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

þ	**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
o	**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	**95-6021257**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
40 Lane Road, Fairfield, NJ	**07004**
(Address of Principal Executive Office)	*(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 þ No o

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 þ Accelerated filer o Non-accelerated filer o

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

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

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

Other

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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.

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PART I. FINANCIAL INFORMATION

ITEM 1. *FINANCIAL STATEMENTS*

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
	(Unaudited) (In thousands, except per share amounts)			
OPERATING REVENUES:				
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
OPERATING EXPENSES:				
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
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		(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)

Equity in net income from unconsolidated investments	4,316	14,672	9,422	21,515
NET INCOME	$ 37,716	$ 51,178	$ 19,798	$ 62,596
Earnings Per Share:				
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.

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COVANTA HOLDING CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	As of	
	June 30, 2007 (Unaudited)	December 31, 2006
	(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		
Current:		
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
Total Current Liabilities	455,116	460,752
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

Total Liabilities	3,360,431	3,655,987
Commitments and Contingencies (Note 16)		
Minority Interests	43,580	42,681
Stockholders Equity:		
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)
Total Stockholders Equity	895,253	739,152
Total Liabilities and Stockholders Equity	$ 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)	
OPERATING ACTIVITIES:		
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
INVESTING ACTIVITIES:		
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)
FINANCING ACTIVITIES:		
Proceeds from the issuance of common stock, net	135,757	
Proceeds from rights offering, net		20,498

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.

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COVANTA HOLDING CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
For The Six Months Ended June 30, 2007

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Earnings	Treasury Stock Shares	Treasury Stock Amount	Total
			(Unaudited, In thousands)					
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 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

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

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.

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:

	Number of Shares	Weighted-Average Grant Date Fair Value
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:

Stock Option Award Grant Date	Risk-Free Interest Rate	Dividend Yield	Volatility Expected (A)	Expected Life
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.

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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:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (In years)	Aggregate Intrinsic Value (In thousands)
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.

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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).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	$ 37,716	$ 51,178	$ 19,798	$ 62,596
Basic earnings per share:				
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
Diluted earnings per share:				
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

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):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
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.

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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):

	Quezon			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
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):

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

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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):

	Waste and Energy Contracts	Landfill, Lease Interest and Other Contracts	Totals
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):

	As of June 30, 2007	As of December 31, 2006
Waste and service contracts	$ 129,992	$ 135,607

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

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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):

	Waste and Service Contracts
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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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.

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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):

	As of	
	June 30, 2007	**December 31, 2006**
Covanta		
1.00% Senior Convertible Debentures due 2027	$ 373,750	$
Covanta Energy Senior Secured Credit Facilities		
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
Covanta Energy Intermediate Subsidiary Debt		
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
Other Covanta Energy long-term debt	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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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):

	Annual Remaining Amortization
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.

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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 Banke