

COVANTA HOLDING CORP
Form 10-Q
July 29, 2008

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, 2008

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)

95-6021257

(I.R.S. Employer Identification Number)

40 Lane Road, Fairfield, NJ

(Address of Principal Executive Office)

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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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 22, 2008
Common Stock, \$0.10 par value	154,280,160 shares

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

**FORM 10-Q QUARTERLY REPORT
For the Quarter Ended June 30, 2008**

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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, 2007 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.

PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****COVANTA HOLDING CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
	(Unaudited)			
	(In thousands, except per share amounts)			
OPERATING REVENUES:				
Waste and service revenues	\$ 242,689	\$ 218,040	\$ 460,312	\$ 416,951
Electricity and steam sales	163,832	126,815	316,897	240,481
Other operating revenues	16,475	10,285	34,553	27,917
Total operating revenues	422,996	355,140	811,762	685,349
OPERATING EXPENSES:				
Plant operating expenses	238,608	199,561	497,619	401,568
Depreciation and amortization expense	51,590	48,436	100,164	96,479
Net interest expense on project debt	13,776	13,886	27,537	28,491
General and administrative expenses	23,135	20,029	47,289	42,221
Write-down of assets, net of insurance recoveries		(13,341)		4,925
Other operating expenses	19,358	9,357	31,859	26,173
Total operating expenses	346,467	277,928	704,468	599,857
Operating income	76,529	77,212	107,294	85,492
Other income (expense):				
Investment income	1,052	1,819	2,692	7,003
Interest expense	(11,563)	(14,718)	(25,283)	(35,978)
Loss on extinguishment of debt				(32,006)
Total other expenses	(10,511)	(12,899)	(22,591)	(60,981)
Income before income tax expense, minority interests and equity in net income from unconsolidated investments	66,018	64,313	84,703	24,511
Income tax expense	(26,260)	(28,822)	(33,796)	(10,646)
Minority interests	(2,225)	(2,091)	(4,094)	(3,489)
Equity in net income from unconsolidated investments	7,320	4,316	12,812	9,422

NET INCOME	\$ 44,853	\$ 37,716	\$ 59,625	\$ 19,798
Weighted Average Common Shares Outstanding:				
Basic	153,387	152,983	153,276	152,234
Diluted	154,848	154,307	154,710	153,603
Earnings Per Share:				
Basic	\$ 0.29	\$ 0.25	\$ 0.39	\$ 0.13
Diluted	\$ 0.29	\$ 0.24	\$ 0.39	\$ 0.13

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2008 (Unaudited)	As of December 31, 2007
ASSETS		
Current:		
Cash and cash equivalents	\$ 143,706	\$ 149,406
Marketable securities available for sale	300	2,495
Restricted funds held in trust	207,320	187,951
Receivables (less allowances of \$3,926 and \$4,353)	252,857	252,114
Unbilled service receivables	55,852	59,232
Deferred income taxes	59,904	29,873
Prepaid expenses and other current assets	112,411	113,927
Total Current Assets	832,350	794,998
Property, plant and equipment, net	2,595,105	2,620,507
Investments in fixed maturities at market (cost: \$21,640 and \$26,338)	21,384	26,260
Restricted funds held in trust	200,683	191,913
Unbilled service receivables	51,255	56,685
Waste, service and energy contracts, net	246,384	268,353
Other intangible assets, net	85,431	88,954
Goodwill	127,763	127,027
Investments in investees and joint ventures	96,281	81,248
Other assets	120,500	112,554
Total Assets	\$ 4,377,136	\$ 4,368,499
LIABILITIES AND STOCKHOLDERS EQUITY		
Current:		
Current portion of long-term debt	\$ 6,776	\$ 6,898
Current portion of project debt	191,885	195,625
Accounts payable	35,494	29,916
Deferred revenue	20,947	25,114
Accrued expenses and other current liabilities	208,254	234,000
Total Current Liabilities	463,356	491,553
Long-term debt	1,009,295	1,012,534
Project debt	1,016,801	1,084,650
Deferred income taxes	487,638	440,723
Waste and service contracts	121,118	130,464

Other liabilities	151,374	141,740
Total Liabilities	3,249,582	3,301,664
Commitments and Contingencies (Note 14)		
Minority Interests	39,269	40,773
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 154,788 and 154,281 shares; outstanding 154,280 and 153,922 shares)	15,479	15,428
Additional paid-in capital	769,814	765,287
Accumulated other comprehensive income	14,339	16,304
Accumulated earnings	288,704	229,079
Treasury stock, at par	(51)	(36)
Total Stockholders Equity	1,088,285	1,026,062
Total Liabilities and Stockholders Equity	\$ 4,377,136	\$ 4,368,499

