

COVANTA HOLDING CORP

Form 10-K

February 26, 2008

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

Form 10-K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007**
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to**

Commission file number: 1-06732
COVANTA HOLDING CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|--|--|
| Delaware <i>(State or Other Jurisdiction of Incorporation or Organization)</i> | 95-6021257 <i>(I.R.S. Employee Identification No.)</i> |
| 40 Lane Road, Fairfield, N.J. <i>(Address of Principal Executive Offices)</i> | 07004 <i>(Zip Code)</i> |

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|--|--|
| Common Stock, \$0.10 par value per share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: N/A

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

As of June 29, 2007, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$2,962,710,442. The aggregate market value was computed by using the closing price of the common stock as of that date on the New York Stock Exchange. (For purposes of calculating this amount only, all directors and executive officers of the registrant have been treated as affiliates.)

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

| Class | February 14, 2008 |
|--|--------------------|
| Common Stock, \$0.10 par value per share | 153,921,882 shares |

Documents Incorporated By Reference:

Part of Form 10-K of Covanta Holding Corporation

Documents Incorporated by Reference

Part III

Portions of the Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Annual Report on Form 10-K 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 its businesses described in Item 1A. Risk Factors of this 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 Annual Report on Form 10-K 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.

AVAILABILITY OF INFORMATION

You may read and copy any materials Covanta files with the SEC at the SEC s Public Reference Room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. Copies of such materials also can be obtained at the SEC s website, www.sec.gov or by mail from the Public Reference Room of the SEC, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Covanta s SEC filings are also available to the public, free of charge, on its corporate website, www.covantaholding.com as soon as reasonably practicable after Covanta electronically files such material with, or furnishes it to, the SEC. Covanta s common stock is traded on the New York Stock Exchange. Material filed by Covanta can be inspected at the offices of the New York Stock Exchange at 20 Broad Street, New York, N.Y. 10005.

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PART I

Item 1. BUSINESS

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

About Covanta Holding Corporation

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 United States, Europe and Asia. We are organized as a holding company which was incorporated in Delaware on April 16, 1992. 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 United States.

We own, have equity investments in, and/or operate 57 energy generation facilities, 47 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, three landfills, and several waste transfer stations.

Revenues were \$1,433 million, \$1,269 million and \$979 million and operating income was \$237 million, \$227 million and \$146 million for the years ended December 31, 2007, 2006 and 2005, respectively. The increase in revenues and operating income over the past three years is primarily attributable to the successful execution of our operating and growth strategies described below and in *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview, Acquisitions and Business Development*.

Our Business Strategy

Our mission is to be the world's leading energy-from-waste company, with a complementary network of other renewable energy generation and waste disposal assets. We expect to build value for our stockholders by satisfying our clients' waste disposal and energy generation needs with safe, reliable and environmentally superior solutions. In order to accomplish this mission and create additional value for our stockholders, we are focused on:

- providing customers with superior service and effectively managing our existing businesses;
- generating sufficient cash to meet our liquidity needs and invest in the business; and
- developing new projects and making acquisitions to grow our business in the United States, Europe and Asia.

Our business is capital intensive because it is based on building and operating municipal solid waste processing and energy generating facilities. In order to provide meaningful growth through development, we must be able to invest our funds, obtain equity and/or debt financing, and provide support to our operating subsidiaries. During the first quarter of 2007, we completed a comprehensive recapitalization utilizing a series of equity and debt financings. With this refinancing, we now have greater flexibility to pursue strategic opportunities by investing in our business and making acquisitions. Additional information related to our recapitalization is described in *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - 2007 Recapitalization* and Note 6. Long-Term Debt of the Notes to the Consolidated Financial Statements (Notes).

Our senior management team has extensive experience in developing, constructing, operating, acquiring and integrating waste and energy services businesses. We intend to continue to focus our efforts on pursuing development

and acquisition-based growth. We anticipate that a part of our future growth will come from acquiring or investing in additional energy-from-waste, waste disposal and renewable energy production businesses in the United States, Europe and Asia.

Our domestic project development efforts include working with our client communities to expand existing energy-from-waste project capacities, new energy-from-waste and other renewable energy projects, contract

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extensions, and businesses ancillary to our existing businesses, such as additional waste transfer, transportation, processing and landfill businesses.

We are pursuing international waste and/or energy business opportunities, particularly in markets where the market demand, regulatory environment or other factors encourage technologies such as energy-from-waste in order to reduce dependence on landfilling. In particular, we are focusing on the United Kingdom, Ireland and China, as well as Italy, Canada and certain other countries.

During 2007, we expanded our network of waste and energy services businesses through acquisitions, equity investments and additional operating and development contracts. In our domestic business, we added three energy-from-waste facilities, one ash landfill, five transfer stations and two biomass projects. In addition, we completed the expansion of the energy-from-waste facility located in and owned by Lee County, Florida, and continued to make progress on the expansion of the Hillsborough County, Florida energy-from-waste facility. In our international business, we announced that we have entered into definitive agreements for the development of a 1,700 metric ton per day (tpd) energy-from-waste project serving the City of Dublin, Ireland and surrounding communities. We also purchased an equity interest in one company and agreed to acquire an equity interest in another company both of which are located in China and will be used to develop energy-from-waste projects in China, and one of which has equity interests in two existing energy-from-waste facilities. Additional information related to our acquisitions and business development during 2007 is described in *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview Acquisitions and Business Development*.

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

Business Segments

Prior to January 1, 2007, we had two reportable business segments – Waste and Energy Services and Other Services. Given our increased focus on developing our international 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, did not meet the quantitative thresholds which required separate disclosure as a reportable segment. Therefore, our reportable segments are now Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

The financial results of the holding company primarily consist of interest expense and income. General and administrative expenses related to officer salaries, legal and other professional fees and insurance are reimbursed by the operating subsidiaries.

Our predominant business is the waste and energy services business, however our historical consolidated operations were conducted in the insurance industry prior to the acquisition of Covanta Energy in March 2004. Our insurance business continues to represent an important element of our structure in that our net operating loss carryforwards (NOLs) were primarily generated through the operations of these former subsidiaries. See Note 9. Income Taxes of

the Notes for more information about our NOLs.

Additional information about our business segments is contained in *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview Business Segments* and in Note 5. Financial Information by Business Segments of the Notes.

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DOMESTIC BUSINESS

Energy-From-Waste Projects

Energy-from-waste projects have two essential purposes: to provide waste disposal services, typically to municipal clients who sponsor the projects, and to use that waste as a fuel source to generate renewable energy. The electricity or steam generated is generally sold to local utilities or industrial customers, and most of the resulting revenues reduce the overall cost of waste disposal services to the municipal clients. These projects are capable of providing waste disposal services and generating electricity or steam, if properly operated and maintained, for several decades. Generally, we provide these waste disposal services and sell the electricity and steam generated under long-term contracts, which expire on various dates between 2008 and 2034. Many of our service contracts may be renewed for varying periods of time, at the option of the municipal client.

We receive revenue in the form of fees pursuant to the service or waste contracts, and in some cases, energy purchase agreements, at facilities we own or operate. We market waste disposal services to third parties predominantly to efficiently utilize that portion of the waste disposal capacity of our energy-from-waste projects which is not dedicated to municipal clients.

We currently operate energy-from-waste projects in 15 states. Most of our energy-from-waste projects were developed and structured contractually as part of competitive procurement processes conducted by municipal entities. As a result, many of these projects have common features. However, each service agreement is different reflecting the specific needs and concerns of a client community, applicable regulatory requirements and other factors. The following describes features generally common to these agreements, as well as important distinctions among them:

We design the facility, help to arrange for financing and then we either construct and equip the facility on a fixed price and schedule basis, or we undertake an alternative role, such as construction management, if that better meets the goals of our municipal client.

For the domestic energy-from-waste projects we own, financing is generally accomplished through tax-exempt and taxable revenue bonds issued by or on behalf of the client community. For these facilities, the bond issuer loans the bond proceeds to us to pay for facility construction and to fund a debt service reserve for the project, which is generally sufficient to pay principal and interest for one year. Project-related debt is included as project debt and the debt service reserves are included as restricted funds held in trust in our consolidated financial statements. Generally, project debt is secured by the revenues pledged under the respective indentures and is collateralized by the facility and the contracts and other assets of our project subsidiary.

Following construction and during operations, we receive revenue from two primary sources: fees we receive for operating projects or for processing waste received, and payments we receive for electricity and/or steam we sell. We have 24 energy-from-waste projects at which we receive a fixed fee (which escalates over time pursuant to contractual indices) which we refer to as having a Service Fee structure. We also have 10 energy-from-waste projects at which we receive a per-ton fee under contracts for processing waste, which we refer to as having a Tip Fee structure. At our Tip Fee projects, we contract on both a long-term and short-term basis to utilize project disposal capacity, and as such we have a greater exposure to waste market price fluctuation, as well as a greater exposure to project operating disruptions that may cause us to reduce waste acceptance.

At projects we own where a Service Fee structure exists, a portion of the revenue we receive represents payments by the client community of debt service on project debt, which we pass along to a bond trustee for payment to bondholders of principal and interest when due. These payments will continue until cash in project debt service reserves is sufficient to pay all remaining debt service payments. Generally, this occurs in the final

year of the service contracts, and during that year we will receive little or no payments representing project debt principal, and as a result we record little or no cash provided by operating activities during that period with respect to the debt for such projects.

We generally sell the energy output from our projects to local utilities pursuant to long-term contracts. Where a Service Fee structure exists, our client community usually retains most (generally 90%) of the energy revenues generated and pays the balance to us. Where Tip Fee structures exist, we retain 100% of the

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energy revenues. At three of our projects, we sell energy output under short-term contracts or on a spot-basis into the regional electricity grid. At our Tip Fee projects, we generally have a greater exposure to energy market price fluctuation, as well as a greater exposure to variability in project operating performance.

We agree to operate the facility and meet minimum waste processing capacity and efficiency standards, energy production levels and environmental standards. Failure to meet these requirements or satisfy the other material terms of our agreement (unless the failure is caused by our client community or by events beyond our control), may result in damages charged to us or, if the breach is substantial, continuing and unremedied, termination of the applicable agreement. These damages could include amounts sufficient to repay project debt (as reduced by amounts held in trust and/or proceeds from sales of facilities securing project debt) and as such, these contingent obligations cannot readily be quantified. We have issued performance guarantees to our client communities and, in some cases other parties, which guarantee that our project subsidiaries will perform in accordance with contractual terms including, where required, the payment of such damages. In circumstances where one or more contracts have been terminated for our default, these contractual damages may be material to our cash flow and financial condition. To date, we have not incurred material liabilities under such performance guarantees.

The client community generally must deliver minimum quantities of municipal solid waste to the facility on a put-or-pay basis and is obligated to pay a fee for its disposal. A put-or-pay commitment means that the client community promises to deliver a stated quantity of waste and pay an agreed amount for its disposal, regardless of whether the full amount of waste is actually delivered. Where a Service Fee structure exists, portions of the service fee escalate to reflect indices for inflation, and in many cases, the client community must also pay for other costs, such as insurance, taxes, and transportation and disposal of the ash residue to the disposal site. Generally, expenses resulting from the delivery of unacceptable and hazardous waste on the site are also borne by the client community. In addition, the contracts generally require the client community to pay increased expenses and capital costs resulting from unforeseen circumstances, subject to specified limits. At three publicly-owned facilities we operate, our client community may terminate the operating contract under limited circumstances but without cause.

Our service and waste disposal agreements, as well as our energy contracts, expire at various times. The extent to which any such expiration will affect us will depend upon a variety of factors, including whether we own the project, market conditions then prevailing, and whether the municipal client exercises options it may have to extend the contract term. As our contracts expire, we will become subject to greater market risk in maintaining and enhancing our revenues. As service agreements at municipally-owned facilities expire, we intend to seek to enter into renewal or replacement contracts to operate such facilities. We will also seek to bid competitively in the market for additional contracts to operate other facilities as similar contracts of other vendors expire. As our service and waste disposal agreements at facilities we own or lease begin to expire, we intend to seek replacement or additional contracts, and because project debt on these facilities will be paid off at such time, we expect to be able to offer rates that will attract sufficient quantities of waste while providing acceptable revenues to us. At facilities we own, the expiration of existing energy contracts will require us to sell our output either into the local electricity grid at prevailing rates or pursuant to new contracts. See discussion under *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview Contract Duration* for additional information concerning the expiration of existing contracts.

To date, we have been successful in extending our existing contracts to operate energy-from-waste facilities owned by municipal clients where market conditions and other factors make it attractive for both us and our municipal clients to do so. See discussion under *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview Acquisitions and Business Development* for additional information concerning development projects. The extent to which additional extensions will be attractive to us and to our municipal clients who own their projects will depend upon the market and other factors noted above. However, we do not believe that either our success or lack of success in entering into additional negotiated extensions to operate such facilities will have a

material impact on our cash flow and profitability. See *Item 1A. Risk Factors* *We may face increased risk of market influences on our revenues after our contracts expire.*

In conjunction with our domestic energy-from-waste business, we also operate ten transfer stations and three landfills in the northeast United States, which we utilize to supplement and manage more efficiently the fuel and ash

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disposal requirements at our energy-from-waste operations. We provide waste procurement services to our waste disposal and transfer facilities which have available capacity to receive waste. With these services we seek to maximize our revenue and ensure that our energy-from-waste facilities are being utilized most efficiently, taking into account maintenance schedules and operating restrictions that may exist from time to time at each facility. We also provide management and marketing of ferrous and non-ferrous metals recovered from energy-from-waste operations, as well as services related to non-hazardous special waste destruction and residue management for our energy-from-waste projects.

Other Renewable Energy Projects

We also engage domestically in developing, owning and/or operating renewable energy production facilities utilizing a variety of energy sources including waste wood (biomass), water (hydroelectric), and landfill gas. We sell the electrical output from each facility, with one exception, to local utilities. We derive our revenues from these facilities primarily from the sale of energy and capacity under energy contracts.

Biomass We own five wood-fired generation facilities and have a 55% interest in a partnership which owns a sixth wood-fired generation facility, all of which are located in California. We procure fuel for the facilities from local sources, primarily through short-term supply agreements. The price of the fuel varies depending on the time of the year, supply and price of energy. These projects sell energy and capacity to utilities under energy contracts that expire between 2014 and 2017.

Hydroelectric We own a 50% equity interest in two run-of-river hydroelectric facilities which have a combined gross generating capacity of 17 megawatts (MW). Both facilities are located in the State of Washington and both sell energy and capacity to Puget Sound Energy under long-term energy contracts. We provide operation and maintenance services at one of the facilities under a cost plus fixed-fee agreement.

Landfill Gas We own and operate four landfill gas projects located in California and one in Massachusetts which produce electricity by burning methane gas produced in landfills. These projects sell energy to various utilities. Upon the expiration of the energy contracts, we expect that these projects will enter into new power off-take arrangements or will be shut down.

Summary information with respect to our domestic projects that are currently operating is provided in the following table:

| | Location | Design Capacity | | Nature of Interest | Contract Expiration Dates | | |
|--------------------------------------|----------------------|----------------------|---------------------|--------------------|---------------------------|--------|------|
| | | Waste Disposal (TPD) | Gross Electric (MW) | | Service/Waste Disposal | Energy | |
| A. ENERGY-FROM-WASTE PROJECTS | | | | | | | |
| TIP FEE STRUCTURES | | | | | | | |
| 1. | Alexandria/Arlington | Virginia | 975 | 22.0 | Owner/Operator | 2013 | 2023 |
| 2. | Delaware Valley | Pennsylvania | 2,688 | 87.0 | Lessee/Operator | 2017 | 2016 |
| 3. | Haverhill | Massachusetts | 1,650 | 44.6 | Owner/Operator | N/A | 2019 |
| 4. | Hempstead(1) | New York | 2,671 | 75.0 | Owner/Operator | 2034 | 2009 |
| 5. | Niagara(2) | New York | 2,250 | 50.0 | Owner/Operator | N/A | 2014 |
| 6. | Pittsfield | Massachusetts | 240 | 8.6 | Owner/Operator | 2015 | 2015 |

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| 7. | Southeast Massachusetts(3) | Massachusetts | 2,700 | 78.0 | Owner/Operator | N/A | 2015 |
| 8. | Springfield | Massachusetts | 400 | 9.4 | Owner/Operator | 2014 | 2010 |
| 9. | Union County | New Jersey | 1,440 | 42.1 | Lessee/Operator | 2023 | N/A |
| 10. | Warren County | New Jersey | 450 | 13.5 | Owner/Operator | N/A | 2013 |

SERVICE FEE STRUCTURES

| | | | | | | | |
|-----|------------------------|--------------|-------|------|-----------------|------|------|
| 11. | Babylon | New York | 750 | 16.8 | Owner/Operator | 2019 | 2019 |
| 12. | Bristol | Connecticut | 650 | 16.3 | Owner/Operator | 2014 | 2014 |
| 13. | Detroit(2)(3)(4) | Michigan | 2,832 | 68.0 | Lessee/Operator | 2009 | 2008 |
| 14. | Essex County | New Jersey | 2,700 | 64.0 | Owner/Operator | 2020 | 2020 |
| 15. | Fairfax County | Virginia | 3,000 | 93.0 | Owner/Operator | 2011 | 2015 |
| 16. | Harrisburg(5) | Pennsylvania | 800 | 20.8 | Operator | 2018 | 2009 |
| 17. | Hartford(3)(6) | Connecticut | 2,000 | 68.5 | Operator | 2012 | 2012 |
| 18. | Hennepin County | Minnesota | 1,212 | 38.7 | Operator | 2018 | 2018 |
| 19. | Hillsborough County(7) | Florida | 1,800 | 46.5 | Operator | 2027 | 2010 |
| 20. | Honolulu(3)(4) | Hawaii | 2,160 | 57.0 | Lessee/Operator | 2010 | 2015 |
| 21. | Huntington(8) | New York | 750 | 24.3 | Owner/Operator | 2012 | 2012 |

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| | Location | Design Capacity | | Nature of Interest | Contract Expiration Dates | | |
|-----------|--|----------------------|---------------------|--------------------|---------------------------|--------|------|
| | | Waste Disposal (TPD) | Gross Electric (MW) | | Service/Waste Disposal | Energy | |
| 22. | Huntsville(2) | Alabama | 690 | | Operator | 2016 | 2014 |
| 23. | Indianapolis(2)(9) | Indiana | 2,362 | 6.5 | Owner/Operator | 2008 | 2028 |
| 24. | Kent County(2) | Michigan | 625 | 16.8 | Operator | 2010 | 2022 |
| 25. | Lake County | Florida | 528 | 14.5 | Owner/Operator | 2014 | 2014 |
| 26. | Lancaster County | Pennsylvania | 1,200 | 33.1 | Operator | 2016 | 2016 |
| 27. | Lee County | Florida | 1,836 | 57.3 | Operator | 2024 | 2015 |
| 28. | Marion County | Oregon | 550 | 13.1 | Owner/Operator | 2014 | 2014 |
| 29. | Montgomery County | Maryland | 1,800 | 63.4 | Operator | 2016 | 2010 |
| 30. | Onondaga County | New York | 990 | 36.8 | Owner/Operator | 2015 | 2025 |
| 31. | Pasco County | Florida | 1,050 | 29.7 | Operator | 2011 | 2024 |
| 32. | Southeast Connecticut | Connecticut | 689 | 17.0 | Owner/Operator | 2015 | 2017 |
| 33. | Stanislaus County | California | 800 | 22.4 | Owner/Operator | 2010 | 2010 |
| 34. | Wallingford | Connecticut | 420 | 11.0 | Owner/Operator | 2010 | 2010 |
| | | SUBTOTAL | 47,658 | 1,265.7 | | | |
| B. | ANCILLARY WASTE PROJECTS | | | | | | |
| | LANDFILLS | | | | | | |
| 35. | Haverhill | Massachusetts | 555 | N/A | Lessee/Operator | N/A | N/A |
| 36. | CMW Semass | Massachusetts | 1,700 | N/A | Operator | 2016 | N/A |
| 37. | Springfield | Massachusetts | 175 | N/A | Owner/Operator | N/A | N/A |
| | | SUBTOTAL | 2,430 | N/A | | | |
| | TRANSFER STATIONS | | | | | | |
| 38. | Braintree | Massachusetts | 1,200 | N/A | Owner/Operator | 2015 | N/A |
| 39. | Canaan | New York | 600 | N/A | Owner/Operator | N/A | N/A |
| 40. | Derwood | Maryland | 2,500 | N/A | Operator | 2015 | N/A |
| 41. | Danvers | Massachusetts | 250 | N/A | Operator | 2011 | N/A |
| 42. | Essex | Massachusetts | 6 | N/A | Operator | 2015 | N/A |
| 43. | Holliston | Massachusetts | 700 | N/A | Owner/Operator | N/A | N/A |
| 44.. | Lynn | Massachusetts | 885 | N/A | Owner/Operator | N/A | N/A |
| 45. | Mamaroneck | New York | 800 | N/A | Owner/Operator | 2015 | N/A |
| 46. | Mt. Kisco | New York | 350 | N/A | Owner/Operator | 2018 | N/A |
| 47. | Springfield | Massachusetts | 500 | N/A | Owner/Operator | N/A | N/A |
| | | SUBTOTAL | 7,791 | N/A | | | |
| C. | OTHER RENEWABLE ENERGY PROJECTS | | | | | | |
| | BIOMASS | | | | | | |
| 48. | Burney Mountain | California | N/A | 11.4 | Owner/Operator | N/A | 2015 |
| 49. | Delano | California | N/A | 49.5 | Owner/Operator | N/A | 2017 |
| 50. | Mendota | California | N/A | 25.0 | Owner/Operator | N/A | 2014 |
| 51. | Mount Lassen | California | N/A | 11.4 | Owner/Operator | N/A | 2015 |
| 52. | Pacific Oroville | California | N/A | 18.7 | Owner/Operator | N/A | 2016 |

| | | | | | | | |
|-----|--|---------------|-----|-------|---------------------|-----|-----------|
| 53. | Pacific Ultrapower Chinese Station(10) | California | N/A | 25.6 | Part Owner | N/A | 2017 |
| | | SUBTOTAL | N/A | 141.6 | | | |
| | HYDROELECTRIC | | | | | | |
| 54. | Koma Kulshan(11) | Washington | N/A | 12.0 | Part Owner/Operator | N/A | 2037 |
| 55. | Weeks Falls(11) | Washington | N/A | 5.0 | Part Owner | N/A | 2022 |
| | | SUBTOTAL | N/A | 17.0 | | | |
| | LANDFILL GAS | | | | | | |
| 56. | Haverhill | Massachusetts | N/A | 1.6 | Lessee/Operator | N/A | N/A |
| 57. | Otay | California | N/A | 7.4 | Owner/Operator | N/A | 2009-2015 |
| 58. | Oxnard | California | N/A | 5.6 | Owner/Operator | N/A | 2009 |
| 59. | Salinas | California | N/A | 1.5 | Owner/Operator | N/A | 2012 |
| 60. | Stockton | California | N/A | 0.8 | Owner/Operator | N/A | 2012 |
| | | SUBTOTAL | N/A | 16.9 | | | |

- (1) We entered into a new contract with the Town of Hempstead for a term of 25 years commencing upon expiration of the existing contract in 2009.
- (2) These facilities have been designed to export steam for sale.
- (3) These facilities use a refuse-derived fuel technology.
- (4) We lease these projects from third party lessors under arrangements where the lease benefits and burdens are primarily those of the related client community.
- (5) We entered into a ten year agreement to maintain and operate an 800 tpd energy-from-waste facility located in Harrisburg, Pennsylvania and have a right of first refusal to purchase the facility.

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- (6) Under contracts with the Connecticut Resource Recovery Authority, we operate only the boilers and turbines for this facility.
- (7) With respect to this project, we have entered into agreements to expand waste processing capacity from 1,200 tpd to 1,800 tpd and to increase gross electricity capacity from 29.0 MW to 46.5 MW. The agreements also extended the contract term from 2007 to 2027.
- (8) Owned by a limited partnership in which the limited partners are not affiliated with us.
- (9) The service contract for this facility expires on November 30, 2008. Negotiations for a contract extension are ongoing.
- (10) On October 18, 2007, we acquired an additional 5% ownership interest in this facility increasing our equity ownership interest to 55%. See Note 3. Acquisitions, Business Development and Dispositions of the Notes.
- (11) We have a 50% ownership interest in these projects.

INTERNATIONAL BUSINESS

General Approach to International Projects

We conduct our international waste and energy businesses through our foreign subsidiaries and affiliates. In general, these projects provide cash returns primarily from equity distributions and, to a lesser extent, operating fees. The projects sell the electricity and steam they generate under either short-term or long-term contracts or market concessions to utilities, governmental agencies providing power distribution, creditworthy industrial users, or local governmental units. Energy-from-waste facilities also sell waste disposal services. In developing our international business, we have employed the same general approach to projects as is described above with respect to domestic projects. We intend to seek to develop or participate in additional international projects, particularly energy-from-waste projects, where the regulatory or market environment is attractive. The ownership and operation of facilities in foreign countries potentially entails significant political and financial uncertainties that typically are not encountered in such activities in the United States, as described below and discussed in *Item 1A. Risk Factors*. With respect to some international energy-from-waste projects, ownership transfer to the sponsoring municipality, for nominal consideration, is required following expiration of the project's long-term operating contract.

Some of the countries in which we currently operate are lesser developed countries or developing countries where the political, social and economic conditions are quite different, and often less stable, than those conditions prevailing in the United States or other developed countries. In order to mitigate these risks both at the outset of project development and over time, we often develop projects jointly with experienced and respected local companies.

When a project is developed, we undertake a credit analysis of the proposed power purchaser and/or fuel suppliers (which for energy-from-waste projects are often municipal governments).

We have typically sought to negotiate long-term contracts for the supply of fuel with reliable suppliers. For our projects that are not energy-from-waste facilities, we have sought, to the extent practicable, to shift the consequences of interruptions in the delivery of fuel (whether due to the fault of the fuel supplier or due to reasons beyond the fuel supplier's control) to the electricity purchaser or service recipient by securing a suspension of the project's operating responsibilities under the applicable agreements and an extension of our operating concession under such agreements. In some instances, we require the energy purchaser or service recipient to continue to make payments of fixed costs if such interruptions occur. In order to mitigate the effect

of short-term interruptions in the supply of fuel, we have also endeavored to provide on-site storage of fuel in sufficient quantities to address such interruptions.

For our energy-from-waste projects in international markets, we expect that a significant portion of each project's waste supply would be under long-term contracts with sponsoring municipalities, thus reducing the risk of fuel supply interruptions or price instability. Where market conditions are favorable, we may also reserve a portion of a facility's capacity for shorter term contracts, or receive waste on a spot basis.

Payment for services that we provide will often be made in whole or in part in the domestic currencies of the host countries. Local governments generally do not assure conversion of such currencies into U.S. dollars, which may be subject to limitations in the currency markets, as well as restrictions of the host country. In addition, fluctuations in the value of such currencies against the value of the U.S. dollar may cause our participation in such projects to yield less return than expected. Transfer of earnings, capital and profits in

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any form beyond the borders of the host country may be subject to special taxes or limitations imposed by host country laws. We have sought to participate in projects where the host country has allowed the convertibility of its currency into U.S. dollars and repatriation of earnings, capital and profits subject to compliance with local regulatory requirements. In some cases, components of project costs incurred or funded in U.S. dollars are recovered without risk of currency fluctuation through negotiated contractual adjustments to the price charged for electricity or service provided. This contractual structure may cause the cost in local currency to the project's power purchaser or service recipient to rise from time to time in excess of local inflation, and consequently there is risk in such situations that such power purchaser or service recipient will, at least in the near-term, be less able or willing to pay for the project's power or service.

We have sought to manage and mitigate these risks through all appropriate means, including:

- developing projects jointly with experienced local partners; political and financial analysis of the host countries and the key participants in each project;
- guarantees of relevant agreements with creditworthy entities;
- political risk and other forms of insurance; and/or
- participation by United States and/or international development finance institutions in the financing of projects.

We determine which mitigation measures to apply based on our ability to balance the risks presented, the availability of such measures and their cost.

We have generally participated in projects which provide services that are treated as a matter of national or key economic importance by the laws and politics of the host country. Therefore, there is a risk that the assets constituting the facilities of these projects could be temporarily or permanently expropriated or nationalized by a host country, made subject to local or national control or be subject to unfavorable legislative action, regulatory decisions or changes in taxation. We believe that working with experienced and reputable local joint venture partners mitigates this risk as well.

In certain cases, we have issued guarantees on behalf of our international operating subsidiaries with respect to contractual obligations to operate certain international power projects and energy-from-waste projects. The potential damages we may owe under such arrangements may be material. Depending upon the circumstances giving rise to such 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 any material liabilities under such guarantees on international projects.

International Projects

We presently have interests in international power projects with an aggregate generating capacity of approximately 969 MW (gross), with our portion of the ownership in these facilities representing approximately 365 MW. In addition to our headquarters in Fairfield, New Jersey, our international business is facilitated through field offices in Shanghai and Guangzhou, China; Chennai, India; Manila, Philippines; Bangkok, Thailand; and Birmingham, England. The following describes the important features of these projects, by fuel type:

Energy-From-Waste

We own a 40% equity interest in Sanfeng Covanta Environmental Industry Co., Ltd. (Sanfeng), a company located in Chongqing Municipality, Peoples Republic of China. Sanfeng is engaged in the business of owning and operating energy-from-waste projects and providing design and engineering, procurement and construction services for

energy-from-waste facilities in China. Sanfeng currently owns minority equity interests in two 1,200 metric tpd, 24 MW mass-burn energy-from-waste projects. Chongqing Iron & Steel Company (Group) Limited holds the remaining 60% equity interest in Sanfeng. The solid waste supply for the projects comes from municipalities under long-term contracts. The municipalities also have the obligation to coordinate the purchase of power from the facilities as part of the long-term contracts for waste disposal. The electrical output from these projects is sold at governmentally established preferential rates under short-term arrangements with local power bureaus.

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We entered into an agreement to acquire a 40% equity interest in Guangzhou Development Covanta Environmental Energy Co., Ltd (GDC Environmental Energy), a company to be located in Guangzhou Municipality, Peoples Republic of China. GDC Environmental Energy will be a newly-formed entity involved in developing energy-from-waste projects in Guangdong Province in Southeast China. Guangzhou Development Industry (Holdings) Co. Ltd. holds the remaining 60% equity interest in GDC Environmental Energy through a wholly-owned subsidiary. Our investment in GDC Environmental Energy is subject to various regulatory approvals and is expected to be completed during early 2008.

We own a 13% equity interest in a 500 metric tpd, 18 MW mass-burn energy-from-waste project at Trezzo sull'Adda in the Lombardy Region of Italy. The remainder of the equity in the project is held by a subsidiary of Falck S.p.A. and the municipality of Trezzo sull'Adda. The project is operated by Ambiente 2000 S.r.l., an Italian special purpose limited liability company of which we own 40%. The solid waste supply for the project comes from municipalities and privately-owned waste haulers under long-term contracts. The electrical output from the Trezzo project is sold at governmentally established preferential rates under a long-term purchase contract to Italy's state-owned electricity grid operator, Gestore della Rete di Trasmissione Nazionale S.p.A.

Hydroelectric

We operate two hydroelectric facilities in Costa Rica through an operating subsidiary pursuant to long-term contracts. We also have a nominal equity investment in each project. The electric output from both of these facilities is sold to Instituto Costarricense de Electricidad, a Costa Rica national electric utility.

Coal

A partnership, in which we hold a 26% equity interest, owns a 510 MW (gross) coal-fired electric power generation facility located in Mauban, Quezon Province, the Philippines (Quezon). The remaining equity interests are held by an affiliate of International Generating Company, an affiliate of General Electric Capital Corporation, and an entity owned by the original project developer. The Quezon project sells electricity to the Manila Electric Company (Meralco), the largest electric distribution company in the Philippines, which serves the area surrounding and including metropolitan Manila.

Under an energy contract expiring in 2025, Meralco is obligated to take-or-pay for stated minimum annual quantities of electricity at an all-in price which consists of capacity, operating, energy, transmission and other fees adjusted for inflation, fuel cost and foreign exchange fluctuations. The Quezon project has entered into two coal supply contracts expiring in 2015 and 2022. Under these supply contracts, the cost of coal is determined using a base energy price adjusted to fluctuations of specified international benchmark prices. Our wholly-owned subsidiary, Covanta Philippines Operating, Inc., operates the project under a long-term agreement with the Quezon project and we have obtained political risk insurance for our equity investment in this project.

On February 21, 2008, the Quezon project and Meralco executed agreements which effect a settlement of various issues which had been pending for several years, including certain amendments to the contract to modify certain commercial terms and to resolve issues relating to the project's performance during its first year of operation. The settlement primarily includes payment by Meralco of approximately \$8.5 million of prior uncollected receivables, a reduction in the capital cost rate recovery payable by Meralco and other terms.

We also have a majority equity interest in a 24 MW (gross) coal-fired cogeneration facility in the Peoples Republic of China. The project entity, in which we hold a majority interest, operates this project. The party holding a minority position in the project is an affiliate of the local municipal government. While the steam produced at this project is intended to be sold under a long-term contract to its industrial host, in practice, steam has been sold on either a

short-term basis to local industries or the industrial host, in each case at varying rates and quantities. The electric power is sold at an average grid rate to a subsidiary of the provincial power bureau. During 2007, we sold our interest in a second coal-fired project in China.

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We hold a 45% equity interest in a barge-mounted 126 MW (gross) diesel/natural gas-fired electric power generation facility located near Haripur, Bangladesh. The remaining equity interests are held by Pendekar Energy (L) Ltd (a consortium of Tanjong Energy Holdings Sdn Bhd (Malaysia) and Al-Jomaih Group (Saudi Arabia)) and an affiliate of Wartsila North America, Inc. The electrical output of the project is sold to the Bangladesh Power Development Board (BPDB) pursuant to an energy contract with minimum energy off-take provisions at an all-in price divided into a fuel component and an other component. The fuel component reimburses the fuel cost incurred by the project up to a specified heat rate. The other component consists of a pre-determined base rate which is adjusted for the actual load factor and foreign exchange fluctuations. The BPDB also supplies all of the project s natural gas requirements at a pre-determined base cost adjusted for fluctuations on actual landed cost of the fuel in Bangladesh. The Government of Bangladesh guarantees the BPDB s contractual obligations. We operate the project under a long-term agreement with the project company and we have obtained political risk insurance for our equity interest in this project.

Heavy Fuel-Oil

We hold majority equity interests in two 106 MW (gross) heavy fuel-oil fired electric power generation facilities in India. We hold a 60% equity interest in the first project (the Samalpatti project), which is located near Samalpatti, in the state of Tamil Nadu. The remaining equity interests in the Samalpatti project are held by affiliates of Shapoorji Pallonji Infrastructure Capital Co. Ltd. and by Wartsila India Power Investment, LLC. We hold a 77% equity interest in the second project (the Madurai project), which is located in Samayanallur, also in the state of Tamil Nadu. The remaining equity interest in the Madurai project is held by an Indian company controlled by the original project developer. Both projects sell their electrical output to the Tamil Nadu Electricity Board (TNEB) pursuant to long-term agreements with a full pass-through all-in pricing structure that takes into account specified heat rates, operation and maintenance costs, and equity returns. TNEB s obligations are guaranteed by the government of the state of Tamil Nadu. Indian oil companies supply the oil requirements of both projects through 15-year fuel supply agreements based on market prices. We operate both projects through subsidiaries under long-term agreements with the project companies.

Disputing several contractual provisions, TNEB has, since 2001, failed to pay the full amount due under the energy contracts for both the Samalpatti and Madurai projects. To date, TNEB has paid the undisputed portion of its payment obligations (approximately 94% of total billings) representing each project s operating costs, fuel costs, debt service and some equity return. Similar to many Indian state electricity boards, TNEB has also failed to fund an escrow account or post a letter of credit required under the project energy contracts, which failure constitutes a default under the project finance documents. Project lenders for both projects have either granted periodic waivers of such default or potential default and/or otherwise approved scheduled equity distributions. Neither such default nor potential default in the project financing arrangements constitutes a default under our financing arrangements. It is possible that the issue of the escrow account and/or letter of credit requirement will be resolved as part of the overall negotiation with TNEB with respect to the disputed receivables in both projects.

During 2007, we disposed of our interest in a 7 MW heavy fuel-oil fired electric power generation facility located in the Philippines.

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Summary information with respect to our international projects that are currently operating is provided in the following table:

| | Location | Design Capacity | | Nature of Interest | Contract Expiration Dates | | |
|--|---------------|-----------------------------|---------------------|--------------------|---------------------------|--------|------|
| | | Waste Disposal (Metric TPD) | Gross Electric (MW) | | Service/Waste Disposal | Energy | |
| A. ENERGY-FROM-WASTE TIP FEE STRUCTURES | | | | | | | |
| 1. | Fuzhou(1) | China | 1,200 | 24 | Part Owner | 2032 | N/A |
| 2. | Tongqing(1) | China | 1,200 | 24 | Part Owner/Operator | 2027 | N/A |
| 3. | Trezzo(2) | Italy | 500 | 18 | Part Owner/Operator | 2023 | 2023 |
| | | SUBTOTAL | 2,900 | 66 | | | |
| B. HYDROELECTRIC | | | | | | | |
| 4. | Don Pedro(3) | Costa Rica | N/A | 14 | Part Owner/Operator | N/A | 2009 |
| 5. | Rio Volcan(3) | Costa Rica | N/A | 17 | Part Owner/Operator | N/A | 2009 |
| | | SUBTOTAL | | 31 | | | |
| C. COAL | | | | | | | |
| 6. | Quezon(4) | Philippines | N/A | 510 | Part Owner/Operator | N/A | 2025 |
| 7. | Yanjiang(5) | China | N/A | 24 | Part Owner/Operator | N/A | N/A |
| | | SUBTOTAL | | 534 | | | |
| D. NATURAL GAS | | | | | | | |
| 8. | Haripur(6) | Bangladesh | N/A | 126 | Part Owner/Operator | N/A | 2014 |
| E. HEAVY FUEL-OIL | | | | | | | |
| 9. | Madurai(7) | India | N/A | 106 | Part Owner/Operator | N/A | 2016 |
| 10. | Samalpatti(8) | India | N/A | 106 | Part Owner/Operator | N/A | 2016 |
| | | SUBTOTAL | N/A | 212 | | | |

(1) We have a 40% equity interest in Sanfeng, which owns equity interests of approximately 32% and 25% in the Fuzhou and Tongqing projects, respectively. Sanfeng operates the Tongqing project. The Fuzhou project company, in which Sanfeng has a 32% interest, operates the Fuzhou project. Ownership of these projects transfers to the applicable municipality at the expiration of the applicable waste disposal agreement.

(2) We have a 13% interest in this project and a 40% interest in the operator Ambiente 2000 S.r.l.

(3) We have nominal ownership interests in these projects.

(4) We have an approximate 26% ownership interest in this project.

- (5) We have an approximate 96% ownership interest in this project. Assets of this project revert back to the local Chinese partner at the expiration of the Joint Venture Agreement in 2017.
- (6) We have an approximate 45% ownership interest in this project. This project is capable of operating through combustion of diesel oil in addition to natural gas.
- (7) We have an approximate 77% ownership interest in this project.
- (8) We have a 60% ownership interest in this project.

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MARKETS, COMPETITION AND BUSINESS CONDITIONS

General Business Conditions

Our business can be adversely affected by general economic conditions, war, inflation, adverse competitive conditions, governmental restrictions and controls, changes in laws, natural disasters, energy shortages, fuel costs, weather, the adverse financial condition of customers and suppliers, various technological changes and other factors over which we have no control. As global populations and consequent economic activity increase, we expect that demand for energy and effective waste management technologies will increase. We expect this to create generally favorable conditions for our existing business and for our efforts to grow our business. We expect that any cyclical or structural downturns in general economic activity may adversely affect both our existing businesses and our ability to grow through development or acquisitions. The domestic marketplace for renewable energy projects, including energy-from-waste projects, may be affected by the current policy debates described below under *Regulation of Business* *Regulations Affecting our Domestic Business* *Recent Policy Debate Regarding Climate Change*. We are actively engaged in the current discussion among policy makers regarding the benefits of energy-from-waste and other renewable energy technologies. The extent to which any resulting legislation will affect the markets in which we compete may depend in part on the extent to which any such legislation recognizes those benefits.

Competition for new contracts and projects is intense in all markets in which we conduct or intend to conduct business, and our businesses are subject to a variety of competitive, regulatory and market influences.

With respect to our waste-related businesses, including our energy-from-waste and waste procurement business, we compete in waste disposal markets, which are highly competitive. In the United States, the market for waste disposal is almost entirely price-driven and is greatly influenced by economic factors within regional waste sheds. These factors include:

- regional population and overall waste production rates;
- the number of other waste disposal sites (including principally landfills and transfer stations) in existence or in the planning or permitting process;
- the available disposal capacity (in terms of tons of waste per day) that can be offered by other regional disposal sites; and
- the availability and cost of transportation options (rail, inter-modal, trucking) to provide access to more distant disposal sites, thereby affecting the size of the waste shed itself.

