payable per \$1,000 principal amount of Debentures will equal 0.25% of the average trading price of \$1,000 principal amount of Debentures during the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period. The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and as such, the fair market value for the embedded derivative was zero as of June 30, 2007. For additional information related to the New Credit Facilities, see Note 12. Changes in Capitalization of the Notes and *Liquidity and Capital Resources - 2007 Recapitalization Plan*.

## **ITEM 4. CONTROLS AND PROCEDURES**

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of Covanta's disclosure controls and procedures, as required by Rule 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934 (the Exchange Act ) as of June 30, 2007. Our disclosure controls and procedures are designed to reasonably assure that information required to be disclosed by us in reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure and is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, believes that our disclosure controls and procedures are effective to provide such reasonable assurance.

Our management, including the Chief Executive Officer and Chief Financial Officer, believes that any disclosure controls and procedures or internal controls and procedures, 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, we cannot provide absolute assurance that all control issues and instances of fraud, if any, within Covanta have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by unauthorized override of the control. The design of any systems of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the

inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and may not be detected.

**Table of Contents****Changes in Internal Control over Financial Reporting**

During the second quarter of 2006, we began implementation of a new operating system for the recording of information relating to our business. We completed this implementation during the second quarter of 2007. We initiated this effort as part of a routine system upgrade and as part of our integration efforts related to the ARC Holdings acquisition. We believe the new operating system will maintain and enhance our system of internal controls over financial reporting and our ability to record, process, summarize and report information required to be disclosed within the time periods specified in the Securities and Exchange Commission's rules and forms.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

See Note 16. Commitments and Contingencies of the Notes to the Condensed Consolidated Financial Statements.

**ITEM 1A. RISK FACTORS**

There have been no material changes during the six months ended June 30, 2007 to the risk factors discussed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006.

**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**

We held our Annual Meeting of Stockholders on May 30, 2007. At that meeting, stockholders voted on the following proposals:

1. To elect ten directors to serve a one-year term that will expire at the next Annual Meeting of Stockholders. The votes cast for each director were as follows:

<b>Directors</b>	<b>For</b>	<b>Withheld</b>
David M. Barse	115,897,692	2,673,983
Ronald J. Broglio	117,933,518	638,157
Peter C.B. Bynoe	117,971,459	600,216
Richard L. Huber	117,969,637	602,038
Anthony J. Orlando	116,726,258	1,845,417
William C. Pate	117,274,340	1,297,335
Robert S. Silberman	117,959,709	611,966
Jean Smith	117,929,479	642,196
Clayton Yeutter	97,941,674	20,630,001
Samuel Zell	115,620,759	2,950,916

2. To ratify the appointment of Ernst & Young LLP, the independent registered public accountants, as our independent auditors for the 2007 fiscal year.

<b>Votes For</b>	<b>Votes Against</b>	<b>Abstentions</b>
118,237,123	63,234	271,318
	53	

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**ITEM 5. *OTHER INFORMATION***

(a) None.

(b) Not applicable.

**ITEM 6. *EXHIBITS***

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 by the Chief Executive Officer.
31.2	Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 by the Chief Financial Officer.
32	Certification of periodic financial report pursuant to Section 906 of Sarbanes-Oxley Act of 2002 by the Chief Executive Officer and Chief Financial Officer.

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**SIGNATURES**

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

Covanta Holding Corporation  
(Registrant)

By: /s/ Mark A. Pytosh

Mark A. Pytosh  
Senior Vice President and Chief Financial Officer

By: /s/ Thomas E. Bucks

Thomas E. Bucks  
Vice President and Chief Accounting Officer

Date: July 25, 2007