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Six Months Ended June 30, 2008 2007 (Unaudited) (In thousands)	
OPERATING ACTIVITIES:		
Net income	\$ 59,625	\$ 19,798
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	100,164	96,479
Write-down of assets, net of insurance recoveries		4,925
Loss on extinguishment of debt		32,006
Amortization of long-term debt deferred financing costs	1,856	1,704
Amortization of debt premium and discount	(5,547)	(7,689)
Stock-based compensation expense	8,061	6,407
Equity in net income from unconsolidated investments	(12,812)	(9,422)
Dividends from unconsolidated investments	15,668	7,194
Minority interests	4,094	3,489
Deferred income taxes	16,363	(1,789)
Other, net	6,606	784
Change in restricted funds held in trust	(14,992)	3,049
Change in working capital, net of effects of acquisitions	(18,709)	(11,348)
Net cash provided by operating activities	160,377	145,587
INVESTING ACTIVITIES:		
Purchase of equity interest	(18,503)	(10,253)
Acquisition of businesses, net of cash acquired	(20,128)	(7,439)
Proceeds from the sale of investment securities	18,177	9,575
Purchase of investment securities	(11,106)	
Purchase of property, plant and equipment	(53,764)	(43,016)
Property insurance proceeds	6,315	7,341
Other, net	(1,146)	233
Net cash used in investing activities	(80,155)	(43,559)
FINANCING ACTIVITIES:		
Proceeds from the issuance of common stock, net		135,757
Proceeds from the exercise of options for common stock, net	221	111
Proceeds from borrowings on long-term debt		949,907
Financings of insurance premiums, net	(6,911)	
Proceeds from borrowings on project debt	4,102	3,389
Principal payments on long-term debt	(3,361)	(1,160,385)

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Principal payments on project debt	(65,164)	(65,489)
Payments of long-term debt deferred financing costs		(18,324)
Payments of tender premiums on debt extinguishment		(32,759)
Decrease in holding company restricted funds		6,660
(Increase) decrease in restricted funds held in trust	(11,174)	4,766
Distributions to minority partners	(3,746)	(4,578)
Net cash used in financing activities	(86,033)	(180,945)
Effect of exchange rate changes on cash and cash equivalents	111	337
Net decrease in cash and cash equivalents	(5,700)	(78,580)
Cash and cash equivalents at beginning of period	149,406	233,442
Cash and cash equivalents at end of period	\$ 143,706	\$ 154,862

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Organization and Basis of Presentation

The terms *we*, *our*, *ours*, *us* and *Company* refer to Covanta Holding Corporation and its subsidiaries; the term *Energy* refers to our subsidiary Covanta Energy Corporation and its subsidiaries.

Organization

We are a leading developer, owner and operator of infrastructure for the conversion of waste to energy (known as *energy-from-waste*), as well as other waste disposal and renewable energy production businesses in the Americas, Europe and Asia. We conduct all of our operations through subsidiaries which are engaged predominantly in the businesses of waste and energy services. We also engage in the independent power production business outside the Americas.

We own, have equity investments in, and/or operate 58 energy generation facilities, 48 of which are in the United States and 10 of which are located outside the United States. Our energy generation facilities use a variety of fuels, including municipal solid waste, wood waste (biomass), landfill gas, water (hydroelectric), natural gas, coal, 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, four landfills, and several waste transfer stations. We 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 United States generally accepted accounting principles (*GAAP*) and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for fair presentation have been included in our 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, 2008. This Form 10-Q should be read in conjunction with the Audited Consolidated Financial Statements and accompanying Notes in our Annual Report on Form 10-K for the year ended December 31, 2007 (*Form 10-K*).

We use the equity method to account for our investments for which we have the ability to exercise significant influence over the operating and financial policies of the investee. Consolidated net income includes our proportionate share of the net income or loss of these companies. Such amounts are classified as *equity in net income from unconsolidated investments* in our condensed consolidated financial statements. Investments in 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.

During the first quarter of 2008, we revised our presentation of the condensed consolidated statements of cash flows to present changes in restricted funds held in trust relating to operating activities as a component of cash flow from operating activities and changes in restricted funds held in trust relating to financing activities (debt principal

repayments) as a component of cash flow from financing activities; previously we included all changes in restricted funds held in trust as a component of cash flow from financing activities. For the six months ended June 30, 2007, we have reclassified the presentation of the changes in restricted funds held related to operating and financing activities, although not material, to conform to the presentation on the condensed consolidated statements of cash flows.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Recent Accounting Pronouncements

In May 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (FSP APB 14-1). The FSP requires the issuer of convertible debt instruments with cash settlement features to separately account for the liability and equity components of the instrument. The debt should be recognized at the present value of its cash flows discounted using the issuer's nonconvertible debt borrowing rate. The equity component should be recognized as the difference between the proceeds from the issuance of the note and the fair value of the liability, net of deferred taxes. FSP APB 14-1 also requires an accretion of the resultant debt discount over the expected life of the debt. FSP APB 14-1, effective for us on January 1, 2009 for our convertible debentures, requires retrospective application for all periods presented, and does not grandfather existing instruments. We estimate that the pre-tax increase in non-cash interest expense to be recognized on our condensed consolidated financial statements using a 7.25% discount rate, our nonconvertible debt borrowing rate at the date of the bond's issuance, would be as follows (in millions):