In the domestic waste disposal market, disposal service providers seek to obtain waste supplies to their facilities by competing on disposal price (usually on a per-ton basis) with other disposal service providers. At all but ten of our energy-from-waste facilities, we typically do not compete in this market because we do not have the contractual right to solicit waste. At these facilities, the client community is responsible for obtaining the waste, if necessary by competing on price to obtain the tons of waste it has contractually promised to deliver to us. At ten of our energy-from-waste facilities and at our waste procurement services businesses, we are responsible for obtaining material amounts of waste supply, and therefore, actively compete in these markets to enter into spot, medium- and long-term contracts. These energy-from-waste projects are generally in densely populated areas, with high waste generation rates and numerous large and small participants in the regional market. Our waste operations are largely concentrated in the northeastern United States. See *Item 1A. Risk Factors* *Our waste operations are concentrated in one region, and expose us to regional economic or market declines* for additional information concerning this geographic concentration. Certain of our competitors in these markets are vertically-integrated waste companies which include waste collection operations, and thus have the ability to control supplies of waste which may restrict our

ability to offer disposal services at attractive prices. Our business does not include waste collection operations.

If a long-term contract expires and is not renewed or extended by a client community, our percentage of contracted disposal capacity will decrease, and we will need to compete in the regional market for waste disposal. At that point, we will compete on price with landfills, transfer stations, other energy-from-waste facilities and other waste disposal technologies that are then offering disposal service in the region. See discussion under *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview - Contract Duration* for additional information concerning the expiration of existing contracts.

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Both domestically and internationally, we may develop or acquire, ourselves or jointly with others, additional waste or energy projects and/or businesses. If we were to do so in a competitive procurement, we would face competition in the selection process from other companies, some of which may have greater financial resources, or more experience in the regional waste and/or energy markets. If we were selected, the amount of market competition we would thereafter face would depend upon the extent to which the revenue at any such project or business would be committed under contract. If we were to develop or acquire additional projects or businesses not in the context of a competitive procurement, we would face competition in the regional market and compete on price with landfills, transfer stations, other energy-from-waste facilities, other energy producers and other waste disposal or energy generation technologies that are then offering service in the region.

In our international energy-from-waste business, we compete principally for new energy-from-waste contracts and projects in China and the United Kingdom, generally in response to public tenders. In both of these markets, there are numerous local and foreign companies with whom we compete for such contracts and projects. If we were to be successful in obtaining such contracts or projects, we expect that a significant portion of each project's waste disposal capacity would be under long-term contracts, thus reducing the competition to which we would be subject in waste disposal markets.

With respect to our electricity sales from most of our energy-from-waste projects and other energy projects, we primarily sell our output pursuant to long-term contracts. Accordingly, we generally do not sell our output into markets where we must compete on price. As these contracts expire, we will participate in such markets if we are unable to enter into new or renewed long-term contracts. In certain countries where we are seeking new waste and energy projects, such as China and the United Kingdom, we may sell our electricity output on short term arrangements to local or regional government entities, or directly into the local electricity grid, rather than pursuant to contract. In these markets we will have greater exposure to electricity price fluctuations. As energy prices continue to rise in the United States and other countries, we may sell our output pursuant to short-term agreements or directly into regional electricity grids, in which case we would have relatively greater exposure to energy market fluctuations. See discussion under *Item 1A. Risk Factors* *We may face increased risk of market influences on our revenues after our contracts expire* for additional information concerning the expiration of existing contracts.

Once a contract is awarded or a project is financed and constructed, our business can be impacted by a variety of risk factors which can affect profitability over the life of a project. Some of these risks are at least partially within our control, such as successful operation in compliance with laws and the presence or absence of labor difficulties or disturbances. Other risk factors are largely out of our control and may have an adverse impact on a project over a long-term. See *Item 1A. Risk Factors* for more information on these types of risks.

Technology, Research and Development

We have the exclusive right to market the proprietary mass-burn technology of Martin GmbH für Umwelt und Energietechnik, referred to herein as "Martin" in the United States, Canada, Mexico, Bermuda and certain Caribbean countries (the "Territory"). Through our investment in Sanfeng, we also have access to the Martin Sity 2000 mass-burn technology in China. The principal feature of the Martin technology is the reverse-reciprocating stoker grate upon which the waste is burned. The patent for the basic stoker grate technology used in the Martin technology has expired and there are various other expired and unexpired patents relating to the Martin technology. We believe that it is Martin's know-how and worldwide reputation in the energy-from-waste industry, and our know-how in designing, constructing and operating energy-from-waste facilities, rather than the use of patented technology, that is important to our competitive position in the energy-from-waste industry. We do not believe that the expiration of the remaining patents covering portions of the Martin technology will have a material adverse effect on our financial condition or competitive position.

Since 1984, our rights to the Martin technology have been provided pursuant to a cooperation agreement with Martin which gives us exclusive rights to market, and distribute parts and equipment for the Martin technology in the Territory. Martin is obligated to assist us in installing, operating and maintaining facilities incorporating the Martin technology. The cooperation agreement renews automatically each year unless notice of termination is given, in which case, the cooperation agreement would terminate ten years after such notice. Any termination would

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not affect our rights to design, construct, operate, maintain or repair energy-from-waste facilities for which contracts have been entered into or proposals made prior to the date of termination.

We believe that mass-burn technology is now the predominant technology used for the combustion of municipal solid waste. We believe that the Martin technology is a proven and reliable mass-burn technology, and that our association with Martin has created significant name recognition and value for our domestic energy-from-waste business. Through facility acquisitions, we own and/or operate energy-from-waste facilities which utilize additional technologies, including non-Martin mass-burn technologies and refuse-derived fuel technologies which include pre-combustion waste processing not required with a mass-burn design. As we continue our efforts to develop and/or acquire additional energy-from-waste projects internationally, we will consider mass-burn and other technologies, including technologies other than those offered by Martin, which best fit the needs of the local environment of a particular project.

We believe that energy-from-waste technologies offer an environmentally superior solution to waste disposal and energy challenges faced by leaders around the world, and that our efforts to expand our domestic and international businesses will be enhanced by the development of additional technologies in such fields as emission controls, residue disposal, alternative waste treatment processes, and combustion controls. During 2007, we advanced our research and development efforts in these areas, and have developed new and cost-effective technologies that represented major advances in controlling nitrogen oxide (NOx) emissions. These technologies, for which patents are pending, have been tested at existing facilities and we are now operating and/or installing such systems at several of our facilities. We also developed and have patents pending for a proprietary process to improve the handling of the residue from our energy-from-waste facilities. We intend to maintain a focus in the years ahead on research and development of technologies in these and other areas that we believe will enhance our competitive position, and offer new technical solutions to waste and energy problems that augment and complement our business.

REGULATION OF BUSINESS

Regulations Affecting Our Domestic Business

Environmental Regulations

Our business activities in the United States are pervasively regulated pursuant to federal, state and local environmental laws. Federal laws, such as the Clean Air Act and Clean Water Act, and their state counterparts, govern discharges of pollutants to air and water. Other federal, state and local laws comprehensively govern the generation, transportation, storage, treatment and disposal of solid and hazardous waste and also regulate the storage and handling of chemicals and petroleum products (such laws and regulations are referred to collectively as the Environmental Regulatory Laws).

Other federal, state and local laws, such as the Comprehensive Environmental Response Compensation and Liability Act commonly known as CERCLA, and collectively referred to with such other laws as the Environmental Remediation Laws, make us potentially liable on a joint and several basis for any onsite or offsite environmental contamination which may be associated with our activities and the activities at our sites. These include landfills we have owned, operated or leased, or at which there has been disposal of residue or other waste generated, handled or processed by our facilities. Some state and local laws also impose liabilities for injury to persons or property caused by site contamination. Some service agreements provide us with indemnification from certain liabilities. In addition, our landfill gas projects have access rights to landfill sites pursuant to certain leases that permit the installation, operation and maintenance of landfill gas collection systems. A portion of these landfill sites have been federally-designated Superfund sites. Each of these leases provide us with indemnification from some liabilities associated with these sites.

The Environmental Regulatory Laws require that many permits be obtained before the commencement of construction and operation of any waste, renewable energy project or water facility, and further require that permits be maintained throughout the operating life of the facility. We can provide no assurance that all required permits will be issued or re-issued, and the process of obtaining such permits can often cause lengthy delays, including

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delays caused by third-party appeals challenging permit issuance. Our failure to meet conditions of these permits or of the Environmental Regulatory Laws can subject us to regulatory enforcement actions by the appropriate governmental unit, which could include fines, penalties, damages or other sanctions, such as orders requiring certain remedial actions or limiting or prohibiting operation. See *Item 1A. Risk Factors – Compliance with environmental laws could adversely affect our results of operations*. To date, we have not incurred material penalties, been required to incur material capital costs or additional expenses, or been subjected to material restrictions on our operations as a result of violations of Environmental Regulatory Laws or permit requirements.

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 Regulatory Laws. 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 CERCLA and/or analogous state Environmental Remediation Laws. 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 have also sent waste to a given site and, in the case of divested operations, our contractual arrangement with the purchaser of such operations.

The Environmental Regulatory Laws may change. New technology may be required or stricter standards may be established for the control of discharges of air or water pollutants, for storage and handling of petroleum products or chemicals, or for solid or hazardous waste or ash handling and disposal. Thus, as new technology is developed and proven, we may be required to incorporate it into new facilities or make major modifications to existing facilities. This new technology may often be more expensive than the technology we use currently.

In 2006, the Environmental Protection Agency (EPA) issued revisions to the New Source Performance Standards (NSPS) and Emission Guidelines (EG) applicable to new and existing municipal waste combustion (MWC) units (the Revised MACT Rule). The Revised MACT Rule lowered the emission limits for most of the regulated air pollutants emitted by MWCs. The general compliance deadline for the revised EG is April 28, 2009; however, the actual compliance date for a particular facility may be earlier or later depending on the state in which the facility is located. We expect that one existing energy-from-waste facility, which we operate on behalf of a municipality, will require certain capital improvements to comply with revised EG. Most existing facilities also will incur increased operating and maintenance costs to meet the revised EG requirements, none of which are expected to be material.

In February 2008, in response to a lawsuit, EPA was granted a voluntary remand of the Revised MACT Rule for the purpose of reconsidering the MWC emission limits. A new rulemaking is expected which may result in more stringent MWC emission limits than are currently included in the Revised MACT Rule; however, pending any such revisions, the requirements and compliance deadlines included in the Revised MACT Rule, discussed above, would remain applicable to subject MWCs. We are not able to predict the timing and potential outcome of any such new rulemaking with respect to MWC emission limits at this time.

Also in 2006, EPA issued a final rule to implement the revised National Ambient Air Quality Standards for fine particulate matter, or PM_{2.5} (Revised PM_{2.5} Rule). Unlike the Revised MACT Rule discussed above, the Revised PM_{2.5} Rule is not specific to energy-from-waste facilities, but instead is a nationwide standard for ambient air quality. The primary impact of the Revised PM_{2.5} Rule will be on those counties in certain states that are designated by EPA as non-attainment with respect to those standards. EPA's Revised PM_{2.5} Rule will guide state implementation plan (SIP) revisions and could result in more stringent regulation of certain energy-from-waste facility emissions that already are regulated by the Revised MACT Rule. EPA is expected to make non-attainment designations pursuant to the Revised PM_{2.5} Rule by November 2009; however, SIP revisions to meet the Revised PM_{2.5} Rule will not be due until April 2013.

The costs to meet new rules for existing facilities owned by municipal clients generally will be borne by the municipal clients. For projects we own or lease, some municipal clients have the obligation to fund such capital improvements, and at certain of our projects we may be required to fund a portion of the related costs. In certain cases, we are required to fund the full cost of capital improvements.

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We believe that most costs incurred to meet the Revised MACT Rule and Revised PM2.5 Rule at facilities we operate may be recovered from municipal clients and other users of our facilities through increased fees permitted to be charged under applicable contracts.

The Environmental Remediation Laws prohibit disposal of regulated hazardous waste at our municipal solid waste facilities. The service agreements recognize the potential for inadvertent and improper deliveries of hazardous waste and specify procedures for dealing with hazardous waste that is delivered to a facility. Under some service agreements, we are responsible for some costs related to hazardous waste deliveries. We have not incurred material hazardous waste disposal costs to date.

Energy Regulations

Our businesses are subject to the provisions of federal, state and local energy laws applicable to the development, ownership and operation of domestic facilities. Pursuant to the Public Utility Regulatory Policies Act of 1978 (PURPA), the Federal Energy Regulatory Commission (FERC) has promulgated regulations that exempt qualifying facilities (cogeneration facilities and other facilities making use of non-fossil fuel power sources such as waste, which meet certain size, ownership and other applicable requirements, referred to as QFs) from compliance with certain provisions of the Federal Power Act (FPA), the Public Utility Holding Company Act of 1935 (PUHCA) (repealed effective February 2006), and certain state laws regulating the rates charged by, or the financial and organizational activities of, electric utilities. PURPA was enacted in 1978 to encourage the development of, among other things, utility electricity generating facilities by requiring electric utilities to offer to purchase electric energy from and sell electric energy to QFs at non-discriminatory rates. The exemptions afforded by PURPA to QFs from regulation under the FPA and most aspects of state electric utility regulation are of great importance to us and our competitors in the energy-from-waste and independent power industries. Except with respect to energy-from-waste facilities with a net power production capacity in excess of 30 MW (where rates are set by the FERC), state public utility commissions must approve the rates, and in some instances other contract terms, by which public utilities purchase electric power from QFs.

The Energy Policy Act of 2005, passed in August 2005, made certain changes to the federal energy laws applicable to our business, the most significant of which are described below:

The Energy Policy Act repealed PUHCA, effective February 2006. PUHCA previously imposed extensive, utility-type regulation and reporting requirements on non-exempt PUHCA holding companies. The repeal of PUHCA has been balanced with increased FERC authority to cause record keeping and conduct investigations under appropriate circumstances. As a company that owns only QFs, exempt wholesale generators and/or foreign utility companies, we are generally exempt from such record keeping and such investigations. The Energy Policy Act amended certain provisions of PURPA. It terminated PURPA's mandatory purchase (and sale) obligation imposed on utilities for the benefit of QFs where the QF has non-discriminatory access to competitive power markets. Existing contracts are grandfathered, but many expansions, renewals and new development projects must rely on competitive power markets, rather than the mandatory purchase (and sale) obligations of PURPA in establishing and maintaining their viability in most geographic regions in which we operate. The Energy Policy Act also eliminated the limitations on utility ownership of QFs. In October 2006, FERC issued final regulations under the Energy Policy Act providing for, among other things, a rebuttable presumption that (1) the competitive power market requirement is satisfied in regions served by Midwest Independent Transmission System Operator, PJM Interconnection, L.L.C., ISO New England, Inc., New York Independent System Operator and the Electric Reliability Council of Texas, and (2) QFs with a capacity greater than 20 MW have non-discriminatory access to those markets. As to QFs with a capacity at or below 20 MW, the regulations provide for a rebuttable presumption that such QFs do not have non-discriminatory access to any market.

The Energy Policy Act's elimination of the limitation on utility ownership of QFs could result in greater utility ownership of QFs than previously was the case due to PURPA and PUHCA restrictions and considerations. If these transactions and development projects occur in the areas of energy-from-waste

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or other renewable energy, it could serve to increase competition with our businesses by bringing greater utility participation to these markets.

The Energy Policy Act extends or establishes certain renewable energy incentives and tax credits which might be helpful to expand our businesses or for new development.

Recent Policy Debate Regarding Climate Change

Increased public and political debate has occurred recently over the need for additional regulation of greenhouse gas (GHG) emissions (principally carbon dioxide (CO_2) and methane) as a contributor to climate change. Such regulations could in the future affect our business. As is the case with all combustion, our facilities do emit CO_2 , however we believe that energy-from-waste creates net reductions in GHG emissions, because it also avoids CO_2 emissions from fossil fuel power plants, methane emissions from landfills, and GHG emissions from mining and processing metal. In addition, energy-from-waste facilities typically are located closer to the source of the waste and thus typically reduce fossil fuel consumption and air emissions associated with long-haul transportation of waste to landfills. For policy makers at the local level, who make decisions on waste disposal alternatives, we believe that using energy-from-waste instead of landfilling will result in significantly lower net GHG emissions, while also introducing more control over the cost of waste disposal and supply of local electrical power. We are actively engaged in encouraging policy makers at state and federal levels to enact legislation that supports energy-from-waste as a superior choice for communities to avoid both the environmental harm caused by landfilling waste, and reduce local reliance on fossil fuels as a source of energy.

During 2007, substantial debate occurred in Congress in the context of energy legislation with respect to proposed policy changes designed to encourage electricity generation from renewable sources. While the final energy legislation, enacted during December 2007, did not include specific requirements for electricity generation from renewable sources, Congress is expected to continue to debate and ultimately enact some form of legislation regarding the need to encourage renewable electricity generation. The extent to which such potential legislation will affect our business will depend in part on whether energy-from-waste and our other renewable technologies are included within the range of renewable technologies that could benefit from such legislation.

Congress is also expected to debate proposed legislation addressing climate change, which would require regulation of a broad range of activities affecting climate, potentially including the operation of our facilities. Certain proposed legislation would establish a cap and trade program for GHG emissions with a market-based emissions trading system aimed at reducing emissions of CO_2 below baseline levels. We cannot predict at this time whether our facilities would be included within the scope of potential regulation under such climate change legislation, or whether our business will otherwise be affected positively or negatively.

While the political discussion in Congress, as well as at the state and regional levels, has not been aimed specifically at waste or energy-from-waste businesses, regulatory initiatives developed to date have been broad in scope and designed generally to promote renewable energy, develop a certified GHG inventory, and ultimately reduce GHG emissions. Many of these more developed initiatives have been at the state or regional levels, and some initiatives exist in regions where we have projects. For example, during 2006, a group of seven northeastern states, including Connecticut, New Jersey and New York, acting through the Regional Greenhouse Gas Initiative (RGGI), issued a model rule to implement reductions in GHG emissions. The RGGI model rule also featured a cap and trade program for regional CO_2 emissions, initially fixed at 1990 levels, followed by incremental reductions below those levels after 2014. To date, RGGI has been focused on fossil fuel-fired electric generators and does not directly affect energy-from-waste facilities; however, we continue to monitor developments with respect to state implementation of RGGI and intend to participate in rulemaking.

We expect that initiatives intended to reduce GHG, such as RGGI and any federal legislation that would impose similar cap and trade programs, may cause electricity prices to rise, thus potentially affecting the prices at which we sell electricity from our facilities which sell into the market.

Among states, California has assumed a leadership role in curtailing GHG emissions. During 2006, California enacted the California Global Warming Solutions Act of 2006 (AB 32). AB 32 requires annual reporting of GHG emissions for sources deemed significant by California's Air Resources Board (CARB) and sets emission limits to cut California's emissions to 1990 levels by 2020. During 2006, we joined the California Climate Action

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Registry, certifying our GHG emissions from our California facilities. As a member, we will participate in the evolving regulatory process by which the CARB will implement the requirements of AB 32. Until CARB issues its regulatory GHG emission reduction program, we cannot predict with certainty the impact of AB 32 on our California facilities.

We have also joined The Climate Registry, a voluntary, collaborative North American GHG emissions registry that is directed by environmental regulators from member states and is supported by regional air quality consortiums. The mission of The Climate Registry is to create a single GHG emissions reporting and verification platform for use throughout North America, using a reporting protocol similar to that already in place in California. The Climate Registry presently includes 39 states (including all but one of the states in which we have operations), the District of Columbia, three Native American tribes, six Canadian Provinces and two Mexican states. In joining The Climate Registry, we will voluntarily report GHG emissions from our energy-from-waste and other technologies. We also plan to participate in rulemaking efforts at the state and federal level which may rely on The Climate Registry as the basis for GHG regulation. To date, at least 54 corporations, state and local governments, and other organizations have joined The Climate Registry as voluntary reporters of GHG emissions.

Regulations Affecting Our International Business

We have ownership and operating interests in energy generation facilities outside the United States. Most countries have expansive systems for the regulation of the energy business. These generally include provisions relating to ownership, licensing, rate setting and financing of generation and transmission facilities.

We provide waste and energy services through environmentally protective project designs, regardless of the location of a particular project. Compliance with environmental standards comparable to those of the United States are often conditions to credit agreements by multilateral banking agencies, as well as other lenders or credit providers. The laws of various countries include pervasive regulation of emissions into the environment, and provide governmental entities with the authority to impose sanctions for violations, although these requirements are generally different from those applicable in the United States. See *Item 1A. Risk Factors Exposure to international economic and political factors may materially and adversely affect our international businesses* and *Compliance with environmental laws could adversely affect our results of operations*.

Climate Change Policies

Certain international markets in which we compete have recently adopted regulatory or policy frameworks that encourage energy-from-waste projects as important components of GHG reduction strategies, as well as waste management planning and practice. For example, the European Union has adopted regulations which require member countries to reduce utilization of and reliance upon landfill disposal. The legislation emanating from the European Union is primarily in the form of Directives, which are not directly applicable within the member countries. Rather, they need enabling legislation to implement them, which results in significant variance between the legislative schemes introduced by member countries. Certain Directives notably affect the regulation of energy-from-waste facilities across the European Union. These include (1) Directive 96/61/EC concerning integrated pollution prevention and control (known as the PPC Directive) which governs emissions to air, land and water from certain large industrial installations, (2) Directive 1999/31/EC concerning the landfill of waste (known as the Landfill Directive) which imposes operational and technical controls on landfills and restricts, on a reducing scale to the year 2020, the amount of biodegradable municipal waste which member countries may dispose of to landfill, and (3) Directive 2000/76/EC concerning the incineration of waste (known as the Waste Incineration Directive or WID), which imposes limits on emissions to air from the incineration and co-incineration of waste. Member countries have begun to implement measures such as imposing incremental fees on landfill disposal and providing rate subsidies for energy generated at energy-from-waste projects.

In response to these directives and in furtherance of its policies to reduce GHG, the United Kingdom now imposes substantial taxes on landfilling of waste: currently £24/ton, increasing annually to £48/ton in 2010. In addition, each local waste authority in the United Kingdom is limited in the amount of biodegradable waste it may landfill each year by the Landfill Allowance Trading Scheme (known as LATS). LATS is structured as a cap-and-trade program which reduces the capped amount of this waste that can be landfilled each year, through

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2016 when capped amounts will be fixed at 35% of 1995 levels. LATS allowances are tradable with other waste authorities, and substantial penalties of £150/ton are levied against authorities not in compliance.

Similarly, China currently has a favorable regulatory environment for the development of energy-from-waste projects. The National Plan issued by the Ministry of Construction sets guidelines for an increase in energy-from-waste capacity from 1.65% (2005 estimate) to 30% by 2030. The Chinese central government has further called for an increase in energy-from-waste output generation from 200 MW (2005 estimate) to 500 MW by 2010, and to three gigawatts by 2020. Energy-from-waste is designated by the Chinese central government as an encouraged industry, and accordingly, China has various promotional laws and policies in place to promote energy-from-waste projects including exemptions and reductions of corporate income tax, value added tax refunds, prioritized commercial bank loans, state subsidies for loan interest, and a guaranteed subsidized price for the sale of electricity.

EMPLOYEES

As of December 31, 2007, we employed approximately 3,500 full-time employees worldwide, of which a majority are employed in the United States.

Of our employees in the United States, approximately 10% are represented by organized labor. Currently, we are party to seven collective bargaining agreements: three expired in 2007 and are pending extensions; one expires in 2008, two expire in 2009, and one expires in 2010.

We consider relations with our employees to be good and do not anticipate any significant labor disputes in 2008.

EXECUTIVE OFFICERS

A list of our executive officers and their business experience follows. Ages shown are as of February 22, 2008.

Anthony J. Orlando was named President and Chief Executive Officer in October 2004. Mr. Orlando was elected as one of our directors in September 2005 and is a member of the Public Policy Committee and the Finance Committee. Previously, he had been President and Chief Executive Officer of Covanta Energy since November 2003. From March 2003 to November 2003, he served as Senior Vice President, Business and Financial Management of Covanta Energy. From January 2001 until March 2003, Mr. Orlando served as Covanta Energy's Senior Vice President, Waste-to-Energy. Previously, he served as Executive Vice President of Covanta Energy Group, Inc. Mr. Orlando joined Covanta Energy in 1987. Age: 48.

Mark A. Pytosh was appointed as Executive Vice President and Chief Financial Officer in December 2007. Mr. Pytosh served as Senior Vice President and Chief Financial Officer since September 2006. Previously, Mr. Pytosh served as Executive Vice President from February 2004 to August 2006 and Chief Financial Officer from May 2005 to August 2006 of Waste Services, Inc., a publicly-traded integrated waste services company. Prior to his tenure with Waste Services Inc., Mr. Pytosh served as a Managing Director in Investment Banking at Lehman Brothers where he led the firm's Global Industrial Group, from November 2000 to February 2004. Before joining Lehman Brothers in 2000, Mr. Pytosh had 15 years of investment banking experience at Donaldson, Lufkin & Jenrette and Kidder, Peabody. Age: 43.

John M. Klett was appointed as our Executive Vice President and Chief Operating Officer in December 2007. Mr. Klett served as Senior Vice President and Chief Operating Officer of Covanta Energy since May 2006 and as Covanta Energy's Senior Vice President, Operations since March 2003. Prior thereto, he served as Executive Vice President of Covanta Waste to Energy, Inc. for more than five years. Mr. Klett joined Covanta Energy in 1986. Mr. Klett has been in the energy-from-waste business since 1977. He has been in the power business since 1965. Age:

61.

Seth Myones was appointed as Covanta Energy's President, Americas, in November 2007, which is comprised principally of Covanta Energy's domestic business. Mr. Myones served as Covanta Energy's Senior Vice President, Business Management, since January 2004. From September 2001 until January 2004, Mr. Myones served as Vice

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President, Waste-to-Energy Business Management for Covanta Projects, Inc., a wholly-owned subsidiary of Covanta Energy. Mr. Myones joined Covanta Energy in 1989. Age: 49.

Timothy J. Simpson was appointed as Executive Vice President, General Counsel and Secretary in December 2007. Mr. Simpson served as Senior Vice President, General Counsel and Secretary since October 2004. Previously, he served as Senior Vice President, General Counsel and Secretary of Covanta Energy since March 2004. From June 2001 to March 2004, Mr. Simpson served as Vice President, Associate General Counsel and Assistant Secretary of Covanta Energy. Previously, he served as Senior Vice President, Associate General Counsel and Assistant Secretary of Covanta Energy Group, Inc. Mr. Simpson joined Covanta Energy in 1992. Age: 49.

Thomas E. Bucks has served as Vice President and Chief Accounting Officer since April 2005. Mr. Bucks served as Controller from February 2005 to April 2005. Previously, Mr. Bucks served as Senior Vice President Controller of Centennial Communications Corp., a leading provider of regional wireless and integrated communications services in the United States and the Caribbean, from March 1995 through February 2005, where he was the principal accounting officer and was responsible for accounting operations and external financial reporting. Age: 51.

Item 1A. RISK FACTORS

The following risk factors could have a material adverse effect on our business, financial condition and results of operations.

We cannot be certain that our NOLs will continue to be available to offset tax liability.

Our NOLs will expire in various amounts, if not used, between 2009 and 2026. The Internal Revenue Service (IRS) has not audited any of our tax returns for any of the years during the carryforward period including those returns for the years in which the losses giving rise to the NOLs were reported. We cannot assure you that we would prevail if the IRS were to challenge the availability of the NOLs. If the IRS were successful in challenging our NOLs, all or some portion of the NOLs would not be available to offset our future consolidated taxable income.

As of December 31, 2007, we estimated that we had approximately \$275 million of NOLs. In order to utilize the NOLs, we must generate consolidated taxable income which can offset such carryforwards. The NOLs are also used to offset income from certain grantor trusts that were established as part of the reorganization in 1990 of certain of our subsidiaries engaged in the insurance business and are administered by state regulatory agencies. During or at the conclusion of the administration of these grantor trusts, taxable income could result, which could utilize a portion of our NOLs and, in turn, could accelerate the date on which we may be otherwise obligated to pay incremental cash taxes.

In addition, if our existing insurance business were to require capital infusions from us in order to meet certain regulatory capital requirements, and we were to fail to provide such capital, some or all of our subsidiaries comprising our insurance business could enter insurance insolvency or bankruptcy proceedings. In such event, such subsidiaries may no longer be included in our consolidated tax return, and a portion, which could constitute a significant portion, of our remaining NOLs may no longer be available to us. In such event, there may be a significant inclusion of taxable income in our federal consolidated income tax return.

Changes in public policies and legislative initiatives could materially affect our business and prospects.

There has been substantial debate recently in the United States and abroad in the context of environmental and energy policies affecting climate change, the outcome of which could have a positive or negative influence on our existing business and our prospects for growing our business. The United States Congress has recently considered the

enactment of new laws that would encourage electricity generation from renewable technologies and discourage such generation from fossil fuels. For example, during 2007 Congress considered proposed legislation which would have established new renewable portfolio standards which are designed to increase the proportion of the nation's electricity that is generated from renewable technologies. Congress also considered extending existing tax benefits to renewable energy technologies, which will expire without such an extension. Both of these policy initiatives, and potentially others that may be considered, could provide material financial and competitive benefits to those

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technologies which are included among those defined as renewable in any legislation that is enacted. Our business could be adversely affected if renewable technologies we use were not included among those technologies identified in any final law as being entitled to the benefits of such laws.

Changes in technology may have a material adverse effect on our profitability.

Research and development activities are ongoing to provide alternative and more efficient technologies to dispose of waste, produce by-products from waste, or to produce power. We and many other companies are pursuing these technologies, and an increasing amount of capital is being invested to find new approaches to waste disposal, waste treatment, and power generation. It is possible that this deployment of capital may lead to advances in these or other technologies which will reduce the cost of waste disposal or power production to a level below our costs and/or provide new or alternative methods of waste disposal or energy generation that become more accepted than those we currently utilize. Unless we are able to participate in these advances, any of these changes could have a material adverse effect on our revenues, profitability and the value of our existing facilities.

Operation of our facilities involves significant risks.

The operation of our facilities involves many risks, including:

- the inaccuracy of our assumptions with respect to the timing and amount of anticipated revenues;
- supply interruptions;
- the breakdown or failure of equipment or processes;
- difficulty or inability to find suitable replacement parts for equipment;
- increases in the prices of commodities we need to continue operating our facilities;
- the unavailability of sufficient quantities of waste or fuel;
- decreases in the fees for solid waste disposal and electricity generated;
- decreases in the demand or market prices for recovered ferrous or non-ferrous metal;
- disruption in the transmission of electricity generated;
- permitting and other regulatory issues, license revocation and changes in legal requirements;
- labor disputes and work stoppages;
- unforeseen engineering and environmental problems;
- unanticipated cost overruns;
- weather interferences, catastrophic events including fires, explosions, earthquakes, droughts and acts of terrorism;
- the exercise of the power of eminent domain; and
- performance below expected levels of output or efficiency.

We cannot predict the impact of these risks on our business or operations. These risks, if they were to occur, could prevent us from meeting our obligations under our operating contracts and have an adverse affect on our results of operations.

Development and construction of new projects and expansions may not commence as anticipated, or at all.

The development and construction of new waste and energy facilities involves many risks including:

- difficulties in identifying, obtaining and permitting suitable sites for new projects;
- the inaccuracy of our assumptions with respect to the cost of and schedule for completing construction;
- difficulty, delays or inability to obtain financing for a project on acceptable terms;
- delays in deliveries of, or increases in the prices of, equipment sourced from other countries;

the unavailability of sufficient quantities of waste or other fuels for startup;
permitting and other regulatory issues, license revocation and changes in legal requirements;
labor disputes and work stoppages;
unforeseen engineering and environmental problems;
unanticipated cost overruns; and

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weather interferences, catastrophic events including fires, explosions, earthquakes, droughts and acts of terrorism.

In addition, new facilities have no operating history and may employ recently developed technology and equipment. Our businesses maintain insurance to protect against risks relating to the construction of new projects; however, such insurance may not be adequate to cover lost revenues or increased expenses. As a result, a new facility may be unable to fund principal and interest payments under its debt service obligations or may operate at a loss. In certain situations, if a facility fails to achieve commercial operation, at certain levels or at all, termination rights in the agreements governing the facility's financing may be triggered, rendering all of the facility's debt immediately due and payable. As a result, the facility may be rendered insolvent and we may lose our interest in the facility.

Construction activities may cost more and take longer than we estimate.

The design and construction of new projects or expansions requires us to contract for services from engineering and construction firms, and make substantial purchases of equipment such as boilers, turbine generators and other components that require large quantities of steel to fabricate. In part because of the high world-wide demand for new energy generating facilities and waste disposal facilities, steel prices have risen sharply and may continue to do so. In addition, this increased demand affects not only the cost of obtaining the services necessary to design and construct these facilities, but also the availability of quality firms to perform the services. These conditions may adversely affect our ability to successfully compete for new projects, or construct and complete such projects on time and within budget.

The rapid growth of our operations could strain our resources and cause our business to suffer.

We have experienced rapid growth and intend to further grow our business. This growth has placed, and potential future growth will continue to place, a strain on our management systems, infrastructure and resources. Our ability to successfully offer services and implement our business plan in a rapidly evolving market requires an effective planning and management process. We expect that we will need to continually evaluate and maintain our financial and managerial controls, reporting systems and procedures. We will also need to expand, train and manage our workforce worldwide. Furthermore, we expect that we will be required to manage an increasing number of relationships with various customers and other third parties. Failure to expand in any of the foregoing areas efficiently and effectively could interfere with the growth and current operation of our business as a whole.

Our efforts to grow our business will require us to incur significant costs in business development, often over extended periods of time, with no guarantee of success.

Our efforts to grow our waste and energy business will depend in part on how successful we are in developing new projects and expanding existing projects. The development period for each project may occur over several years, during which we incur substantial expenses relating to siting, design, permitting, community relations, financing and professional fees associated with all of the foregoing. Not all of our development efforts will be successful, and we may decide to cease developing a project for a variety of reasons. If the cessation of our development efforts were to occur at an advanced stage of development, we may have incurred a material amount of expenses for which we will realize no return.

A failure to identify suitable acquisition candidates and to complete acquisitions could have an adverse effect on our business strategy and growth plans.

As part of our business strategy, we intend to continue to pursue acquisitions of complementary businesses. Although we regularly evaluate acquisition opportunities, we may not be able to successfully identify suitable acquisition

candidates, obtain sufficient financing on acceptable terms to fund acquisitions or complete acquisitions.

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Our insurance and contractual protections may not always cover lost revenues, increased expenses or liquidated damages payments.

Although our businesses maintain insurance, obtain warranties from vendors, require contractors to meet certain performance levels and, in some cases, pass risks we cannot control to the service recipient or output purchaser, the proceeds of such insurance, warranties, performance guarantees or risk sharing arrangements may not be adequate to cover lost revenues, increased expenses or liquidated damages payments.

Performance reductions could materially and adversely affect us and our projects may operate at lower levels than expected.

Most service agreements for our energy-from-waste facilities provide for limitations on damages and cross-indemnities among the parties for damages that such parties may incur in connection with their performance under the service agreement. In most cases, such contractual provisions excuse our businesses from performance obligations to the extent affected by uncontrollable circumstances and provide for service fee adjustments if uncontrollable circumstances increase our costs. We cannot assure you that these provisions will prevent our businesses from incurring losses upon the occurrence of uncontrollable circumstances or that if our businesses were to incur such losses they would continue to be able to service their debt.

We have issued or are party to performance guarantees and related contractual obligations associated with our energy and waste facilities. With respect to our domestic and international businesses, we have issued guarantees to our municipal clients and other parties that we will perform in accordance with contractual terms, including, where required, the payment of damages or other obligations. The obligations guaranteed will depend upon the contract involved. Many of our subsidiaries have contracts to operate and maintain energy-from-waste facilities. In these contracts, the subsidiary typically commits to operate and maintain the facility in compliance with legal requirements; to accept minimum amounts of solid waste; to generate a minimum amount of electricity per ton of waste; and to pay damages to contract counterparties under specified circumstances, including those where the operating subsidiary's contract has been terminated for default. Any contractual damages or other obligations incurred by us could be material, and in circumstances where one or more subsidiary's contract has been terminated for its default, such damages could include amounts sufficient to repay project debt. Additionally, damages payable under such guarantees on our owned energy-from-waste facilities could expose us to recourse liability on project debt. Certain of our operating subsidiaries which have issued these guarantees may not have sufficient sources of cash to pay such damages or other obligations. We cannot assure you that we will be able to continue to avoid incurring material payment obligations under such guarantees or that, if we did incur such obligations, that we would have the cash resources to pay them.

Our businesses generate their revenue primarily under long-term contracts and must avoid defaults under those contracts in order to service their debt and avoid material liability to contract counterparties.

We must satisfy performance and other obligations under contracts governing energy-from-waste facilities. These contracts typically require us to meet certain performance criteria relating to amounts of waste processed, energy generation rates per ton of waste processed, residue quantity and environmental standards. Our failure to satisfy these criteria may subject us to termination of operating contracts. If such a termination were to occur, we would lose the cash flow related to the projects and incur material termination damage liability, which may be guaranteed by us. In circumstances where the contract has been terminated due to our default, we may not have sufficient sources of cash to pay such damages. We cannot assure you that we will be able to continue to perform our respective obligations under such contracts in order to avoid such contract terminations, or damages related to any such contract termination, or that if we could not avoid such terminations that we would have the cash resources to pay amounts that may then become due.

We have provided guarantees and financial support in connection with our projects.

We are obligated to guarantee or provide financial support for our projects in one or more of the following forms:

support agreements in connection with service or operating agreement-related obligations;

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direct guarantees of certain debt relating to our facilities;
contingent obligations to pay lease payment installments in connection with certain of our facilities;
agreements to arrange financing for projects under development;
contingent credit support for damages arising from performance failures;
environmental indemnities; and
contingent capital and credit support to finance costs, in most cases in connection with a corresponding increase in service fees, relating to uncontrollable circumstances.

Many of these contingent obligations cannot readily be quantified, but, if we were required to provide this support, it may be material to our cash flow and financial condition.

We may face increased risk of market influences on our revenues after our contracts expire.

Our contracts to operate energy-from-waste projects expire on various dates between 2008 and 2034, and our contracts to sell energy output generally expire when the project's operating contract expires. Expiration of these contracts will subject us to greater market risk in entering into new or replacement contracts at pricing levels which will generate comparable or enhanced revenues. As our operating contracts at municipally-owned projects approach expiration, we will seek to enter into renewal or replacement contracts to continue operating such projects. However, we cannot assure you that we will be able to enter into renewal or replacement contracts on favorable terms, or at all. We will seek to bid competitively for additional contracts to operate other facilities as similar contracts of other vendors expire. The expiration of existing energy sales contracts, if not renewed, will require us to sell project energy output either into the electricity grid or pursuant to new contracts.

At some of our facilities, market conditions may allow us to effect extensions of existing operating contracts along with facility expansions. Such extensions and expansions are currently being considered at a limited number of our facilities in conjunction with our clients. If we are unable to reach agreement with our municipal clients on the terms under which they would implement such extensions and expansions, or if the implementation of these extensions, including renewals and replacement contracts, and expansions are materially delayed, this may adversely affect our cash flow and profitability. We cannot assure you that we will be able to enter into such contracts or that the terms available in the market at the time will be favorable to us.

Our businesses depend on performance by third parties under contractual arrangements.

Our waste and energy businesses depend on a limited number of third parties to, among other things, purchase the electric and steam energy produced by our facilities, and supply and deliver the waste and other goods and services necessary for the operation of our energy facilities. The viability of our facilities depends significantly upon the performance by third parties in accordance with long-term contracts, and such performance depends on factors which may be beyond our control. If those third parties do not perform their obligations, or are excused from performing their obligations because of nonperformance by our waste and energy businesses or other parties to the contracts, or due to force majeure events or changes in laws or regulations, our businesses may not be able to secure alternate arrangements on substantially the same terms, if at all, for the services provided under the contracts. In addition, the bankruptcy or insolvency of a participant or third party in our facilities could result in nonpayment or nonperformance of that party's obligations to us.

Concentration of suppliers and customers may expose us to heightened financial exposure.

Our waste and energy services businesses often rely on single suppliers and single customers at our facilities, exposing such facilities to financial risks if any supplier or customer should fail to perform its obligations.

For example, our businesses often rely on a single supplier to provide waste, fuel, water and other services required to operate a facility and on a single customer or a few customers to purchase all or a significant portion of a facility's output. In most cases our businesses have long-term agreements with such suppliers and customers in order to mitigate the risk of supply interruption. The financial performance of these facilities depends on such customers and suppliers continuing to perform their obligations under their long-term agreements. A facility's financial results could be materially and adversely affected if any one customer or supplier fails to fulfill its contractual obligations and we are unable to find other customers or suppliers to produce the same level of

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profitability. We cannot assure you that such performance failures by third parties will not occur, or that if they do occur, such failures will not adversely affect the cash flows or profitability of our businesses.

In addition, we rely on the municipal clients as a source not only of waste for fuel but also of revenue from the fees for disposal services we provide. Because our contracts with municipal clients are generally long-term, we may be adversely affected if the credit quality of one or more of our municipal clients were to decline materially.

Our business is subject to pricing fluctuations caused by the waste disposal and energy markets.

While we sell the majority of our waste disposal capacity and energy output pursuant to long-term contracts, a material portion of this capacity and output is subject to market price fluctuation. Consequently, our operating results may be adversely affected by fluctuations in waste disposal and energy prices.

Our waste operations are concentrated in one region, and expose us to regional economic or market declines.

The majority of our waste disposal facilities are located in the northeastern United States, primarily along the Washington, D.C. to Boston, Massachusetts corridor. Adverse economic developments in this region could affect regional waste generation rates and demand for waste disposal services provided by us. Adverse market developments caused by additional waste disposal capacity in this region could adversely affect waste disposal pricing. Either of these developments could have a material adverse effect on our revenues and cash generation.