	2007	2008	2009	2010	2011	2012-2027	Total
Pre-tax increase in non-cash interest expense	\$ 5.2	\$ 6.1	\$ 6.5	\$ 7.0	\$ 7.6	\$ 213.9	\$ 246.3

In March 2008, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161), which is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand the effects on an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for us on January 1, 2009. Although we do not currently expect the adoption of SFAS 161 to result in additional financial reporting disclosures, we are continuing to assess the potential disclosure effects of SFAS 161.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish accounting and reporting for the noncontrolling (minority) interests in a subsidiary and the deconsolidation of a subsidiary. Moreover, SFAS 160 eliminates the diversity that currently exists in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. SFAS 160 is effective for us on January 1, 2009. Although we do not currently expect the adoption of SFAS 160 to have a material impact on our consolidated financial statements, we are continuing to assess the potential effects of SFAS 160.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141(R)). SFAS 141(R)'s objective is to improve reporting by creating greater consistency in the accounting and financial reporting of business combinations, resulting in more complete, comparable, and relevant information for investors and other users of financial statements. To achieve this goal, the new standard requires the acquiring entity in a business combination to recognize and measure all of the assets acquired and liabilities assumed in the transaction including any noncontrolling interest of the acquired entity; to recognize and measure any goodwill acquired or gain resulting from a bargain purchase; establishes the acquisition-date fair value as the measurement objective; and requires the acquirer to disclose to investors and other users of financial statements all of the information they need to

evaluate and understand the nature and financial effect of the business combination. SFAS 141(R) is effective for us on January 1, 2009. We are continuing to assess the potential effects of SFAS 141(R).

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 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value (fair value option). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that the effect of the first remeasurement to fair value will be reported as a cumulative-effect adjustment to the opening balance of retained earnings and unrealized

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. We adopted SFAS 159 on January 1, 2008, but did not elect to apply the fair value option to any of our eligible financial assets and liabilities.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements. SFAS 157 was effective for us on January 1, 2008. In February 2008, the FASB issued FASB Staff Position FAS 157-2, Effective Date of FASB Statement No. 157, which deferred the effective date of SFAS 157 for one year for all non-financial assets and non-financial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The partial adoption of SFAS 157 on January 1, 2008 had no impact on our financial position, results of operations, cash flows or earnings per share. Our investment securities that are traded on a national securities exchange are stated at the last reported sales price on the day of valuation; other securities in the over-the-counter market and listed securities for which no sale was reported on the date are stated at the last quoted bid price.

	As of June 30, 2008	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(In thousands)		
Marketable securities available for sale	\$ 300	\$ 300	\$	\$
Investments in fixed maturities at market	21,384	21,384		
Derivatives - Contingent interest feature of the Convertible Debentures (See Note 12)	0		0	
Total	\$ 21,684	\$ 21,684	\$ 0	\$

Note 3. Acquisitions and Business Development

Our growth strategy includes the acquisition of waste and energy related businesses located in markets with significant growth opportunities, as well as the development of new projects and expansion of existing projects. Acquisitions are accounted for under the purchase method of accounting. The results of operations reflect the period of ownership of the acquired businesses and business development projects. The acquisitions in the section below are

not material to our unaudited condensed consolidated financial statements individually or in the aggregate and therefore, disclosures of pro forma financial information have not been presented.

Domestic

Tulsa Energy-from-Waste Facility

On June 2, 2008, we acquired an energy-from-waste facility in Tulsa, Oklahoma from The CIT Group/Equipment Financing, Inc. for cash consideration of approximately \$12.7 million. The design capacity of the facility is 1,125 tons per day (tpd) of waste and gross electric capacity of 16.5 megawatts (MW). This facility was shut down by the prior owner in the summer of 2007 and we are planning to return two of the facility's three boilers to service before the end of 2008, and return its third boiler to service during 2009.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Peabody Landfill

On May 20, 2008, we acquired a landfill for the disposal of ash in Peabody, Massachusetts from Peabody Monofill Associates, Inc. and others for cash consideration of approximately \$7.4 million.

Harrisburg Energy-from-Waste Facility

In February 2008, we entered into a ten year agreement to maintain and operate an 800 tpd energy-from-waste facility located in Harrisburg, Pennsylvania. Under the agreement, we have a right of first refusal to purchase the facility. We also have agreed to provide construction management services and to advance up to \$25.5 million in funding for certain facility improvements required to enhance facility performance, the repayment of which is guaranteed by the City of Harrisburg. As of June 30, 2008, we have advanced \$1.0 million under this funding arrangement.

Massachusetts Energy-From-Waste Facilities and Transfer Stations

On October 1, 2007, we acquired the operating businesses of EnergyAnswers Corporation for cash consideration of approximately \$41 million. We also assumed net debt of \$21 million (\$23 million of consolidated indebtedness net of \$2 million of restricted funds held in trust). These businesses include a 400 tpd energy-from-waste facility in Springfield, Massachusetts and a 240 tpd energy-from-waste facility in Pittsfield, Massachusetts. Approximately 75% of waste revenues are contracted for at these facilities. We subsequently sold certain assets acquired in this transaction for a total consideration of \$5.8 million during the fourth quarter of 2007 and the first quarter of 2008. The purchase price allocation included \$9.8 million of goodwill.

Westchester Transfer Stations

On October 1, 2007, we acquired two waste transfer stations in Westchester County, New York from Regus Industries, LLC for cash consideration of approximately \$7.3 million.

Biomass Energy Facilities

On July 16, 2007, we acquired Central Valley Biomass Holdings, LLC (Central Valley) from The AES Corporation. Under the terms of the purchase agreement, we paid \$51 million in cash plus approximately \$5 million in cash related to post-closing adjustments and transaction costs. Central Valley owns two biomass energy facilities and a biomass energy fuel management business, which are all located in California. In addition, we invested approximately \$8 million prior to December 31, 2007 and \$9.7 million during the six months ended June 30, 2008 in capital improvements to significantly increase the facilities productivity and improve environmental performance. The purchase price allocation included \$23.6 million of goodwill.

Holliston Transfer Station

On April 30, 2007, we acquired a waste transfer station in Holliston, Massachusetts from Casella Waste Systems Inc. for cash consideration of approximately \$7.5 million.

Lee County Energy-from-Waste Facility

In December 2007, we completed the expansion and commenced the operation of the expanded energy-from-waste facility located in and owned by Lee County in Florida. We expanded waste processing capacity from 1,200 tpd to 1,836 tpd and increased gross electricity capacity from 36.9 MW to 57.3 MW. As part of the agreement to implement this expansion, we received a long-term operating contract extension expiring in 2024.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Hillsborough County Energy-from-Waste Facility

We designed, constructed, and now operate and maintain the 1,200 tpd mass-burn energy-from-waste facility located in and owned by Hillsborough County in Florida. Due to the growth in the amount of municipal solid waste generated in Hillsborough County, Hillsborough County informed us of its desire to expand the facility's waste processing and electricity generation capacities. In August 2005, we entered into agreements with Hillsborough County to implement this expansion, and to extend the agreement under which we operate the facility through 2027. Environmental and other project related permits have been secured and the expansion construction commenced on December 29, 2006. Completion of the expansion, and commencement of the operation of the expanded project, is expected in 2009.

International

China

On April 2, 2008, our project joint venture with Chongqing Iron & Steel Company (Group) Limited received an award to build, own, operate and transfer an 1,800 tpd energy-from-waste facility for Chengdu Municipality, in Sichuan Province, Peoples Republic of China. On June 25, 2008, the project's 25 year waste concession agreement was executed. In connection with this project, we invested \$17.1 million for a 49% equity interest in the project joint venture. The Chengdu project is expected to commence construction near the end of 2008, and commence operations in 2011.

In December 2007, we entered into a joint venture with Guangzhou Development Power Investment Co., Ltd. through which we intend to develop energy-from-waste projects in Guangdong Province, Peoples Republic of China. We hold a 40% equity interest in the joint venture entity, Guangzhou Development Covanta Environmental Energy Co., Ltd (GDC Environmental Energy), and on June 6, 2008, we invested \$1.5 million in the joint venture.

On April 25, 2007, we purchased a 40% equity interest in Chongqing Sanfeng Environmental Industry Co., Ltd. (Sanfeng), a company located in Chongqing Municipality, Peoples Republic of China. The company, which was renamed Sanfeng Covanta Environmental Industry Co., Ltd., owns minority equity interests in two 1,200 metric tpd 24 MW mass-burn energy-from-waste projects. We made an initial cash payment of approximately \$10 million in connection with our investment in Sanfeng.

Ireland

On September 6, 2007, we entered into definitive agreements to build, own, operate and transfer a 1,700 metric tpd energy-from-waste project serving the City of Dublin, Ireland and surrounding communities. The Dublin project is being developed and will be owned by Dublin Waste to Energy Limited, which is co-owned by us and DONG Energy Generation A/S. As part of the transaction, we purchased a controlling stake in Dublin Waste to Energy Limited. Project construction, which is expected to start in late 2008, is estimated to cost approximately 300 million euros and is expected to require 36 months to complete. Dublin Waste to Energy Limited has a 25-year tip fee type contract to provide disposal service for approximately 320,000 metric tons of waste annually. The project is expected to sell electricity into the local electricity grid under short-term arrangements. We, along with DONG Energy Generation A/S, have committed to provide financing for all phases of the project; however, we expect that numerous project financing structures will be available once the initial development phase is complete.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Earnings Per Share

Per share data is based on the weighted average outstanding number of our, par value \$0.10 per share, common stock during the relevant period. Basic earnings per share are calculated using 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, and rights whether or not currently exercisable. Diluted earnings per share for all the periods presented does 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,	
	2008	2007	2008	2007
Net income	\$ 44,853	\$ 37,716	\$ 59,625	\$ 19,798
Basic earnings per share:				
Weighted average basic common shares outstanding	153,387	152,983	153,276	152,234
Basic earnings per share	\$ 0.29	\$ 0.25	\$ 0.39	\$ 0.13
Diluted earnings per share:				
Weighted average basic common shares outstanding	153,387	152,983	153,276	152,234
Stock options	745	651	682	636
Restricted stock	716	673	752	733
Convertible debentures				
Weighted average diluted common shares outstanding	154,848	154,307	154,710	153,603
Diluted earnings per share	\$ 0.29	\$ 0.24	\$ 0.39	\$ 0.13
Stock options excluded from the weighted average dilutive common shares outstanding because their inclusion would have been antidilutive	300	1,785	300	1,785
Restricted stock awards excluded from the weighted average dilutive common shares outstanding because their inclusion would have been antidilutive				