Some of our energy contracts involve greater risk of exposure to performance levels which could result in materially lower revenues.

Some of our energy-from-waste facilities receive 100% of the energy revenues they generate. As a result, if we are unable to operate these facilities at their historical performance levels for any reason, our revenues from energy sales could materially decrease.

Exposure to international economic and political factors may materially and adversely affect our international businesses.

Our international operations expose us to political, legal, tax, currency, inflation, convertibility and repatriation risks, as well as potential constraints on the development and operation of potential business, any of which can limit the benefits to us of an international project.

Our projected cash distributions from most of our existing international facilities come from facilities located in countries with sovereign ratings below investment grade. The financing, development and operation of projects outside the United States can entail significant political and financial risks, which vary by country, including:

- changes in law or regulations;
- changes in electricity pricing;
- changes in foreign tax laws and regulations;
- changes in United States federal, state and local laws, including tax laws, related to foreign operations;
- compliance with United States federal, state and local foreign corrupt practices laws;
- changes in government policies or personnel;
- changes in general economic conditions affecting each country, including conditions in financial markets;
- changes in labor relations in operations outside the United States;
- political, economic or military instability and civil unrest;
- expropriation and confiscation of assets and facilities; and

credit quality of entities that purchase our power.

The legal and financial environment in foreign countries in which we currently own assets or projects could also make it more difficult for us to enforce our rights under agreements relating to such projects.

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Any or all of the risks identified above with respect to our international projects could adversely affect our revenue and cash generation. As a result, these risks may have a material adverse effect on our business, consolidated financial condition and results of operations.

Our reputation could be adversely affected if opposition to our efforts to grow our business results in adverse publicity or our businesses were to fail to comply with United States or foreign laws or regulations.

With respect to our efforts to renew our contracts and grow our waste and energy business both domestically and internationally, we sometimes experience opposition from advocacy groups or others intended to halt a development effort or other opportunity we may be pursuing. Such opposition is often intended to discourage third parties from doing business with us and may be based on inaccurate, incomplete or inflammatory assertions. We cannot provide any assurance that our reputation would not be adversely affected as a result of adverse publicity resulting from such opposition. Some of our projects and new business may be conducted in countries where corruption has historically penetrated the economy to a greater extent than in the United States. It is our policy to comply, and to require our local partners and those with whom we do business to comply, with all applicable anti-bribery laws, such as the U.S. Foreign Corrupt Practices Act and with applicable local laws of the foreign countries in which we operate. We cannot provide any assurance that our reputation would not be adversely affected if we were reported to be associated with corrupt practices or if we or our local partners failed to comply with such laws.

Exposure to foreign currency fluctuations may affect our results from operations.

We have sought to participate in projects where the host country has allowed the convertibility of its currency into U.S. dollars and repatriation of earnings, capital and profits subject to compliance with local regulatory requirements. As we grow our business in other countries and enter new international markets, currency volatility may impact the amount we are required to invest in new projects, as well our reported results.

In some cases, components of project costs incurred or funded in the currency of the United States are recovered with limited exposure to currency fluctuations through negotiated contractual adjustments to the price charged for electricity or service provided. This contractual structure may cause the cost in local currency to the project's power purchaser or service recipient to rise from time to time in excess of local inflation. As a result, there is a risk in such situations that such power purchaser or service recipient will, at least in the near term, be less able or willing to pay for the project's power or service.

Exposure to fuel supply prices may affect our costs and results of operations for our international projects.

Changes in the market prices and availability of fuel supplies to generate electricity may increase our cost of producing power, which could adversely impact our energy businesses' profitability and financial performance.

The market prices and availability of fuel supplies for some of our international facilities fluctuate. Any price increase, delivery disruption or reduction in the availability of such supplies could affect our ability to operate the facilities and impair their cash flow and profitability. We may be subject to further exposure if any of our future international operations are concentrated in facilities using fuel types subject to fluctuating market prices and availability. We may not be successful in our efforts to mitigate our exposure to supply and price swings.

Our inability to obtain resources for operations may adversely affect our ability to effectively compete.

Our energy-from-waste facilities depend on solid waste for fuel, which provides a source of revenue. For most of our facilities, the prices we charge for disposal of solid waste are fixed under long-term contracts and the supply is guaranteed by sponsoring municipalities. However, for some of our energy-from-waste facilities, the availability of

solid waste to us, as well as the tipping fee that we must charge to attract solid waste to our facilities, depends upon competition from a number of sources such as other energy-from-waste facilities, landfills and transfer stations competing for waste in the market area. In addition, we may need to obtain waste on a competitive basis as our long-term contracts expire at our owned facilities. There has been consolidation and there may be further consolidation in the solid waste industry which would reduce the number of solid waste collectors or haulers that are

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competing for disposal facilities or enable such collectors or haulers to use wholesale purchasing to negotiate favorable below-market disposal rates. The consolidation in the solid waste industry has resulted in companies with vertically integrated collection activities and disposal facilities. Such consolidation may result in economies of scale for those companies as well as the use of disposal capacity at facilities owned by such companies or by affiliated companies. Such activities can affect both the availability of waste to us for disposal at some of our energy-from-waste facilities and market pricing.

Compliance with environmental laws could adversely affect our results of operations.

Costs of compliance with federal, state, local and foreign existing and future environmental regulations could adversely affect our cash flow and profitability. Our waste and energy businesses are subject to extensive environmental regulation by federal, state and local authorities, primarily relating to air, waste (including residual ash from combustion) and water. We are required to comply with numerous environmental laws and regulations and to obtain numerous governmental permits in operating our facilities. Our businesses may incur significant additional costs to comply with these requirements. Environmental regulations may also limit our ability to operate our facilities at maximum capacity or at all. If our businesses fail to comply with these requirements, we could be subject to civil or criminal liability, damages and fines. Existing environmental regulations could be revised or reinterpreted and new laws and regulations could be adopted or become applicable to us or our facilities, and future changes in environmental laws and regulations could occur. This may materially increase the amount we must invest to bring our facilities into compliance, or impose additional expense on our operations, or otherwise impose structural changes to markets which would adversely affect our competitive positioning in those markets.

In addition, lawsuits or enforcement actions by federal, state and/or foreign regulatory agencies may materially increase our costs. Stricter environmental regulation of air emissions, solid waste handling or combustion, residual ash handling and disposal, and waste water discharge could materially affect our cash flow and profitability. Certain environmental laws make us potentially liable on a joint and several basis for the remediation of contamination at or emanating from properties or facilities we currently or formerly owned or operated or properties to which we arranged for the disposal of hazardous substances. Such liability is not limited to the cleanup of contamination we actually caused. Although we seek to obtain indemnities against liabilities relating to historical contamination at the facilities we own or operate, we cannot provide any assurance that we will not incur liability relating to the remediation of contamination, including contamination we did not cause.

Our businesses may not be able to obtain or maintain, from time to time, all required environmental regulatory approvals. If there is a delay in obtaining any required environmental regulatory approvals or if we fail to obtain and comply with them, the operation of our facilities could be jeopardized or become subject to additional costs.

Energy regulation could adversely affect our revenues and costs of operations.

Our waste and energy businesses are subject to extensive energy regulations by federal, state and foreign authorities. We cannot predict whether the federal, state or foreign governments will modify or adopt new legislation or regulations relating to the solid waste or energy industries. The economics, including the costs, of operating our facilities may be adversely affected by any changes in these regulations or in their interpretation or implementation or any future inability to comply with existing or future regulations or requirements.

The Federal Power Act (FPA) regulates energy generating companies and their subsidiaries and places constraints on the conduct of their business. The FPA regulates wholesale sales of electricity and the transmission of electricity in interstate commerce by public utilities. Under PURPA, our domestic facilities are exempt from most provisions of the FPA and state rate regulation. Our foreign projects are also exempt from regulation under the FPA.

The Energy Policy Act of 2005 enacted comprehensive changes to the domestic energy industry which may affect our businesses. The Energy Policy Act removed certain regulatory constraints that previously limited the ability of utilities and utility holding companies to invest in certain activities and businesses, which may have the effect over time of increasing competition in energy markets in which we participate. In addition, the Energy Policy Act includes provisions that may remove some of the benefits provided to non-utility electricity generators, like us, after our existing energy sale contracts expire. As a result, we may face increased competition after such expirations occur.

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If our businesses lose existing exemptions under the FPA, the economics and operations of our energy projects could be adversely affected, including as a result of rate regulation by the Federal Energy Regulatory Commission, with respect to our output of electricity, which could result in lower prices for sales of electricity. In addition, depending on the terms of the project's power purchase agreement, a loss of our exemptions could allow the power purchaser to cease taking and paying for electricity under existing contracts. Such results could cause the loss of some or all contract revenues or otherwise impair the value of a project and could trigger defaults under provisions of the applicable project contracts and financing agreements. Defaults under such financing agreements could render the underlying debt immediately due and payable. Under such circumstances, we cannot assure you that revenues received, the costs incurred, or both, in connection with the project could be recovered through sales to other purchasers.

Failure to obtain regulatory approvals could adversely affect our operations.

Our waste and energy businesses are continually in the process of obtaining or renewing federal, state, local and foreign approvals required to operate our facilities. While our businesses currently have all necessary operating approvals, we may not always be able to obtain all required regulatory approvals, and we may not be able to obtain any necessary modifications to existing regulatory approvals or maintain all required regulatory approvals. If there is a delay in obtaining any required regulatory approvals or if we fail to obtain and comply with any required regulatory approvals, the operation of our facilities or the sale of electricity to third parties could be prevented, made subject to additional regulation or subject our businesses to additional costs or a decrease in revenue.

The energy industry is becoming increasingly competitive, and we might not successfully respond to these changes.

We may not be able to respond in a timely or effective manner to the changes resulting in increased competition in the energy industry in both domestic and international markets. These changes may include deregulation of the electric utility industry in some markets, privatization of the electric utility industry in other markets and increasing competition in all markets. To the extent competitive pressures increase and the pricing and sale of electricity assumes more characteristics of a commodity business, the economics of our business may be subject to greater volatility.

Our substantial indebtedness could adversely affect our business, financial condition and results of operations and our ability to meet our payment obligations under our indebtedness.

The level of our consolidated indebtedness could have significant consequences on our future operations, including:

- making it difficult for us to meet our payment and other obligations under our outstanding indebtedness, including the 1.00% Senior Convertible Debentures (the "Debentures");
- limiting our ability to obtain additional financing to fund working capital, capital expenditures, acquisitions and other general corporate purposes;
- subjecting us to the risk of increased sensitivity to interest rate increases on indebtedness under our credit facilities;
- limiting our flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business, the industries in which we operate and the general economy; and
- placing us at a competitive disadvantage compared to our competitors that have less debt or are less leveraged.

Any of the above-listed factors could have an adverse effect on our business, financial condition and results of operations and our ability to meet our payment obligations under our consolidated debt, and the price of our common stock.

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We cannot assure you that our cash flow from operations will be sufficient to service our indebtedness.

Our ability to meet our obligations under our indebtedness depends on our ability to generate cash and our ability to receive dividends and distributions from our subsidiaries in the future. This, in turn, is subject to many factors, some of which are beyond our control, including the following:

the continued operation and maintenance of our facilities, consistent with historical performance levels; maintenance or enhancement of revenue from renewals or replacement of existing contracts and from new contracts to expand existing facilities or operate additional facilities; market conditions affecting waste disposal and energy pricing, as well as competition from other companies for contract renewals, expansions and additional contracts, particularly after our existing contracts expire; and general economic, financial, competitive, legislative, regulatory and other factors.

We cannot assure you that our business will generate cash flow from operations, or that future borrowings will be available to us under our credit facilities or otherwise, in an amount sufficient to enable us to meet our payment obligations under our outstanding indebtedness and to fund other liquidity needs. If we are not able to generate sufficient cash flow to service our debt obligations, we may need to refinance or restructure our debt, sell assets, reduce or delay capital investments, or seek to raise additional capital. If we are unable to implement one or more of these alternatives, we may not be able to meet our payment obligations under our outstanding indebtedness, and which could have a material and adverse affect on our financial condition.

Our debt agreements contain covenant restrictions that may limit our ability to operate our business.

Our credit facilities contain operating and financial restrictions and covenants that impose operating and financial restrictions on us and require us to meet certain financial tests. Complying with these covenant restrictions may have a negative impact on our business, results of operations and financial condition by limiting our ability to engage in certain transactions or activities, including:

incurring additional indebtedness or issuing guarantees, in excess of specified amounts; creating liens, in excess of specified amounts; making certain investments, in excess of specified amounts; entering into transactions with our affiliates; selling certain assets, in excess of specified amounts; making cash distributions or paying dividends to us, in excess of specified amounts; redeeming capital stock or making other restricted payments to us, in excess of specified amounts; and merging or consolidating with any person.

Our ability to comply with these covenants is dependent on our future performance, which will be subject to many factors, some of which are beyond our control, including prevailing economic conditions. As a result of these covenants, our ability to respond to changes in business and economic conditions and to obtain additional financing, if needed, may be restricted, and we may be prevented from engaging in transactions that might otherwise be beneficial to us, or in declaring and paying dividends to our stockholders. In addition, the failure to comply with these covenants in our credit facilities could result in a default thereunder and a default under the Debentures. Upon the occurrence of such an event of default, the lenders under our credit facilities could elect to declare all amounts outstanding under such agreement, together with accrued interest, to be immediately due and payable. If the lenders accelerate the payment of the indebtedness under our credit facilities, we cannot assure you that the assets securing such indebtedness would be sufficient to repay in full that indebtedness and our other indebtedness, including the Debentures, and which could have a material and adverse affect on our financial condition.

Our controls and procedures may not prevent or detect all errors or acts of fraud.

Our management, including our Chief Executive Officer and Chief Financial Officer, believes that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must consider the benefits of controls relative to their costs. Inherent limitations within a

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control system include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by an unauthorized override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and may not be prevented or detected.

Failure to maintain an effective system of internal control over financial reporting may have an adverse effect on our stock price.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, and the rules and regulations promulgated by the Securities and Exchange Commission (SEC) to implement Section 404, we are required to furnish a report by our management to include in our annual report on Form 10-K regarding the effectiveness of our internal control over financial reporting. The report includes, among other things, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management.

We have in the past discovered, and may potentially in the future discover, areas of internal control over financial reporting which may require improvement. If we are unable to assert that our internal control over financial reporting is effective now or in any future period, or if our auditors are unable to express an opinion on the effectiveness of our internal controls, we could lose investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on our stock price.

Provisions of our certificate of incorporation and Debentures could discourage an acquisition by a third party.

Provisions of our restated certificate of incorporation could make it more difficult for a third party to acquire control of us. For example, our restated certificate of incorporation authorizes our Board of Directors to issue preferred stock without requiring any stockholder approval, and preferred stock could be issued as a defensive measure in response to a takeover proposal. These provisions could make it more difficult for a third party to acquire us even if an acquisition might be in the best interest of our stockholders. In addition, certain provisions of the Debentures could make it more difficult or more expensive for a third party to acquire us. Upon the occurrence of certain transactions constituting a fundamental change, the holders of the Debentures will have the right to require us to repurchase their Debentures. We may also be required to issue additional shares upon conversion or provide for conversion based on the acquirer's capital stock in the event of certain fundamental changes. These possibilities could discourage an acquisition of us.

The market price of our common stock may fluctuate significantly, and this may make it difficult for holders to resell our common stock when they want or at prices that they find attractive.

The price of our common stock on the New York Stock Exchange constantly changes. We expect that the market price of our common stock will continue to fluctuate. In addition, because the Debentures are convertible into our common stock, volatility or depressed prices for our common stock could have a similar effect on the trading price of the Debentures. Consequently, there can be no assurance as to the liquidity of an investment in our common stock.

The market price of our common stock may fluctuate as a result of a variety of factors, many of which are beyond our control. These factors include:

- changes in the waste and energy market conditions;
- quarterly variations in our operating results;

our operating results that vary from the expectations of management, securities analysts and investors;
changes in expectations as to our future financial performance;
announcements of strategic developments, significant contracts, acquisitions and other material events by us or
our competitors;

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the operating and securities price performance of other companies that investors believe are comparable to us;
future sales of our equity or equity-related securities;
changes in the economy and the financial markets;
departures of key personnel;
changes in governmental regulations; and
geopolitical conditions, such as acts or threats of terrorism or military conflicts.

In addition, in recent years, the stock market in general has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market price of securities issued by many companies for reasons often unrelated to their operating performance. These broad market fluctuations may adversely affect the market price of our common stock, regardless of our operating results.

Future issuances of our common stock will dilute the ownership interests of stockholders and may adversely affect the trading price of our common stock.

We are not restricted from issuing additional shares of our common stock, or securities convertible into or exchangeable for our common stock. Future sales of substantial amounts of our common stock or equity-related securities in the public market, or the perception that such sales could occur, could materially and adversely affect prevailing trading prices of our common stock. In addition, the conversion of some or all of the Debentures will dilute the ownership interests of our existing stockholders. Any sales in the public market of our common stock issuable upon such conversion could adversely affect prevailing market prices of our common stock. In addition, the existence of the Debentures may encourage short selling by market participants because the conversion of the Debentures could depress the trading price of our common stock.

Concentrated stock ownership may discourage unsolicited acquisition proposals.

As of February 14, 2008, SZ Investments, L.L.C., together with its affiliate, EGI-Fund (05-07) Investors, L.L.C., referred to as Fund 05-07 and, collectively with SZ Investments, L.L.C. SZ Investments, and Third Avenue Trust, on behalf of Third Avenue Value Fund, referred to as Third Avenue, separately own approximately 15.1% and 5.7%, respectively, or when aggregated, approximately 20.8% of our outstanding common stock. Although there are no agreements among SZ Investments and Third Avenue regarding their voting or disposition of shares of our common stock, the level of their combined ownership of shares of our common stock could have the effect of discouraging or impeding an unsolicited acquisition proposal. Further, as a result, these stockholders may continue to have the ability to influence the election or removal of our directors and influence the outcome of matters presented for approval by our stockholders. Circumstances may occur in which the interests of these stockholders could be in conflict with the holders of the Debentures.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We own 5.4 acres in Fairfield, New Jersey where our corporate offices reside. In addition, we lease various office facilities in California aggregating approximately 25,539 square feet and we own undeveloped land in Massachusetts and California aggregating approximately 95 acres. As of December 31, 2007, we owned or operated 60 domestic projects consisting of 34 energy-from-waste operations, three landfills, ten transfer stations, six wood waste (biomass) energy projects, two water (hydroelectric) energy projects, and five landfill gas energy projects. Principal projects are described above under *Item 1. Business Domestic Business*. Domestic projects noted which we own or lease are

conducted at properties, which we also own or lease, aggregating approximately 921 acres, of which approximately 580 acres are owned and approximately 341 acres are leased.

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We operate our international projects through a network of offices located in Shanghai and Guangzhou, China; Chennai, India; Manila, Philippines; Bangkok, Thailand; and Birmingham, England, where we lease office space aggregating approximately 23,370 square feet. As of December 31, 2007, we are the part owner/operator of ten international projects of which three are owned or controlled by subsidiaries with businesses conducted at leased properties aggregating approximately 65.8 acres. Principal projects are described above under *Item 1. Business International Business*.

Item 3. LEGAL PROCEEDINGS

For information regarding legal proceedings, see Note 21. Commitments and Contingencies of the Notes to the Consolidated Financial Statements in Item 8, which information is incorporated herein by reference.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of stockholders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2007.

Table of Contents**PART II****Item 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the New York Stock Exchange under the symbol CVA . On February 14, 2008, there were approximately 1,033 holders of record of our common stock. On February 14, 2008, the closing price of our common stock on the New York Stock Exchange was \$26.49 per share. The following table sets forth the high and low stock prices of our common stock for the last two years.

| | 2007 | | 2006 | |
|----------------|----------|----------|----------|----------|
| | High | Low | High | Low |
| First Quarter | \$ 24.22 | \$ 21.29 | \$ 18.15 | \$ 14.61 |
| Second Quarter | \$ 26.35 | \$ 21.69 | \$ 18.60 | \$ 14.36 |
| Third Quarter | \$ 26.50 | \$ 20.60 | \$ 21.84 | \$ 16.04 |
| Fourth Quarter | \$ 28.82 | \$ 23.16 | \$ 22.84 | \$ 18.52 |

We have not paid dividends on our common stock and do not expect to declare or pay any dividends in the foreseeable future. We currently intend to retain all earnings to fund operations and expansion of our business. Under current financing arrangements, there are restrictions on the ability of our subsidiaries to transfer funds to us in the form of cash dividends, loans or advances that would likely limit the future payment of dividends on our common stock. See *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - 2007 Recapitalization.*

Item 6. SELECTED FINANCIAL DATA

| | For the Years Ended December 31, | | | | |
|---|---|--------------|------------|------------|-------------|
| | 2007 | 2006 | 2005(1) | 2004(2) | 2003(3) |
| | (In thousands of dollars, except per share amounts) | | | | |
| Statements of Operations Data | | | | | |
| Operating revenues | \$ 1,433,087 | \$ 1,268,536 | \$ 978,763 | \$ 576,196 | \$ 41,123 |
| Equity in net income (loss) from unconsolidated investments | \$ 22,196 | \$ 28,636 | \$ 25,609 | \$ 17,024 | \$ (54,877) |
| Net income (loss) | \$ 130,513 | \$ 105,789 | \$ 59,326 | \$ 34,094 | \$ (69,225) |
| Income (loss) per share: | | | | | |
| Basic | \$ 0.85 | \$ 0.73 | \$ 0.49 | \$ 0.39 | \$ (1.05) |
| Diluted | \$ 0.85 | \$ 0.72 | \$ 0.46 | \$ 0.37 | \$ (1.05) |
| Weighted average common shares outstanding: | | | | | |
| Basic | 152,653 | 145,663 | 122,209 | 88,543 | 66,073 |
| Diluted | 153,997 | 147,030 | 127,910 | 91,199 | 66,073 |

| | As of December 31, | | | | |
|--|--------------------|------|---------|---------|---------|
| | 2007 | 2006 | 2005(1) | 2004(2) | 2003(3) |

(In thousands of dollars, except per share amounts)

Balance Sheet Data

| | | | | | |
|---|--------------|--------------|--------------|--------------|------------|
| Cash and cash equivalents | \$ 149,406 | \$ 233,442 | \$ 128,556 | \$ 96,148 | \$ 17,952 |
| Restricted funds held in trust | \$ 379,864 | \$ 407,921 | \$ 447,432 | \$ 239,918 | \$ |
| Property, plant and equipment, net | \$ 2,620,507 | \$ 2,637,923 | \$ 2,724,843 | \$ 819,400 | \$ 254 |
| Total assets | \$ 4,368,499 | \$ 4,437,820 | \$ 4,702,165 | \$ 1,939,081 | \$ 162,648 |
| Long-term debt | \$ 1,019,432 | \$ 1,260,123 | \$ 1,308,119 | \$ 312,896 | \$ 40,000 |
| Project debt | \$ 1,280,275 | \$ 1,435,947 | \$ 1,598,284 | \$ 944,737 | \$ |
| Stockholders' equity | \$ 1,026,062 | \$ 739,152 | \$ 599,241 | \$ 134,815 | \$ 27,791 |
| Book value per share of common stock(4) | \$ 6.67 | \$ 5.01 | \$ 4.24 | \$ 1.84 | \$ 0.50 |
| Shares of common stock outstanding | 153,922 | 147,500 | 141,166 | 73,430 | 55,105 |

(1) For the year ended December 31, 2005, Covanta ARC Holdings, Inc.'s results of operations were included in our consolidated results subsequent to June 24, 2005.

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- (2) For the year ended December 31, 2004, Covanta Energy Corporation's results of operations were included in our consolidated results subsequent to March 10, 2004.
- (3) For the year ended December 31, 2003, equity in net loss from unconsolidated investments consisted of our equity in the net loss of former investees in the marine services business.
- (4) Book value per share of common stock is calculated by dividing stockholders' equity by the number of shares of common stock outstanding.

Item 7. *MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*

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.

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 United States, Europe and Asia. We are organized as a holding company and conduct all of our operations through subsidiaries which are engaged predominantly in the businesses of waste and energy services. We also engage in the independent power production business outside the United States.

We own, have equity investments in, and/or operate 57 energy generation facilities, 47 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, three landfills, and several waste transfer stations.

Our mission is to be the world's leading energy-from-waste company, with a complementary network of renewable energy generation and waste disposal assets. We expect to build value for our stockholders by satisfying our clients waste disposal and energy generation needs with safe, reliable and environmentally superior solutions. In order to accomplish this mission and create additional value for our stockholders, we are focused on:

- providing customers with superior service and effectively managing our existing businesses;
- generating sufficient cash to meet our liquidity needs and invest in the business; and
- developing new projects and making acquisitions to grow our business in the United States, Europe and Asia.

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

We are actively engaged in the current discussion among policy makers in the United States regarding the benefits of energy-from-waste and the reduction of our dependence on landfilling for waste disposal and fossil fuels for energy. The extent to which we are successful in growing our business will depend in part on our ability to effectively communicate the benefits of energy-from-waste to public planners seeking waste disposal solutions, and to policy makers seeking to encourage renewable energy technologies as viable alternatives to reliance on fossil fuels as a source of energy.

Our business is capital intensive because it is based upon building and operating municipal solid waste processing and energy generating projects. In order to provide meaningful growth through development, we must be able to invest our funds, obtain equity and/or debt financing, and provide support to our operating subsidiaries. During the first quarter of 2007, we completed a comprehensive recapitalization utilizing a series of equity and debt financings. With this refinancing, we have greater flexibility to pursue strategic opportunities by investing in the

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business, and making acquisitions. Additional information related to our recapitalization is described below under *Liquidity and Capital Resources – 2007 Recapitalization* and Note 6. Long-Term Debt of the Notes to the Consolidated Financial Statements (Notes).

We continue to focus on enhancing stockholder value by implementing our financial, operating and growth strategies. Revenues were \$1,433 million, \$1,269 million and \$979 million and operating income was \$237 million, \$227 million and \$146 million for the years ended December 31, 2007, 2006, and 2005, respectively. The increase in revenues and operating income over the past three years is primarily attributable to the successful execution of our operating and growth strategies.

Acquisitions and Business Development

In our domestic business, we are pursuing additional growth opportunities through project expansions, new energy-from-waste and other renewable energy projects, contract extensions, acquisitions, and businesses ancillary to our existing business, such as additional waste transfer, transportation, processing and landfill businesses.

We are also pursuing international waste and/or renewable energy business opportunities, particularly in markets where the market demand, regulatory environment or other factors encourage technologies such as energy-from-waste in order to reduce dependence on landfilling for waste disposal and fossil fuels in order to reduce GHG production. In particular, we are focusing on the United Kingdom, Ireland and China, and are also pursuing opportunities in certain markets in Europe, such as Italy, and in Canada and other markets in the Americas.

During 2007, we continued to grow our business via acquisitions, investments, project expansions, contract extensions and new contracts as described below.

Domestic Business

We acquired the operating businesses of EnergyAnswers Corporation (EnergyAnswers) for approximately \$41 million in cash. 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 ton per day (tpd) energy-from-waste facility in Springfield, Massachusetts and a 240 tpd energy-from-waste facility in Pittsfield, Massachusetts. Both energy-from-waste projects have tip fee type contracts. Approximately 75% of waste revenues are contracted for at these facilities. In addition, we acquired businesses that include a landfill operation in Springfield, Massachusetts, which is used for ash disposal; and two transfer stations, one in Canaan, New York, permitted to transfer 600 tpd of waste, and the other located at the Springfield energy-from-waste facility, permitted to transfer 500 tpd of waste. We subsequently sold certain assets acquired in this transaction for a total consideration of \$5.8 million during the fourth quarter of 2007 and during the first quarter of 2008.

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, all located in California's Central Valley. These facilities added 75 megawatts (MW) to our portfolio of renewable energy plants. In addition, we invested approximately \$8 million prior to December 31, 2007, and expect to invest an additional \$7 million to \$12 million during 2008, in capital improvements to increase the facilities' productivity and improve environmental performance. We entered into a new tip fee type contract with the Town of Hempstead in New York for a term of 25 years commencing upon expiration of the existing contract in 2009.

We acquired two waste transfer stations in Westchester County, New York from Regus Industries, LLC for cash consideration of approximately \$7.3 million. These facilities increased our total waste capacity by

approximately 1,150 tpd and enhance our portfolio of transfer stations in the Northeast United States. We acquired a waste transfer station in Holliston, Massachusetts from Casella Waste Systems Inc. for cash consideration of approximately \$7.5 million. This facility increased our total waste capacity by approximately 700 tpd.

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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.

We entered into a ten year agreement to maintain and operate an 800 tpd energy-from-waste facility located in Harrisburg, Pennsylvania and obtained a right of first refusal to purchase the facility. 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. Under the agreement, we 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.

We designed, constructed, operate and maintain the 1,200 tpd mass-burn energy-from-waste facility located in and owned by Hillsborough County in Florida. In August 2005, we entered into agreements with Hillsborough County to implement an expansion, and to extend the agreement under which we operate the facility from 2007 to 2027. During 2006, environmental and other project related permits were 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 early 2009.

We acquired an additional 5% ownership interest in Pacific Ultrapower Chinese Station, a biomass energy facility located in California, which increased our equity ownership interest to 55%.

International Business

We entered into an agreement to acquire a 40% equity interest in Guangzhou Development Covanta Environmental Energy Co., Ltd (GDC Environmental Energy), a company to be located in Guangzhou Municipality, Peoples Republic of China. GDC Environmental Energy will be a newly-formed entity involved in developing energy-from-waste projects in Guangdong Providence in Southeast China. Guangzhou Development Industry (Holdings) Co., Ltd. holds the remaining 60% equity interest in GDC Environmental Energy through a wholly-owned subsidiary. Our investment in GDC Environmental Energy is subject to various regulatory approvals and is expected to be completed during early 2008.

We purchased a 40% equity interest in Sanfeng Covanta Environmental Industry Co., Ltd. (Sanfeng), a company located in Chongqing Municipality, Peoples Republic of China. Sanfeng is engaged in the business of owning and operating energy-from-waste projects and providing design and engineering, procurement and construction services for energy-from-waste facilities in China. Sanfeng currently owns minority equity interests in two 1,200 metric tpd 24 MW mass-burn energy-from-waste projects. Chongqing Iron & Steel Company (Group) Limited holds the remaining 60% equity interest in Sanfeng. We paid approximately \$10 million in connection with our investment in Sanfeng. We expect to utilize Sanfeng as a key component of our effort to grow our energy-from-waste business in China. We expect to make additional investments as and when Sanfeng is successful in developing additional projects.

We announced that we have entered into definitive agreements for the development of a 1,700 metric tpd energy-from-waste project serving the City of Dublin, Ireland and surrounding communities. The Dublin project, which marks our most significant entry to date into the European waste and renewable energy markets, 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. Under the Dublin project agreements, several customary conditions must be satisfied before construction can begin, including the issuance of all required licenses and permits. The permitting process is underway and construction is expected to commence in late 2008.

We are responsible for the design and construction of the project, which is estimated to cost approximately 300 million euros and will require 36 months to complete. We will operate and maintain the project for Dublin Waste to Energy Limited, which has a 25-year Tip Fee type contract with Dublin to provide disposal service

for approximately 320,000 metric tons of waste annually. The project is structured on a build-own-operate-transfer model, where ownership will transfer to Dublin after the 25-year term, unless extended. The project is expected to sell electricity into the local grid under short-term arrangements. We have committed to provide financing for all phases of the project, along with DONG Energy Generation A/S;

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however, we expect that numerous project financing structures will be available once the initial development phase is complete.

Business Segments

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

The financial results of the holding company primarily consist of interest expense and income. General and administrative expenses related to legal and other professional fees and insurance are reimbursed by the operating subsidiaries under an administrative services agreement.

Our predominant business is the waste and energy services business, however our historical consolidated operations were conducted in the insurance industry prior to the acquisition of Covanta Energy in March 2004. Our insurance business continues to represent an important element of our structure in that our net operating loss carryforwards (NOLs) were primarily generated through the operations of these former subsidiaries. See Note 9. Income Taxes of the Notes for more information about our NOLs.

Domestic

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

International

We also engage in the independent power production and energy-from-waste businesses outside the United States, through field offices where local management is focused on operating existing businesses and pursuing growth opportunities. Through subsidiaries, we have ownership interests in, and/or operate facilities in the Philippines, China, Bangladesh, India, Costa Rica, and Italy. The Costa Rica facilities generate electricity from hydroelectric resources while the other independent power production facilities generate electricity and steam by combusting coal, natural gas, or heavy fuel oil. In addition, two facilities in China and one facility in Italy generate electricity by processing waste received. For these projects, our international subsidiary receives revenue from operating fees, electricity and steam sales, and in some cases cash from equity distributions.

Contract Structures

We have 24 energy-from-waste projects where we charge a fixed fee (which escalates over time pursuant to contractual indices that we believe are appropriate to reflect price inflation) for operation and maintenance services.

We refer to these projects as having a Service Fee structure. Our contracts at Service Fee projects provide revenue that does not materially vary based on the amount of waste processed or energy generated and as such is relatively stable for the contract term. In addition, at most of our Service Fee projects, the operating subsidiary retains only a fraction of the energy revenues generated, with the balance used to provide a credit to the municipal client against its disposal costs. Therefore, in these projects, the municipal client derives most of the benefit and risk of energy production and changing energy prices.

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We also have 13 energy-from-waste projects where we receive a per-ton fee under contracts for processing waste. We refer to these projects as having a Tip Fee structure. At Tip Fee projects, we generally enter into long-term waste disposal contracts for a substantial portion of project disposal capacity and retain all of the energy revenue generated. These Tip Fee service agreements include stated fixed fees earned by us for processing waste up to certain base contractual amounts during specified periods. These Tip Fee service agreements also set forth the per-ton fees that are payable if we accept waste in excess of the base contractual amounts. The waste disposal and energy revenue from these projects is more dependent upon operating performance and, as such, is subject to greater revenue fluctuation to the extent performance levels fluctuate.

Under both structures, our returns are expected to be stable if we do not incur material unexpected operation and maintenance costs or other expenses. In addition, most of our energy-from-waste project contracts are structured so that contract counterparties generally bear, or share in, the costs associated with events or circumstances not within our control, such as uninsured force majeure events and changes in legal requirements. The stability of our revenues and returns could be affected by our ability to continue to enforce these obligations. Also, at some of our energy-from-waste facilities, commodity price risk is mitigated by passing through commodity costs to contract counterparties. With respect to our other domestic renewable energy projects and international independent power projects, such structural features generally do not exist because either we operate and maintain such facilities for our own account or we do so on a cost-plus basis rather than a fixed-fee basis.

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

Contract Duration

We operate energy-from-waste projects under long-term agreements. For those projects we own, our contract to sell the project's energy output (either electricity or steam) generally expires at or after the date when the initial term of our contract to operate or receive waste also expires. Expiration of these contracts will subject us to greater market risk in maintaining and enhancing revenues as we enter into new contracts. Following the expiration of the initial contracts, we intend to enter into replacement or additional contracts for waste supplies and will sell our energy output either into the regional electricity grid or pursuant to new contracts. Because project debt on these facilities will be paid off at such time, we believe that we will be able to offer disposal services at rates that will attract sufficient quantities of waste and provide acceptable revenues. For those projects we operate but do not own, prior to the expiration of the initial term of our operating contract, we will seek to enter into renewal or replacement contracts to continue operating such projects. We will seek to bid competitively in the market for additional contracts to operate other facilities as similar contracts of other vendors expire.

Energy-from-Waste Project Ownership

In our domestic business, we operate many publicly-owned energy-from-waste facilities and own and operate many other energy-from-waste facilities. In addition, as a result of acquisitions of additional projects originally owned or operated by other vendors, we operate several projects under a lease structure where a third party lessor owns the project. Regardless of ownership structure, we provide the same service to our municipal clients and customers.

Under any of these ownership structures, the municipalities typically borrow funds to pay for the facility construction by issuing bonds. In a private ownership structure, the municipal entity loans the bond proceeds to the project subsidiary, the facility is recorded as an asset, and the project debt is recorded as a liability, on our consolidated

balance sheet. In a public ownership structure, the municipality would fund the construction costs without loaning the bond proceeds to us.

At all projects where a Service Fee structure exists (regardless of ownership structure), our municipal clients are generally responsible contractually for paying the project debt after construction is complete. At the 11 publicly-owned Service Fee projects we operate, the municipality pays periodic debt service directly to a trustee under an

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indenture. We own 13 projects where a Service Fee structure exists, and at these projects the municipal client pays debt service as a component of a monthly service fee payment to us.

Under these service agreements, we bill municipalities fees to service project debt (principal and interest). The amounts billed, and the amount of cash we receive from these municipalities, are based on the actual principal amortization schedule for the project bonds. However, we recognize revenue on a levelized basis over the term of the applicable service agreement. In the beginning of the service agreement, principal billed and cash received is less than the amount of levelized revenue recognized related to principal. At some point during the service agreement, the amount we bill will exceed the levelized revenue. 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 service 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 service agreement.

For all projects where a Tip Fee structure exists and neither debt service nor lease rent is expressly included in the fee paid to us. Accordingly, we do not record revenue reflecting principal on this project debt or on lease rent. In most cases, our operating subsidiaries for these projects make equal monthly deposits with their respective project trustees in amounts sufficient for the trustees to pay principal and interest, or lease rent, when due.

The term of our operating contracts with municipal clients generally coincides with the term of the bonds issued to pay for the project construction. In many cases, the municipality has contractual rights (not obligations) to extend the contract. If a contract is not extended on a publicly-owned project, our role, and our revenue, with respect to that project would cease. If a contract is not extended on a project that we own, we would be free to enter into new revenue generating contracts for waste supply (with the municipality, other municipalities, or private waste haulers) and for electricity or steam sales. We would, in such cases, have no remaining project debt to repay from project revenue, and would be entitled to retain 100% of energy sales revenue.

Seasonal Trends

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

Other Factors Affecting Performance

We have historically performed our operating obligations without experiencing material unexpected service interruptions or incurring material increases in costs. In addition, with respect to many of our contracts, we generally have limited our exposure for risks not within our control. With respect to projects acquired in acquisitions, we have assumed contracts where there is less contractual protection against such risks and more exposure to market influences. For additional information about such risks and damages that we may owe for unexcused operating performance failures, see *Item 1A. Risk Factors*. In monitoring and assessing the ongoing operating and financial performance of our businesses, we focus on certain key factors: tons of waste processed, electricity and steam sold,

and boiler availability.

Our ability to meet or exceed historical levels of performance at projects, and our general financial performance, is affected by the following:

Seasonal or long-term changes in market prices for waste, energy, or ferrous and non-ferrous metals, for projects where we sell into those markets;

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Seasonal, geographic and other variations in the heat content of waste processed, and thereby the amount of waste that can be processed by a energy-from-waste facility;
Our ability to avoid unexpected increases in operating and maintenance costs while ensuring that adequate facility maintenance is conducted so that historic levels of operating performance can be sustained;
Contract counterparties' ability to fulfill their obligations, including the ability of our various municipal customers to supply waste in contractually committed amounts, and the availability of alternate or additional sources of waste if excess processing capacity exists at our facilities; and
The availability and adequacy of insurance to cover losses from business interruption in the event of casualty or other insured events.

General financial performance at our international projects is also affected by the following:

Changes in fuel price for projects in which such costs are not completely passed through to the electricity purchaser through revenue adjustments, or delays in the effectiveness of revenue adjustments;
The amounts of electricity actually requested by purchasers of electricity, and whether or when such requests are made, our facilities are then available to deliver such electricity;
The financial condition and creditworthiness of purchasers of power and services provided by us;
Fluctuations in the value of the domestic currency against the value of the U.S. dollar for projects in which we are paid in whole or in part in the domestic currency of the host country; and
Political risks inherent to the international business which could affect both the ability to operate the project in conformance with existing agreements and the repatriation of dividends from the host country.

RESULTS OF OPERATIONS

As discussed above, 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. Certain prior period amounts have been reclassified in the consolidated financial statements to conform to the current period presentation.

The comparability of the information provided below with respect to our revenues, expenses and certain other items for periods during each of the years presented was affected by several factors, in addition to the Covanta ARC Holdings, Inc. (ARC Holdings) acquisition in June 2005. Our Warren County, New Jersey energy-from-waste facility emerged from bankruptcy on December 15, 2005 and was included as a consolidated subsidiary since its emergence date. Our Huantai and Linan coal facilities, both of which were located in China, were sold in June 2006 and September 2007, respectively, and were not included as consolidated subsidiaries since their respective disposition dates. As outlined above under *Acquisitions and Business Development*, our acquisition and business development initiatives in 2007 resulted in various additional projects which increased comparative 2007 revenues and expenses. These factors must be taken into account in developing meaningful comparisons between the periods compared below.