On January 31, 2007, we issued 1.00% Senior Convertible Debentures due 2027 (the "Debentures"). The Debentures are convertible under certain circumstances if the closing sale price of our common stock exceeds a specified conversion price before February 1, 2025. As of June 30, 2008, the Debentures did not have a dilutive effect on earnings per share.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Financial Information by Business Segments

We have two reportable segments, Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively. The results of our reportable segments are as follows (in thousands):

	Reportable Segments		All Other(1)	Total
	Domestic	International		
Three Months Ended June 30, 2008:				
Operating revenues	\$ 350,729	\$ 69,152	\$ 3,115	\$ 422,996
Operating income (loss)	73,553	3,506	(530)	76,529
Three Months Ended June 30, 2007:				
Operating revenues	\$ 300,604	\$ 52,008	\$ 2,528	\$ 355,140
Operating income (loss)	73,080	4,820	(688)	77,212
Six Months Ended June 30, 2008:				
Operating revenues	\$ 674,013	\$ 131,931	\$ 5,818	\$ 811,762
Operating income (loss)	98,907	9,344	(957)	107,294
Six Months Ended June 30, 2007:				
Operating revenues	\$ 588,359	\$ 91,809	\$ 5,181	\$ 685,349
Operating income (loss)	78,315	8,323	(1,146)	85,492

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

Note 6. Changes in Capitalization***Long-Term Debt***

Long-term debt is as follows (in thousands):

	June 30, 2008	As of December 31, 2007
1.00% Senior Convertible Debentures due 2027	\$ 373,750	\$ 373,750
Term loan due 2014	641,875	645,125
Other long-term debt	446	557
Total	1,016,071	1,019,432
Less: current portion	(6,776)	(6,898)

Total long-term debt			\$ 1,009,295	\$ 1,012,534
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Short-Term Liquidity

As of June 30, 2008, we had available credit for liquidity as follows (in thousands):

	Total Available Under Facility	Maturing	Outstanding Letters of Credit as of June 30, 2008	Available as of June 30, 2008
Revolving Loan Facility(1)	\$ 300,000	2013	\$	\$ 300,000
Funded L/C Facility	\$ 320,000	2014	\$ 312,007	\$ 7,993

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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2007 Recapitalization

During the first quarter of 2007, we completed a comprehensive recapitalization utilizing a series of equity and debt financings including the following transactions:

the refinancing of our previously existing credit facilities with new credit facilities, comprised of a \$300 million revolving credit facility (the Revolving Loan Facility), a \$320 million funded letter of credit facility (the Funded L/C Facility), and a \$650 million term loan (the Term Loan Facility) (collectively referred to as the Credit Facilities);

an underwritten public offering of 6.118 million shares of our common stock, from 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, 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 and redemptions, of approximately \$611.9 million in aggregate principal amount of outstanding notes previously issued by certain of our intermediate subsidiaries. We completed our tender offer and redemptions for approximately \$604.4 million in aggregate principal amount of outstanding notes on February 22, 2007. The remaining \$7.5 million of the outstanding notes were redeemed in April 2007 and September 2007.

As a result of the recapitalization, we recognized a loss on extinguishment of debt of approximately \$32.0 million, pre-tax, which was 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.

Credit Facilities

The loan documentation under the Credit Facilities contains customary affirmative and negative covenants and financial covenants. We were in compliance with all required covenants as of June 30, 2008.

Stockholders Equity

During the six months ended June 30, 2008, we granted 491,336 restricted stock awards and 250,000 options to purchase our common stock. See Note 11. Stock-Based Compensation.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Comprehensive Income

The components of comprehensive income are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Comprehensive income, net of income taxes:				
Net income	\$ 44,853	\$ 37,716	\$ 59,625	\$ 19,798
Foreign currency translation	(2,281)	2,199	(1,254)	2,633
SFAS 158 unrecognized net loss	(170)	53	(339)	53
Net unrealized (gain) loss on available-for-sale securities	(302)	20	(372)	237
Net realized gain on derivative instruments				(2,125)
Net comprehensive (loss) income adjustments	(2,753)	2,272	(1,965)	798
Comprehensive income	\$ 42,100	\$ 39,988	\$ 57,660	\$ 20,596

Note 8. 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 file a federal consolidated income tax return with our eligible subsidiaries. Our subsidiary, 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 currently estimate our annual effective tax rate, including discrete items, for the year ended December 31, 2008 to be approximately 39.9%. We review the annual effective tax rate on a quarterly basis as projections are revised. The effective income tax rate was 39.9% and 43.4% for the six months ended June 30, 2008 and 2007, respectively. The liability for uncertain tax positions, exclusive of interest and penalties, was \$26.7 million and \$25.4 million as of June 30, 2008 and December 31, 2007, respectively. No material additional liabilities were recorded for uncertain tax positions during the six months ended June 30, 2008. Included in the balance of unrecognized tax benefits as of June 30, 2008 are potential benefits of \$3.4 million that, if recognized, would impact the effective tax rate.

We continue to reflect interest accrued on uncertain tax positions and penalties as part of the tax provision under FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, (FIN 48). For the three months ended June 30, 2008 and 2007, we recognized \$0.4 million and \$0.3 million, respectively and for the six months ended June 30, 2008 and 2007, we recognized \$0.7 million and \$0.5 million, respectively of interest and penalties on uncertain tax positions. As of June 30, 2008 and December 31, 2007, we had accrued interest and penalties associated with unrecognized tax benefits of \$8.3 million and \$7.6 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. Federal income tax returns for our subsidiary Covanta Energy are closed for the years through 2002. However, to the extent net operating loss carryforwards (NOLs) are utilized from earlier years, this will allow the IRS to re-examine closed years. The tax returns of our subsidiary Covanta ARC Holdings, Inc. and its subsidiaries (ARC Holdings) 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. 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

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Our NOLs predominantly arose from our predecessor insurance entities (which were subsidiaries of our predecessor, which was 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.

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 existing arrangements with the California Commissioner of Insurance nor the final administration by the Missouri Director of Insurance will result in a material reduction in available NOLs. In connection with the continued administration of the trust estates and implementation of arrangements with us, the California Commissioner has received court approvals, and may receive additional approvals during 2008, that may result in additional tax deduction or NOLs, which may be material, becoming available to us.

We had consolidated federal NOLs estimated to be approximately \$275 million for federal income tax purposes as of December 31, 2007. The NOLs will expire in various amounts from December 31, 2009 through December 31, 2026, if not used. In addition to the consolidated federal NOLs, as of December 31, 2007, we had additional federal credit carryforwards of \$23.1 million, federal loss carryforwards of \$85.0 million and state NOL carryforwards of \$232.4 million, all of which will expire between 2008 and 2026. These deferred tax assets are offset by a valuation allowance of \$33.2 million.

For further information, refer to Note 9. Income Taxes of the Notes to the Consolidated Financial Statements included in our Form 10-K.

Note 9. Supplementary Information

Operating Revenues

The components of waste and service revenues are as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Waste and service revenues unrelated to project debt	\$ 218,965	\$ 193,186	\$ 412,829	\$ 366,572
Revenue earned explicitly to service project debt-principal	17,167	17,290	34,364	34,580
Revenue earned explicitly to service project debt-interest	6,557	7,564	13,119	15,799

Total waste and service revenues	\$ 242,689	\$ 218,040	\$ 460,312	\$ 416,951
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Under some of our service agreements, we bill municipalities fees to service project debt (principal and interest). The amounts billed are based on the actual principal amortization schedule for the project bonds. Regardless of the amounts billed to client communities relating to project debt principal, we recognize revenue earned explicitly to service project debt principal on a levelized basis over the term of the applicable agreement. In the beginning of the agreement, principal billed is less than the amount of levelized revenue recognized related to principal and we record an unbilled service receivable asset. At some point during the agreement, the amount we bill will exceed the levelized revenue and the unbilled service receivable begins to reduce, and ultimately becomes nil at the end of the contract.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In the final year(s) of a contract, cash is utilized from debt service reserve accounts to pay remaining principal amounts due to project bondholders and such amounts are no longer billed to or paid by municipalities. Generally, therefore, in the last year of the applicable agreement, little or no cash is received from municipalities relating to project debt, while our levelized service revenue continues to be recognized until the expiration date of the term of the agreement.

Our independent power production facilities in India generate electricity and steam explicitly for specific purchasers and as such, these agreements are considered lease arrangements. Electricity and steam sales included lease income from our international business of \$59.0 million and \$42.2 million for the three months ended June 30, 2008 and 2007, respectively, and \$113.1 million and \$72.4 million for the six months ended June 30, 2008 and 2007, respectively.

Operating Costs*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 were \$15.3 million and \$13.3 million for the three months ended June 30, 2008 and 2007, respectively, and \$31.7 million and \$29.1 million for the six months ended June 30, 2008 and 2007, respectively.