Table of Contents**RESULTS OF OPERATIONS Year Ended December 31, 2007 vs. Year Ended December 31, 2006**

Our consolidated results of operations are presented on a reported basis in the table below (in thousands of dollars, except per share amounts):

| | For the Years Ended December 31, | | Increase (Decrease) |
|---|---|-------------------|--------------------------------|
| | 2007 | 2006 | 2007 vs 2006 |
| CONSOLIDATED RESULTS OF OPERATIONS: | | | |
| Total operating revenues | \$ 1,433,087 | \$ 1,268,536 | \$ 164,551 |
| Total operating expenses | 1,196,477 | 1,041,776 | 154,701 |
| Operating income | 236,610 | 226,760 | 9,850 |
| Other income (expense): | | | |
| Investment income | 10,578 | 11,770 | (1,192) |
| Interest expense | (67,104) | (109,507) | (42,403) |
| Loss on extinguishment of debt | (32,071) | (6,795) | 25,276 |
| Total other expenses | (88,597) | (104,532) | (15,935) |
| Income before income tax expense, minority interests and equity in net income from unconsolidated investments | 148,013 | 122,228 | 25,785 |
| Income tax expense | (31,040) | (38,465) | (7,425) |
| Minority interests | (8,656) | (6,610) | 2,046 |
| Equity in net income from unconsolidated investments | 22,196 | 28,636 | (6,440) |
| NET INCOME | \$ 130,513 | \$ 105,789 | 24,724 |
| Weighted Average Common Shares Outstanding: | | | |
| Basic | 152,653 | 145,663 | 6,990 |
| Diluted | 153,997 | 147,030 | 6,967 |
| Earnings Per Share: | | | |
| Basic | \$ 0.85 | \$ 0.73 | \$ 0.12 |
| Diluted | \$ 0.85 | \$ 0.72 | \$ 0.13 |

The following general discussions should be read in conjunction with the above table, the consolidated financial statements and the Notes thereto and other financial information appearing and referred to elsewhere in this report. Additional detail relating to changes in operating revenues and operating expenses, and the quantification of specific factors affecting or causing such changes, is provided in the Domestic and International segment discussions below.

Consolidated Results of Operations ***Comparison of Reported Results for the Year Ended December 31, 2007 vs. Reported Results for the Year Ended December 31, 2006***

Operating revenues increased by \$164.6 million primarily due to the following:

contribution from new businesses acquired,
increased construction revenues relating to expansion of our Hillsborough County facility,
higher waste and service revenues at our existing energy-from-waste facilities, and
increased demand from the electricity offtaker at our Indian facilities and resulting higher electricity generation.

Operating expenses increased by \$154.7 million primarily due to the following:

operating costs of new businesses acquired,
increased construction expenses relating to the expansion of our Hillsborough County facility,
increased plant operating expenses due to normal escalations in costs, such as wages, materials, and plant maintenance,
expenses incurred as a result of a fire at our SEMASS energy-from-waste facility on March 31, 2007, and

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increased plant operating expenses at our Indian facilities primarily due to increased demand from the electricity offtaker and resulting higher generation.

Investment income decreased by \$1.2 million primarily due to lower invested cash balances and lower interest rates on invested funds. Interest expense decreased by \$42.4 million primarily due to lower loan balances and lower interest rates resulting from the 2007 recapitalization. As a result of the recapitalization in the first quarter of 2007, we recognized a loss on extinguishment of debt charge of approximately \$32.1 million, pre-tax, which is comprised of the write-down of deferred financing costs, tender premiums paid for the intermediate subsidiary debt, and a call premium paid in connection with previously existing financing arrangements. These amounts were partially offset by the write-down of unamortized premiums relating to the intermediate subsidiary debt and a gain associated with the settlement of our interest rate swap agreements in February 2007. In May 2006, as a result of amendments to our financing arrangements that existed at that time, we recognized a loss on extinguishment of debt of \$6.8 million for the year ended December 31, 2006. See Note 6. Long-Term Debt of the Notes for additional information.

Equity in net income from unconsolidated investments decreased by \$6.4 million primarily due to the effects of the following factors relating to Quezon Power, Inc. (Quezon) in the Philippines:

Quezon recorded a cumulative deferred income tax benefit in 2006 of \$31.7 million, of which \$7.0 million relates to our equity share in Quezon. The realization of this deferred tax benefit is subject to fluctuations in the value of the Philippine peso versus the U.S. dollar. During the year ended December 31, 2007, we reduced the cumulative deferred income tax benefit by approximately \$4.3 million, as a result of the strengthening of the Philippine peso versus the U.S. dollar;

A decrease in equity in net income from unconsolidated investments for the year ended December 31, 2007 of approximately \$4.1 million due to increased tax expense for Quezon related to the conclusion of a six-year income tax holiday in May 2006;

Quezon recorded a gain resulting from a settlement with Manila Electric Company (Meralco), the largest electric distribution company in the Philippines, related to various issues which had been pending for several years, including certain amendments to the contract to modify certain commercial terms and to resolve issues relating to the project's performance during its first year of operation. The settlement primarily includes payment by Meralco to Quezon of approximately \$8.5 million of prior uncollected receivables, of which \$1.9 million relates to our equity share in Quezon.

See Note 8. Equity Method Investments of the Notes for additional information.

Income tax expense decreased by \$7.4 million primarily due to a reduction of the valuation allowance by \$35.0 million, as discussed in Note 9. Income Taxes of the Notes. This was partially offset by expiring NOL tax benefits of \$6.0 million and taxes at the statutory rate on increased pre-tax income resulting primarily from lower interest expense. During 2006, we recorded a one-time tax benefit of \$10 million associated with the adoption of the permanent reinvestment exception under Accounting Principles Board (APB) Opinion No. 23, Accounting for Income Taxes Special Areas (APB 23) as discussed in Note 9. Income Taxes of the Notes.

Table of Contents***Domestic Business Results of Operations Comparison of Reported Results for the Year Ended December 31, 2007 vs. Reported Results for the Year Ended December 31, 2006***

The domestic business results of operations are presented on a reported basis in the table below (in thousands of dollars):

| | For the Years Ended December 31, | | Increase (Decrease) |
|---------------------------------------|---|-------------------|--------------------------------|
| | 2007 | 2006 | 2007 vs 2006 |
| Waste and service revenues | \$ 860,252 | \$ 813,260 | \$ 46,992 |
| Electricity and steam sales | 325,804 | 301,339 | 24,465 |
| Other operating revenues | 59,561 | 3,328 | 56,233 |
| Total operating revenues | 1,245,617 | 1,117,927 | 127,690 |
| Plant operating expenses | 664,641 | 612,202 | 52,439 |
| Depreciation and amortization expense | 187,875 | 184,921 | 2,954 |
| Net interest expense on project debt | 48,198 | 53,270 | (5,072) |
| General and administrative expenses | 71,022 | 66,439 | 4,583 |
| Other operating expense (income) | 53,789 | (5,388) | 59,177 |
| Total operating expenses | 1,025,525 | 911,444 | 114,081 |
| Operating income | \$ 220,092 | \$ 206,483 | 13,609 |

Operating Revenues

Variances in revenues for the domestic segment are as follows (in millions of dollars):

| | Domestic Segment Operating Revenue Variances | | |
|---|---|-------------------------|-----------------|
| | Existing Business | New Business | Total |
| Waste and service revenues | | | |
| Service fee | \$ 5.2 | \$ 14.9 | \$ 20.1 |
| Tip fee | 4.7 | 13.9 | 18.6 |
| Scrap metal | 8.2 | 0.1 | 8.3 |
| Total waste and service revenues | 18.1 | 28.9 | 47.0 |
| Electricity and steam sales | 9.7 | 14.8 | 24.5 |
| Other operating revenues | 56.2 | | 56.2 |
| Total operating revenues | \$ 84.0 | \$ 43.7 | \$ 127.7 |

Revenues from Service Fee arrangements for existing businesses increased primarily due to contractual escalations, partially offset by lower revenues earned explicitly to service debt of \$4.8 million.

Revenues from Tip Fee arrangements for existing businesses increased primarily due to pricing escalations, partially offset by a decrease in waste volume and reduced revenues of \$4.1 million at our SEMASS facility following its fire on March 31, 2007.

Scrap metal revenues increased primarily due to higher pricing for ferrous and non-ferrous metal.

Electricity and steam sales for existing business increased primarily due to higher energy rates. This increase was partially offset by energy rate settlements of \$3.7 million related to prior years, and a decrease in revenues of \$1.9 million due to lower waste volume resulting from the temporary suspension of operations at our SEMASS facility following its fire on March 31, 2007.

Other operating revenues increased primarily due to construction revenues related to the expansion for the Hillsborough County facility.

Table of Contents*Operating Expenses*

Variances in plant operating expenses for the domestic segment are as follows (in millions of dollars):

| | Domestic Segment Operating Expense Variances | | |
|--------------------------------|---|-------------------------|--------------|
| | Existing Business | New Business | Total |
| Total plant operating expenses | \$ 10.7 | \$ 41.7 | \$ 52.4 |

Existing business plant operating expenses increased by \$10.7 million primarily due to normal escalations in costs such as wages, materials and plant maintenance, and higher stock-based compensation expense of \$2.0 million. In addition, costs related to the fire at the SEMASS energy-from-waste facility were \$3.3 million, which was net of \$2.7 million and \$2.0 million of insurance recoveries for clean-up costs and business interruption, respectively.

Depreciation and amortization expense increased by \$3.0 million primarily due to additions of property, plant and equipment.

Net interest expense on project debt decreased by \$5.1 million primarily due to lower project debt balances.

General and administrative expenses increased by \$4.6 million primarily due to increased stock-based compensation expense and increased business development spending.

On March 31, 2007, our SEMASS energy-from-waste facility experienced a fire in the front-end receiving portion of the facility. Damage was extensive to this portion of the facility and operations at the facility were suspended completely for approximately 20 days. As a result of this loss, we recorded an asset impairment of \$17.3 million, pre-tax, which represented the net book value of the assets destroyed. The cost of repair or replacement, and business interruption losses, were insured under the terms of applicable insurance policies, subject to deductibles. During the year ended December 31, 2007, we recorded insurance recoveries of \$17.3 million related to repair and reconstruction, \$2.7 million related to clean-up costs and \$2.0 million related to business interruption losses. Insurance recoveries were recorded as a reduction to the loss related to the write-down of assets where such recoveries related to repair and reconstruction costs, or as a reduction to operating expenses where such recoveries related to other costs or business interruption losses.

Other operating expense increased by \$59.2 million primarily due to costs related to expansion construction at the Hillsborough County facility. See Note 12. Supplementary Financial Information of the Notes for additional information.

International Business Results of Operations Comparison of Reported Results for the Year Ended December 31, 2007 vs. Reported Results for the Year Ended December 31, 2006

The international business results of operations are presented on a reported basis in the table below (in thousands of dollars):

| | For the Years Ended December 31, | | Increase (Decrease) |
|---------------------------------------|---|-------------|--------------------------------|
| | 2007 | 2006 | 2007 vs 2006 |
| Waste and service revenues | \$ 4,144 | \$ 4,373 | \$ (229) |
| Electricity and steam sales | 173,073 | 132,495 | 40,578 |
| Total operating revenues | 177,217 | 136,868 | 40,349 |
| Plant operating expenses | 136,919 | 99,954 | 36,965 |
| Depreciation and amortization expense | 8,998 | 8,193 | 805 |
| Net interest expense on project debt | 6,381 | 6,940 | (559) |
| General and administrative expenses | 8,584 | 4,394 | 4,190 |
| Other operating income | (3,848) | (2,452) | 1,396 |
| Total operating expenses | 157,034 | 117,029 | 40,005 |
| Operating income | \$ 20,183 | \$ 19,839 | 344 |

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Variances in revenues and plant operating expenses for the international segment are as follows (in millions of dollars):

| | International Segment | |
|--------------------------------|--|--|
| | Operating Revenue Variances | Plant Operating Expense Variances |
| Indian facilities energy sales | \$ 49.1 | \$ 43.8 |
| Yanjiang steam sales | (1.9) | (1.5) |
| Sale of Huantai facility | (2.9) | (2.6) |
| Sale of Linan facility | (3.7) | (3.2) |
| Other | (0.3) | 0.5 |
| Total | \$ 40.3 | \$ 37.0 |

The increases in revenues and plant operating expenses under energy contracts at both Indian facilities resulted primarily from increased demand from the electricity offtaker and resulting higher electricity generation. The decreases in revenues and plant operating expenses from the Yanjiang facility in China resulted from lower steam sales. Additional decreases in revenues and plant operating expenses resulted from the sale of the Huantai coal facility in China during the second quarter of 2006 and the sale of the Linan coal facility in China during the third quarter of 2007.

Depreciation and amortization expense increased by \$0.8 million primarily due to the foreign currency translation effects at our facilities in India.

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

General and administrative expenses increased by \$4.2 million primarily due to normal wage and benefit escalations and additional business development spending.

Other operating income increased by \$1.4 million primarily due to the \$1.7 million gain related to the sale of the Linan coal facility in China during the third quarter of 2007 combined with a \$1.0 million re-measurement gain on the foreign currency denominated debt at one of the Indian facilities, compared to a \$1.2 million gain related to the sale of the Huantai coal facility in China during the second quarter of 2006.

RESULTS OF OPERATIONS Year Ended December 31, 2006 vs. Year Ended December 31, 2005

The results of operations for the year ended December 31, 2005 are not representative of our ongoing results since the results of operations for ARC Holdings were only included in our consolidated results of operations from June 25, 2005 forward. Therefore, given the significance of the ARC Holdings acquisitions to our results of operations and financial condition, we believe that an understanding of our reported results, trends and ongoing performance is enhanced by presenting results on a pro forma basis for the year ended December 31, 2005 at both the consolidated and Domestic and International segment levels. Our consolidated and segment results of operations, as reported and where applicable, on a pro forma basis, are summarized in the tables and discussions below. However, the pro forma results are equivalent to reported results for the year ended December 31, 2006 as there are no pro forma adjustments

for this period. The pro forma based presentation for the year ended December 31, 2005 assumes that the acquisition of ARC Holdings occurred on January 1, 2005. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of 2005 or that may result in the future. In addition, the pro forma information provided has not been adjusted to reflect any operating efficiencies that have been realized as a result of the ARC Holdings acquisition. The pro forma adjustments are described starting on page 54.

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Our consolidated results of operations are presented on both a reported and pro forma basis in the table below (in thousands of dollars, except per share amounts):

| | For the Years Ended December 31, | | | |
|---|---|------------------|-------------------|------------------|
| | Reported | | Pro Forma | |
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | | |
| CONSOLIDATED RESULTS OF OPERATIONS: | | | | |
| Total operating revenues | \$ 1,268,536 | \$ 978,763 | \$ 1,268,536 | \$ 1,209,075 |
| Total operating expenses | 1,041,776 | 832,547 | 1,041,776 | 1,016,431 |
| Operating income | 226,760 | 146,216 | 226,760 | 192,644 |
| OTHER INCOME (EXPENSE): | | | | |
| Investment income | 11,770 | 6,129 | 11,770 | 7,354 |
| Interest expense | (109,507) | (89,973) | (109,507) | (119,244) |
| Loss on extinguishment of debt | (6,795) | | (6,795) | |
| Gain on derivative instruments, ACL warrants | | 15,193 | | 15,193 |
| Total other expenses | (104,532) | (68,651) | (104,532) | (96,697) |
| Income before income taxes, minority interests and equity in net income from unconsolidated investments | 122,228 | 77,565 | 122,228 | 95,947 |
| Income tax expense | (38,465) | (34,651) | (38,465) | (43,176) |
| Minority interests | (6,610) | (9,197) | (6,610) | (9,253) |
| Equity in net income from unconsolidated investments | 28,636 | 25,609 | 28,636 | 25,609 |
| NET INCOME | \$ 105,789 | \$ 59,326 | \$ 105,789 | \$ 69,127 |
| Weighted Average Common Shares Outstanding: | | | | |
| Basic | 145,663 | 122,209 | 145,663 | 139,996 |
| Diluted | 147,030 | 127,910 | 147,030 | 145,698 |
| EARNINGS PER SHARE: | | | | |
| Basic | \$ 0.73 | \$ 0.49 | \$ 0.73 | \$ 0.49 |
| Diluted | \$ 0.72 | \$ 0.46 | \$ 0.72 | \$ 0.47 |

The following general discussions should be read in conjunction with the above table, the consolidated financial statements and the Notes thereto and other financial information appearing and referred to elsewhere in this report. Additional detail related to operating revenues and operating expenses, and the quantification of specific factors

affecting or causing such changes, is provided in the Domestic and International segment discussions below.

Consolidated Results of Operations Comparison of Reported Results for the Year Ended December 31, 2006 vs. Reported Results for the Year Ended December 31, 2005

Our operating revenues increased by \$289.8 million primarily from increases in waste and service revenues of \$179.1 million and increases in electricity and steam sales of \$111.1 million. Our operating income increased by \$80.5 million resulting primarily from impacts of the businesses acquired as part of the ARC Holdings acquisition in the second quarter of 2005, combined with increased operating revenues, cost reduction initiatives in 2006 in the Domestic segment and lower operating expenses due to the absence of an aggregate of \$17.1 million of expenses in 2005 related to the California Grantor Trust Settlement, acquisition-related charges and restructuring charges. For additional information, see Note 3. Acquisitions, Business Development and Dispositions and Note 9. Income Taxes of the Notes.

Our total investment income increased by \$5.6 million primarily due to higher invested cash balances. Interest expense increased by \$19.5 million primarily due to financing arrangements put into place as part of the ARC Holdings acquisition in June 2005. As a result of amendments to our financing arrangements in May 2006, a loss on extinguishment of debt of \$6.8 million was recognized for the year ended December 31, 2006. For the year ended December 31, 2005, we realized a pre-tax gain on derivative instruments of \$15.2 million related to an investment in American Commercial Lines LLC (ACL) warrants which was liquidated in October 2005 as discussed in Note 19. Financial Instruments of the Notes.

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Equity in net income from unconsolidated investments increased by \$3.0 million primarily due to \$1.5 million related to earnings from domestic investments combined with \$1.5 million related to the effects of the following factors relating to Quezon in the Philippines:

the absence during 2006 of a major scheduled turbine-generator maintenance project that occurred during 2005 that is generally scheduled twice in a seven-year cycle combined with lower project debt interest expense; a \$7.0 million cumulative deferred income tax benefit, which relates to our equity share in the \$31.7 million cumulative deferred income tax benefit recorded by Quezon in the second quarter of 2006 related to unrealized foreign exchange losses that are expected to be tax deductible for Philippine tax purposes in future years, offset by a \$2.1 million adjustment to this deferred tax asset as a result of strengthening of the Philippine peso versus the U.S. dollar in the last six months of 2006; a \$2.3 million write-off of a deferred income tax asset due to a change in the deductibility of the amortization of deferred financing costs; and an increase in tax expense of approximately \$4.1 million related to the conclusion of a six-year income tax holiday in May 2006.

Income tax expense increased by \$3.8 million due to higher taxable income primarily from impacts of the businesses acquired as part of the ARC Holdings acquisition offset by a one-time tax benefit of \$10 million recorded during 2006 associated with the adoption of the permanent reinvestment exception under APB 23 as discussed in Note 9. Income Taxes of the Notes.

Consolidated Results of Operations Comparison of Reported Results for the Year Ended December 31, 2006 vs. Pro Forma Results for the Year Ended December 31, 2005

Our operating revenues increased by \$59.5 million primarily from increases in waste and service revenues of \$28.5 million and increases in electricity and steam sales of \$31.4 million due to contract fee escalations and higher energy and ferrous and non-ferrous metal prices. Our operating income increased by \$34.1 million primarily due to higher operating revenues, cost reduction initiatives and reduced operating expenses due to the absence of \$10.3 million of expenses in 2005 related to the California Grantor Trust Settlement. For additional information, see Note 9. Income Taxes of the Notes.

Our total investment income increased by \$4.4 million primarily due to higher invested cash balances. Interest expense decreased by \$9.7 million primarily due lower outstanding debt balances and lower interest rates relating to amendments to our financing arrangements in May 2006. As a result of these 2006 amendments, a loss on extinguishment of debt of \$6.8 million was recognized for the year ended December 31, 2006. For the year ended December 31, 2005, we realized a pre-tax gain on derivative instruments of \$15.2 million related to an investment in ACL warrants which was liquidated in October 2005 as discussed in Note 19. Financial Instruments of the Notes.

Equity in net income from unconsolidated investments increased by \$3.0 million primarily due to \$1.5 million related to earnings from domestic investments combined with \$1.5 million related to the effects of the following factors relating to the Quezon facility:

the absence during 2006 of a major scheduled turbine-generator maintenance project that occurred during 2005 that is generally scheduled twice in a seven-year cycle combined with lower project debt interest expense; a \$7.0 million cumulative deferred income tax benefit, which relates to our equity share in the \$31.7 million cumulative deferred income tax benefit recorded by Quezon in the second quarter of 2006 related to unrealized foreign exchange losses that are expected to be tax deductible for Philippine tax purposes in future years, offset by a \$2.1 million adjustment to this deferred tax asset as a result of strengthening of the Philippine peso versus the U.S. dollar in the last six months of 2006;

a \$2.3 million write-off of a deferred income tax asset due to a change in the deductibility of the amortization of deferred financing costs; and
an increase in tax expense of approximately \$4.1 million related to the conclusion of a six-year income tax holiday in May 2006.

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Income tax expense decreased by \$4.7 million primarily due to a one-time tax benefit of \$10 million recorded during the three months ended June 30, 2006 associated with the adoption of the permanent reinvestment exception under APB 23 offset by higher taxable income. For additional detail, see Note 9. Income Taxes of the Notes.

Domestic Business Results of Operations *Comparison of Reported Results for the Year Ended December 31, 2006 vs. Pro Forma Results for the Year Ended December 31, 2005*

The domestic business results of operations are presented on both a reported and pro forma basis in the table below (in thousands of dollars):

| | For the Years Ended December 31, | | | |
|---------------------------------------|----------------------------------|------------|------------|------------|
| | Reported | | Pro Forma | |
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | | |
| Waste and service revenues | \$ 813,260 | \$ 634,268 | \$ 813,260 | \$ 784,920 |
| Electricity and steam sales | 301,339 | 194,057 | 301,339 | 273,717 |
| Other operating revenues | 3,328 | 2,693 | 3,328 | 2,693 |
| Total operating revenues | 1,117,927 | 831,018 | 1,117,927 | 1,061,330 |
| Plant operating expenses | 612,202 | 471,641 | 612,202 | 578,394 |
| Depreciation and amortization expense | 184,921 | 116,083 | 184,921 | 174,610 |
| Net interest expense on project debt | 53,270 | 44,762 | 53,270 | 59,828 |
| General and administrative expenses | 66,439 | 59,249 | 66,439 | 68,983 |
| California Grantor Trust Settlement | | 10,342 | | 10,342 |
| Acquisition-related charges | | 3,950 | | |
| Other operating income | (5,388) | (3,651) | (5,388) | (3,132) |
| Total operating expenses | 911,444 | 702,376 | 911,444 | 889,025 |
| Operating income | \$ 206,483 | \$ 128,642 | \$ 206,483 | \$ 172,305 |

Total domestic revenues increased by \$56.6 million primarily due to contract fee escalations and higher energy and ferrous and non-ferrous metal prices as described below.

Waste and service revenues increased by \$28.3 million or 3.6% resulting from the impacts of the following factors:

Revenue from energy-from-waste projects structured with Service Fee arrangements increased by \$9.1 million. Such revenues increased by \$13.5 million primarily due to contractual escalations and higher additional waste service fees offset by a reduction of \$4.4 million related to lower revenues earned explicitly to service debt; Revenue from energy-from-waste projects structured with Tip Fee arrangements increased by \$13.4 million. Such revenues increased by \$5.2 million primarily driven by higher volumes of waste handled and favorable pricing and \$8.2 million primarily due to the emergence of a subsidiary from bankruptcy in December 2005, and its subsequent inclusion in our consolidated results of operations; and

Other waste and service fee revenues increased by \$5.8 million primarily due to higher pricing for ferrous and non-ferrous metal.

Electricity and steam revenue increased by \$27.6 million or 10.1%, comprised of an increase of \$18.3 million due to higher energy rates and increased production, and an increase of \$5.2 million due to the emergence of a subsidiary from bankruptcy in December 2005, and its subsequent inclusion in our consolidated results of operations. Also contributing to the favorable variance was a \$4.8 million gain relating to the settlement of a dispute regarding the 2005 power rate at one of our facilities. These gains were partially offset by \$0.7 million due to the termination of activities at two landfill gas facilities.

Plant operating expenses increased by \$33.8 million primarily due to the scope of scheduled plant maintenance, normal cost escalations such as wages, and the emergence of a subsidiary from bankruptcy in December 2005, and its subsequent inclusion in our consolidated results of operations, partially offset by cost reduction initiatives.

Depreciation and amortization expense increased by \$10.3 million primarily due to additions to property, plant and equipment and the emergence of a subsidiary from bankruptcy in December 2005, and its subsequent inclusion in our consolidated results of operations.

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Net interest expense on project debt decreased by \$6.6 million primarily as a result of lower project debt balances.

General and administrative expenses decreased by \$2.5 million primarily due to synergies from the ARC Holdings acquisition partially offset by wage escalations and increased development spending.

During the fourth quarter of 2005, we incurred \$10.3 million of allocated expenses relating to the California Grantor Trust Settlement. For additional information, see Note 9. Income Taxes of the Notes.

Other operating income increased by \$2.3 million primarily due to final distributions and settlements of disputed matters relating to Covanta Energy's reorganization, and insurance recoveries.

International Business Results of Operations Comparison of Reported Results for the Year Ended December 31, 2006 vs. Pro Forma Results for the Year Ended December 31, 2005

The international business results of operations are presented on both a reported and pro forma basis in the table below (in thousands of dollars):

| | For the Years Ended December 31, | | | |
|---------------------------------------|---|-------------|------------------|-------------|
| | Reported | | Pro Forma | |
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | | |
| Waste and service revenues | \$ 4,373 | \$ 4,235 | \$ 4,373 | \$ 4,235 |
| Electricity and steam sales | 132,495 | 128,713 | 132,495 | 128,713 |
| Total revenues | 136,868 | 132,948 | 136,868 | 132,948 |
| Plant operating expenses | 99,954 | 87,997 | 99,954 | 87,997 |
| Depreciation and amortization expense | 8,193 | 8,731 | 8,193 | 8,731 |
| Net interest expense on project debt | 6,940 | 7,669 | 6,940 | 7,669 |
| General and administrative expenses | 4,394 | 4,967 | 4,394 | 4,967 |
| Restructuring charges | | 2,765 | | |
| Other operating (income) expenses | (2,452) | 2,764 | (2,452) | 2,764 |
| Total operating expenses | 117,029 | 114,893 | 117,029 | 112,128 |
| Operating income | \$ 19,839 | \$ 18,055 | \$ 19,839 | \$ 20,820 |

Variances in revenues and plant operating expenses for the international segment are as follows (in millions of dollars):

| International Segment | |
|------------------------------------|--|
| Operating Revenue Variances | Plant Operating Expense Variances |

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| | | | | |
|---|----|-------|----|-------|
| Indian facilities energy sales | \$ | 16.6 | \$ | 18.9 |
| Yanjiang and Linan steam sales | | (1.3) | | (0.7) |
| Debt service component of revenue | | (1.1) | | |
| Provision related to dispute with off-taker | | (1.4) | | |
| Sale of Huantai facility | | (9.0) | | (7.4) |
| Other | | 0.1 | | 1.2 |
| Total | \$ | 3.9 | \$ | 12.0 |

The increases in revenues and plant operating expenses under energy contracts at both Indian facilities resulted primarily from higher fuel costs passed through to the electricity offtaker. The decreases in revenues and plant operating expenses from the Yanjiang and Linan coal facilities in China resulted from lower steam sales. Additional decreases in revenues and plant operating expenses resulted from the sale of the Huantai coal facility in China during the second quarter of 2006.

Depreciation and amortization expense decreased by \$0.5 million primarily due to the sale of the Huantai facility in China during the second quarter of 2006.

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Net interest expense on project debt decreased by \$0.7 million primarily due to the scheduled quarterly payment of project debt at both Indian facilities, partially offset by an increase in the amortization of deferred financing costs at both projects.

Other operating income increased by \$5.2 million primarily due to the effects of the following factors:

a \$1.7 million write-off of the remaining assets of the Bataan facility in the Philippines during the year ended December 31, 2005;

a \$1.2 million gain on the sale of the Huantai facility in China during the second quarter of 2006; and

a \$0.4 million gain on the sale of inventory at the Bataan facility in the Philippines during the second quarter of 2006.

General and administrative expenses decreased by \$0.6 million primarily due to lower personnel costs.

Table of Contents**Pro Forma Reconciliations**

The following tables provide reconciliations from the as reported results to the pro forma results presented above for the consolidated and Domestic and International segments where applicable (in thousands of dollars, except per share amounts). Notes to the pro forma reconciliations begin directly after the tables.

CONSOLIDATED PRO FORMA RECONCILIATIONS

| | Year Ended December 31, 2005 | | | |
|---|-------------------------------------|--------------------|------------------|------------------|
| | As Reported | Acquisition | Pro forma | |
| | | Activity | Adjust. | Pro Forma |
| | | (Unaudited) | | |
| Operating revenues | | | | |
| Waste and service revenues | \$ 638,503 | \$ 148,792 | \$ 1,860 | \$ 789,155 |
| Electricity and steam sales | 322,770 | 79,660 | | 402,430 |
| Other operating revenues | 17,490 | | | 17,490 |
| Total operating revenues | 978,763 | 228,452 | 1,860 | 1,209,075 |
| Operating expenses | | | | |
| Plant operating expenses | 559,638 | 103,617 | 3,136 | 666,391 |
| Depreciation and amortization expense | 124,925 | 57,032 | 1,495 | 183,452 |
| Net interest expense on project debt | 52,431 | 13,964 | 1,102 | 67,497 |
| General and administrative expenses | 67,481 | 52,133 | (42,399) | 77,215 |
| California Grantor Trust Settlement | 10,342 | | | 10,342 |
| Restructuring charges | 2,765 | | (2,765) | |
| Acquisition-related charges | 3,950 | | (3,950) | |
| Other operating expenses | 11,015 | 519 | | 11,534 |
| Total operating expenses | 832,547 | 227,265 | (43,381) | 1,016,431 |
| Operating income | 146,216 | 1,187 | 45,241 | 192,644 |
| Other income (expenses) | | | | |
| Investment income | 6,129 | 1,225 | | 7,354 |
| Interest expense | (89,973) | (26,368) | (2,903) | (119,244) |
| Gain on derivative instruments, ACL warrants | 15,193 | | | 15,193 |
| Total other expenses | (68,651) | (25,143) | (2,903) | (96,697) |
| Income before income tax (expense) benefit, minority interest and equity in net income from unconsolidated investments | | | | |
| | 77,565 | (23,956) | 42,338 | 95,947 |
| Income tax expense | (34,651) | 6,033 | (14,558) | (43,176) |
| Minority interest | (9,197) | (56) | | (9,253) |
| | 25,609 | | | 25,609 |

Equity in net income of unconsolidated
investments

| | | | | |
|-------------------|-----------|-------------|-----------|-----------|
| Net income | \$ 59,326 | \$ (17,979) | \$ 27,780 | \$ 69,127 |
|-------------------|-----------|-------------|-----------|-----------|

Weighted Average Common Shares
Outstanding:

| | | | | |
|-------|---------|--|--------|---------|
| Basic | 122,209 | | 17,787 | 139,996 |
|-------|---------|--|--------|---------|

| | | | | |
|---------|---------|--|--------|---------|
| Diluted | 127,910 | | 17,788 | 145,698 |
|---------|---------|--|--------|---------|

Earnings Per Share:

| | | | |
|-------|---------|--|---------|
| Basic | \$ 0.49 | | \$ 0.49 |
|-------|---------|--|---------|

| | | | |
|---------|---------|--|---------|
| Diluted | \$ 0.46 | | \$ 0.47 |
|---------|---------|--|---------|

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| | Year Ended December 31, 2005 | | | | | | | |
|---------------------------------------|------------------------------|-------------------------|-------------------------|-------------------|-------------------------------|-------------------------|-------------------------|------------------|
| | As Reported | Domestic | | | As Reported (Unaudited) | International | | As Reported |
| | | Acquisition Activity | Pro Forma Adjust. | Pro Forma | | Acquisition Activity | Pro Forma Adjust. | |
| Operating revenues | | | | | | | | |
| Waste and service revenues | \$ 634,268 | \$ 148,792 | \$ 1,860 | \$ 784,920 | \$ 4,235 | \$ | \$ | \$ 4,235 |
| Electricity and steam sales | 194,057 | 79,660 | | 273,717 | 128,713 | | | 128,713 |
| Other operating revenues | 2,693 | | | 2,693 | | | | |
| Total operating revenues | 831,018 | 228,452 | 1,860 | 1,061,330 | 132,948 | | | 132,948 |
| Operating expenses | | | | | | | | |
| Plant operating expenses | 471,641 | 103,617 | 3,136 | 578,394 | 87,997 | | | 87,997 |
| Depreciation and amortization expense | 116,083 | 57,032 | 1,495 | 174,610 | 8,731 | | | 8,731 |
| Net interest expense on project debt | 44,762 | 13,964 | 1,102 | 59,828 | 7,669 | | | 7,669 |
| General and administrative expenses | 59,249 | 52,133 | (42,399) | 68,983 | 4,967 | | | 4,967 |
| California Grantor Trust Settlement | 10,342 | | | 10,342 | | | | |
| Acquisition-related charges | 3,950 | | (3,950) | | | | | |
| Restructuring charges | | | | | 2,765 | | (2,765) | |
| Other operating (income) expenses | (3,651) | 519 | | (3,132) | 2,764 | | | 2,764 |
| Total operating expenses | 702,376 | 227,265 | (40,616) | 889,025 | 114,893 | | (2,765) | 112,128 |
| Operating income | \$ 128,642 | \$ 1,187 | \$ 42,476 | \$ 172,305 | \$ 18,055 | \$ | \$ 2,765 | \$ 20,820 |

Notes To Pro Forma Reconciliations**Pro Forma Assumptions**

The unaudited pro forma combined consolidated financial statements reflect the following assumptions:

ARC Holdings Transactions Acquisition Activity:

Represents ARC Holdings results of operations prior to June 25, 2005 for the pro forma year ended December 31, 2005.

We acquired 100% of the issued and outstanding shares of ARC Holdings capital stock on January 1, 2005 on the same terms described in Note 3. Acquisitions, Business Development and Dispositions of the Notes. The debt structure that was in place as of January 1, 2005 was assumed to be refinanced (prior to the amendment to the credit facilities on May 26, 2006) on the same terms described in Note 3. Acquisitions, Business Development and Dispositions of the Notes in connection with the acquisition of ARC Holdings.

Pro Forma Adjustments

The following are a summary of the pro forma adjustments made:

Waste and service revenues: To record additional revenues prior to June 25, 2005, as a result of conforming debt service revenue recognition at ARC Holdings subsidiaries to our debt service revenue recognition policy, which policy has been implemented by ARC Holdings since its acquisition.

Plant operating expenses: To record as rent expense the net impact of the change in the fair value of a lease owned by an operating subsidiary of ARC Holdings as of January 1, 2005.

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Depreciation and amortization expense: To reverse historical depreciation and amortization expense and to record pro forma depreciation and amortization expense based on fair values assigned to ARC Holdings property, plant and equipment and amortizable intangible assets prior to its acquisition date of June 24, 2005.

Net interest expense on project debt: To reverse ARC Holdings project debt prior bond issuance cost amortization and to record the impact of fair value adjustments to ARC Holdings project debt prior to its acquisition date of June 24, 2005.

General and administrative expenses: To reverse ARC Holdings executive compensation of approximately \$30 million and related expenses of approximately \$12 million in the periods prior to its acquisition date of June 24, 2005.

Restructuring charges: To reverse severance and incentive payments to certain of our international business executives as a result of overhead reductions made possible by the elimination of international's separate capital structure and debt repayments in connection with the refinancing of debt.

Acquisition-related charges: To reverse employee bonuses and integration expenses as a result of the acquisition of ARC Holdings.

Interest expense: To reverse ARC Holdings pre-acquisition period amortization of deferred financing costs; to record the impact of the fair value adjustment to the intermediate debt of ARC Holdings; to record the effect of the fair value adjustment associated with terminating an obligation to one of ARC Holdings prior owners; and to record the net adjustment to interest expense as a result of the new capital structure, prior to the amendment to the credit facilities on May 26, 2006, described in *Liquidity and Capital Resources* below. Additionally, to adjust for changes in valuation estimates of ARC Holdings debt premiums in the quarter ended December 31, 2005.

Income tax (expense) benefit: To record the adjustment for the estimated income tax effects associated with the pro forma adjustments to pre-tax income and arrive at a blended assumed effective tax rate 45% for the year ended December 31, 2005. We used an effective tax rate rather than the combined federal and statutory rate based upon the nature of the permanent difference related to the pro forma adjustments.

Earnings per share and weighted average shares outstanding: Basic and diluted earnings per share and the average shares outstanding used in the calculation of basic and diluted earnings per share of common stock and shares of common stock outstanding for the pro forma year ended December 31, 2005 have been adjusted, as necessary, to reflect the issuance of 66.7 million shares pursuant to a pro rata rights offering to all of our stockholders on June 24, 2005 in connection with the ARC Holdings acquisition as if they occurred on January 1, 2005. In addition, diluted earnings per share and the weighted average shares used in the calculation of diluted earnings per share of common stock and shares of common stock outstanding for the pro forma year ended December 31, 2005 has been adjusted, as necessary, to reflect the offering of 5.7 million shares of our common stock in a rights offering as if it occurred on January 1, 2005.

LIQUIDITY AND CAPITAL RESOURCES

Generating sufficient cash to invest in our business, meet our liquidity needs, pay down project debt, and pursue strategic opportunities remain important objectives of management. We derive our cash flows principally from our operations at our domestic and international projects, where our historical levels of production allow us to satisfy project debt covenants and payments, and distribute cash. We typically receive cash distributions from our domestic projects on either a monthly or quarterly basis, whereas a material portion of cash from our international projects is received semi-annually, during the second and fourth quarters.

During the first quarter of 2007, we completed a comprehensive recapitalization utilizing a series of equity and debt financings. Under the new credit facilities, we have substantially greater, but not unrestricted, ability to make investments in our business and to take advantage of opportunities to grow our business through investments and acquisitions, both domestically and internationally. Additional information, including material terms related to our recapitalization, is contained below under *2007 Recapitalization* and in Note 6. Long-Term Debt of the Notes.

Our primary future cash requirements will be to fund capital expenditures to maintain our existing businesses, make debt service payments and grow our business through acquisitions and business development. We will also seek to enhance our cash flow from renewals or replacement of existing contracts, from new contracts to expand existing facilities or operate additional facilities and by investing in new projects.

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The frequency and predictability of our receipt of cash from projects differs, depending upon various factors, including whether restrictions on distributions exist in applicable project debt arrangements, whether a project is domestic or international, and whether a project has been able to operate at historical levels of production.

Additionally, as of December 31, 2007, we had available credit for liquidity of \$268.8 million under the Revolving Loan Facility (as defined below) and unrestricted cash of \$149.4 million.

As of December 31, 2007, we were in compliance with the covenants under the Credit Facilities (as defined below). We believe that when combined with our other sources of liquidity, including our existing cash on hand and the Revolving Loan Facility, we will generate sufficient cash over at least the next twelve months to meet operational needs, make capital expenditures, invest in the business and service debt due.

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 the 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 (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 1.00% Senior Convertible Debentures due 2027 (the 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 our intermediate subsidiaries.

We completed our public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, respectively, and we closed on the 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. On April 16, 2007 and September 6, 2007, all remaining outstanding ARC Notes and the remaining outstanding MSW I Notes and MSW II Notes were redeemed, respectively. Additional information, including material terms related to our recapitalization, are described in Note 6. Long-Term Debt of the Notes.

As a result of the recapitalization, we recognized a loss on extinguishment of debt of approximately \$32.1 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.

Credit Agreement Financial Covenants

The loan documentation under the Credit Facilities contains customary affirmative and negative covenants and financial covenants as discussed in Note 6. Long-Term Debt of the Notes. We expect that the negative covenants will place limitations on us, but be materially less restrictive than the restrictions in effect prior to February 9, 2007. We were in compliance with all required covenants as of December 31, 2007.

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

maximum Covanta Energy leverage ratio of 4.25 to 1.00 for the four quarter period ended December 31, 2007, which measures Covanta Energy's principal amount of consolidated debt less certain restricted funds dedicated to repayment of project debt principal and construction costs (Consolidated Adjusted Debt) to its adjusted earnings before interest, taxes, depreciation and amortization, as calculated under the Credit

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Facilities (Adjusted EBITDA). The definition of Adjusted EBITDA in the Credit Facilities excludes certain non-cash charges. The maximum Covanta Energy leverage ratio allowed under the Credit Facilities adjusts in future periods as follows:

- 4.25 to 1.00 for each of the four quarter periods ended March 31, June 30 and September 30, 2008;
- 4.00 to 1.00 for each of the four quarter periods ended December 31, 2008, March 31, June 30 and September 30, 2009;
- 3.75 to 1.00 for each of the four quarter periods ended December 31, 2009, March 31, June 30 and September 30, 2010;
- 3.50 to 1.00 for each four quarter period thereafter;

maximum Covanta Energy capital expenditures incurred to maintain existing operating businesses of \$100 million per fiscal year, subject to adjustment due to an acquisition by Covanta Energy; and minimum Covanta Energy interest coverage ratio of 3.00 to 1.00, which measures Covanta Energy's Adjusted EBITDA to its consolidated interest expense plus certain interest expense of ours, to the extent paid by Covanta Energy.

Sources and Uses of Cash Flow

| | For the Years Ended December 31, | | | Increase (Decrease) | |
|--|---|-------------|-------------|----------------------------|---------------------|
| | 2007 | 2006 | 2005 | 2007 vs 2006 | 2006 vs 2005 |
| | (In thousands of dollars) | | | | |
| Net cash provided by operating activities | \$ 358,098 | \$ 311,199 | \$ 208,259 | \$ 46,899 | \$ 102,940 |
| Net cash used in investing activities(1) | (179,910) | (66,904) | (676,879) | 113,006 | (609,975) |
| Net cash (used in) provided by financing activities | (262,842) | (139,630) | 501,249 | 123,212 | (640,879) |
| Effect of exchange rate changes on cash and cash equivalents | 618 | 221 | (221) | 397 | 442 |
| Net (decrease) increase in cash and cash equivalents | \$ (84,036) | \$ 104,886 | \$ 32,408 | (188,922) | 72,478 |

- (1) For the years ended December 31, 2007 and 2006, net cash used in investing activities is net of proceeds of \$2.3 million and \$3.6 million, respectively, from the sale of facilities in China. For the year ended December 31, 2005, net cash used in investing activities is net of cash acquired from ARC Holdings of \$62.4 million.

Year Ended December 31, 2007 vs. Year Ended December 31, 2006

Net cash provided by operating activities for the year ended December 31, 2007 was \$358.1 million, an increase of \$46.9 million from the prior year. The increase was primarily due to lower interest paid of \$59.1 million resulting from the 2007 recapitalization and from lower project debt balances.

Net cash used in investing activities for the year ended December 31, 2007 was \$179.9 million, an increase of \$113.0 million from the prior year. The increase was primarily due to the following:

higher purchases of property, plant and equipment of \$31.4 million, principally comprised of:
 \$18.1 million relating to rebuilding at the SEMASS facility following the fire; and
 \$12.1 million relating to our Central Valley biomass facilities and our Holliston transfer station businesses acquired during 2007;
the acquisition of businesses, net of cash acquired, of \$110.5 million;
an equity investment in Sanfeng for \$10.3 million;
partially offset by property insurance proceeds of \$9.4 million related to the fire at our SEMASS energy-from-waste facility and the acquisition of a non-controlling interest in a subsidiary during 2006 of \$27.5 million.

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Net cash used in financing activities for the year ended December 31, 2007 was \$262.8 million, an increase of \$123.2 million from the prior year. This increase was primarily due to the 2007 recapitalization. The net proceeds from refinancing the previously existing credit facilities with the Credit Facilities was \$5.6 million, net of transaction fees. Proceeds of approximately \$364.4 million and \$136.6 million, each net of underwriting discounts and commissions, were received during the year ended December 31, 2007 related to underwritten public offerings of Debentures and common stock, respectively. The combination of the proceeds from the public offerings of Debentures and common stock and approximately \$130.0 million in cash and restricted cash (available for use as a result of the recapitalization) were utilized for the repayment, by means of a tender offer, of approximately \$611.9 million in principal amount of outstanding notes previously issued by certain intermediate subsidiaries.

Year Ended December 31, 2006 vs. Year Ended December 31, 2005

Cash provided by operating activities was \$311.2 million, an increase of \$102.9 million from the prior year. The increase in cash flow from operating activities was primarily due to operations acquired in the ARC Holdings acquisition in June 2005 of approximately \$64 million.

Net cash used in investing activities was \$66.9 million in the year ended December 31, 2006 and was primarily due to \$54.3 million in purchases of property, plant and equipment and the acquisition of the limited partnership interests Covanta Onondaga Limited Partnership for \$27.5 million in December 2006.

Net cash used in financing activities was \$139.6 million for the year ended December 31, 2006 and was primarily driven by the payment of project and long-term debt partially offset by the proceeds from borrowings of long-term debt and a decrease in restricted funds held in trust. On February 24, 2006, we completed a rights offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds. During 2005, we received net proceeds from the ARC Holdings rights offering of \$395.9 million to fund a portion of the \$740.0 million cash purchase price for the outstanding shares in ARC Holdings.

Project Debt***Domestic Project Debt***

Financing for the energy-from-waste projects is generally accomplished through tax-exempt and taxable municipal revenue bonds issued by or on behalf of the municipal client. For such facilities that are owned by a subsidiary of ours, the municipal issuers of the bond loans the bond proceeds to our subsidiary to pay for facility construction. For such facilities, project-related debt is included as Project debt (short- and long-term) in our consolidated financial statements. Generally, such project debt is secured by the revenues generated by the project and other project assets including the related facility. The only potential recourse to us with respect to project debt arises under the operating performance guarantees described below under *Other Commitments and Contingencies*.

Certain subsidiaries had recourse liability for project debt which is recourse to a certain ARC Holdings subsidiary, but is non-recourse to us and as of December 31, 2007 was as follows (in thousands of dollars):

| | |
|---|------------|
| Covanta Niagara, L.P. Series 2001 Bonds | \$ 165,010 |
| Covanta Southeastern Connecticut Company Corporate Credit Bonds | 43,500 |
| Covanta Hempstead Company Corporate Credit Bonds | 42,670 |
| Total | \$ 251,180 |

International Project Debt

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

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Our insurance business requires both readily liquid assets and adequate capital to meet ongoing obligations to policyholders and claimants, as well as to pay ordinary operating expenses. Our insurance business meets both its short-term and long-term liquidity requirements through operating cash flows that include premium receipts, investment income and reinsurance recoveries. To the extent operating cash flows do not provide sufficient cash flow, the insurance business relies on the sale of invested assets. Its investment policy guidelines require that all loss and loss adjustment expense (LAE) liabilities be matched by a comparable amount of investment grade assets. We believe that the insurance business has both adequate capital resources and sufficient reinsurance to meet its current operating requirements.

The investment portfolio for our insurance business was as follows as of December 31, 2007 (in thousands of dollars):

| | Amortized Cost | Fair Value |
|------------------------|-----------------------|-------------------|
| Investments by grade: | | |
| Fixed maturities: | | |
| U.S. Government/Agency | \$ 14,750 | \$ 14,813 |
| Mortgage-backed | 5,707 | 5,570 |
| Corporate (AAA to A) | 5,865 | 5,862 |
| Corporate (BBB) | 16 | 15 |
| Total fixed maturities | 26,338 | 26,260 |
| Equity securities | 909 | 1,110 |
| Total | \$ 27,247 | \$ 27,370 |

Capital Requirements

The following table summarizes our gross contractual obligations including project debt, leases and other obligations as of December 31, 2007 (in thousands of dollars, Note references are to the Notes):

| | Total | 2008 | Payments Due by Period | | 2013 and Beyond |
|-------------------------------------|--------------|-------------|-------------------------------|----------------------|------------------------|
| | | | 2009 and 2010 | 2011 and 2012 | |
| Domestic project debt (Note 7) | \$ 1,178,408 | \$ 151,053 | \$ 325,960 | \$ 236,824 | \$ 464,571 |
| International project debt (Note 7) | 70,914 | 33,861 | 31,404 | 5,649 | |
| Total project debt (Note 7) | 1,249,322 | 184,914 | 357,364 | 242,473 | 464,571 |
| Term Loan Facility (Note 6) | 645,125 | 6,500 | 13,000 | 13,000 | 612,625 |
| Debentures(1) | 373,750 | | | | 373,750 |
| Other long-term debt | 557 | 398 | 137 | 22 | |
| Total debt obligations(2) | 2,268,754 | 191,812 | 370,501 | 255,495 | 1,450,946 |

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| | | | | | |
|--------------------------------------|--------------|-----------|------------|-----------|--------------|
| Less: Non-recourse debt(3) | (1,249,879) | (185,312) | (357,501) | (242,495) | (464,571) |
| Total recourse debt | \$ 1,018,875 | \$ 6,500 | \$ 13,000 | \$ 13,000 | \$ 986,375 |
| Operating leases | 392,729 | 36,786 | 96,890 | 73,700 | 185,353 |
| Less: Non-recourse rental payments | (233,000) | (19,278) | (46,427) | (47,182) | (120,113) |
| Total recourse rental payments | \$ 159,729 | \$ 17,508 | \$ 50,463 | \$ 26,518 | \$ 65,240 |
| Interest payments(4) | 648,659 | 107,871 | 153,394 | 111,444 | 275,950 |
| Less: Non-recourse interest payments | (378,681) | (73,644) | (115,713) | (74,071) | (115,253) |
| Total recourse interest payments | \$ 269,978 | \$ 34,227 | \$ 37,681 | \$ 37,373 | \$ 160,697 |
| Retirement plan obligations(5) | \$ 25,850 | \$ 4,870 | \$ 9,710 | \$ 6,110 | \$ 5,160 |
| FIN 48 tax obligations(6) | \$ 33,041 | \$ | \$ 21,846 | \$ 8,574 | \$ 2,621 |
| Total obligations | \$ 1,507,473 | \$ 63,105 | \$ 132,700 | \$ 91,575 | \$ 1,220,093 |

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- (1) 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. In addition, beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures, calculated with reference to the trading price of the Debentures. As of December 31, 2007, the closing price of our common stock did not exceed the specified conversion price, and therefore, for purposes of this Capital Requirements chart, we have assumed no conversions or redemptions of the Debentures and no contingent interest related to the Debentures. For information detailing the contingent interest, conversion or redemption features of the Debentures, see Note 6. Long-Term Debt of the Notes.
- (2) Excludes \$31.0 million of unamortized debt premium.
- (3) Payment obligations for the project debt associated with owned energy-from-waste facilities are limited recourse to the operating subsidiary and non-recourse to us, subject to operating performance guarantees and commitments.
- (4) Interest payments on the Term Loan Facility and letter of credit fees are estimated based on current LIBOR rates and are estimated assuming contractual principal repayments.
- (5) Retirement plan obligations are based on actuarial estimates for the pension plan obligations and post-retirement plan obligations as of December 31, 2007.
- (6) FIN 48 obligations are based upon the expected date of settlement taking into account all of our administrative rights including possible litigation.

Other Commitments and Contingencies

Other commitments as of December 31, 2007 were as follows (in thousands of dollars):

| | Commitments Expiring by Period | | |
|-----------------------------|---------------------------------------|-------------------------------|-------------------------------|
| | Total | Less Than One Year | More Than One Year |
| Letters of credit | \$ 380,670 | \$ 57,983 | \$ 322,687 |
| Surety bonds | 61,981 | | 61,981 |
| Total other commitments net | \$ 442,651 | \$ 57,983 | \$ 384,668 |

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.

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See Note 6. Long-Term Debt of the Notes for specific criteria related to contingent interest, conversion or redemption features of the Debentures.

We have issued or are party to performance guarantees and related contractual support obligations undertaken pursuant to agreements to construct and operate certain domestic and international energy and waste facilities, and one domestic water facility. 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 material. To date, we have not incurred material liabilities under such performance guarantees. See *Item 1A. Risk Factors* *We have provided guarantees and financial support in connection with our projects.*

Insurance Coverage

We periodically review our insurance programs to ensure that our coverage is appropriate for the risks attendant to our business. As part of this review, we assess whether we have adequate coverage for risk to our physical assets from extreme weather events. We have obtained insurance for our assets and operations that provides coverage for what we believe are probable maximum losses, subject to self-insured retentions, policy limits and premium costs which we believe to be appropriate. However, the insurance obtained does not cover us for all possible losses.

Off-Balance Sheet Arrangements

We are party to lease arrangements with our municipal clients at our Union County, New Jersey, Alexandria, Virginia and Delaware County, Pennsylvania energy-from-waste facilities. At our Union County facility, we lease the facility from the Union County Utilities Authority, referred to as the UCUA, under a lease that expires in 2023, which we may extend for an additional five years. We guarantee a portion of the rent due under the lease. Rent under the lease is sufficient to allow the UCUA to repay tax exempt bonds issued by it to finance the facility and which mature in 2023.

At our Alexandria facility, we are a party to a lease which expires in 2025 related to certain pollution control equipment that was required in connection with the Clean Air Act amendments of 1990, and which was financed by the City of Alexandria and by Arlington County, Virginia. We own this facility, and the rent under this lease is sufficient to pay debt service on tax exempt bonds issued to finance such equipment and which mature in 2013.

Our Covanta Delaware Valley, L.P. (Delaware Valley) facility is a party to a lease for the facility that expires in 2019. We are obligated to pay a portion of lease rent, designated as Basic Rent B, and could be liable to pay certain related contractually-specified amounts, referred to as Stipulated Loss, in the event of a default in the payment of rent under the Delaware Valley lease beyond the applicable grace period. The Stipulated Loss is similar to lease termination liability and is generally intended to provide the lessor with the economic value of the lease, for the remaining lease term, had the default in rent payment not occurred. The balance of rental and Stipulated Loss obligations are payable by a trust formed and collateralized by the project's former operator in connection with the disposition of its interest in the Delaware Valley facility. Pursuant to the terms of various guarantee agreements, we have guaranteed the payments

of Basic Rent B and Stipulated Loss to the extent such payments are not made by our subsidiary, referred to as the Delaware Partnership . We do not believe, however, that such payments constitute a material obligation of our subsidiary since our subsidiary expects to continue to operate the Delaware Valley facility in the ordinary course for the entire term of the lease and will continue to pay rent throughout the term of the lease. As of December 31, 2007, the estimated Stipulated Loss would have been \$143.7 million.

We are also a party to lease arrangements pursuant to which we lease rolling stock in connection with our energy-from-waste and independent power facilities, as well as certain office equipment. Rent payable under these

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arrangements is not material to our financial condition. We generally use operating lease treatment for all of the foregoing arrangements. A summary of the operating lease obligations is contained in Note 15. Leases of the Notes.

As described above under *Other Commitments*, we have issued or are party to performance guarantees and related contractual obligations undertaken mainly pursuant to agreements to construct and operate certain energy and waste facilities. To date, we have not incurred material liabilities under our guarantees, either on domestic or international projects.

We have investments in several investees and joint ventures which are accounted for under the equity and cost methods and therefore we do not consolidate the financial information of those companies. See Note 8. Equity Method Investments of the Notes for additional information regarding these investments.

Discussion of Critical Accounting Policies

In preparing our consolidated financial statements in accordance with United States generally accepted accounting principles, we are required to use judgment in making estimates and assumptions that affect the amounts reported in our financial statements and related notes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. These estimates form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Many of our critical accounting policies are subject to significant judgments and uncertainties which could potentially result in materially different results under different conditions and assumptions. Future events rarely develop exactly as forecast, and the best estimates routinely require adjustment.

Stock-Based Compensation

We calculate the fair value of our share-based option awards using the Black-Scholes option pricing model which requires estimates of the expected life of the award and stock price volatility. For the option awards granted prior to 2007, we determined an expected life of eight years in accordance with SFAS 123 and SFAS 123R. In December 2007, the SEC issued Staff Accounting Bulletin (SAB) No. 110, which permits use of the simplified method, as discussed in SAB No. 107, to determine the expected life of plain vanilla options. The expected life for the options issued in 2007 was determined using this simplified method and as such, the expected lives of the options issued in 2007 range from 6.5 years to 6.04 years.

In addition, we also estimate expected forfeitures for our options and share-based awards and the probability of achieving specific performance factors affecting the vesting of our share-based awards. For our current share-based awards, our estimate of a forfeiture rate and determination of achieving stated performance vesting factors will have the most significant impact on the compensation cost we must recognize. We recognize compensation costs using the graded vesting attribution method over the requisite service period of the award, which is generally three to five years.

We review the forfeiture rate at least annually and revise compensation expense, if necessary. Prior to the second quarter of 2007, we recognized compensation expense based on an overall forfeiture rate of 8%. In order to better reflect compensation expense by type of award, i.e. options versus restricted stock, we reevaluated the forfeiture rate during the second quarter of 2007. The new forfeiture rates range from 8% to 15% depending on the type of award and the vesting period. The cumulative effect of the change in the forfeiture rate to compensation expense did not have a material effect on our financial results of operations.

Purchase Accounting

As described in Note 3. Acquisitions, Business Development and Dispositions of the Notes, we allocate acquisition purchase prices to identified intangible assets and tangible assets acquired and liabilities assumed based on their estimated fair values at the dates of acquisition, with any residual amounts allocated to goodwill. The fair value estimates used reflect our best estimates based on our work and the work of independent valuation consultants based on relevant information available to us. These estimates, and the assumptions used by us and by our valuation consultants, are subject to inherent uncertainties and contingencies beyond our control. For example, we used the discounted cash flow method to estimate the value of many of our assets. This entailed developing projections about future cash flows and adopting an appropriate discount rate. We cannot predict with certainty actual cash flows and

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the selection of a discount rate is heavily dependent on judgment. If different cash flow projections or discount rates were used, the fair values of our assets and liabilities could be materially increased or decreased. Accordingly, there can be no assurance that such estimates and assumptions reflected in the valuations will be realized, or that further adjustments will not occur. The assumptions and estimates used by us substantially affect our balance sheet. In addition, the valuations impact depreciation and amortization expense and changes in such assumptions and estimates may affect earnings in the future. During the current year, some of our estimates have been refined which resulted in changes to assets and liabilities recognized on the balance sheet as of December 31, 2007.

Depreciation and Amortization

We have estimated the useful lives over which we depreciate our long-lived assets. Additionally, in accordance with SFAS No. 143, Accounting for Asset Retirement Obligations, we have capitalized the estimate of our legal liabilities which includes closure and post-closure costs for landfill cells and site restoration for certain energy-from-waste and power producing sites.

Goodwill and Intangible Assets

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we evaluate our goodwill and indefinite lived intangible assets for impairment at least annually or when indications of impairment exist. Our judgments regarding the existence of impairment indicators are based on regulatory factors, market conditions, anticipated cash flows and operational performance of our acquired assets. There has been no impairment recognized in the current year, however an impact of impairment in the future could have a material impact on our financial position and results of operations.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, we evaluate our long-term assets and amortizable intangible assets for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. No events or change in circumstances occurred during the period to warrant this testing. However, had an event or change in circumstances occurred, the impact of recognizing an impairment could have a material impact on our financial position and results of operations.

Net Operating Loss Carryforwards Deferred Tax Assets

As described in Note 9. Income Taxes of the Notes, we have recorded a deferred tax asset related to the NOLs. The amount recorded was calculated based upon future taxable income arising from (a) the reversal of temporary differences during the period the NOLs are available and (b) future operating income expected from our domestic and international businesses, to the extent it is reasonably predictable.

We estimated that we have NOLs of approximately \$275 million for federal income tax purposes as of the end of 2007. The NOLs will expire in various amounts beginning on December 31, 2009 through December 31, 2026, if not used. The amount of NOLs available to us will be reduced by any taxable income generated by current members of our tax consolidated group including certain grantor trusts relating to the Mission Insurance Entities or increased to the extent of any new losses recorded.

The Internal Revenue Service (IRS) has not audited any of our tax returns for the years in which the losses giving rise to the NOLs were reported, and the IRS could challenge any past and future use of the NOLs.

Loss Contingencies

As described in Note 21. Commitments and Contingencies of the Notes, 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 with respect to these matters on an ongoing basis and when losses are considered probable and reasonably estimable, we 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 and disclosure is made regarding the possibility of additional losses. We review such estimates on an ongoing basis as developments occur with respect to such matters and may in the future increase or decrease such estimates. There can be no assurance that our initial or adjusted estimates of losses will reflect the ultimate loss we

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may experience regarding such matters. Any inaccuracies could potentially have a material adverse effect on our consolidated financial condition.

Financial Instruments

As described in Note 19. Financial Instruments of the Notes, the estimated fair-value amounts have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the amounts that we would realize in a current market exchange.

For cash and cash equivalents, restricted cash, and marketable securities, the carrying value of these amounts is a reasonable estimate of their fair value. The fair value of restricted funds held in trust is based on quoted market prices of the investments held by the trustee. The insurance subsidiaries' fixed maturity debt and equity securities portfolio are classified as available-for-sale and are carried at fair value.

Fair values for debt were determined based on interest rates that are currently available to us for issuance of debt with similar terms and remaining maturities for debt issues that are not traded on quoted market prices. The fair value of project debt is estimated based on quoted market prices for the same or similar issues.

The fair value of our interest rate swap agreements is the estimated amount we would receive or pay to terminate the agreement based on the net present value of the future cash flows as defined in the agreement.

Revenue Recognition

We earn fees to service project debt (principal and interest) where such fees are expressly included as a component of the service fee paid by the client community pursuant to applicable energy-from-waste service agreements. Regardless of the timing of amounts paid by client communities relating to project debt principal, we record service revenue with respect to this principal component on a levelized basis over the term of the applicable service agreement. Unbilled service receivables related to energy-from-waste operations are discounted in recognizing the present value for services performed currently in order to service the principal component of the project debt. Fees for waste disposal are recognized in the period received. Revenue from electricity and steam sales are recorded when delivered at rates specified in the contracts. We also earn fees under fixed-price construction contracts, in which case revenue is accounted for using the percentage-of-completion of services rendered.

Pensions

Our pension and other postretirement benefit plans are accounted for in accordance with SFAS No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans*—an amendment to FASB Statements No. 87, 88, 106 and 132(R) (SFAS 158), which require costs and the related obligations and assets arising from the pension and other postretirement benefit plans to be accounted for based on actuarially-determined estimates. Upon the adoption of SFAS 158 in December 2006, we recognized a net gain of \$2.5 million, \$1.7 million net of deferred tax, in Accumulated Other Comprehensive Income (AOCI) to reflect the funded status of the pension and postretirement benefit obligations.

On an annual basis, management evaluates the assumed discount rate and expected return on assets used to determine pension benefit and other postretirement benefit obligations. The discount rate is determined based on the timing of future benefit payments and expected rates of return currently available on high quality fixed income securities whose cash flows match the timing and amount of future benefit payments of the plan. Based on this evaluation, we increased the discount rate assumption for benefit obligations from 5.75% as of December 31, 2006 to 6.50% as of

December 31, 2007. We recorded a pension plan liability equal to the amount by which the present value of the projected benefit obligations (using a discount rate of 6.50%) exceeded the fair value of pension assets as of December 31, 2007. We recognized a net actuarial gain of \$14.5 million, \$9.4 million net of deferred tax, in AOCI during the year ended December 31, 2007.

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Unpaid Losses and Loss Adjustment Expenses

Our insurance subsidiaries establish loss and loss adjustment expense (LAE) reserves that are estimates of amounts needed to pay claims and related expenses in the future for insured events that have already occurred. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain.

Reserves are typically comprised of (1) case reserves for claims reported and (2) reserves for losses that have occurred but for which claims have not yet been reported, referred to as incurred but not reported (IBNR) reserves, which include a provision for expected future development on case reserves. Case reserves are estimated based on the experience and knowledge of claims staff regarding the nature and potential cost of each claim and are adjusted as additional information becomes known or payments are made. IBNR reserves are derived by subtracting paid loss and LAE and case reserves from estimates of ultimate loss and LAE. Actuaries estimate ultimate loss and LAE using various generally accepted actuarial methods applied to known losses and other relevant information. Like case reserves, IBNR reserves are adjusted as additional information becomes known or payments are made.

Our insurance subsidiaries use independent actuaries which we significantly rely on to form a conclusion on reserve estimates. Those independent actuaries use several generally accepted actuarial methods to evaluate the insurance business loss reserves, each of which has its own strengths and weaknesses. The independent actuaries place more or less reliance on a particular method based on the facts and circumstances at the time the reserve estimates are made and through discussions with our insurance subsidiaries management.

Recent Accounting Pronouncements

See Note 1. Organization and Summary of Significant Accounting Policies and Note 2. Recent Accounting Pronouncements of the Notes for a summary of additional accounting policies and new accounting pronouncements.

Related-Party Transactions

Employment Arrangements

See the descriptions of our employment agreements with Anthony J. Orlando, Mark A. Pytosh, John M. Klett, Timothy J. Simpson and Seth Myones which are incorporated by reference into *Item 11. Executive Compensation* of this Annual Report on Form 10-K.

Affiliate Agreements

Clayton Yeutter, a current director, is senior advisor to the law firm of Hogan & Hartson LLP. Hogan & Hartson has provided Covanta Energy with certain legal services for many years including 2007. This relationship preceded our acquisition of Covanta Energy and Mr. Yeutter did not direct or have any direct or indirect involvement in the procurement, provision, oversight or billing of such legal services and does not directly or indirectly benefit from those fees. The Board has determined that such relationship does not interfere with Mr. Yeutter's exercise of independent judgment as a director.

As described in Note 8. Equity Method Investments of the Notes, we hold a 26% investment in Quezon. We are party to an agreement with Quezon in which 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 fiscal years ended December 31,

2007, 2006 and 2005, we collected \$35.4 million, \$26.9 million, and \$29.5 million, respectively, for the operation and maintenance of the facility. As of December 31, 2007 and December 31, 2006, the net amount due to Quezon was \$1.1 million and \$2.2 million, respectively, which represents advance payments received from Quezon for operation and maintenance costs.

SZ Investments, Third Avenue and D.E. Shaw Laminar Portfolios, L.L.C. (Laminar), then representing aggregate ownership of approximately 40% of our outstanding common stock, each agreed to and participated in the ARC Holdings Rights Offering and acquired at least their respective pro rata portion of the shares. As

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consideration for their commitments, we paid each of these stockholders an amount equal to 1.75% of their respective equity commitments, which in the aggregate was \$2.8 million. We also agreed to amend an existing registration rights agreement to provide these stockholders with the right to demand that we undertake an underwritten offering within twelve months of the closing of the acquisition of ARC Holdings in order to provide such stockholders with liquidity or to register for resale common stock acquired in such offering. None of such stockholders exercised such right to request an underwritten offering prior to the expiration of such period.

As part of the Covanta Energy acquisition, we agreed to conduct the 9.25% Offering and because of the possibility that the 9.25% Offering could not be completed prior to the completion of the ARC Holdings Rights Offering, we restructured the 9.25% Offering to offer an additional 2.7 million shares of our common stock at the same purchase price as in the ARC Holdings Rights Offering. On February 24, 2006, we completed the 9.25% Offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds, including 633,380 shares purchased by Laminar pursuant to the exercise of rights held by Laminar as a holder of 9.25% debentures.

Item 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

In the normal course of business, our subsidiaries are party to financial instruments that are subject to market risks arising from changes in interest rates, foreign currency exchange rates, and commodity prices. Our use of derivative instruments is very limited and we do not enter into derivative instruments for trading purposes. The following analysis provides quantitative information regarding our exposure to financial instruments with market risks. We use a sensitivity model to evaluate the fair value or cash flows of financial instruments with exposure to market risk that assumes instantaneous, parallel shifts in exchange rates and interest rate yield curves. There are certain limitations inherent in the sensitivity analysis presented, primarily due to the assumption that exchange rates change in a parallel manner and that interest rates change instantaneously. In addition, the fair value estimates presented herein are based on pertinent information available to us as of December 31, 2007. Further information is included in Note 19. Financial Instruments of the Notes.

Interest Rate Risk

We have project debt outstanding bearing interest at floating rates that could subject us to the risk of increased interest expense due to rising market interest rates, or an adverse change in fair value due to declining interest rates on fixed rate debt. Of our project debt, approximately \$164.8 million was floating rate debt at December 31, 2007. However, interest rate risk relating to the floating rate project debt is borne by the client communities because debt service is passed through to those clients under the contractual structure of their agreements. We had only one interest rate swap relating to project debt outstanding as of December 31, 2007 in the notional amount of \$72.4 million related to floating rate project debt. Gains and losses, however, on this swap are for the account of the client community and are not borne by us.

We were required, under financing arrangements in effect from June 24, 2005 to February 9, 2007, to enter into hedging arrangements with respect to a portion of our exposure to interest rate changes with respect to our borrowing under the previously existing credit facilities. The impact of the swaps decreased interest expense for the year ended December 31, 2006 by \$2.4 million and increased interest expense for the year ended December 31, 2005 by \$0.7 million. As of December 31, 2006, the net after-tax deferred gain in other comprehensive income was \$2.1 million (\$3.3 million before income taxes which was recorded in other assets). In connection with the refinancing of our credit facilities, the interest rate swap agreements were settled on February 9, 2007. We recognized a gain associated with the settlement of our interest rate swap agreements of \$3.4 million, pre-tax. The Term Loan Facility, discussed below, does not require us to enter into interest rate swap agreements. For additional information, see Note 6. Long-Term Debt and Note 19. Financial Instruments of the Notes and *Liquidity and Capital Resources 2007 Recapitalization*.

Outstanding loan balances under the Credit Facilities bear interest at floating rates, which are calculated as either interest at a reserve adjusted British Bankers Association Interest Settlement Rate, commonly referred to as LIBOR, the prime rate or the Federal Funds rate plus 0.5% per annum, plus a borrowing margin. For details as to the various election options under the Credit Facility, see Note 6. Long-Term Debt of the Notes. As of December 31, 2007, the outstanding balance of the Term Loan was \$645.1 million. We have not entered into any interest rate hedging

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arrangements against this balance. A hypothetical increase of 1.00% in the underlying December 31, 2007 market interest rates would result in a potential loss to twelve month future earnings of \$6.5 million.

Contingent Interest

On January 31, 2007, we completed an underwritten public offering of \$373.8 million aggregate principal amount of 1.00% Senior Convertible Debentures due 2027 (the "Debentures"). The Debentures bear interest at a rate of 1.00% per year, payable semi-annually in arrears, on February 1 and August 1 of each year, commencing on August 1, 2007 and will mature on February 1, 2027. Beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures during any six-month interest period in which the trading price of the Debentures measured over a specified number of trading days is 120% or more of the principal amount of the Debentures. When applicable, the contingent interest payable per \$1,000 principal amount of Debentures will equal 0.25% of the average trading price of \$1,000 principal amount of Debentures during the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period. The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and as such, the fair market value for the embedded derivative was zero as of December 31, 2007. For additional information related to the Credit Facilities, see Note 6. Long-Term Debt of the Notes and *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources 2007 Recapitalization.*

Foreign Currency Exchange Rate Risk

We have investments in energy projects in various foreign countries, including the Philippines, China, India and Bangladesh, and to a much lesser degree, England, Ireland, Italy and Costa Rica. We do not enter into currency transactions to hedge our exposure to fluctuations in currency exchange rates. At some projects, we have mitigated our currency risks by structuring our project contracts so that our revenues are adjusted in line with corresponding changes in currency rates. Therefore, only working capital and project debt denominated in other than a project entity's functional currency are exposed to currency risks.

As of December 31, 2007, we had \$70.9 million of project debt related to two heavy fuel-oil projects in India. For \$63.0 million of the debt (related to project entities whose functional currency is the Indian rupee), exchange rate fluctuations were recorded as translation adjustments in other comprehensive income within stockholders' equity in our consolidated balance sheets. The remaining \$7.9 million of debt was denominated in U.S. dollars.

The potential loss in fair value for such financial instruments from a 10% adverse change in December 31, 2007 quoted foreign currency exchange rates would be approximately \$6.3 million.

As of December 31, 2007, we also had net investments in foreign subsidiaries and projects. See Note 8. Equity Method Investments of the Notes for further discussion.

Commodity Price Risk and Contract Revenue Risk

We have not entered into futures, forward contracts, swaps or options to hedge purchase and sale commitments, fuel requirements, inventories or other commodities. Alternatively, we attempt to mitigate the risk of energy and fuel market fluctuations by structuring contracts related to our energy projects in the manner described above in *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation Overview Contract Structures.*

Generally, we are protected against fluctuations in the waste disposal market, and thus our ability to charge acceptable fees for our services, through long-term service agreements and disposal contracts at our energy-from-waste facilities. At ten of our energy-from-waste facilities, differing amounts of waste disposal capacity are not subject to long-term contracts and, therefore, we are partially exposed to the risk of market fluctuations in the waste disposal fees we may charge. Our long-term service agreements begin to expire in 2008, and energy sales contracts at owned projects generally expire at or after the date on which that project's long-term agreement expires. Expiration of these contracts will subject us to greater market risk in maintaining and enhancing our revenues. As our agreements at municipally-owned projects expire, we will seek to enter into renewal or replacement contracts to

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continue operating such projects. As our agreements at facilities we own begin to expire, we intend to seek replacement or additional contracts for waste supplies, and because project debt on these facilities will be paid off at such time, we expect to be able to offer disposal services at rates that will attract sufficient quantities of waste and provide acceptable revenues. We will seek to bid competitively in the market for additional contracts to operate other facilities as similar contracts of other vendors expire. At facilities we own, the expiration of existing energy sales contracts will require us to sell our output either into the local electricity grid or pursuant to new contracts. There can be no assurance that we will be able to enter into such renewals, replacement or additional contracts, or that the price and other terms available in the market at the time will be favorable to us.

We have similar protection against energy market fluctuations at most of our projects, which have long-term contracts for the sale of energy output. At a few of our projects, we enter into shorter term arrangements for energy sales, or have market-based pricing and therefore, we have some exposure to energy market fluctuations with respect to these projects. In addition, we sell recovered materials, principally ferrous metals, under short-term arrangements from most of our energy-from-waste projects, and have some exposure to market fluctuations with respect to such sales. While the ferrous metals markets fluctuate, given the amount of revenue we derive from such sales, we do not expect any such fluctuations to have a material affect on our financial results.

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

Risk Related to the Investment Portfolio

The objectives in managing the investment portfolio held by our insurance subsidiary are to maintain necessary liquidity and maximize investment income and investment returns while minimizing overall market risk. Investment strategies are developed based on many factors including duration of liabilities, underwriting results, overall tax position, regulatory requirements, and fluctuations in interest rates. Investment decisions are made by management, in consultation with an independent investment advisor, and approved by our insurance subsidiary's board of directors. Market risk represents the potential for loss due to adverse changes in the fair value of securities. The market risks related to the fixed maturity portfolio are primarily credit risk, interest rate risk, reinvestment risk and prepayment risk. The market risk related to the equity portfolio is price risk.

Fixed Maturities

Interest rate risk is the price sensitivity of fixed maturities to changes in interest rate. We view these potential changes in price within the overall context of asset and liability matching. We estimate the payout patterns of the liabilities, primarily loss reserves, of our insurance subsidiary to determine their duration. Duration targets are set for the fixed income portfolio after consideration of the duration of the liabilities that we believe mitigate the overall interest rate risk. Our exposure to interest rate risk is mitigated by the relative short-term nature of our insurance and other liabilities. The effective duration of the portfolio as of December 31, 2007 and 2006 was 1.6 years. We believe that the portfolio duration is appropriate given the relative short-tail nature of the auto programs and projected run-off of all other lines of business. A hypothetical 100 basis point increase in market interest rates would cause an approximate 1.9% decrease in the fair value of the portfolio while a hypothetical 100 basis point decrease would cause an approximate 1.8% increase in fair value. Credit risk is the price sensitivity of fixed maturities to changes in the credit quality of such investment. Our exposure to credit risk is mitigated by our investment in high quality fixed income alternatives.

Fixed maturities held by our insurance subsidiary include mortgage-backed securities and collateralized mortgage obligations, collectively (MBS) representing 21.6% and 23.1% of total fixed maturities as of December 31, 2007 and 2006, respectively. All MBS held by our insurance subsidiary were issued by the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC), which are both rated AAA by Moody's Investors Services. FNMA and FHLMC guarantee the principal balance of their securities. FNMA guarantees timely payment of principal and interest.

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One of the risks associated with MBS is the timing of principal payments on the mortgages underlying the securities. We attempt to limit repayment risk by purchasing MBS whose cost is below or does not significantly exceed par, and by primarily purchasing structured securities with repayment protection which provides more certain cash flow to the investor such as MBS with sinking fund schedules known as Planned Amortization Classes (PAC) and Targeted Amortization Classes (TAC). The structures of PACs and TACs attempt to increase the certainty of the timing of prepayment and thereby minimize the prepayment and interest rate risk. In 2007, our insurance subsidiary recognized less than \$0.1 million in loss on sales of fixed maturities.