Amortization of waste, service and energy contracts

The vast majority of our waste, service and energy contracts were valued in March 2004 and June 2005 related to the acquisitions of Covanta Energy and ARC Holdings, respectively. These intangible assets and liabilities were recorded using then-available information at their estimated fair market values based upon discounted cash flows. The following table details the amount of the actual/estimated amortization expense and contra-expense associated with these intangible assets and liabilities as of June 30, 2008 included or expected to be included in our statement of income for each of the years indicated (in thousands):

	Waste, Service and Energy Contracts (Amortization Expense)	Waste and Service Contracts (Contra-Expense)
Six Months ended June 30, 2008	\$ 22,730	\$ (6,476)
Remainder of 2008	\$ 23,023	\$ (6,561)
2009	42,302	(13,178)
2010	29,864	(12,721)
2011	26,740	(12,408)
2012	24,647	(12,413)

Thereafter		99,808		(63,837)
Total	\$	246,384	\$	(121,118)

SEMASS Fire

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 preliminary estimate of the net book value of the damaged assets. During the year ended December 31, 2007, we reduced the impairment recorded by \$1.0 million, pre-tax, based upon additional analysis as the facility was being restored.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The cost of repair or replacement, and business interruption losses, are insured under the terms of applicable insurance policies, subject to deductibles. We recorded \$5.2 million in the second quarter of 2008 upon receipt of cash proceeds of \$7.2 million in settlement of our business interruption claim. 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 plant operating expenses where such recoveries relate to other costs or business interruption losses. We recorded insurance recoveries as follows (in millions):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Repair and reconstruction (reduction to Write-down of assets)	\$	\$ 13.3	\$	\$ 13.3
Clean-up costs (reduction to Plant operating expenses)	\$	\$ 2.7	\$	\$ 2.7
Business interruption losses (reduction to Plant operating expenses)	\$ 5.2	\$	\$ 5.2	\$

During the second half of 2007, we recorded additional insurance recoveries of \$4.0 million related to repair and reconstruction and \$2.0 million related to business interruption losses.

Other operating expenses

The components of other operating expenses are as follows (in thousands):

	Other Operating Expenses			
	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Construction costs	\$ 12,110	\$ 7,685	\$ 25,267	\$ 21,831
Insurance subsidiary operating expenses	3,417	2,429	5,788	4,640
Insurance recoveries	(21)	(78)	(3,769)	(78)
Foreign exchange loss (gain)	493	(858)	(4)	(1,073)
Other	3,359	179	4,577	853
Total other operating expenses	\$ 19,358	\$ 9,357	\$ 31,859	\$ 26,173

Note 10. Benefit Obligations*Pension and Other Benefit Obligations*

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

	Pension Benefits				Other Post-Retirement Benefits			
	For the Three Months Ended June 30,		For the Six Months Ended June 30,		For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007	2008	2007	2008	2007
Service cost	\$	\$	\$	\$	\$	\$	\$	\$
Interest cost	1,176	1,145	2,352	2,291	137	192	274	384
Expected return on plan assets	(1,182)	(1,107)	(2,364)	(2,215)				
Amortization of actuarial (gain) loss	(131)		(262)		(39)	27	(77)	53
Net periodic benefit cost	\$ (137)	\$ 38	\$ (274)	\$ 76	\$ 98	\$ 219	\$ 197	\$ 437

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Defined Contribution Plans

Substantially all of our domestic employees are eligible to participate in defined contribution plans we sponsor. Our costs related to defined contribution plans were \$2.7 million and \$2.5 million for the three months ended June 30, 2008 and 2007, respectively and \$6.9 million and \$6.5 million for the six months ended June 30, 2008 and 2007, respectively.

Note 11. Stock-Based Compensation

Compensation expense related to our stock-based payment awards totaled \$4.4 million and \$8.1 million during the three and six months ended June 30, 2008, respectively, and \$4.4 million and \$6.4 million during the three and six months ended June 30, 2007, respectively.

During the six months ended June 30, 2008, we awarded certain employees 450,836 shares of restricted stock awards. The restricted stock awards will be expensed over the requisite service period, subject to an assumed ten percent forfeiture rate. The terms of the restricted stock awards include two vesting provisions; one based on a performance factor and continued service (applicable to 66% of the award) and one based solely on continued service (applicable to 34% of the award). If all performance and service criteria are satisfied, the awards vest during March of 2009, 2010 and 2011.

On May 1, 2008, in accordance with our existing program for annual director compensation, we awarded 40,500 restricted stock awards under the Directors Plan. We determined that the service vesting condition of the restricted stock awards granted to the directors on May 1, 2008 to be non-substantive and, in accordance with SFAS No. 123 (revised 2004), *Share-Based Payments*, recorded the entire fair value of the award as compensation expense on the grant date.

On February 21, 2008 and March 31, 2008, we granted options to purchase an aggregate of 200,000 shares and 50,000 shares, respectively, of common stock. The options expire 10 years from the date of grant and vest in equal installments over five years commencing on March 17, 2009. The stock option fair values were estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

Grant Date	Exercise Price	Risk-Free Interest Rate	Dividend Yield	Volatility Expected	Expected Life
February 21, 2008	\$ 26.26	3.387%	0%	28%	6.54 years
March 31, 2008	\$ 27.50	2.977%	0%	31%	6.48 years

As of June 30, 2008, we had approximately \$14.9 million and \$8.8 million of unrecognized compensation expense related to our unvested restricted stock awards and unvested stock options, respectively. We expect this compensation expense to be recognized over a weighted average period of 2.0 years for our unvested restricted stock awards and 3.9 years for our unvested stock options.