Equity Securities

Our insurance subsidiary's investments in equity securities are generally limited to Fortune 500 companies with strong balance sheets, along with a history of dividend growth and price appreciation. As of December 31, 2007, equity securities represented 4% of our insurance company's total investment portfolio.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Covanta Holding Corporation

We have audited the accompanying consolidated balance sheets of Covanta Holding Corporation (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedules listed in the Index at Item 8. These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Covanta Holding Corporation at December 31, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 9 to the consolidated financial statements, effective January 1, 2007 the Company adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Covanta Holding Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 24, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

MetroPark, New Jersey
February 24, 2008

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COVANTA HOLDING CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

| | For the Years Ended December 31, | | |
|--|---|-------------------|------------------|
| | 2007 | 2006 | 2005 |
| | (In thousands, except per share amounts) | | |
| OPERATING REVENUES: | | | |
| Waste and service revenues | \$ 864,396 | \$ 817,633 | \$ 638,503 |
| Electricity and steam sales | 498,877 | 433,834 | 322,770 |
| Other operating revenues | 69,814 | 17,069 | 17,490 |
| Total operating revenues | 1,433,087 | 1,268,536 | 978,763 |
| OPERATING EXPENSES: | | | |
| Plant operating expenses | 801,560 | 712,156 | 559,638 |
| Depreciation and amortization expense | 196,970 | 193,217 | 124,925 |
| Net interest expense on project debt | 54,579 | 60,210 | 52,431 |
| General and administrative expenses | 82,729 | 73,599 | 67,481 |
| Other operating expenses | 60,639 | 2,594 | 11,015 |
| California Grantor Trust Settlement | | | 10,342 |
| Restructuring charges | | | 2,765 |
| Acquisition-related charges | | | 3,950 |
| Total operating expenses | 1,196,477 | 1,041,776 | 832,547 |
| Operating income | 236,610 | 226,760 | 146,216 |
| Other income (expense): | | | |
| Investment income | 10,578 | 11,770 | 6,129 |
| Interest expense | (67,104) | (109,507) | (89,973) |
| Loss on extinguishment of debt | (32,071) | (6,795) | |
| Gain on derivative instruments, ACL warrants | | | 15,193 |
| Total other expenses | (88,597) | (104,532) | (68,651) |
| Income before income tax expense, minority interests and equity in net income from unconsolidated investments | 148,013 | 122,228 | 77,565 |
| Income tax expense | (31,040) | (38,465) | (34,651) |
| Minority interests | (8,656) | (6,610) | (9,197) |
| Equity in net income from unconsolidated investments | 22,196 | 28,636 | 25,609 |
| NET INCOME | \$ 130,513 | \$ 105,789 | \$ 59,326 |

Weighted Average Common Shares Outstanding:

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| | | | |
|----------------------------|---------|---------|---------|
| Basic | 152,653 | 145,663 | 122,209 |
| Diluted | 153,997 | 147,030 | 127,910 |
| Earnings Per Share: | | | |
| Basic | \$ 0.85 | \$ 0.73 | \$ 0.49 |
| Diluted | \$ 0.85 | \$ 0.72 | \$ 0.46 |

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

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COVANTA HOLDING CORPORATION
CONSOLIDATED BALANCE SHEETS

| | As of December 31, | |
|---|---|---------------------|
| | 2007 | 2006 |
| | (In thousands, except per share amounts) | |
| ASSETS | | |
| Current: | | |
| Cash and cash equivalents | \$ 149,406 | \$ 233,442 |
| Marketable securities available for sale | 2,495 | 7,080 |
| Restricted funds held in trust | 187,951 | 178,054 |
| Receivables (less allowances of \$4,353 and \$4,469) | 252,114 | 209,306 |
| Unbilled service receivables | 59,232 | 56,868 |
| Deferred income taxes | 29,873 | 24,146 |
| Prepaid expenses and other current assets | 113,927 | 94,690 |
| Total Current Assets | 794,998 | 803,586 |
| Property, plant and equipment, net | 2,620,507 | 2,637,923 |
| Investments in fixed maturities at market (cost: \$26,338 and \$35,833, respectively) | 26,260 | 35,007 |
| Restricted funds held in trust | 191,913 | 229,867 |
| Unbilled service receivables | 56,685 | 73,067 |
| Waste, service and energy contracts, net | 268,353 | 296,528 |
| Other intangible assets, net | 88,954 | 87,046 |
| Goodwill | 127,027 | 91,282 |
| Investments in investees and joint ventures | 81,248 | 73,717 |
| Other assets | 112,554 | 109,797 |
| Total Assets | \$ 4,368,499 | \$ 4,437,820 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current: | | |
| Current portion of long-term debt | \$ 6,898 | \$ 36,434 |
| Current portion of project debt | 195,625 | 190,242 |
| Accounts payable | 29,916 | 20,151 |
| Deferred revenue | 25,114 | 16,457 |
| Accrued expenses and other current liabilities | 234,000 | 197,468 |
| Total Current Liabilities | 491,553 | 460,752 |
| Long-term debt | 1,012,534 | 1,223,689 |
| Project debt | 1,084,650 | 1,245,705 |
| Deferred income taxes | 440,723 | 420,263 |
| Waste and service contracts | 130,464 | 135,607 |
| Other liabilities | 141,740 | 169,971 |

| | | |
|---|--------------|--------------|
| Total Liabilities | 3,301,664 | 3,655,987 |
| Commitments and Contingencies (Note 21) | | |
| Minority Interests | 40,773 | 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 154,281 and 147,657 shares; outstanding 153,922 and 147,500 shares) | 15,428 | 14,766 |
| Additional paid-in capital | 765,287 | 619,685 |
| Accumulated other comprehensive income | 16,304 | 3,942 |
| Accumulated earnings | 229,079 | 100,775 |
| Treasury stock, at par | (36) | (16) |
| Total Stockholders Equity | 1,026,062 | 739,152 |
| Total Liabilities and Stockholders Equity | \$ 4,368,499 | \$ 4,437,820 |

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

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COVANTA HOLDING CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For the Years Ended December 31, | | |
|---|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| | (In thousands) | | |
| OPERATING ACTIVITIES: | | | |
| Net income | \$ 130,513 | \$ 105,789 | \$ 59,326 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization expense | 196,970 | 193,217 | 124,925 |
| Revenue contract levelization | (555) | 3,419 | 2,068 |
| Amortization of long-term debt deferred financing costs | 3,841 | 3,858 | 10,785 |
| Amortization of debt premium and discount | (14,857) | (22,506) | (18,058) |
| Loss on extinguishment of debt | 32,071 | 6,795 | |
| Provision for doubtful accounts | 1,184 | 2,251 | 2,008 |
| Stock-based compensation expense | 13,448 | 6,887 | 4,057 |
| Equity in net income from unconsolidated investments | (22,196) | (28,636) | (25,609) |
| Dividends from unconsolidated investments | 24,250 | 19,375 | 19,287 |
| Minority interests | 8,656 | 6,610 | 9,197 |
| Gain on derivative instruments, ACL warrants | | | (15,193) |
| Deferred income taxes | 5,869 | 20,908 | 17,759 |
| Other, net | (1,801) | 6,872 | 6,003 |
| Change in operating assets and liabilities, net of effects of acquisitions: | | | |
| Restricted funds for emergence costs | | | 13,201 |
| Receivables | (36,084) | (8,577) | 2,701 |
| Unbilled service receivables | 19,403 | 17,294 | 11,949 |
| Accounts payable and accrued expenses | 22,880 | 2,351 | 7,691 |
| Accrued emergence costs | | | (13,201) |
| Unpaid losses and loss adjustment expenses | (4,984) | (8,848) | (17,402) |
| Other, net | (20,510) | (15,860) | 6,765 |
| Net cash provided by operating activities | 358,098 | 311,199 | 208,259 |
| INVESTING ACTIVITIES: | | | |
| Acquisition of businesses, net of cash acquired | (110,465) | | (684,990) |
| Proceeds from the sale of investment securities | 15,057 | 10,615 | 30,827 |
| Purchase of investment securities | (622) | (774) | (3,458) |
| Acquisition of non-controlling interest in subsidiary | | (27,500) | |
| Purchase of equity interest | (11,199) | | |
| Purchase of property, plant and equipment | (85,748) | (54,267) | (23,527) |
| Property insurance proceeds | 9,441 | | |
| Other, net | 3,626 | 5,022 | 4,269 |

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| | | | |
|--|-------------|------------|------------|
| Net cash used in investing activities | (179,910) | (66,904) | (676,879) |
| FINANCING ACTIVITIES: | | | |
| Proceeds from the issuance of common stock, net | 135,757 | | |
| Proceeds from rights offerings, net | | 20,498 | 395,791 |
| Proceeds from the exercise of options for common stock, net | 812 | 1,126 | 2,984 |
| Proceeds from borrowings on long-term debt | 949,907 | 97,619 | 675,000 |
| Financings of insurance premiums, net | 7,927 | | |
| Proceeds from borrowings on project debt | 3,506 | 6,868 | 43,561 |
| Proceeds from borrowings on revolving credit facility | 30,000 | | |
| Principal payments on long-term debt | (1,181,130) | (140,638) | (368,432) |
| Principal payments on project debt | (164,167) | (151,095) | (188,975) |
| Payments of borrowings on revolving credit facility | (30,000) | | |
| Payments of long-term debt deferred financing costs | (18,324) | (2,129) | (35,485) |
| Payments of tender premiums on debt extinguishment | (33,016) | (1,952) | |
| Increase in holding company restricted funds | 6,660 | | (6,471) |
| Decrease (increase) in restricted funds held in trust | 36,925 | 39,373 | (6,337) |
| Distributions to minority partners | (7,699) | (9,263) | (12,249) |
| Other, net | | (37) | 1,862 |
| Net cash (used in) provided by financing activities | (262,842) | (139,630) | 501,249 |
| Effect of exchange rate changes on cash and cash equivalents | 618 | 221 | (221) |
| Net (decrease) increase in cash and cash equivalents | (84,036) | 104,886 | 32,408 |
| Cash and cash equivalents at beginning of period | 233,442 | 128,556 | 96,148 |
| Cash and cash equivalents at end of period | \$ 149,406 | \$ 233,442 | \$ 128,556 |
| Cash Paid for Interest and Income Taxes: | | | |
| Interest | \$ 146,677 | \$ 205,807 | \$ 154,545 |
| Income taxes | \$ 24,122 | \$ 17,398 | \$ 16,737 |

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

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COVANTA HOLDING CORPORATION
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

| | Common Stock | | Additional | Unearned | Accumulated | Accumulated | Treasury | | Total |
|--|--------------|----------|------------|--------------|----------------|-------------|----------|---------|------------|
| | Shares | Amount | Paid-In | Compensation | Comprehensive | Earnings | Shares | Amount | |
| | | | | | (Loss) | (Deficit) | | | |
| | | | | | (In thousands) | | | | |
| Balance as of December 31, 2004 | 73,441 | \$ 7,344 | \$ 194,783 | \$ (3,489) | \$ 583 | \$ (64,340) | 11 | \$ (66) | \$ 134,815 |
| Stock-based compensation expense | | | (29) | | | | | | (29) |
| Amortization of unearned compensation | | | | 4,086 | | | | | 4,086 |
| Adjustment of unearned compensation for terminated employees | (18) | (2) | (164) | 166 | | | | | |
| Shares issued in rights offering, net of costs | 66,673 | 6,667 | 389,124 | | | | | | 395,791 |
| Exercise of options to purchase common stock | 724 | 72 | 4,937 | | | | | | 5,009 |
| Shares cancelled on exercise of options | (21) | (1) | (290) | | | | 69 | 58 | (233) |
| Share issued in restricted stock award | 447 | 45 | 5,317 | (5,346) | | | | | 16 |
| ACL gift upon emergence from bankruptcy | | | 508 | | | | | | 508 |
| Comprehensive income, net of income taxes: | | | | | | | | | |
| Net income | | | | | | 59,326 | | | 59,326 |
| | | | | | (675) | | | | (675) |

| | | | | | | | | | |
|--|---------|--------|---------|---------|---------|---------|----|-----|---------|
| Foreign currency translation | | | | | | | | | |
| Minimum pension liability | | | | | (331) | | | | (331) |
| Net unrealized loss on available-for-sale securities | | | | | (1,055) | | | | (1,055) |
| Net unrealized gain on derivative instruments | | | | | 2,013 | | | | 2,013 |
| Total comprehensive income | | | | | (48) | 59,326 | | | 59,278 |
| Balance as of December 31, 2005 | 141,246 | 14,125 | 594,186 | (4,583) | 535 | (5,014) | 80 | (8) | 599,241 |
| Reclass of unearned compensation upon adoption of FAS 123R | | | (4,583) | 4,583 | | | | | |
| Shares issued in rights offering | 5,697 | 570 | 19,928 | | | | | | 20,498 |
| Stock-based compensation expense | | | 6,887 | | | | | | 6,887 |
| Tax benefit related to exercise of stock options and vesting of restricted stock | | | 2,242 | | | | | | 2,242 |
| Shares cancelled or terminated for employees | | | 7 | | | | 71 | (7) | |
| Shares cancelled for non-vested stock rights for terminated employee | | | (37) | | | | 6 | (1) | (38) |
| Exercise of options to purchase common stock | 178 | 18 | 1,108 | | | | | | 1,126 |
| Shares issued in non-vested stock award | 536 | 53 | (53) | | | | | | |

| | | | | | | | | | |
|--|---------|--------|---------|-------|---------|---------|------|--|---------|
| Comprehensive income, net of income taxes: | | | | | | | | | |
| Net income | | | | | | 105,789 | | | 105,789 |
| Foreign currency translation | | | | 986 | | | | | 986 |
| Minimum pension liability adjustment | | | | 100 | | | | | 100 |
| Net unrealized gain on available-for-sale securities | | | | 559 | | | | | 559 |
| Net unrealized gain on derivative instruments | | | | 112 | | | | | 112 |
| Total comprehensive income | | | | 1,757 | | 105,789 | | | 107,546 |
| Adjustment for unrecognized net gain upon adoption of FAS 158 | | | | 1,650 | | | | | 1,650 |
| 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 | 135,143 | | | | | | 135,755 |
| Stock-based compensation expense | | | 13,448 | | | | | | 13,448 |
| Effect of FIN 48 adoption | | | | | | (2,209) | | | (2,209) |
| Tax benefit related to exercise of stock options and vesting of restricted stock | | | 200 | | | | | | 200 |
| Shares cancelled or terminated by employees | | | 3 | | | 27 | (3) | | |
| Shares cancelled for tax withholdings for | | | (3,954) | | | 175 | (17) | | (3,971) |

| | | | | | | | | | |
|--|---------|-----------|------------|----|-----------|------------|---------|---------|--------------|
| vested stock awards | | | | | | | | | |
| Exercise of options to purchase common stock | 113 | 11 | 801 | | | | | | 812 |
| Shares issued in non-vested stock award | 393 | 39 | (39) | | | | | | |
| Comprehensive income, net of income taxes: | | | | | | | | | |
| Net income | | | | | | 130,513 | | | 130,513 |
| Foreign currency translation | | | | | | 4,388 | | | 4,388 |
| AFAS 158 unrecognized net gain | | | | | | 9,446 | | | 9,446 |
| Minimum pension liability adjustment | | | | | | (59) | | | (59) |
| Net unrealized gain on available-for-sale securities | | | | | | 712 | | | 712 |
| Net unrealized gain on derivative instruments | | | | | | (2,125) | | | (2,125) |
| Total comprehensive income | | | | | | 12,362 | 130,513 | | 142,875 |
| Balance as of December 31, 2007 | 154,281 | \$ 15,428 | \$ 765,287 | \$ | \$ 16,304 | \$ 229,079 | 359 | \$ (36) | \$ 1,026,062 |

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

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**COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1. Organization and Summary of Significant Accounting Policies

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 energy-from-waste, waste disposal and renewable energy production businesses in the United States, Europe and Asia. We are organized as a holding company which was incorporated in Delaware on April 16, 1992. Our predominant business is the waste and energy services business.

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 United States. We own, have equity investments in, and/or operate 57 energy generation facilities, 47 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, three landfills, and several waste transfer stations.

Prior to January 1, 2007, we had two reportable business segments Waste and Energy Services and Other Services. Given our increased focus on developing our international 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, did not meet the quantitative thresholds which required separate disclosure as a reportable segment. Therefore, our reportable segments are now Domestic and International, which are comprised of our domestic and international waste and energy services operations, respectively.

Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements reflect the results of our operations, cash flows and financial position and of our majority-owned or controlled subsidiaries. All intercompany accounts and transactions have been eliminated.

Equity Method of Investments

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 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. We monitor investments for other than temporary declines in value and make reductions when appropriate.

Revenues

Waste and Service Revenues

Revenues from waste and service agreements consist of the following:

1) Fees earned under contract to operate and maintain energy-from-waste, independent power and water facilities are recognized as revenue when services are rendered, regardless of the period they are billed;

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**COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

2) Fees earned to service project debt (principal and interest) where such fees are expressly included as a component on the service fee paid by the client community pursuant to applicable energy-from-waste service agreements. Regardless of the timing of amounts paid by client communities 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. Unbilled service receivables related to energy-from-waste operations are discounted in recognizing the present value for services performed currently in order to service the principal component of the project debt;

3) Fees earned for processing waste in excess of contractual requirements are recognized as revenue beginning in the period when we process the excess waste. Some of our contracts include stated fixed fees earned by us for processing waste up to certain base contractual amounts during specified periods. These contracts also set forth the per-ton fees that are payable if we accept waste in excess of the base contractual amounts;

4) Tipping fees earned under waste disposal agreements are recognized as revenue in the period the waste is received; and

5) Other miscellaneous fees, such as revenue for ferrous and non-ferrous metal recovered and recycled, are generally recognized as revenue when ferrous and non-ferrous metal is sold.

Electricity and Steam Sales

Revenue from the sale of electricity and steam are earned and recorded based upon output delivered and capacity provided at rates specified under contract terms or prevailing market rates net of amounts due to client communities under applicable service agreements. We account for certain long-term power contracts in accordance with Emerging Issues Task Force (EITF) No. 91-6, Revenue Recognition of Long-Term Power Sales Contracts and EITF No. 96-17,

Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms which require that power revenues under these contracts be recognized as the lesser of (a) amounts billable under the respective contracts; or (b) an amount determinable by the kilowatt hours made available during the period multiplied by the estimated average revenue per kilowatt hour over the term of the contract. The determination of the lesser amount is to be made annually based on the cumulative amounts that would have been recognized had each method been applied consistently from the beginning of the contract. The difference between the amount billed and the amount recognized is included in other long-term liabilities.

Construction Revenues

Revenues under fixed-price construction contracts are recognized using the percentage-of-completion method, measured by the cost-to-cost method. Under this method, total contract costs are estimated, and the ratio of costs incurred to date to the estimated total costs on the contract is used to determine the percentage-of-completion. This method is used because we consider the costs incurred to be the best available measure of progress on these contracts. Contracts to manage, supervise, or coordinate the construction activity of others are recognized using the percentage-of-completion method, measured by the efforts-expended method. Under this method revenue is earned based on the ratio of hours incurred to the total estimated hours required by the contract. We consider measuring the work on labor hours to be the best available measure of progress on these contracts. Construction revenues are recorded as other operating revenues in the consolidated statements of income.

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 consolidated financial statements. Total pass through costs for the years ended December 31, 2007, 2006 and 2005 were \$63.5 million, \$59.3 million, and \$61.6 million, respectively.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Taxes

Deferred income taxes are based on the difference between the financial reporting and tax basis of assets and liabilities. The deferred income tax provision represents the change during the reporting period in the deferred tax assets and deferred tax liabilities, net of the effect of acquisitions and dispositions. Deferred tax assets include tax losses and credit carryforwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

During the periods covered by the consolidated financial statements, we filed a consolidated Federal income tax return, which included all eligible United States subsidiary companies. Foreign subsidiaries were taxed according to regulations existing in the countries in which they do business. Our subsidiary, Covanta Lake II, Inc. has not been a member of any consolidated tax group since February 20, 2004.

In 2006 and 2007, we adopted the permanent reinvestment exception under Accounting Principles Board (APB) Opinion No. 23, Accounting for Income Taxes Special Areas (APB 23) and Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, (FIN 48), respectively. For additional information related to the impact of applying these provisions, see Note 9. Income Taxes.

Stock-Based Compensation

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payments (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). SFAS 123R focuses primarily on accounting for share-based awards to employees in exchange for services, and it requires entities to recognize compensation expense for these awards. The cost for equity-based stock awards is expensed based on their grant date fair value. For additional information, see Note 17. Stock-Based Award Plans.

Prior to January 1, 2006, we accounted for stock-based awards under the intrinsic value method of APB 25. In accordance with APB 25, we did not record compensation expense related to our stock option awards because the strike price was equal to the fair value of the underlying stock on the grant date; however, we did record compensation expense over the requisite service period for restricted stock awards.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments having maturities of three months or less from the date of purchase. These short-term investments are stated at cost, which approximates market value.

Investments

The insurance subsidiaries fixed maturity debt and equity securities portfolio are classified as available-for-sale and are carried at fair value. Changes in fair value are credited or charged directly to Accumulated Other Comprehensive Income (AOCI) in the consolidated statements of stockholders equity as unrealized gains or losses, respectively. All securities transactions are recorded on the trade date. Investment gains or losses realized on the sale of securities are determined using the specific identification method. Realized gains and losses are recognized in the consolidated

statements of income based on the amortized cost of fixed maturities and cost basis for equity securities on the date of trade, subject to any previous adjustments for other than temporary declines. For additional information, see Note 13. Investments.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other than temporary declines in fair value are recorded as realized losses in the consolidated statements of income and the cost basis of the security is reduced. We consider the following factors in determining whether declines in the fair value of securities are other than temporary :

- the significance of the decline in fair value compared to the cost basis;
- the time period during which there has been a significant decline in fair value;
- whether the unrealized loss is credit-driven or a result of changes in market interest rates;
- a fundamental analysis of the business prospects and financial condition of the issuer; and
- our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

Restricted Funds Held in Trust

Restricted funds held in trust are primarily amounts received by third party trustees relating to certain projects we own which may be used only for specified purposes. We generally do not control these accounts. They include debt service reserves for payment of principal and interest on project debt, deposits of revenues received with respect to projects prior to their disbursement, as provided in the relevant indenture or other agreements, and lease reserves for lease payments under operating leases. Such funds are invested principally in United States Treasury bills and notes and United States government agency securities. Restricted fund balances are as follows (in thousands of dollars):

| | As of December 31, | | | |
|--------------------|--------------------|------------|------------|------------|
| | 2007 | | 2006 | |
| | Current | Noncurrent | Current | Noncurrent |
| Debt service funds | \$ 116,251 | \$ 135,372 | \$ 85,806 | \$ 175,528 |
| Revenue funds | 23,658 | | 25,303 | |
| Other funds | 48,042 | 56,541 | 66,945 | 54,339 |
| Total | \$ 187,951 | \$ 191,913 | \$ 178,054 | \$ 229,867 |

Restricted Funds for Emergence Costs

We had \$20.0 million and \$19.6 million as of December 31, 2007 and 2006 in cash held in restricted accounts to pay for certain taxes which may be due relating to Covanta Energy's bankruptcy, which occurred prior to its acquisition by us, and that are estimated to be paid in the future. Cash held in such restricted accounts is not available for general corporate purposes.

Deferred Financing Costs

As of December 31, 2007 and 2006, we had \$17.7 million and \$23.5 million, respectively, of net deferred financing costs recorded on the consolidated balance sheets. These costs were incurred in connection with our various financing arrangements. These costs are being amortized using the effective interest rate method over the expected period that the related financing was to be outstanding. See Note 6. Long-Term Debt 2007 Recapitalization.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred Revenue

Deferred revenue consisted of the following (in thousands of dollars):

| | As of December 31, | | | |
|------------------------------------|--------------------|-----------------|------------------|-----------------|
| | 2007 | | 2006 | |
| | Current | Noncurrent | Current | Noncurrent |
| Advance billings to municipalities | \$ 11,610 | \$ | \$ 7,985 | \$ |
| Unearned insurance premiums | 896 | | 641 | |
| Other | 12,608 | 4,931 | 7,831 | 5,517 |
| Total | \$ 25,114 | \$ 4,931 | \$ 16,457 | \$ 5,517 |

Advance billings to various customers are billed one or two months prior to performance of service and are recognized as income in the period the service is provided. Noncurrent deferred revenue relates to electricity contract levelization and is included in other noncurrent liabilities in the consolidated balance sheets.

Property, Plant and Equipment

Property, plant, and equipment acquired from acquisitions were recorded at our estimate of their fair values on the date of the acquisition. Additions, improvements and major expenditures are capitalized if they increase the original capacity or extend the remaining useful life of the original asset more than one year. Maintenance repairs and minor expenditures are expensed in the period incurred. Depreciation is computed using the straight-line method over the estimated remaining useful lives of the assets, which range up to 38 years for energy-from-waste facilities. The original useful lives generally range from three years for computer equipment to 50 years for components of energy-from-waste facilities. Leasehold improvements are depreciated over the remaining life of the lease or the asset, whichever is shorter. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the consolidated balance sheet and any gain or loss is reflected in the consolidated statements of income.

Asset Retirement Obligations

In accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143), we recognize a legal liability for asset retirement obligations when it is incurred generally upon acquisition, construction, or development. Our legal liabilities include closure and post-closure costs for landfill cells and site restoration for certain energy-from-waste and power producing sites. We principally determine the liability using internal estimates of the costs using current information, assumptions, and interest rates, but also use independent appraisals as appropriate to estimate costs. When a new liability for asset retirement obligation is recorded, we capitalize the cost of the liability by increasing the carrying amount of the related long-lived asset. The liability is accreted to its present value each period and the capitalized cost is depreciated over the useful life of the related asset. We recognize period-to-period changes in the liability resulting from revisions to the timing or the amount of the original estimate of the undiscounted cash flows. Any changes are incorporated into the carrying amount of the

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

liability and will result in an adjustment to the amount of asset retirement cost allocated to expense in subsequent periods. Our asset retirement obligation is presented as follows (in thousands of dollars):

| | As of December 31, | |
|---|---------------------------|-------------|
| | 2007 | 2006 |
| Beginning of period asset retirement obligation | \$ 26,517 | \$ 25,506 |
| Accretion expense | 2,091 | 2,308 |
| Deductions(1) | (5,290) | (5,972) |
| Additions(2) | 2,202 | 4,675 |
| End of period asset retirement obligation | \$ 25,520 | \$ 26,517 |
| Less: current portion | (964) | (2,777) |
| Asset retirement obligation | \$ 24,556 | \$ 23,740 |

(1) Deductions in 2007 and 2006 related to expenditures and settlements of the asset retirement obligation liability and net revisions based on current estimates of the liability and revised expected cash flows and life of the liability.

(2) Additions in 2007 related primarily to purchase price allocations for asset retirement obligations for the two biomass energy facilities acquired in California in 2007. Additions in 2006 related primarily to asset retirement obligation revisions based on purchase price allocation during 2006 for the Covanta ARC Holdings, Inc. (ARC Holdings) acquisition (See Note 3. Acquisitions, Business Development and Dispositions).

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. Intangible assets and liabilities, as well as lease interest, renewable energy credits and other indefinite-lived assets, are recorded using at their estimated fair market values based upon discounted cash flows in accordance with SFAS No. 141, Business Combinations (SFAS 141).

Amortization for the above market waste, service and energy contracts and below market waste and energy contracts was calculated using the straight-line method. The remaining weighted-average contract life is approximately 10 years for both the above market waste, service and energy contracts and below market waste and energy contracts. See Note 10. Amortization of Waste, Service and Energy Contracts.

Impairment of Goodwill, Other Intangibles and Long-Lived Assets

We evaluate goodwill and indefinite-lived intangible assets not subject to amortization for impairment on an annual basis, or more frequently if events occur or circumstances change indicating that the fair value of a reporting unit may be below its carrying amount, in accordance with SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142).

The evaluation of goodwill requires a comparison of the estimated fair value of the reporting unit to which the goodwill has been assigned to its carrying value. If the carrying value of the reporting unit exceeds the fair value of that reporting unit, then the reporting unit's carrying value of goodwill is compared to its implied value of goodwill. If the carrying value of the reporting unit's goodwill exceeds the implied value of goodwill, this difference will be recorded as an adjustment to the goodwill balance, resulting in an impairment charge. The fair value was determined using a discounted cash flow approach based on forward-looking information regarding market share and costs for each reporting unit as well as an appropriate discount rate. For indefinite-lived intangible assets, the evaluation requires a comparison of the estimated fair value of the asset, which is generally estimated using a discounted future net cash flow projection, to the carrying value of the asset. If the carrying value of an indefinite-lived intangible asset exceeds its fair value, as generally estimated using a discounted future net cash flow projection, then the carrying value of the asset is reduced to its fair value.

Intangible and other long-lived assets such as property, plant and equipment and purchased intangible assets with finite lives, are evaluated for impairment whenever events or changes in circumstances indicate its carrying

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

value may not be recoverable over their estimated useful life in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. In reviewing for impairment, we compare the carrying value of the relevant assets to the estimated undiscounted future cash flows expected from the use of the assets and their eventual disposition. When the estimated undiscounted future cash flows are less than their carrying amount, an impairment loss is recognized equal to the difference between the asset's fair value and its carrying value. To determine fair value, we principally use internal discounted cash flow estimates, but also use quoted market prices when available and independent appraisals as appropriate to determine fair value. Cash flow estimates are derived from historical experience and internal business plans with an appropriate discount rate applied.

Accumulated Other Comprehensive Income

AOCI, in the statement of stockholders' equity, includes unrealized gains and losses excluded from the consolidated statements of income. These unrealized gains and losses consist of unrecognized gains or losses on our pension and other postretirement benefit obligations, foreign currency translation adjustments, unrealized losses on securities classified as available-for-sale, and net unrealized gains and losses on interest rate swaps.

Interest Rate Swap Agreements

We used derivative financial instruments to manage risk from changes in interest rates pursuant to the requirements under one of our debt agreements in existence as of December 31, 2006. We recognize derivative instruments on the balance sheet at their fair value. Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a cash flow hedge are included in the consolidated statements of stockholders' equity as a component of AOCI until the hedged cash flows impact earnings. Any hedge ineffectiveness is included in current-period earnings. On February 9, 2007, our interest swap arrangements were settled and unrealized gains of \$2.1 million, net of tax, were reflected in earnings. For additional information regarding derivative financial instruments, see Note 19. Financial Instruments.

Foreign Currency Translation

For foreign operations, assets and liabilities are translated at year-end exchange rates and revenues and expenses are translated at the average exchange rates during the year. Gains and losses resulting from foreign currency translation are included in the consolidated statements of stockholders' equity as a component of AOCI. Currency transaction gains and losses are recorded in Other Operating Expenses in the consolidated statements of income.

Pension and Postretirement Benefit Obligations

Our pension and other postretirement benefit plans are accounted for in accordance with SFAS No. 158, Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment to FASB Statements No. 87, 88, 106 and 132(R) (SFAS 158), which require costs and the related obligations and assets arising from the pension and other postretirement benefit plans to be accounted for based on actuarially-determined estimates. Upon the adoption of SFAS 158 in December 2006, we recognized a net gain of \$2.5 million, \$1.7 million net of deferred tax, in AOCI to reflect the funded status of the pension and postretirement benefit obligations. We recognized a net actuarial gain of \$14.5 million, \$9.4 million net of deferred tax, in AOCI during the year ended December 31, 2007. For additional information, see Note 16. Employee Benefit Plans.

Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses (LAE) are based on estimates of reported losses and historical experience for incurred but unreported claims, including losses reported by other insurance companies for reinsurance assumed, and estimates of expenses for investigating and adjusting all incurred and unadjusted claims. We believe that the provisions for unpaid losses and LAE are adequate to cover the cost of losses and LAE incurred to date. However, such liability is based upon estimates which may change and there can be no assurance

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

that the ultimate liability will not exceed such estimates. Unpaid losses and LAE are continually monitored and reviewed, and as settlements are made or reserves adjusted, differences are included in current operations. The following table summarizes the activity in the insurance subsidiaries' liability for unpaid losses and LAE (in thousands of dollars):

| | As of December 31, | | |
|--|---------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Net unpaid losses and LAE at beginning of year | \$ 25,712 | \$ 32,082 | \$ 46,228 |
| Incurred, net, related to: | | | |
| Current year | 6,398 | 7,579 | 8,172 |
| Prior years | 1,492 | 297 | 1,763 |
| Total net incurred | 7,890 | 7,876 | 9,935 |
| Paid, net, related to: | | | |
| Current year | (3,905) | (4,085) | (4,792) |
| Prior years | (7,357) | (10,221) | (19,349) |
| Total net paid | (11,262) | (14,306) | (24,141) |
| Plus: Increase in allowance for reinsurance recoverable on unpaid losses | 60 | 60 | 60 |
| Net unpaid losses and LAE at end of year | 22,400 | 25,712 | 32,082 |
| Plus: Reinsurance recoverable on unpaid losses | 10,036 | 12,308 | 14,786 |
| Gross unpaid losses and LAE at end of year | \$ 32,436 | \$ 38,020 | \$ 46,868 |

Use of Estimates

The preparation of financial statements requires us to make estimates and assumptions that affect the reported amounts of assets or liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include useful lives of long-lived assets, unbilled service receivables, cash flows and taxable income from future operations, unpaid losses and LAE, allowances for uncollectible receivables, and liabilities related to pension obligations, and for workers' compensation, severance and certain litigation.

Reclassifications

Certain prior period amounts have been reclassified in the financial statements to conform to the current period presentation.

Note 2. Recent Accounting Pronouncements

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 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 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 gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 was effective for us on January 1, 2008. We do not expect the adoption of SFAS 159 to have a material impact on our consolidated financial statements.

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 defers the effective date of SFAS 157 for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We do not expect the adoption of SFAS 157 to have a material impact on our consolidated financial statements.

Note 3. Acquisitions, Business Development and Dispositions

Our growth strategy includes the acquisition of waste and energy related businesses located in markets with significant growth opportunities and the development 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, business development projects and dispositions.

Acquisitions and Business Development***EnergyAnswers Corporation***

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 tons per day (*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 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 during the first quarter of 2008. Our preliminary purchase price allocation, which includes \$9.8 million of goodwill, is based on estimates and assumptions any changes to which could affect the reported amounts of assets, liabilities and expenses resulting from this acquisition.

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.

Pacific Ultrapower Chinese Station, California

On October 18, 2007, we acquired an additional 5% ownership interest in our subsidiary Pacific Ultrapower Chinese Station, a biomass energy facility located in California, for less than \$1 million in cash, increasing our

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

ownership interest to a majority interest of 55%. Although we have acquired majority interest, we do not have the ability to exercise significant influence over the operating and financial policies of the investee and therefore, we continue to account for this investment under the equity method.

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 expect to invest an additional \$7 million to \$12 million during 2008, in capital improvements to significantly increase the facilities' productivity and improve environmental performance. Our preliminary purchase price allocation, which includes \$22.9 million of goodwill, is based on estimates and assumptions any changes to which could affect the reported amounts of assets, liabilities and expenses resulting from this acquisition.

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 \$7.5 million.

Harrisburg Energy-from-Waste Facility

On May 29, 2007, we entered into a ten year agreement to maintain and operate an 800 tpd energy-from-waste facility located in Harrisburg, Pennsylvania and have a right of first refusal to purchase the facility. 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. Under the agreement, we 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.

Hempstead Energy-from-Waste Facility

We entered into a new Tip Fee type contract with the Town of Hempstead in New York for a term of 25 years commencing upon expiration of the existing contract in 2009.

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 megawatts (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.

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, which would otherwise expire in 2007, 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 early 2009.

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COVANTA HOLDING CORPORATION
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Covanta Onondaga Limited Partnership

On December 27, 2006, we acquired for \$27.5 million in cash the limited partnership interests held by unaffiliated entities in Covanta Onondaga Limited Partnership, our subsidiary which owns and operates an energy-from-waste facility in Onondaga County, New York.

ARC Holdings

On June 24, 2005, we acquired 100% of the issued and outstanding shares of ARC Holdings' capital stock. We paid approximately \$747 million in cash and transaction costs for the capital stock of ARC Holdings and assumed the consolidated net debt of ARC Holdings of \$1.3 billion as of June 24, 2005 (\$1.5 billion of consolidated indebtedness net of \$0.2 billion of cash and restricted funds held in trust). The acquisition of ARC Holdings was financed by a combination of debt and equity.

As part of the ARC Holdings acquisition, we entered into credit arrangements which totaled approximately \$1.1 billion, which was guaranteed by us and certain of our domestic subsidiaries. These credit arrangements were amended in May 2006 and later refinanced in January 2007. For details related to these financing arrangements, see Note 6. Long-Term Debt.

The equity component of the financing consisted of a \$400 million offering of warrants to purchase our common stock (the ARC Holdings Rights Offering). We received net proceeds of approximately \$395.8 million (\$400 million gross proceeds, net of \$4.2 million of expenses) and issued 66,673,004 shares of common stock. Three of our largest stockholders committed to participate in the ARC Holdings Rights Offering and acquired at least their pro rata portion of the shares. As consideration for their commitments, we paid each of these stockholders an amount equal to 1.75% of their respective equity commitments, which in the aggregate was \$2.8 million and was accounted for as a reduction of the ARC Holdings Rights Offering proceeds. See Note 20. Related-Party Transactions.

The purchase price was comprised of the following (in millions of dollars):

| | |
|--------------------------|------------|
| Cash | \$ 740.0 |
| Debt assumed | 1,494.0 |
| Direct transaction costs | 7.3 |
| Restructuring liability | 9.1 |
| | \$ 2,250.4 |

The purchase price included acquisition-related restructuring charges of \$9.1 million which were recorded as a liability and assumed in the ARC Holdings acquisition, and consisted primarily of severance and related benefits, and the costs of vacating duplicate facilities. As of December 31, 2007, the remaining acquisition-related restructuring liability was \$0.4 million.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the allocation of values to the assets acquired and liabilities assumed at June 24, 2005 in conformity with the SFAS 141 and SFAS No. 109, Accounting for Income Taxes (SFAS 109) (in thousands of dollars):

| | |
|--|------------------|
| Current assets | \$ 233,659 |
| Property, plant and equipment | 1,982,847 |
| Intangible assets (excluding goodwill) | 287,421 |
| Goodwill | 93,409 |
| Other assets | 144,368 |
| Total assets acquired | \$ 2,741,704 |
| Current liabilities | \$ 76,258 |
| Current portion of long-term debt | 29,958 |
| Current portion of project debt | 64,344 |
| Long-term debt | 662,379 |
| Project debt | 737,385 |
| Deferred income taxes | 250,945 |
| Other liabilities | 170,029 |
| Total liabilities assumed | 1,991,298 |
| Minority interest acquired | 3,058 |
| Net assets acquired | \$ 747,348 |

The acquired intangible assets of \$287.4 million relate to favorable energy and waste contracts, landfill rights, other nonamortizing intangibles and a favorable leasehold interest with an approximate ten-year average useful life.

International Joint Ventures***China Joint Ventures***

On December 12, 2007, we entered into an agreement to acquire a 40% equity interest in Guangzhou Development Covanta Environmental Energy Co., Ltd (GDC Environmental Energy), a company to be located in Guangzhou Municipality, Peoples Republic of China. GDC Environmental Energy will be a newly-formed entity involved in developing energy-from-waste projects in Guangdong Providence in Southeast China. Our investment in GDC Environmental Energy is subject to various regulatory approvals and is expected to be completed during the first quarter of 2008.

On April 25, 2007, we purchased a 40% equity interest in Chongqing Sanfeng Environmental Industry Co., Ltd., 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.

Dublin Joint Venture

On September 6, 2007, we announced that we had entered into definitive agreements for the development of 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.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Dispositions

On September 13, 2007, we completed the sale of the Linan coal facility in China for \$2.3 million and recorded a pre-tax gain of approximately \$1.7 million in other operating income in our consolidated statements of income.

On June 10, 2006, we completed the sale of the Huantai coal facility in China for \$3.6 million and recorded a pre-tax gain of approximately \$1.2 million in other operating income in our consolidated statements of income.

Pro Forma Results of Operations

With the exception of acquisition of ARC Holdings, the acquisitions and dispositions in this Note are not material to our consolidated financial statements individually or in the aggregate and therefore, disclosures of pro forma financial information have not been presented. The results of operations from ARC Holdings are included in our consolidated results of operations from June 25, 2005. The following table sets forth certain unaudited consolidated operating results for 2005 as if the acquisition of ARC Holdings was consummated on the same terms at January 1, 2005 (in thousands, except per share amounts):

| Pro Forma (unaudited) | For the Year Ended December 31, 2005 |
|-------------------------------------|---|
| Total operating revenues | \$ 1,209,075 |
| Net income | \$ 69,127 |
| Basic earnings per share: | |
| Weighted average shares outstanding | 139,996 |
| Earnings per share | \$ 0.49 |
| Diluted earnings per share: | |
| Weighted average shares outstanding | 145,698 |
| Earnings per share | \$ 0.47 |

The pro forma results are not necessarily indicative of the results of operations that actually would have resulted had the acquisitions been in effect at the beginning of the period or of future results.

Restructuring and Acquisition-Related Charges

We incurred restructuring costs in 2005 of \$2.8 million. The restructuring costs resulted from \$2.1 million of severance payments to certain of our international segment executives in connection with overhead reductions made possible by the elimination of the international s separate capital structure during the second quarter of 2005. An additional \$0.7 million was paid to remaining international segment executives as incentive payments from existing contractual obligations relating to international debt repayment in connection with the ARC Holdings acquisition.

In connection with the acquisition of ARC Holdings, we incurred integration costs of \$4.0 million for the year ended December 31, 2005 primarily related to professional fees and employee incentive costs. These charges were included as part of the operating costs of the Domestic segment.

Note 4. Earnings Per Share and Stockholders Equity

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 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, and rights whether or not currently exercisable. Diluted earnings per share for all the

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

periods presented does not include securities if their effect was anti-dilutive (in thousands, except per share amounts).

| | For the Years Ended December 31, | | |
|--|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Net income | \$ 130,513 | \$ 105,789 | \$ 59,326 |
| Basic earnings per share: | | | |
| Weighted average basic common shares outstanding | 152,653 | 145,663 | 122,209 |
| Basic earnings per share | \$ 0.85 | \$ 0.73 | \$ 0.49 |
| Diluted earnings per share: | | | |
| Weighted average basic common shares outstanding | 152,653 | 145,663 | 122,209 |
| Stock options | 620 | 557 | 688 |
| Restricted stock | 724 | 402 | 869 |
| Rights | | 408 | 4,144 |
| Weighted average diluted common shares outstanding | 153,997 | 147,030 | 127,910 |
| Diluted earnings per share | \$ 0.85 | \$ 0.72 | \$ 0.46 |
| Stock options excluded from the weighted average dilutive common shares outstanding because their inclusion would have been antidilutive | 1,745 | 50 | |

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 December 31, 2007, the Debentures did not have a dilutive effect on earnings per share. See Note 6. Long-Term Debt for a description of the Debentures.

Stockholders' Equity

As of December 31, 2007, there were 154,280,996 shares of common stock issued of which 153,921,745 were outstanding; the remaining 359,251 shares of common stock issued but not outstanding were held as treasury stock as of December 31, 2007.

The following represents shares of common stock reserved for future issuance:

**As of December 31,
2007**

Shares available for issuance under equity plans 4,122,938

As of December 31, 2007, there were 10,000,000 shares of preferred stock authorized, with none issued or outstanding. The preferred stock may be divided into a number of series as defined by our Board of Directors. The Board of Directors are authorized to fix the rights, powers, preferences, privileges and restrictions granted to and imposed upon the preferred stock upon issuance.

During the year ended December 31, 2007, we granted 393,495 restricted stock awards and 1,805,000 options to purchase our common stock. For information related to stock-based award plans, see Note 17. Stock-Based Award Plans.

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

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effective January 1, 2007, we adopted the provisions of FIN 48. The impact of applying the provisions of this interpretation decreased our opening balance retained earnings by \$2.2 million in 2007. See Note 9. Income Taxes for additional information.

On February 24, 2006, we completed a rights offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds. See Note 20. Related-Party Transactions.

Note 5. Financial Information by Business Segments

Given our increased focus on developing our international 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, did not meet the quantitative thresholds which required 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. Prior period amounts have been reclassified below to conform to the current segment presentation.

The results of our reportable segments are as follows (in thousands of dollars):

| | Reportable Segments | | | |
|---|----------------------------|----------------------|---------------------|--------------|
| | Domestic | International | All Other(1) | Total |
| Year Ended December 31, 2007: | | | | |
| Operating revenues | \$ 1,245,617 | \$ 177,217 | \$ 10,253 | \$ 1,433,087 |
| Depreciation and amortization | 187,875 | 8,998 | 97 | 196,970 |
| Operating income (loss) | 220,092 | 20,183 | (3,665) | 236,610 |
| As of December 31, 2007: | | | | |
| Total assets (includes goodwill of \$127.0 million) | \$ 4,007,621 | \$ 257,481 | \$ 103,397 | \$ 4,368,499 |
| Capital additions | 84,983 | 528 | 237 | 85,748 |
| Year Ended December 31, 2006: | | | | |
| Operating revenues | \$ 1,117,927 | \$ 136,868 | \$ 13,741 | \$ 1,268,536 |
| Depreciation and amortization | 184,921 | 8,193 | 103 | 193,217 |
| Operating income | 206,483 | 19,839 | 438 | 226,760 |
| As of December 31, 2006: | | | | |
| Total assets (includes goodwill of \$91.3 million) | \$ 4,097,310 | \$ 216,518 | \$ 123,992 | \$ 4,437,820 |
| Capital additions | 53,651 | 599 | 17 | 54,267 |
| Year Ended December 31, 2005: | | | | |

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| | | | | |
|-------------------------------|------------|------------|-----------|------------|
| Operating revenues | \$ 831,018 | \$ 132,948 | \$ 14,797 | \$ 978,763 |
| Depreciation and amortization | 116,083 | 8,731 | 111 | 124,925 |
| Operating income (loss) | 128,642 | 18,055 | (481) | 146,216 |

As of December 31, 2005:

| | | | | |
|---|--------------|------------|------------|--------------|
| Total assets (includes goodwill of \$255.9 million) | \$ 4,373,603 | \$ 195,422 | \$ 133,140 | \$ 4,702,165 |
| Capital additions | 22,893 | 575 | 59 | 23,527 |

(1) All other is comprised of our insurance subsidiaries operations and the financial results of the holding company.

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Our operations are principally in the United States. Operations outside of the United States are primarily in Asia, with some projects in Europe and Latin America. A summary of revenues and total assets by geographic area is as follows (in thousands of dollars):

| | United States | India | Other International | Total |
|------------------------------|---------------|------------|------------------------|--------------|
| Operating Revenues: | | | | |
| Year Ended December 31, 2007 | \$ 1,255,870 | \$ 157,405 | \$ 19,812 | \$ 1,433,087 |
| Year Ended December 31, 2006 | \$ 1,131,667 | \$ 108,150 | \$ 28,719 | \$ 1,268,536 |
| Year Ended December 31, 2005 | \$ 845,814 | \$ 94,680 | \$ 38,269 | \$ 978,763 |
| Total Assets: | | | | |
| As of December 31, 2007 | \$ 4,079,552 | \$ 91,710 | \$ 197,237 | \$ 4,368,499 |
| As of December 31, 2006 | \$ 4,199,607 | \$ 71,098 | \$ 167,115 | \$ 4,437,820 |

Note 6. Long-Term Debt**2007 Recapitalization**

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

the refinancing of our previously existing credit facilities with new credit facilities, comprised of a \$300 million revolving credit facility, a \$320 million funded letter of credit facility, and a \$650 million term loan (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 public offerings of common stock and Debentures, including over-allotment options exercised by underwriters, on January 31, 2007 and February 6, 2007, respectively, and we closed on the Credit Facilities on February 9, 2007. We completed our tender offer and redemptions for approximately \$611.9 million in aggregate principal amount of outstanding notes at various times during 2007. See *Intermediate Subsidiary Debt* below for specific terms related to the redemptions.