Note 12. Financial Instruments

Interest Rate Swaps

Under financing arrangements in effect from June 24, 2005 to February 9, 2007, we were required to enter into hedging arrangements with respect to a portion of our exposure to interest rate changes with respect to our borrowing under the credit facilities which were in effect. 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. In connection with the refinancing of our debt facilities in January 2007, the interest rate swap agreements described above were settled on February 9, 2007 for a pre-tax gain of \$3.4 million and we were no longer required to enter into interest rate swap agreements.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contingent Interest

On January 31, 2007, we completed an underwritten public offering of \$373.8 million aggregate principal amount of Senior Convertible 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 the fair market value for the embedded derivative was zero as of June 30, 2008.

Note 13. Related-Party Transactions

We are party to an agreement with Quezon Power, Inc. (Quezon), in which we hold a 26% equity investment, where we assumed responsibility for the operation and maintenance of Quezon 's coal-fired electricity generation facility. Accordingly, 26% of the net income of Quezon is reflected in our statement of income and as such, 26% of the revenue earned under the terms of the operation and maintenance agreement is eliminated against Equity in Net Income from Unconsolidated Investments. For the three months ended June 30, 2008 and 2007, we collected \$11.2 million and \$10.7 million, respectively, and for the six months ended June 30, 2008 and 2007, we collected \$20.2 million and \$18.0 million, respectively, for the operation and maintenance of the facility. As of June 30, 2008 and December 31, 2007, the net amount due to Quezon was \$5.4 million and \$1.1 million, respectively, which represents advance payments received from Quezon for operation and maintenance costs.

Note 14. 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

Our operations are subject to environmental regulatory laws and environmental remediation laws. Although our 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 we are in substantial compliance with existing environmental laws and regulations.

We 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, we may be exposed to joint and several liabilities for remedial action

or damages. Our ultimate liability in connection with such environmental claims will depend on many factors, including our 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.

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 our responsibility. Although the ultimate outcome and expense of any litigation, including environmental remediation, is uncertain, we believe 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 is undertaking a Remedial Investigation/Feasibility Study (Study) of the LPRSA under EPA oversight. The cost to complete the Study is estimated at \$37 million, in addition to EPA oversight costs. Essex's share of the Study costs to date are not material to its financial position and results of operations; however, the Study costs are exclusive of any costs that may be required of PRPs to remediate the LPRSA or costs associated with natural resource damages to the LPRSA that may be assessed against PRPs. 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 LPRSA remedial costs and/or natural resource damages.

COVANTA HOLDING CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Concluded)

Other Matters

Other commitments as of June 30, 2008 were as follows (in thousands):

	Commitments Expiring by Period		
	Total	Less Than One Year	More Than One Year
Letters of credit	\$ 320,431	\$ 60,289	\$ 260,142
Surety bonds	61,981		61,981
Total other commitments net	\$ 382,412	\$ 60,289	\$ 322,123

The letters of credit were issued under various credit facilities (primarily the Funded L/C Facility and the Revolving Credit Facility) 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.

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 by the beneficiary, the amount drawn would be immediately repayable by us to the issuing bank. If we do not immediately repay such amounts drawn under these letters of credit, unreimbursed amounts would be treated under the Credit Facilities as additional term loans in the case of letters of credit issued under the Funded L/C Facility, or as revolving loans in the case of letters of credit issued under the Revolving Loan Facility.

The surety bonds listed on the table above relate primarily to performance obligations (\$53.0 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, we 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.

For specific criteria related to contingent interest, conversion or redemption features of the Debentures, refer to Note 6 of the Notes to Consolidated Financial Statements in our Form 10-K.

We have issued or are party to performance guarantees and related contractual support obligations undertaken pursuant to agreements to construct and operate domestic and international waste and energy facilities. For some projects, such performance guarantees include obligations to repay certain financial obligations if the project revenues are insufficient to do so, or to obtain financing for a project. With respect to our domestic and international businesses, we have issued guarantees to municipal clients and other parties that our subsidiaries will perform in accordance with contractual terms, including, where required, the payment of damages or other obligations. Additionally, damages payable under such guarantees on our energy-from-waste facilities could expose us to recourse liability on project debt. If we must perform under one or more of such guarantees, our 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 and is presently not estimable. 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 our then-available sources of funds. To date, we have not incurred material liabilities under such guarantees, either on domestic or international projects.

Note 15. Subsequent Event

On July 25, 2008, we entered into a new tip fee type contract with the City of Indianapolis for a term of 10 years commencing upon expiration of the existing service fee type contract in December 2008.

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 following discussion addresses our financial condition as of June 30, 2008 and our results of operations for the three and six months ended June 30, 2008, 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, 2007 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, 2007 and in the interim unaudited financial statements and notes included in our Quarterly Reports on Form 10-Q for the periods ended March 31, 2008, 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 a leading developer, owner and operator of infrastructure for the conversion of waste to energy (known as energy-from-waste), as well as other waste disposal and renewable energy production businesses in the Americas, Europe and Asia. We are organized as a holding company and conduct all of our operations throu