As a result of the recapitalization, we recognized a loss on extinguishment of debt of approximately \$32.1 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

Under the Credit Facilities, we have substantially greater, but not unrestricted, ability to make investments in our business and to take advantage of opportunities to grow our business through investments and acquisitions, both domestically and internationally. The 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 term loan facility, due 2014, in the initial amount of \$650 million and of which \$645.1 million was outstanding as of December 31, 2007 (the Term Loan Facility).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization Terms

The 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 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Total |
|-------------------------------|----------|----------|----------|----------|----------|----------|------------|------------|
| | \$ 6,500 | \$ 6,500 | \$ 6,500 | \$ 6,500 | \$ 6,500 | \$ 6,500 | \$ 606,125 | \$ 645,125 |

Under the Credit Facilities, we are 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 (as defined in the credit agreement) to be used for this purpose is 50%, 25%, or 0%, based on measurement of the leverage ratio under the financial covenants.

Interest and Fee Terms

Loans under the Credit Facilities are designated, at our election, as Eurodollar rate loans or base rate loans. Eurodollar loans bear interest at a reserve adjusted British Bankers Association Interest Settlement Rate, commonly referred to as

LIBOR, for deposits in dollars plus a borrowing margin as described below. Interest on Eurodollar rate loans is payable at the end of the applicable interest period of one, two, three or six months (and at the end of every three months in the case of six month Eurodollar loans). Base rate loans bear interest at (a) a rate per annum equal to the greater of (1) the prime rate designated in the relevant facility or (2) the Federal Funds rate plus 0.5% per annum, plus (b) a borrowing margin as described below.

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

The borrowing margins referred to above for the Credit Facilities are as follows:

| | |
|--|--|
| Borrowing Margin for Term Loans, Funded Letters of Credit and Credit-Linked | Borrowing Margin for Term Loans, Funded Letters of Credit and Credit-Linked |
|--|--|

| Leverage Ratio | Borrowing Margin for Revolving Loans (Eurodollar Loans) | Borrowing Margin for Revolving Loans (Base Rate Loans) | Deposits (Eurodollar Loans) | Deposits (Base Rate Loans) |
|--|--|---|--|---|
| ³ 4.00:1.00 | 2.00% | 1.00% | 1.75% | 0.75% |
| < 4.00:1.00 and ³ 3.25:1.00 | 1.75% | 0.75% | 1.50% | 0.50% |
| < 3.25:1.00 and ³ 2.75:1.00 | 1.50% | 0.50% | 1.50% | 0.50% |
| < 2.75:1.00 | 1.25% | 0.25% | 1.50% | 0.50% |

Guarantees and Securitization

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

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Credit Agreement Financial Covenants

The loan documentation under the Credit Facilities contains customary affirmative and negative covenants and financial covenants. During the term of the Credit Facilities, the negative covenants may place limitations on us, but are materially less restrictive than the restrictions in effect prior to February 9, 2007. We were in compliance with all required covenants as of December 31, 2007.

The affirmative covenants of the Credit Facilities include covenants relating to the following:

- financial statements and other reports;
- continued existence;
- payment of taxes and claims;
- maintenance of properties;
- insurance coverage;
- inspections by lenders (subject to frequency and cost reimbursement limitations);
- lenders meetings;
- compliance with laws;
- environmental matters;
- additional material real estate assets;
- designation of subsidiaries; and
- post-closing matters.

The negative covenants of the Credit Facilities include limitations on the following:

- indebtedness (including guarantee obligations);
- liens;
- negative pledge clauses;
- restricted junior payments;
- clauses restricting subsidiary distributions;
- investments;
- fundamental changes;
- disposition of assets;
- acquisitions;
- conduct of business;
- amendments or waivers of certain agreements;
- changes in fiscal year; and
- hedge agreements.

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

- maximum Covanta Energy leverage ratio of 4.25 to 1.00 for the four quarter period ended December 31, 2007, which measures Covanta Energy's principal amount of consolidated debt less certain restricted funds dedicated to repayment of project debt principal and construction costs (Consolidated Adjusted Debt) to its adjusted earnings before interest, taxes, depreciation and amortization, as calculated under the Credit Facilities

(Adjusted EBITDA). The definition of Adjusted EBITDA in the Credit Facilities excludes certain non-cash charges. The maximum Covanta Energy leverage ratio allowed under the Credit Facilities adjusts in future periods as follows:

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

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

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

3.50 to 1.00 for each four quarter period thereafter;

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

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

Defaults under the Credit Facilities include:

- non-payment of principal when due;
- non-payment of any amount payable to an issuing bank in reimbursement of any drawing under a letter of credit when due;
- non-payment of interest, fees or other amounts after a grace period of five days;
- cross-default to material indebtedness;
- violation of a covenant (subject, in the case of certain affirmative covenants, to a grace period of thirty days);
- material inaccuracy of a representation or warranty when made;
- bankruptcy events with respect to us, Covanta Energy or any material subsidiary or group of subsidiaries of Covanta Energy;
- material judgments;
- certain material ERISA events;
- change of control (subject to exceptions for certain of our existing owners);
- failure of subordination; and
- actual or asserted invalidity of any guarantee or security document.

Equity Offering

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

Debentures

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

The Debentures bear interest at a rate of 1.00% per year, payable semi-annually in arrears, on February 1 and August 1 of each year, commencing on August 1, 2007 and will mature on February 1, 2027. Beginning with the six-month interest period commencing February 1, 2012, we will pay contingent interest on the Debentures during any six-month interest period in which the trading price of the Debentures measured over a specified number of trading days is 120% or more of the principal amount of the Debentures. When applicable, the contingent interest payable per \$1,000 principal amount of Debentures will equal 0.25% of the average trading price of \$1,000 principal amount of Debentures during the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period. The contingent interest feature in the Debentures is an embedded derivative instrument. The first contingent cash interest payment period does not commence until February 1, 2012, and the fair market value for the embedded derivative was zero as of December 31, 2007.

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Under limited circumstances, prior to February 1, 2025, the Debentures are convertible by the holders into cash and shares of our common stock, if any, initially based on a conversion rate of 35.4610 shares of our common stock per \$1,000 principal amount of Debentures, (which represents an initial conversion price of approximately \$28.20 per share). Additionally, the terms of the Debentures require that under certain circumstances, such as an acquisition of us by a third party, the payment by us of a cash dividend on our common stock, or where a cash tender offer is made for our common stock, we are obligated to adjust the conversion rate applicable to the Debentures. This adjustment requirement constitutes a contingent beneficial conversion feature that is part of the Debentures. If such an adjustment were to occur, (i) the amount of the contingent beneficial conversion feature would be bifurcated from the Debentures, (ii) the liability recorded in our financial statements with respect to the Debentures would be reduced by the amount bifurcated, and (iii) the amount bifurcated would be recorded as a charge to interest expense and accreted to the Debenture liability over the remaining term of Debentures, or the conversion date of the Debentures, if earlier. In no event will the total number of shares of our common stock issuable upon conversion exceed 42.5531 per \$1,000 principal amount of Debentures, or a maximum of 15,904,221 shares issuable.

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

Intermediate Subsidiary Debt

On January 23, 2007, we commenced cash tender offers for (a) any and all of the outstanding 8 1/2% Senior Secured Notes due 2010 (the MSW I Notes) issued by MSW Energy Holdings LLC and its wholly owned subsidiary, MSW Energy Finance Co., Inc. (b) any and all of the outstanding 7 3/8% Senior Secured Notes due 2010 (the MSW II Notes) issued by MSW Energy Holdings II LLC and its wholly owned subsidiary, MSW Energy Finance Co. II, Inc. and (c) any and all of the outstanding 6.26% Senior Notes due 2015 (the ARC Notes) of Covanta ARC LLC. On February 22, 2007, \$190.2 million, \$223.6 million and \$190.6 million of the MSW I Notes, MSW II Notes and ARC Notes, respectively, were redeemed under the terms described below.

The remaining \$1.4 million of the ARC Notes were redeemed on April 16, 2007 at a total redemption price of \$743.50 per \$1,000 in original principal amount of the ARC Notes, which included principal outstanding, premium and accrued interest up to the redemption date. On September 6, 2007, the remaining \$5.6 million and \$0.5 million of outstanding MSW I Notes and MSW II Notes were redeemed at \$1,042.50 and \$1,036.88, respectively, per \$1,000 principal amount (plus accrued and unpaid interest to the date of redemption).

Short-Term Liquidity

As of December 31, 2007, we had available credit for liquidity as follows (in thousands of dollars):

Total

| | Available Under Facility | Maturing | Outstanding Letters of Credit as of December 31, 2007 | Available as of December 31, 2007 |
|----------------------------|---|-----------------|--|--|
| Revolving Loan Facility(1) | \$ 300,000 | 2013 | \$ 31,216 | \$ 268,784 |
| Funded L/C Facility | \$ 320,000 | 2014 | \$ 319,931 | \$ 69 |

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

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COVANTA HOLDING CORPORATION
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2006 Refinancing

In May 2006, as a result of amendments to our financing arrangements existing at that time, we recognized a loss on extinguishment of debt of \$6.8 million, pre-tax, which was comprised of the write-down of deferred financing costs and a call premium paid on extinguishment. On June 30, 2006, we utilized a new term loan commitment of \$140 million on the first lien term loan facility to prepay \$140 million under the second lien term loan facility.

Financing Costs

All deferred financing costs are amortized to interest expense over the life of the related debt using the effective interest method. Amortization of deferred financing costs is included as a component of interest expense and was \$3.8 million, \$3.9 million, and \$10.8 million for the years ended December 31, 2007, 2006, and 2005, respectively.

Note 7. Project Debt

Project debt is presented below (in thousands of dollars):

| | As of December 31, | |
|--|---------------------------|-------------|
| | 2007 | 2006 |
| Project debt related to Service Fee structures | | |
| 4.0-6.75% serial revenue bonds due 2008 through 2015 | \$ 219,236 | \$ 263,430 |
| 3.0-7.0% term revenue bonds due 2008 through 2022 | 204,702 | 224,225 |
| Adjustable-rate revenue bonds due 2008 through 2019 | 100,610 | 111,115 |
| 7.322% other debt obligations due 2008 through 2020 | 54,345 | 69,509 |
| Subtotal | 578,893 | 668,279 |
| Unamortized debt premium, net | 14,385 | 22,907 |
| Total Service Fee structure related project debt | 593,278 | 691,186 |
| Project debt related to Tip Fee structures | | |
| 4.875-6.70% serial revenue bonds due 2008 through 2016 | 330,420 | 388,645 |
| 5.00-8.375% term revenue bonds due 2010 through 2019 | 269,095 | 257,750 |
| Subtotal | 599,515 | 646,395 |
| Unamortized debt premium, net | 16,568 | 22,216 |
| Total Tip Fee structure related project debt | 616,083 | 668,611 |
| International project debt | 70,914 | 76,150 |
| Total project debt | 1,280,275 | 1,435,947 |

| | | |
|--|--------------|--------------|
| Less current project debt (includes \$10,711 and \$14,656 of unamortized premium) | (195,625) | (190,242) |
| Noncurrent project debt | \$ 1,084,650 | \$ 1,245,705 |

Project debt associated with the financing of energy-from-waste facilities is arranged by municipal entities through the issuance of tax-exempt and taxable revenue bonds or other borrowings. For those facilities we own, that project debt is recorded as a liability on our consolidated financial statements. Generally, debt service for project debt related to Service Fee Structures is the primary responsibility of municipal entities, whereas debt service for project debt related to Tip Fee structures is paid by our project subsidiary from project revenue expected to be sufficient to cover such expense.

Payment obligations for our project debt associated with energy-from-waste facilities are limited recourse to the operating subsidiary and non-recourse to us, subject to operating performance guarantees and commitments. These obligations are secured by the revenues pledged under various indentures and are collateralized principally by a mortgage lien and a security interest in each of the respective energy-from-waste facilities and related assets.

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As of December 31, 2007, such revenue bonds were collateralized by property, plant and equipment with a net carrying value of \$2.5 billion and restricted funds held in trust of approximately \$365.5 million.

The interest rates on adjustable-rate revenue bonds are adjusted periodically based on current municipal-based interest rates. The average adjustable rate for such revenue bonds was 3.40% and 3.84% as of December 31, 2007 and 2006, respectively, and the average adjustable rate for such revenue bonds was 3.55% and 3.38% during 2007 and 2006 for the full year, respectively.

International project debt includes the following obligations as of December 31, 2007:

\$37.2 million due to financial institutions, of which \$7.9 million is denominated in U.S. dollars and \$29.3 million is denominated in Indian rupees, relating to the construction of a heavy fuel-oil fired diesel engine power plant in India and working capital debt relating to the operations of the project. The U.S. dollar debt bears a coupon rate at the three-month LIBOR, plus 4.5% (9.73% as of December 31, 2007). The outstanding Indian rupee debt borrowed for construction of the power plant was reset to a floating rate of 10.5% in October 2007, the end of the agreed term of three years. The average coupon rate on the working capital debt was 11.5% in 2007. The construction related debt extends through 2011. The entire debt is non-recourse to us, and is secured by the project assets. The power off-taker failed to fund the escrow account or post the letter of credit required under the energy contract which failure constitutes a technical default under the project finance documents. The project lenders have not declared an event of default due to this matter and have permitted continued distributions of project dividends.

\$33.7 million due to financial institutions relating to the construction of a second heavy fuel-oil fired diesel engine power plant in India and working capital debt relating to the operations of the project. The entire debt is denominated in Indian rupees. The construction related debt bears coupon rates ranging from 8% to 12.5% in 2007 and the average coupon rate on the working capital debt was 11.5% in 2007. The construction related debt extends through 2010. The entire debt is non-recourse to us and is secured by the project assets. The power off-taker failed to fund the escrow account or post the letter of credit required under the energy contract which failure constitutes a technical default under the project finance documents. The project lenders have not declared an event of default due to this matter and have permitted continued distributions of project dividends.

As of December 31, 2007, we had one interest rate swap agreement related to domestic project debt that economically fixes the interest rate on certain adjustable-rate revenue bonds. For additional information related to this interest rate swap, see Note 19. Financial Instruments.

The maturities of long-term project debt as of December 31, 2007 are as follows (in thousands of dollars):

| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | Total | Less: Current Portion | Total Noncurr Project I |
|----|---------|---------|---------|---------|---------|------------|-----------|-----------------------------|-------------------------------|
| \$ | 184,914 | 179,069 | 178,295 | 121,865 | 120,608 | 464,571 | 1,249,322 | (184,914) | 1,064 |
| | 10,711 | 7,784 | 5,309 | 2,677 | 1,825 | 2,647 | 30,953 | (10,711) | 20 |

\$ 195,625 \$ 186,853 \$ 183,604 \$ 124,542 \$ 122,433 \$ 467,218 \$ 1,280,275 \$ (195,625) \$ 1,084

Note 8. Equity Method Investments

Our subsidiaries are party to joint venture agreements through which we have equity investments in several operating projects. The joint venture agreements generally provide for the sharing of operational control as well as voting percentages. We record our share of earnings from our equity investees in equity in net income from unconsolidated investments in our consolidated statements of income.

On December 15, 2005, our subsidiary owning and operating the Warren County, New Jersey energy-from-waste facility emerged from bankruptcy and was subsequently included as a consolidated subsidiary in our financial statements. Prior to December 15, 2005, we recorded our investment in this subsidiary using the equity method.

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As of December 31, 2007 and 2006, investments in investees and joint ventures accounted for under the equity method were as follows (in thousands of dollars):

| | Ownership Interest as of December 31, 2007 | 2007 | Ownership Interest as of December 31, 2006 | 2006 |
|--|---|-------------|---|-------------|
| Ultrapower Chinese Station Plant (U.S.)(1) | 55% | \$ 4,880 | 50% | \$ 4,824 |
| South Fork Plant (U.S.) | 50% | 1,141 | 50% | 1,009 |
| Koma Kulshan Plant (U.S.) | 50% | 6,059 | 50% | 5,051 |
| Ambiente 2000 (Italy) | 40% | 757 | 40% | 283 |
| Haripur Barge Plant (Bangladesh) | 45% | 13,982 | 45% | 13,332 |
| Quezon Power (Philippines) | 26% | 43,159 | 26% | 49,218 |
| Sanfeng (China) | 40% | 11,270 | | |
| Total investments | | \$ 81,248 | | \$ 73,717 |

- (1) On October 18, 2007, we acquired an additional 5% ownership interest in this investee increasing our ownership interest to a majority interest of 55%. Although we have acquired majority interest, we do not have the ability to exercise significant influence over the operating and financial policies of the investee and therefore, we continue to account for this investment under the equity method.

The unaudited combined results of operations and financial position of our equity method investments are summarized below (in thousands of dollars):

| | 2007 | 2006 |
|--|-------------|-------------|
| Condensed Statements of Operations for the years ended December 31: | | |
| Revenues | \$ 331,230 | \$ 321,507 |
| Operating income | 153,981 | 129,071 |
| Net income | 57,472 | 83,390 |
| Company's share of net income | 22,196 | 28,636 |
| Condensed Balance Sheets as of December 31: | | |
| Current assets | \$ 208,795 | \$ 155,521 |
| Noncurrent assets | 792,166 | 811,403 |
| Total assets | 1,000,961 | 966,924 |
| Current liabilities | 158,235 | 166,659 |
| Noncurrent liabilities | 441,914 | 400,592 |
| Total liabilities | 600,115 | 567,251 |

Quezon Power, Inc. (Quezon)

Equity in net income from unconsolidated investments primarily relates to our 26% investment in Quezon in the Philippines. The Quezon project sells electricity to Manila Electric Company (Meralco), the largest electric distribution company in the Philippines, which serves the area surrounding and including metropolitan Manila. Under an energy contract expiring in 2025, Meralco is obligated to take-or-pay for stated minimum annual quantities of electricity produced by the facility at an all-in price which consists of capacity, operating, energy, transmission and other fees adjusted for inflation, fuel cost and foreign exchange fluctuations. The Quezon project has entered into two coal supply contracts expiring in 2015 and 2022. Under these supply contracts, the cost of coal is determined using a base energy price adjusted to fluctuations of specified international benchmark prices. Our subsidiary operates the project under a long-term agreement with the Quezon project and we have obtained political risk insurance for our equity investment in this project.

On February 21, 2008, Quezon and Meralco executed agreements which effect a settlement of various issues which had been pending for several years, including certain amendments to the contract to modify certain commercial terms and to resolve issues relating to the project's performance during its first year of operation. The

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settlement primarily includes payment by Meralco of approximately \$8.5 million of prior uncollected receivables, a reduction in the capital cost rate recovery payable by Meralco and other terms.

The results of operations for Quezon were (in thousands of dollars):

| | For the Years Ended December 31, | | |
|------------------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Revenues | \$ 280,013 | \$ 271,817 | \$ 245,571 |
| Operating income | 139,426 | 119,328 | 110,872 |
| Net income | 47,702 | 73,118 | 66,824 |

In the quarter ended June 30, 2006, Quezon recorded a cumulative deferred income tax benefit of \$31.7 million, of which \$7.0 million relates to our equity share in Quezon, on the basis of rulings which were issued by the Philippine tax authorities 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 U.S. dollar. During the last six months of 2006 and during the year ended December 31, 2007, we reduced the cumulative deferred income tax benefit by approximately \$2.1 million and \$4.3 million, respectively, as a result of the strengthening of the Philippine peso versus the U.S. dollar.

For approximately six years ended May 2006, Quezon has 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 year ended December 31, 2007 and 2006 includes approximately \$8.2 million and \$4.1 million, respectively, of increased tax expense for Quezon related to the conclusion of this income tax holiday.

During the fourth quarter of 2006, equity earnings were reduced by \$2.3 million due to the write-off of a deferred income tax asset due to a change in the deductibility of the amortization of deferred financing costs related to our Quezon facility.

Note 9. Income Taxes

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.

Effective January 1, 2007, we adopted the provisions of FIN 48. This interpretation is intended to increase the relevancy and comparability of financial reporting by clarifying the way companies account for uncertainty in income taxes. FIN 48 prescribes a consistent recognition threshold and measurement attribute, as well as clear criteria for subsequently recognizing, derecognizing and measuring such tax positions for financial statement purposes. The cumulative effect of applying the provisions of this interpretation was a \$2.2 million decrease to our opening balance retained earnings in 2007, which was comprised of an increase of \$5.5 million to the liability for uncertain tax positions, a \$16.4 million increase to deferred tax assets, and a \$13.1 million decrease to property, plant and equipment.

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A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands of dollars):

| | |
|--|-----------|
| Balance as of January 1, 2007 | \$ 24,483 |
| Additions based on tax positions related to the current year | 500 |
| Additions for tax positions of prior years | 398 |
| Reductions for tax positions of prior years | |
| Settlements | |
| Balance at December 31, 2007 | \$ 25,381 |

The liability for uncertain tax positions, exclusive of interest and penalties, was \$25.4 million and \$24.5 million as of December 31, and January 1, 2007, respectively. Included in the balance of uncertain tax benefits as of

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December 31, 2007 are potential benefits of \$2.5 million that, if recognized, would affect the effective tax rate. We do not expect any significant increases or decreases in the amount of unrecognized tax benefits in the next 12 months.

We record interest accrued on uncertain tax positions and penalties as part of the tax provision under FIN 48. For the year ended December 31, 2007 and 2006, we recognized \$0.9 million and zero, respectively of interest and penalties on uncertain tax positions. As of December 31, and January 1, 2007, we had accrued interest and penalties associated with uncertain tax positions of \$7.6 million and \$6.7 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 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. The tax returns of our subsidiary 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 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.

As of December 31, 2006, we had a valuation allowance of \$68.2 million. During 2007, we reduced our valuation allowance by \$35.0 million. The reduction primarily included a \$31.4 million adjustment related to NOLs that were due to expire in 2007 and were utilized as a reduction to income tax expense in 2007. The additional reduction to the valuation allowance of \$3.6 million related to previously unrecognized state NOLs and federal NOLs for our unconsolidated subsidiary Covanta Lake II, Inc.

During 2006, we reduced our valuation allowance by \$22.8 million. The reduction primarily included a net \$13.0 million adjustment to the goodwill associated with the acquisition of ARC Holdings, since the facts and circumstances associated with these items existed as of the date of the ARC Holdings acquisition, and if not for the ARC Holdings acquisition we would not have been able to make the conclusion that it was more likely than not that these deferred tax assets would be realized, and \$10.3 million that was a reduction to income tax expense.

During 2006, we adopted the permanent reinvestment exception under APB 23 whereby we will no longer provide for 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 which may be developed or acquired. As a result of the adoption of APB 23, we recognized a benefit of \$10.0 million in 2006 associated with the reversal of deferred taxes accrued on unremitted earnings of international affiliates in prior periods. This policy resulted in an unrecognized deferred tax liability of approximately \$24.7 million and \$18.7 million as of December 31, 2007 and 2006, respectively. Cumulative undistributed foreign earnings for which United States taxes were not provided were included in consolidated retained earnings in the amount of approximately \$71.9 million and \$54.8 million as of December 31, 2007 and 2006, respectively.

Deferred tax assets relating to tax benefits of employee stock option grants have been reduced to reflect exercises in the calendar year ended December 31, 2007. Some exercises resulted in tax deductions in excess of previously

recorded benefits based on the option value at the time of grant (a windfall). Although these additional tax benefits or windfalls were reflected in the NOLs, pursuant to SFAS 123R, the additional tax benefit associated with the windfall is not recognized until the deduction reduces taxes payable. Accordingly, since the tax benefit does not reduce our current taxes payable in 2007 due to the NOLs, these windfall tax benefits were not reflected in our NOLs in the deferred tax assets for 2007. Windfalls included in NOLs but not reflected in deferred tax assets for 2007 were \$10.0 million.

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We had consolidated federal NOLs estimated to be approximately \$275 million for federal income tax purposes as of the end of 2007. The NOLs will expire in various amounts from December 31, 2009 through December 31, 2026, if not used. Our NOLs will expire, if not used, in the following amounts in the following years (in thousands of dollars):

| | Amount of Carryforward Expiring |
|------|--|
| 2008 | \$ |
| 2009 | 23,903 |
| 2010 | 23,600 |
| 2011 | 19,755 |
| 2012 | 38,255 |
| 2019 | 33,635 |
| 2022 | 26,931 |
| 2023 | 108,331 |
| 2024 | 212 |
| 2025 | 203 |
| 2026 | 260 |
| | \$ 275,085 |

In addition to the consolidated federal NOLs, we have 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.

The components of income tax expense were as follows (in thousands of dollars):

| | For the Years Ended December 31, | | |
|---------------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Current: | | | |
| Federal | \$ 3,373 | \$ (4,889) | \$ 5,757 |
| State | 15,186 | 15,196 | 4,194 |
| Foreign | 6,612 | 7,250 | 6,941 |
| Total current | 25,171 | 17,557 | 16,892 |
| Deferred: | | | |
| Federal | 8,793 | 29,819 | 12,014 |
| State | (3,038) | 1,530 | 5,916 |
| Foreign | 114 | (10,441) | (171) |

| | | | |
|--------------------------|-----------|-----------|-----------|
| Total deferred | 5,869 | 20,908 | 17,759 |
| Total income tax expense | \$ 31,040 | \$ 38,465 | \$ 34,651 |

Domestic and foreign pre-tax income was as follows (in thousands of dollars):

| | For the Years Ended December 31, | | |
|----------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Domestic | \$ 125,890 | \$ 102,944 | \$ 58,602 |
| Foreign | 22,123 | 19,284 | 18,963 |
| Total | \$ 148,013 | \$ 122,228 | \$ 77,565 |

The effective income tax rate was 21.0% and 31.5% for the year ended December 31, 2007 and 2006, respectively. Excluding a cumulative adjustment of \$10.0 million due to the adoption of APB 23, the effective income tax rate was 39.7% for the year ended December 31, 2006. The decrease in the effective tax rate for the year ended December 31, 2007 compared to the year ended December 31, 2006 is primarily the result of reductions in the

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valuation allowance against federal and state NOLs. A portion of the federal NOL was due to expire in 2007 and would not have been utilized had the Mission Insurance Trusts settled in 2007. The trusts did not settle in 2007, and therefore, the losses that were due to expire in 2007 were utilized. The release of this valuation provided a benefit of \$31.4 million. The other \$3.6 million of benefit relates to the release of valuation allowance associated with state NOLs and federal NOLs of our unconsolidated subsidiary, Covanta Lake II, Inc. Other items affecting our 2007 rate included: the recognition of \$1.0 million of interest receivable relating to our outstanding NOL carryback claim with the federal government and an increase from 2006 of approximately \$1.4 million in production tax credits generated. Approximately \$17.1 million of federal NOLs expired resulting in a charge to income tax expense of \$6 million in 2007.

We recognized benefits from a foreign tax holiday in India. The Samalpatti and Madurai project companies began taking advantage of a tax holiday under Indian law in April of 2005. The Indian tax holiday permits the companies to use the alternative tax rate, currently approximately 11%, for a 10 year period.

The aggregate benefit and affect on diluted earnings per share was as follows (in thousands of dollars):

| | For the Years Ended December 31, | | |
|-----------------------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Aggregate benefit | \$ 4,433 | \$ 4,092 | \$ 2,086 |
| Affect on diluted EPS | \$ 0.03 | \$ 0.03 | \$ 0.02 |

A reconciliation of our income tax expense at the federal statutory income tax rate of 35% to income tax expense at the effective tax rate is as follows (in thousands of dollars):

| | For the Years Ended December 31, | | |
|--|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Income tax expense at the federal statutory rate | \$ 51,805 | \$ 42,780 | \$ 27,148 |
| State and other tax expense | 8,972 | 12,296 | 6,572 |
| Change in valuation allowance | (34,968) | (10,319) | (9,485) |
| Grantor trust income | 5,580 | 6,210 | 5,250 |
| Subpart F income and foreign dividends | 90 | 2,328 | 7,190 |
| Taxes on foreign earnings | (1,132) | (9,531) | (7) |
| Production tax credits | (4,525) | (3,158) | (3,132) |
| Expiration of tax attributes | 5,977 | | |
| Other, net | (759) | (2,141) | 1,115 |
| Total income tax expense | \$ 31,040 | \$ 38,465 | \$ 34,651 |

In 2007, we restructured several of our entities owned by ARC Holdings. As a result of the restructuring, these entities have become disregarded for tax purposes. Accordingly, the deferred tax liability for these pass-through entities has been reclassified to the underlying deferred tax assets or liabilities of the former partnership.

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The tax effects of temporary differences that give rise to the deferred tax assets and liabilities are presented as follows (in thousands of dollars):

| | As of December 31, | |
|--|---------------------------|--------------|
| | 2007 | 2006 |
| Deferred Tax Assets: | | |
| Loss reserve discounting | \$ 926 | \$ 2,135 |
| Capital loss carryforward | 24,048 | 24,228 |
| Net operating loss carryforwards | 101,466 | 155,517 |
| Accrued expenses | 37,844 | 42,042 |
| Tax basis in bond and other costs | 10,819 | 12,893 |
| Deferred tax assets attributable to Covanta Lake II, Inc. | 5,713 | 5,505 |
| Deferred tax assets attributable to pass-through entities | 84,368 | 84,368 |
| Other | 18,115 | 4,290 |
| AMT and other credit carryforwards | 23,055 | 17,441 |
| | | |
| Total gross deferred tax asset | 306,354 | 348,419 |
| Less: valuation allowance | (33,246) | (68,215) |
| | | |
| Total deferred tax asset | 273,108 | 280,204 |
| | | |
| Deferred Tax Liabilities: | | |
| Unremitted earnings of foreign subsidiaries | | |
| Unbilled accounts receivable | 24,779 | 32,728 |
| Property, plant and equipment | 553,359 | 156,340 |
| Intangible assets | 35,583 | 45,425 |
| Deferred tax liabilities attributable to pass-through entities | 43,382 | 433,857 |
| Other, net | 26,855 | 7,971 |
| | | |
| Total gross deferred tax liability | 683,958 | 676,321 |
| | | |
| Net deferred tax liability | \$ (410,850) | \$ (396,117) |

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 1980s. 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. Based on a review of the claims activity and balance sheets of the California grantor trusts, we believe that additional tax deductions will be recognized by the California grantor trusts as they wind down. In the fourth quarter of 2006, a deferred tax asset of \$84.4 million was recognized on our consolidated balance sheet for this expected benefit. Additionally, \$12.0 million was recognized as a deferred tax asset as a result of revised taxable losses from the grantor trusts for the 2004 tax year. These increases were recorded as a

reduction to goodwill associated with the ARC Holdings acquisition, since the facts and circumstances associated with these items existed as of the date of the ARC Holdings acquisition, and if not for the ARC Holdings acquisition we would not have been able to make the conclusion that it was more likely than not that these deferred tax assets would be realized. See Note 11. Other Intangible Assets and Goodwill for additional information regarding these adjustments to goodwill.

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. These include the treatment of certain claims against the grantor trusts which are entitled to distributions of an aggregate of 1,572,625 shares of our common stock previously issued to the California Commissioner under existing agreements entered into at the inception of the Mission insurance entities

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reorganization. The distribution of such shares by the California Commissioner is among the final steps necessary to conclude the insolvency cases relating to the trusts being administered by the California Commissioner.

In connection with these agreements and in order to facilitate the orderly conclusion of the grantor trust estates, the distribution of such stock and the settlement of the related disputes, we have paid an aggregate amount equal to approximately \$9.14 million to the California Commissioner. Additionally, we reimbursed an additional \$1.175 million to the California Commissioner's Conservation and Liquidation Office in 2006 related to expenses associated with these agreements.

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 distribution of the remaining 154,756 shares of our common stock by the Missouri Director to 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 or the related distribution by the Missouri Director of shares of our common stock.

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.

Note 10. Amortization of Waste, Service and Energy Contracts***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. Intangible assets and liabilities are recorded at their estimated fair market values based upon discounted cash flows.

Amortization for the above market waste, service and energy contracts and below market waste and energy contracts was calculated using the straight-line method. The remaining weighted-average contract life is approximately 10 years for both the above market waste, service and energy contracts and below market waste and energy contracts.

Waste, Service and Energy contracts consisted of the following (in thousands of dollars):

| | Useful Life | As of December 31, 2007 | | | As of December 31, 2006 | | |
|---------------------------|--------------|-------------------------|--------------------------|------------|-------------------------|--------------------------|------------|
| | | Gross Carrying Amount | Accumulated Amortization | Net | Gross Carrying Amount | Accumulated Amortization | Net |
| Waste, service and energy | 2 - 21 years | \$ 405,794 | \$ 137,441 | \$ 268,353 | \$ 388,378 | \$ 91,850 | \$ 296,528 |

contracts
(asset)
Waste
and
service
contracts
(liability)

| | | | | | | | |
|---|----------|--------------|-------------|--------------|--------------|-------------|--------------|
| 1 | 15 years | \$ (159,575) | \$ (29,111) | \$ (130,464) | \$ (152,321) | \$ (16,714) | \$ (135,607) |
|---|----------|--------------|-------------|--------------|--------------|-------------|--------------|

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The following table details the amount of the actual/estimated amortization expense and contra-expense associated with these intangible assets and liabilities as of December 31, 2007 included or expected to be included in our statement of income for each of the years indicated (in thousands of dollars):

| | Waste, Service and Energy Contracts (Amortization Expense) | Waste and Service Contracts (Contra-Expense) |
|------------------------------|---|---|
| Year ended December 31, 2007 | \$ 45,591 | \$ (12,397) |
| 2008 | \$ 45,357 | \$ (13,390) |
| 2009 | 41,785 | (13,441) |
| 2010 | 29,467 | (13,028) |
| 2011 | 26,378 | (12,687) |
| 2012 | 24,320 | (12,692) |
| Thereafter | 101,046 | (65,226) |
| Total | \$ 268,353 | \$ (130,464) |

Note 11. Other Intangible Assets and Goodwill*Other Intangible Assets*

Other intangible assets consisted of the following (in thousands of dollars):

| | Useful Life | As of December 31, 2007 | | | As of December 31, 2006 | | |
|-------------------------------------|---------------|-----------------------------|-----------------------------|-----------|-----------------------------|-----------------------------|-----------|
| | | Gross Carrying Amount | Accumulated Amortization | Net | Gross Carrying Amount | Accumulated Amortization | Net |
| Lease interest and other | 11 - 22 years | \$ 72,235 | \$ 7,598 | \$ 64,637 | \$ 72,154 | \$ 4,555 | \$ 67,599 |
| Landfill | 6 years | 17,985 | 5,198 | 12,787 | 17,985 | 3,066 | 14,919 |
| Total amortizable intangible assets | | 90,220 | 12,796 | 77,424 | 90,139 | 7,621 | 82,518 |
| Other intangibles | Indefinite | 11,530 | | 11,530 | 4,528 | | 4,528 |
| | | \$ 101,750 | \$ 12,796 | \$ 88,954 | \$ 94,667 | \$ 7,621 | \$ 87,046 |

Intangible assets,
net

The following table details the amount of the actual/estimated amortization expense associated with other intangible assets as of December 31, 2007 included or expected to be included in our statements of income for each of the years indicated (in thousands of dollars):

| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | Total |
|-------------------------------|----------|----------|----------|----------|----------|------------|-----------|
| Annual Remaining Amortization | \$ 5,153 | \$ 5,153 | \$ 5,153 | \$ 5,153 | \$ 5,153 | \$ 51,659 | \$ 77,424 |

Amortization Expense related to other intangible assets was \$5.2 million, \$5.7 million and \$2.0 million for the years ended December 31, 2007, 2006 and 2005. Lease interest amortization is recorded as rent expense in plant operating expenses and was \$3.0 million, \$3.0 million, and \$1.5 million for the years ended December 31, 2007, 2006, and 2005 respectively.

Goodwill

Goodwill was \$127.0 million and \$91.3 million as of December 31, 2007 and 2006, respectively. 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 acquisitions in accordance with the provisions of SFAS 142. Goodwill has an indefinite life and is not amortized but is to be reviewed for impairment under the provisions of SFAS 142. We performed the required annual impairment review of our recorded goodwill for reporting units using a discounted cash flow approach as of October 1, 2007 and determined that no goodwill was impaired. As of December 31, 2007, goodwill of approximately \$25.5 million is deductible for federal income tax purposes.

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The following table details the changes in carrying value of goodwill for the years ended December 31, 2007 and 2006 (in thousands of dollars):

| | Total |
|---|----------------|
| Balance as of December 31, 2005 | \$ 255,927 |
| Purchase price allocation adjustments for the ARC Holdings acquisition | |
| Reduction of liability owed to one of the prior owners of ARC Holdings (Note 3) | (27,358) |
| Increase in an unfavorable waste contract liability | 12,140 |
| Increase to carrying value of property, plant and equipment | (9,531) |
| Increase to net deferred tax assets related to Grantor Trust items (Note 9) | (109,796) |
| Increase to deferred tax assets associated with opening balance sheet adjustments | (36,940) |
| Other, net | 6,840 |
| Balance as of December 31, 2006 | \$ 91,282 |
| Decrease to federal tax receivable associated with opening balance sheet adjustments for the ARC Holdings acquisition | 2,127 |
| Goodwill related to the Central Valley acquisition | 22,889 |
| Goodwill related to the Westchester County transfer stations acquired | 896 |
| Goodwill related to the EnergyAnswers acquisition | 9,833 |
| Balance as of December 31, 2007 | \$ 127,027 |

Note 12. Supplementary Financial Information***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 Years Ended December 31, | | |
|---|---|----------------|----------------|
| | 2007 | 2006 | 2005 |
| Waste and service revenues unrelated to project debt | \$ 764,560 | \$ 711,832 | \$ 544,418 |
| Revenue earned explicitly to service project debt-principal | 69,163 | 69,097 | 59,060 |
| Revenue earned explicitly to service project debt-interest | 30,673 | 36,704 | 35,025 |
| Total waste and service revenues | \$ 864,396 | \$ 817,633 | \$ 638,503 |

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 service agreement. In the beginning of the service 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 service agreement, the amount we bill will exceed the levelized revenue and the unbilled service receivable begins to reduce, (and can become a credit balance) until it becomes nil at the end of the contract.

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 service 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 service agreement.

SEMASS Partnership (SEMASS), our subsidiary, sells the electric power output from the SEMASS facility to Commonwealth Electric Company d/b/a NSTAR Electric (NSTAR) under two separate power sale agreements. With respect to one of the agreements, a dispute arose between SEMASS and NSTAR regarding the power purchase rate applicable to power deliveries on and after January 1, 2005. In December 2005, SEMASS initiated an arbitration process to resolve the dispute. SEMASS and NSTAR engaged in settlement negotiations, and executed a

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definitive settlement agreement and related amendments to the power sale agreements. The settlement became effective in December 2006 at which time SEMASS received approximately \$8.1 million, comprised of \$4.8 million related to 2005 and \$3.3 million related to 2006, which were recorded as electricity and steam sales.

Other Operating Expenses

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

| | For the Years Ended December 31, | | |
|---|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Construction costs | \$ 55,675 | \$ 2,476 | \$ 2,088 |
| Insurance subsidiary operating expenses | 10,699 | 10,435 | 11,902 |
| Proceeds related to insurance recoveries | (1,909) | (4,855) | (1,774) |
| Unrealized/realized foreign exchange (gain) loss | (1,719) | (587) | 980 |
| Proceeds received for distributions and settlements related to the reorganization of Covanta Energy | | (2,600) | |
| Other | (2,107) | (2,275) | (2,181) |
| Total other operating expenses | \$ 60,639 | \$ 2,594 | \$ 11,015 |

Selected Supplementary Balance Sheet Information

Selected supplementary balance sheet information is as follows (in thousands of dollars):

| | As of December 31, | |
|---|---------------------------|-------------|
| | 2007 | 2006 |
| Securities available-for-sale (Note 13) | \$ 2,225 | \$ 2,206 |
| Other noncurrent receivables | 8,409 | 11,131 |
| Interest rate swap (Note 19) | 8,913 | 13,125 |
| Contract acquisition costs | 8,569 | |
| Reinsurance recoverable on unpaid losses | 10,035 | 12,308 |
| Deferred financing costs | 14,143 | 19,440 |
| Spare parts | 16,048 | 14,314 |
| Restricted funds for pre-petition tax liabilities | 19,997 | 19,604 |
| Other | 24,215 | 17,669 |
| Total Other Noncurrent Assets | \$ 112,554 | \$ 109,797 |
| Taxes payable | \$ 2,224 | \$ 1,842 |
| Asset retirement obligations (Note 1) | 964 | 2,777 |

| | | |
|---|-------------------|-------------------|
| Insurance | 2,040 | 2,208 |
| Pension and profit sharing | 4,987 | 2,097 |
| Interest payable | 20,676 | 31,135 |
| Payroll and payroll taxes | 29,853 | 34,284 |
| Accrued liabilities to client communities | 75,528 | 64,630 |
| Operating expenses | 79,135 | 44,992 |
| Other | 18,593 | 13,503 |
| Total Accrued Expenses and Other Current Liabilities | \$ 234,000 | \$ 197,468 |
| Service contract obligations | \$ | \$ 9,607 |
| Deferred revenue | 4,931 | 5,517 |
| Interest rate swap (Note 19) | 8,913 | 9,855 |
| Benefit obligations (Note 16) | 17,360 | 38,979 |
| Asset retirement obligations (Note 1) | 24,556 | 23,740 |
| Tax liabilities for uncertain tax positions (Note 9) | 33,041 | 26,622 |
| Insurance loss and loss adjustment reserves (Note 1) | 32,436 | 38,020 |
| Other | 20,503 | 17,631 |
| Total Other Noncurrent Liabilities | \$ 141,740 | \$ 169,971 |

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Note 13. Investments

The cost or amortized cost, unrealized gains, unrealized losses and fair value of our investments categorized by type of security, were as follows (in thousands of dollars):

| | Cost or Amortized Cost | As of December 31, 2007 | | Fair |
|---|---------------------------------------|--------------------------------|----------------------------|--------------|
| | | Unrealized Gain | Unrealized Loss | Value |
| Current investments: | | | | |
| Fixed maturities | \$ 2,495 | \$ | \$ | \$ 2,495 |
| Equity securities insurance business | 909 | 231 | 30 | 1,110 |
| Total current investments | \$ 3,404 | \$ 231 | \$ 30 | \$ 3,605 |
| Noncurrent investments: | | | | |
| Fixed maturities insurance business: | | | | |
| U.S. government/Agency | \$ 14,750 | \$ 70 | \$ 7 | \$ 14,813 |
| Mortgage-backed | 5,707 | 3 | 140 | 5,570 |
| Corporate | 5,881 | 8 | 12 | 5,877 |
| Total fixed maturities insurance business | 26,338 | 81 | 159 | 26,260 |
| Investment at cost international business | 3,437 | | | 3,437 |
| Mutual and bond funds | 2,225 | 24 | | 2,249 |
| Total noncurrent investments | \$ 32,000 | \$ 105 | \$ 159 | \$ 31,946 |

| | Cost or Amortized Cost | As of December 31, 2006 | | Fair |
|--------------------------------------|---------------------------------------|--------------------------------|----------------------------|--------------|
| | | Unrealized Gain | Unrealized Loss | Value |
| Current investments: | | | | |
| Fixed maturities | \$ 7,080 | \$ | \$ | \$ 7,080 |
| Equity securities insurance business | 1,289 | 261 | 1 | 1,549 |
| Total current investments | \$ 8,369 | \$ 261 | \$ 1 | \$ 8,629 |
| Noncurrent investments: | | | | |
| Fixed maturities insurance business: | | | | |
| U.S. government/Agency | \$ 17,596 | \$ 3 | \$ 361 | \$ 17,238 |

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| | | | | |
|---|-----------|--------|--------|-----------|
| Mortgage-backed | 8,456 | 1 | 358 | 8,099 |
| Corporate | 9,781 | 12 | 123 | 9,670 |
| Total fixed maturities insurance business | 35,833 | 16 | 842 | 35,007 |
| Investment at cost international business | 3,284 | | | 3,284 |
| Mutual and bond funds | 2,206 | 98 | | 2,304 |
| Total noncurrent investments | \$ 41,323 | \$ 114 | \$ 842 | \$ 40,595 |

The following table sets forth a summary of temporarily impaired investments held by our insurance subsidiary (in thousands of dollars):

| Description of Investments | As of December 31, 2007 | | As of December 31, 2006 | |
|--|----------------------------|-------------------|----------------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury and other direct U.S. Government obligations | \$ 4,718 | \$ 7 | \$ 16,894 | \$ 361 |
| Federal agency mortgage backed securities | 5,419 | 140 | 8,060 | 358 |
| Corporate bonds | 4,148 | 12 | 8,223 | 123 |
| Total fixed maturities | 14,285 | 159 | 33,177 | 842 |
| Equity securities | 240 | 30 | 14 | 1 |
| Total temporarily impaired investments | \$ 14,525 | \$ 189 | \$ 33,191 | \$ 843 |

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Of the fixed maturity investments noted above, 99% were acquired between June 30, 2002 and December 31, 2004 during an historic low interest rate environment and are investment grade securities rated A or better. The number of U.S. Treasury and federal agency obligations, mortgage backed securities, and corporate bonds temporarily impaired are 11, 23, and 5 respectively. Of the total temporarily impaired fixed maturity investments with a fair value of \$14.3 million as of December 31, 2007, approximately \$7.4 million have maturities within 12 months and \$6.9 million have maturities greater than 12 months.

Our fixed maturities held by our insurance subsidiary include mortgage-backed securities and collateralized mortgage obligations, collectively (MBS) representing 21.6% and 23.1% of the total fixed maturities at years ended December 31, 2007 and 2006, respectively. Our MBS holdings are issued by the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC), both of which are rated AAA by Moody's Investors Services. MBS and callable bonds, in contrast to other bonds, are more sensitive to market value declines in a rising interest rate environment than to market value increases in a declining interest rate environment.

The expected maturities of noncurrent fixed maturity securities held by our insurance subsidiary, by amortized cost and fair value are shown below (in thousands of dollars):

| | As of December 31, 2007 | |
|------------------------------|--------------------------------|-------------------|
| | Amortized Cost | Fair Value |
| Available-for-sale: | | |
| One year or less | \$ 11,685 | \$ 11,696 |
| Over one year to five years | 14,069 | 13,982 |
| Over five years to ten years | 584 | 582 |
| More than ten years | | |
| Total fixed maturities | \$ 26,338 | \$ 26,260 |

Our fixed maturity and equity securities portfolio is classified as available-for-sale and is carried at fair value. Changes in fair value are credited or charged directly to stockholders' equity as unrealized gains or losses included as part of AOCI, respectively. Other than temporary declines in fair value are recorded as realized losses in the statement of income and the cost basis of the security is reduced.

The following reflects the change in net unrealized gain (loss) on available-for-sale securities included as a separate component of accumulated AOCI in stockholders' equity (in thousands of dollars):

| | For the Years Ended December 31, | | |
|-----------------------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Fixed maturities, net | \$ 747 | \$ 331 | \$ (1,103) |

| | | | |
|---|--------|--------|------------|
| Equity securities, net | (59) | 130 | 22 |
| Mutual and bond funds | 24 | 98 | 26 |
| Change in net unrealized gain (loss) on investments | \$ 712 | \$ 559 | \$ (1,055) |

The components of net unrealized gain (loss) on available-for-sale securities consist of the following (in thousands of dollars):

| | For the Years Ended | | |
|---|----------------------------|-------------|-------------|
| | December 31, | | |
| | 2007 | 2006 | 2005 |
| Net unrealized holding gain (loss) on available-for-sale securities arising during the period | \$ 698 | \$ 777 | \$ (950) |
| Reclassification adjustment for net realized losses on available-for-sale securities included in net income | 14 | (218) | (105) |
| Net unrealized gain (loss) on available-for-sale securities | \$ 712 | \$ 559 | \$ (1,055) |

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Net realized investment gains (losses) are as follows for our insurance subsidiary (in thousands of dollars):

| | For the Years Ended December 31, | | |
|-------------------------------------|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Net realized investment (loss) gain | | | |
| Fixed maturities | \$ (75) | \$ (96) | \$ (70) |
| Equity securities | 61 | 314 | (1) |
| Net realized investment (loss) gain | \$ (14) | \$ 218 | \$ (71) |

Net investment income earned on our fixed maturity and equity securities portfolio was as follows (in thousands of dollars):

| | For the Years Ended December 31, | | |
|--|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Holding Company | | | |
| Fixed maturities | \$ | \$ | \$ |
| Short-term investments | 4,360 | 2,318 | 702 |
| Net investment income holding company | \$ 4,360 | \$ 2,318 | \$ 702 |
| Insurance business | | | |
| Fixed maturities | \$ 1,196 | \$ 1,582 | \$ 2,021 |
| Dividend income | 61 | 81 | 74 |
| Other, net | 371 | 183 | 156 |
| Total investment income | 1,628 | 1,846 | 2,251 |
| Less: investment expense | 172 | 211 | 252 |
| Net investment income insurance business | \$ 1,456 | \$ 1,635 | \$ 1,999 |

The insurance business, in compliance with state insurance laws and regulations, had securities with a fair value of approximately \$17.1 million and \$19.4 million as of the years ended December 31, 2007 and 2006, respectively, on deposit with various states or governmental regulatory authorities. In addition, as of the years ended December 31, 2007 and 2006, the insurance business had investments with a fair value of \$6.6 million and \$6.4 million, respectively, held in trust or as collateral under the terms of certain reinsurance treaties and letters of credit.

Note 14. Property, Plant and Equipment, net

Property, plant and equipment consisted of the following (in thousands of dollars):

| | Useful Lives | As of December 31, | |
|--|--------------|--------------------|--------------|
| | | 2007 | 2006 |
| Land | | \$ 23,967 | \$ 8,976 |
| Facilities and equipment | 3-38 years | 2,999,718 | 2,870,964 |
| Landfills | | 26,574 | 29,194 |
| Construction in progress | | 46,850 | 26,872 |
| Total | | 3,097,109 | 2,936,006 |
| Less accumulated depreciation and amortization | | (476,602) | (298,083) |
| Property, plant, and equipment net | | \$ 2,620,507 | \$ 2,637,923 |

Depreciation and amortization expense related to property, plant and equipment amounted to \$162.0 million, \$156.9 million, and \$95.8 million for the years ended December 31, 2007, 2006 and 2005, respectively. The

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

increase in Land relates primarily to acquisitions completed in 2007. See Note 3. Acquisitions, Business Development and Dispositions.

Note 15. Leases

Leases are primarily operating leases for leaseholds on energy-from-waste facilities and independent power projects, as well as for trucks and automobiles, and machinery and equipment. Some of these operating leases have renewal options. Expense under operating leases was \$29.8 million, \$26.8 million and \$21.7 million for the years ended December 31, 2007, 2006 and 2005, respectively.

The following is a schedule, by year, of future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2007 (in thousands of dollars):

| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | Total |
|--|-------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| Future Minimum Rental Payments | \$ 36,786 | \$ 56,624 | \$ 40,266 | \$ 40,344 | \$ 33,356 | \$ 185,353 | \$ 392,729 |
| Non-Recourse Portion of Future Minimum Rental Payments | \$ 19,278 | \$ 23,065 | \$ 23,362 | \$ 23,571 | \$ 23,611 | \$ 120,113 | \$ 233,000 |

Future minimum rental payment obligations include \$241.7 million of future non-recourse rental payments that relate to energy-from-waste facilities. Of this amount \$147.7 million is supported by third-party commitments to provide sufficient service revenues to meet such obligations. The remaining \$94.0 million is related to an energy-from-waste facility at which we serve as operator and directly market one half of the facility's disposal capacity. This facility currently generates sufficient revenues from short-, medium-, and long-term contracts to meet rental payments. We anticipate renewing the contracts or entering into new contracts to generate sufficient revenues to meet remaining future rental payments.

Covanta Delaware Valley, L.P. (Delaware Valley) leases a facility pursuant to an operating lease that expires in July 2019. In certain default circumstances under such lease, Delaware Valley becomes obligated to pay a contractually specified stipulated loss value that declines over time and was approximately \$143.7 million as of December 31, 2007.

Electricity and steam sales include lease income of approximately \$139.6 million, \$95.9 million, and \$91.6 million for the year ended December 31, 2007, 2006, and 2005, respectively, related to two Indian and one Chinese power project that were deemed to be operating lease arrangements under EITF No. 01-08, Determining Whether an Arrangement Contains a Lease (EITF 01-08). These amounts represent contingent rentals because the lease payments for each facility depend on a factor directly related to the future use of the leased property. The output deliverable and capacity provided by our two Indian facilities have each been purchased by a single party under long-term power purchase agreements which expire in 2016. The electric power and steam off-take arrangements and maintenance agreement for one of our Chinese coal facilities were also with a single party. In June 2006, we sold our ownership interest in this Chinese coal facility.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property, plant and equipment accounted for as leased to others under EITF 01-08 consisted of the following (in thousands of dollars):

| | As of December 31, | |
|--|---------------------------|-------------|
| | 2007 | 2006 |
| Land | \$ 43 | \$ 33 |
| Energy facilities | 91,207 | 75,376 |
| Buildings, machinery and improvements | 9,362 | 8,220 |
| Total | 100,612 | 83,629 |
| Less accumulated depreciation and amortization | (35,994) | (19,374) |
| Property, plant, and equipment net | \$ 64,618 | \$ 64,255 |

Note 16. Employee Benefit Plans

We sponsor various retirement plans covering the majority of our domestic employees and retirees, as well as other post-retirement benefit plans for a small number of domestic retirees that include healthcare benefits and life insurance coverage. Domestic employees not participating in our retirement plans generally participate in retirement plans offered by collective bargaining units of which these employees are members. The majority of our international employees participate in defined benefit or defined contribution retirement plans as required or available in accordance with local laws.

Defined Contribution Plans

Substantially all of our domestic employees are eligible to participate in defined contribution plans we sponsor. The defined contribution plans allow employees to contribute a portion of their compensation on a pre-tax basis in accordance with specified guidelines. We match a percentage of employee contributions up to certain limits. We also provide a company contribution to the defined contribution plans for eligible employees. Our costs related to all defined contribution plans were \$12.2 million and \$11.0 million for the years ended December 31, 2007 and 2006, respectively.

Pension and Postretirement Benefit Obligations

Effective December 31, 2005, we froze the defined benefit pension plan for domestic employees who do not participate in retirement plans offered by collective bargaining units. All active employees who were eligible participants in the defined benefit pension plan, as of December 31, 2005, became 100% vested and have a non-forfeitable right to these benefits as of such date.

Our pension and other postretirement benefit plans are accounted for in accordance with SFAS 158, which require costs and the related obligations and assets arising from the pension and other postretirement benefit plans to be accounted for based on actuarially-determined estimates. Upon the adoption of SFAS 158 in December 2006, we

recognized a net gain of \$2.5 million, \$1.7 million net of deferred tax, in AOCI to reflect the funded status of the pension and postretirement benefit obligations.

On an annual basis, we evaluate the assumed discount rate and expected return on assets used to determine pension benefit and other postretirement benefit obligations. The discount rate is determined based on the timing of future benefit payments and expected rates of return currently available on high quality fixed income securities whose cash flows match the timing and amount of future benefit payments of the plan. Based on this evaluation, we increased the discount rate assumption for benefit obligations from 5.75% as of December 31, 2006 to 6.50% as of December 31, 2007. We recorded a pension plan liability equal to the amount by which the present value of the projected benefit obligations (using a discount rate of 6.50%) exceeded the fair value of pension assets as of December 31, 2007. We recognized a net actuarial gain of \$14.5 million, \$9.4 million net of deferred tax, in AOCI during the year ended December 31, 2007.

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The following table is a reconciliation of the changes in the benefit obligations and fair value of assets for our defined benefit pension and other postretirement benefit plans, the funded status (using a December 31 measurement date) of the plans and the related amounts recognized in our consolidated balance sheets (in thousands of dollars, except percentages as noted):

| | Pension Benefits | | Other Benefits | |
|---|---|---|---|---|
| | For the Year Ended December 31, 2007 | For the Year Ended December 31, 2006 | For the Year Ended December 31, 2007 | For the Year Ended December 31, 2006 |
| Change in benefit obligation: | | | | |
| Benefit obligation | \$ 80,145 | \$ 75,167 | \$ 13,851 | \$ 11,582 |
| Service cost | | | | |
| Interest cost | 4,582 | 4,300 | 768 | 617 |
| Actuarial (gain) loss | (10,023) | 2,101 | (4,726) | 2,593 |
| Benefits paid | (1,810) | (1,423) | (1,083) | (941) |
| Benefit obligation at end of year | \$ 72,894 | \$ 80,145 | \$ 8,810 | \$ 13,851 |
| Change in plan assets: | | | | |
| Plan assets at fair value | \$ 55,211 | \$ 45,342 | \$ | \$ |
| Actual return on plan assets | 4,035 | 5,275 | | |
| Contributions | 4,203 | 6,017 | 1,082 | 941 |
| Benefits paid | (1,810) | (1,423) | (1,082) | (941) |
| Plan assets at fair value at end of year | \$ 61,639 | \$ 55,211 | \$ | \$ |
| Reconciliation of accrued benefit liability and net amount recognized: | | | | |
| Funded status of the plan | \$ (11,255) | \$ (24,934) | \$ (8,810) | \$ (13,851) |
| Unrecognized net gain | | | | |
| Net amount recognized | \$ (11,255) | \$ (24,934) | \$ (8,810) | \$ (13,851) |
| Accumulated other comprehensive income recognized under SFAS 158: | | | | |
| Net actuarial (gain) loss | \$ (14,644) | \$ (4,999) | \$ (2,371) | \$ 2,460 |
| Net prior service cost | | | | |
| Total as of December 31, 2007 | \$ (14,644) | \$ (4,999) | \$ (2,371) | \$ 2,460 |

Weighted average assumptions used to determine net periodic benefit expense for years ending December 31:

| | | | | |
|--------------------------------|-------|-------|-------|-------|
| Discount rate | 5.75% | 5.75% | 5.75% | 5.75% |
| Expected return on plan assets | 8.00% | 8.00% | N/A | N/A |
| Rate of compensation increase | 4.00% | 4.00% | N/A | N/A |

Weighted average assumptions used to determine projected benefit obligations as of December 31:

| | | | | |
|-------------------------------|-------|-------|-------|-------|
| Discount rate | 6.50% | 5.75% | 6.50% | 5.75% |
| Rate of compensation increase | 4.00% | 4.00% | N/A | N/A |

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Plan assets had a fair value of \$61.6 million and \$55.2 million as of December 31, 2007 and 2006, respectively. The allocation of plan assets was as follows:

| | As of December 31, | |
|-----------------------|-------------------------------|-------------|
| | 2007 | 2006 |
| Total Equities | 52% | 74% |
| Total Debt Securities | 42% | 20% |
| Other | 6% | 6% |
| Total | 100% | 100% |

Our expected return on plan assets assumption is based on historical experience and by evaluating input from the trustee managing the plans assets. The expected return on the plan assets is also impacted by the target allocation of assets, which is based on our goal of earning the highest rate of return while maintaining risk at acceptable levels. The plan strives to have assets sufficiently diversified so that adverse or unexpected results from one security class will not have an unduly detrimental impact on the entire portfolio. The target ranges of allocation of assets are as follows:

| | | |
|-----------------------|----|-----|
| Total Equities | 20 | 55% |
| Total Debt Securities | 35 | 95% |
| Other | 0 | 10% |

We anticipate that the long-term asset allocation on average will approximate the targeted allocation. Actual asset allocations are reviewed and the pension plans investments are rebalanced to reflect the targeted allocation when considered appropriate.

An annual rate of increase of 10.0% in the per capita cost of health care benefits was assumed for 2007 for covered employees. The rate was assumed to decrease gradually to 5.5% in 2017 and remain at that level.

For the pension plans with accumulated benefit obligations in excess of plan assets, the projected benefit obligation, accumulated benefit obligation, and fair value of plan assets were \$72.9 million, \$57.5 million, and \$61.6 million, respectively as of December 31, 2007 and \$80.1 million, \$60.3 million, and \$55.2 million, respectively as of December 31, 2006.

We estimate that the future benefits payable for the retirement and post-retirement plans in place are as follows (in thousands of dollars).

| | As of December 31, | | | | | |
|--|---------------------------|-------------|-------------|-------------|-------------|--------------------|
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 - 2017 |

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| | | | | | | |
|------------------------------|----------|----------|----------|----------|----------|-----------|
| Pension Benefits | \$ 1,017 | \$ 1,236 | \$ 1,186 | \$ 1,448 | \$ 2,504 | \$ 13,598 |
| Other Benefits Post Medicare | \$ 739 | \$ 747 | \$ 760 | \$ 784 | \$ 800 | \$ 3,333 |

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Pension costs for our defined benefit plans and other post-retirement benefit plans included the following components (in thousands of dollars):

| | Pension Benefits | | Other Benefits | |
|---|---|---|---|---|
| | For the Year Ended December 31, 2007 | For the Year Ended December 31, 2006 | For the Year Ended December 31, 2007 | For the Year Ended December 31, 2006 |
| Components of Net Periodic Benefit Cost: | | | | |
| Service cost | \$ | \$ | \$ | \$ |
| Interest cost | 4,582 | 4,300 | 768 | 617 |
| Expected return on plan assets | (4,430) | (3,689) | | |
| Amortization of net actuarial (gain) loss | | (64) | 105 | |
| Net periodic benefit cost | 152 | 547 | 873 | 617 |
| SFAS 88 settlement cost | 18 | | | |
| Final net periodic benefit cost | \$ 170 | \$ 547 | \$ 873 | \$ 617 |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage point change in the assumed health care trend rate would have the following effects (in thousands of dollars):

| | One-Percentage Point Increase | One-Percentage Point Decrease |
|--|--|--|
| Effect on total service and interest cost components | \$ 55 | \$ (48) |
| Effect on postretirement benefit obligation | \$ 475 | \$ (421) |

Note 17. Stock-Based Award Plans***Stock-Based Compensation***

We recognize stock-based compensation expense in accordance with the provisions of 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.

The impact to the consolidated financial statements, as a result of the adoption of SFAS 123R compared to continued recognition of stock-based compensation under APB 25, was approximately \$5.5 million and \$1.4 million to income before income taxes and approximately \$4.3 million and \$1.2 million to net income for the years ended December 31, 2007 and 2006, respectively. The impact on both basic and diluted earnings per share was approximately \$0.03 per share and less than \$0.01 per share for the years ended December 31, 2007 and 2006, respectively. The reductions that resulted from the adoption of SFAS 123R reflected the stock-based compensation expense associated with the unvested stock option awards. Stock-based compensation expense previously recognized in accordance with APB 25 for restricted stock awards remained essentially unchanged under the provisions of SFAS 123R.

Prior to the adoption of SFAS 123R, we recognized stock-based compensation expense in accordance with APB 25 and followed the disclosure requirements of SFAS 123. The stock option fair values were estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions for 2005: dividend yield of 0% per annum; an expected life of approximately 8 years; expected volatility of 70% - 80%; and a risk free interest rate of 4% - 5%. The following table illustrates the effect on net income and earnings per share as if we had applied the fair

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value recognition provisions of SFAS 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148) (in thousands of dollars, except per share amounts).

| | | For the Year Ended December 31, 2005 |
|---|--------|---|
| Net income as reported | \$ | 59,326 |
| Add: Actual stock-based option expense included in net income net of tax effects | | (19) |
| Less: Stock-based compensation expense determined under SFAS 123 net of tax effects | | (2,613) |
| Pro forma net income | \$ | 56,694 |
| Basic earnings per share: | | |
| As reported | \$ | 0.49 |
| Pro forma | \$ | 0.46 |
| Diluted earnings per share: | | |
| As reported | \$ | 0.46 |
| Pro forma | \$ | 0.44 |

We received \$0.8 million, \$1.1 million, and \$3.0 million from the exercise of non-qualified stock options in the years ended December 31, 2007, 2006, and 2005 respectively. The tax benefits related to the exercise of the non-qualified stock options and the vesting of the restricted stock award were not recognized during 2007 due to our 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 consolidated statements of cash flows in the period the tax benefit is recognized.

We recognize compensation costs using the graded vesting attribution method over the requisite service period of the award, which is generally three to five years. 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. 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 awards), 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.

Stock-Based Award Plans

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.

The purpose of the Award Plans is to promote our interests (including our subsidiaries and affiliates) and our stockholders' interests by using equity interests to attract, retain and motivate our management, non-employee directors and other eligible persons and to encourage and reward their contributions to our performance and profitability. The Award Plans provide for awards to be made in the form of (a) shares of restricted stock, (b) incentive stock options, (c) non-qualified stock options, (d) stock appreciation rights, (e) performance awards, or (f) other stock-based awards which relate to or serve a similar function to the awards described above. Awards may be made on a stand alone, combination or tandem basis. The maximum aggregate number of shares of common stock available for issuance is 6,000,000 under the Employees Plan and 400,000 under the Directors Plan.

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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 8% forfeiture rate. Prior to vesting, restricted stock awards have all of the rights of common stock (other than the right to sell or otherwise transfer or to receive dividends, when issued). Commencing with share-based stock awards granted in 2007, we calculated the fair value of share-based stock awards based on the closing price on the date the award was granted. Prior to 2007, we calculated the fair value of our share-based stock awards based on the average of the high and low price on the day prior to the grant date.

On March 19, 2007, March 26, 2007, June 6, 2007, and December 10, 2007, we awarded certain employees restricted stock awards of 350,249, 876, 1,592, and 1,059, respectively, under the Employees Plan. On May 30, 2007, in accordance with our existing program for annual director compensation, we awarded 36,000 restricted stock awards under the Directors Plan. On December 6, 2007, we awarded 3,719 shares of restricted stock under the Directors Plan to a newly appointed director. We determined that the service vesting condition of the restricted stock awards granted to the directors on May 30, 2007 and December 6, 2007 to be non-substantive and, in accordance with SFAS 123R, recorded the entire fair value of the awards as compensation expense on their respective grant dates.

Changes in nonvested restricted stock awards during the year ended December 31, 2007 were as follows:

| | Number of Shares | Weighted- Average Grant Date Fair Value |
|--------------------------------|-----------------------------|--|
| Nonvested at December 31, 2006 | 935,533 | \$ 13.85 |
| Granted | 393,495 | 22.35 |
| Vested | (491,508) | 12.43 |
| Forfeited | (24,694) | 16.91 |
| Nonvested at December 31, 2007 | 812,826 | 18.77 |

As of December 31, 2007, there was \$8.5 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 \$7.9 million, \$5.5 million, \$4.1 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Stock Options

2004 Stock Option Plan

We have also awarded stock options to certain employees and directors. Stock options awarded to directors vested immediately. Stock options awarded to employees typically vested annually over three years. We had one nonvested stock option award outstanding as of December 31, 2005, which was granted in October 2004. The fair value of the options was calculated using the Black-Scholes option pricing model with the following assumptions:

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fair value option price \$5.68; risk-free interest rate 4.25%; dividend yield 0%; expected volatility (based on historical volatility) 76%; and expected life 8 years.

On March 19, 2007, May 7, 2007, and December 10, 2007, we granted stock options to purchase an aggregate of 1,755,000 shares, 30,000 shares, and 20,000 shares, respectively, of common stock under the Employees Plan. The stock options have an exercise price of \$22.02 per share, \$24.80 per share, and \$28.34 per share, respectively, and their grants expire 10 years from the date of grant. The stock option grants vest in equal installments over five years commencing on March 17, 2008. The stock option grants will be expensed over the requisite service period, subject to a 15% forfeiture rate.

We calculate the fair value of our share-based option awards using the Black-Scholes option pricing model which requires estimates of the expected life of the award and stock price volatility. For the option awards granted prior to 2007, we determined an expected life of eight years in accordance with SFAS 123 and SFAS 123R. In December 2007, the SEC issued Staff Accounting Bulletin (SAB) No. 110, which permits use of the simplified method, as discussed in SAB No. 107, to determine the expected life of plain vanilla options. The expected life for the options issued in 2007 was determined using this simplified method. The fair value of the stock option awards granted during the year ended December, 2006 and 2007 was calculated using the following assumptions:

| Grant Date | Risk-Free Interest Rate | Dividend Yield | Volatility Expected (A) | Expected Life (B) |
|-------------------|-------------------------------|-------------------|-------------------------------|-------------------------|
| September 1, 2006 | 4.65% | 0% | 40% | 8.0 years |
| March 19, 2007 | 4.58% | 0% | 31% | 6.5 years |
| May 7, 2007 | 4.627% | 0% | 29% | 6.42 years |
| December 10, 2007 | 4.23% | 0% | 34% | 6.04 years |

(A) Expected volatility is based on implied volatility.

(B) Simplified method per SAB 107 and 110.

The following table summarizes activity and balance information of the options under the Award Plans and 1995 Plan:

| | 2007 | | As of December 31, 2006 | | 2005 | |
|--|--------|--|----------------------------|--|--------|--|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |

1995 Stock Option Plan

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| | | | | | | |
|--|-----------|----------|-----------|----------|-----------|---------|
| Outstanding at the beginning of the year | 178,426 | \$ 5.11 | 315,093 | \$ 5.26 | 795,677 | \$ 4.87 |
| Granted | | | | | | |
| Exercised | 70,000 | 7.06 | 136,667 | 5.45 | 427,250 | 4.41 |
| Forfeited | | | | | 53,334 | 6.25 |
| Outstanding at the end of the year | 108,426 | \$ 3.86 | 178,426 | \$ 5.11 | 315,093 | \$ 5.26 |
| Options exercisable at year end | 108,426 | \$ 3.86 | 178,426 | \$ 5.11 | 305,093 | \$ 5.38 |
| Options available for future grant | | | | | | |
| 2004 Stock Option Plan | | | | | | |
| Outstanding at the beginning of the year | 851,238 | \$ 8.87 | 928,115 | \$ 8.14 | 1,124,449 | \$ 7.43 |
| Granted | 1,805,000 | 22.14 | 50,000 | 20.35 | 120,006 | 12.90 |
| Exercised | 42,795 | 7.43 | 41,543 | 9.19 | 296,340 | 7.45 |
| Forfeited | 60,000 | 22.02 | 85,334 | 7.43 | 20,000 | 7.43 |
| Outstanding at the end of the year | 2,553,443 | \$ 17.96 | 851,238 | \$ 8.87 | 928,115 | \$ 8.14 |
| Options exercisable at year end | 500,617 | \$ 9.24 | 216,572 | \$ 10.12 | 258,115 | \$ 9.97 |
| Options available for future grant | 1,295,735 | | 3,494,230 | | 4,081,535 | |

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As of December 31, 2007, options for shares were in the following price ranges:

| Exercise Price Range | Options Outstanding | | Weighted Average Remaining Contractual Life (Years) | Options Exercisable | |
|----------------------|---------------------|---------------------------------------|--|------------------------|---------------------------------------|
| | Number of Shares | Weighted Average Exercise Price | | Number of Shares | Weighted Average Exercise Price |
| \$1.45 - \$5.31 | 108,426 | \$ 3.86 | 4.23 | 108,426 | \$ 3.86 |
| \$7.43 | 651,771 | 7.43 | 6.80 | 368,945 | 7.43 |
| \$12.90 | 106,672 | 12.90 | 7.70 | 106,672 | 12.90 |
| \$20.35 - \$22.02 | 1,745,000 | 21.97 | 9.20 | 25,000 | 20.35 |
| \$24.80 - \$28.34 | 50,000 | 26.22 | 9.60 | | |
| | 2,661,869 | 17.39 | | 609,043 | 8.28 |

The aggregate intrinsic value as of December 31, 2007 for options outstanding, options vested and expected to vest in the future and options exercisable was \$27.3 million, \$25.3 million, and \$11.8 million, respectively. The aggregate intrinsic value represents the total pre-tax intrinsic value (the difference between the closing stock price on the last trading day of 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on the last trading day of 2007 (December 31, 2007). The intrinsic value changes based on the fair market value of our common stock. Total intrinsic value of options exercised for the year ended as of December 31, 2007 was \$1.8 million.

As of December 31, 2007, there were options to purchase 2,367,008 shares of common stock that had vested and were expected to vest in future periods at a weighted average exercise price of \$16.99. The total fair value of options expensed was \$5.5 million for the year ended December 31, 2007. As of December 31, 2007, there was \$9.5 million of total unrecognized compensation expense related to stock options which is expected to be recognized over a weighted-average period of 4.2 years.

Note 18. Accumulated Other Comprehensive Income

AOCI, net of income taxes, consists of the following (in thousands of dollars):

| | As of December 31, | |
|--|-----------------------|--------|
| | 2007 | 2006 |
| Foreign currency translation | \$ 5,248 | \$ 860 |
| Minimum pension liability | (362) | (303) |
| Amortization of SFAS 158 unrecognized net actuarial gain | 11,096 | 1,650 |

| | | |
|--|-----------|----------|
| Net unrealized gain on interest rate swap | | 2,125 |
| Net unrealized loss on available-for-sale securities | 322 | (390) |
| Accumulated other comprehensive income | \$ 16,304 | \$ 3,942 |

Note 19. Financial Instruments

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, Disclosures About Fair Value of Financial Instruments. The estimated fair-value amounts have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that we would realize in a current market exchange.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For cash and cash equivalents, restricted funds, and marketable securities, the carrying value of these amounts is a reasonable estimate of their fair value. The fair value of restricted funds held in trust is based on quoted market prices of the investments held by the trustee.

Fair values for debt were determined based on interest rates that are currently available to us for issuance of debt with similar terms and remaining maturities for debt issues that are not traded on quoted market prices. The fair value of project debt is estimated based on quoted market prices for the same or similar issues.

The fair value of our interest rate swap agreement is the estimated amount we would receive or pay to terminate the agreement based on the net present value of the future cash flows as defined in the agreement.

The fair-value estimates presented herein are based on pertinent information available to us as of December 31, 2007. However, such amounts have not been comprehensively revalued for purposes of these financial statements since December 31, 2007, and current estimates of fair value may differ significantly from the amounts presented herein.

The estimated fair value of financial instruments is presented as follows (in thousands of dollars):

| | As of December 31, 2007 | |
|--|--------------------------------|---------------------------------|
| | Carrying Amount | Estimated Fair Value |
| Assets: | | |
| Cash and cash equivalents | \$ 149,406 | \$ 149,406 |
| Receivables | 265,542 | 265,542 |
| Restricted funds | 399,861 | 399,269 |
| Parent investments – fixed maturity securities | 2,495 | 2,495 |
| Insurance business investments – fixed maturity securities | 26,260 | 26,260 |
| Insurance business investments – equity securities | 1,110 | 1,110 |
| Interest rate swap receivable | 8,913 | 8,913 |
| Liabilities: | | |
| Long-term debt | \$ 1,019,432 | \$ 1,029,349 |
| Project debt | 1,280,275 | 1,283,562 |
| Interest rate swap payable | 8,913 | 8,913 |

Off Balance-Sheet Financial Instruments:

Guarantees(a)

- (a) Additionally guarantees include approximately \$1.5 million of guarantees related to international energy projects.

ACL Warrants

On January 12, 2005, two of our subsidiaries received warrants to purchase 168,230 shares of common stock of our former subsidiary, American Commercial Lines LLC (ACL), at \$12.00 per share. The number of shares and exercise price subject to the warrants were subsequently adjusted to 672,920 shares at an exercise price of \$3.00 per share, as a result of a four-for-one stock split effective as of August 2005. The warrants were given by certain of the former creditors of ACL under the ACL plan of reorganization. Our investment in ACL was written down to zero in 2003.

We recorded the warrants as a derivative security in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). We recorded the warrants at their aggregate fair value of \$0.8 million on the grant date and marked the warrants to their fair value each subsequent financial statement date. During October 2005, we converted the ACL warrants into shares of ACL s common stock and sold the shares resulting in net cash proceeds of \$18 million and a realized pre-tax gain of \$15.2 million.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest Rate Swaps

As of December 31, 2007, we had one interest rate swap agreement related to project debt that economically fixes the interest rate on certain adjustable-rate revenue bonds. This swap agreement was entered into in September 1995 and expires in January 2019. Any payments made or received under the swap agreement, including fair value amounts upon termination, are included as an explicit component of the client community's obligation under the related service agreement. Therefore, all payments made or received under the swap agreement are a pass through to the client community. Under the swap agreement, we paid an average fixed rate of 9.8% from 2003 through January 2005, and will pay 5.18% thereafter through January 2019, and received a floating rate equal to the rate on the adjustable rate revenue bonds, unless certain triggering events occur (primarily credit events), which results in the floating rate converting to either a set percentage of LIBOR or a set percentage of the BMA Municipal Swap Index, at the option of the swap counterparty. In the event we terminate the swap prior to its maturity, the floating rate used for determination of settling the fair value of the swap would also be based on a set percentage of one of these two rates at the option of the counterparty. For the year ended December 31, 2007 the floating rate on the swap averaged 3.56%. The notional amount of the swap as of December 31, 2007 was \$72.4 million and is reduced in accordance with the scheduled repayments of the applicable revenue bonds. The counterparty to the swap is a major financial institution. We believe the credit risk associated with nonperformance by the counterparty is not significant. The swap agreement resulted in increased debt service expense of \$1.2 million and \$1.4 million for 2007 and 2006, respectively. The effect on our weighted-average borrowing rate of the project debt was an increase of 0.09% for 2007.

We were required, under financing arrangements in effect from June 24, 2005 to February 9, 2007, to enter into hedging arrangements with respect to a portion of our exposure to interest rate changes with respect to our borrowing under the previously existing credit facilities. On July 8, 2005, we entered into two separate pay fixed, receive floating interest rate swap agreements with a total notional amount of \$300 million. On March 21, 2006, we entered into one additional pay fixed, receive floating interest rate swap agreement with a notional amount of \$37.5 million. On December 27, 2006, the notional amount of the original swap agreements reduced to \$250 million from \$300 million. These swaps were designated as cash flow hedges in accordance with SFAS 133. Accordingly, unrealized gains or losses are deferred in other comprehensive income until the hedged cash flows affect earnings. The impact of the swaps decreased interest expense for the year ended December 31, 2006 by \$2.4 million and increased interest expense for the year ended December 31, 2005 by \$0.7 million. As of December 31, 2006, the net after-tax deferred gain in other comprehensive income was \$2.1 million (\$3.3 million before income taxes which was recorded in other assets). In connection with the refinancing of our previously existing credit facilities, the interest rate swap agreements described above were settled on February 9, 2007. We recognized a gain associated with the settlement of our interest rate swap agreements of \$3.4 million, pre-tax. The Credit Facilities do not require us to enter into interest rate swap agreements. For additional information related to the Credit Facilities, see Note 6. Long-Term Debt.

Note 20. Related-Party Transactions

One member of our current Board of Directors is a senior advisor to a major law firm which Covanta Energy has used for several years, including many years prior to 2004, when we acquired Covanta Energy. Such member of the Board of Directors has had no direct or indirect involvement in the procurement, oversight or provision of services we receive from this law firm, is not involved in any manner in the billing of such services, and does not directly or indirectly benefit from associated fees. We paid this law firm approximately \$0.9 million in 2007, \$0.3 million in 2006 and \$0.8 million in 2005.

We have entered into a corporate services agreement with Covanta Energy, pursuant to which we provide to Covanta Energy, at its expense, certain administrative and professional services. Covanta Energy pays most of our expenses, which totaled \$6.0 million, \$5.3 million and \$17.8 million for the years ended December 31, 2007, 2006 and 2005, respectively. The amounts accrued but not paid under these arrangements totaled \$0.4 million and \$1.7 million for the years ended December 31, 2007 and 2006.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As described in Note 8. Equity Method Investments, we hold a 26% investment in Quezon. We are party to an agreement with Quezon in which 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 fiscal years ended December 31, 2007, 2006 and 2005, we collected \$35.4 million, \$26.9 million, and \$29.5 million, respectively, for the operation and maintenance of the facility. As of December 31, 2007 and December 31, 2006, the net amount due to Quezon was \$1.1 million and \$2.2 million, respectively, which represents advance payments received from Quezon for operation and maintenance costs.

SZ Investments, Third Avenue and Laminar, then representing aggregate ownership of approximately 40% of our outstanding common stock, each agreed to and participated in the ARC Holdings Rights Offering and acquired at least their respective pro rata portion of the shares. As consideration for their commitments, we paid each of these stockholders an amount equal to 1.75% of their respective equity commitments, which in the aggregate was \$2.8 million. We also agreed to amend an existing registration rights agreement to provide these stockholders with the right to demand that we undertake an underwritten offering within twelve months of the closing of the acquisition of ARC Holdings in order to provide such stockholders with liquidity or to register for resale common stock acquired in such offering. None of such stockholders exercised such right to request an underwritten offering prior to the expiration of such period.

As part of the Covanta Energy acquisition, we agreed to conduct the 9.25% Offering and because of the possibility that the 9.25% Offering could not be completed prior to the completion of the ARC Holdings Rights Offering, we restructured the 9.25% Offering to offer an additional 2.7 million shares of our common stock at the same purchase price as in the ARC Holdings Rights Offering. On February 24, 2006, we completed the 9.25% Offering in which 5,696,911 shares were issued in consideration for \$20.8 million in gross proceeds, including 633,380 shares purchased by Laminar pursuant to the exercise of rights held by Laminar as a holder of 9.25% debentures.

Note 21. Commitments and Contingencies

We 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.

Covanta Energy Corporation

Generally, claims and lawsuits arising from events occurring prior to their respective petition dates against Covanta Energy and its subsidiaries, that had filed bankruptcy petitions and subsequently emerged from bankruptcy, have been resolved pursuant to the Covanta Energy reorganization plan, and have been discharged pursuant to orders of the Bankruptcy Court which confirmed the Covanta Energy reorganization plan or similar plans of subsidiaries emerging separately from Chapter 11. However, to the extent that claims are not dischargeable in bankruptcy, such claims may not be discharged. For example, the claims of certain persons who were personally injured prior to the petition date but whose injury only became manifest thereafter may not be discharged pursuant to the Covanta Energy reorganization plan.

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.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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.

Other Commitments

Other commitments as of December 31, 2007 were as follows (in thousands of dollars):

| Commitments Expiring by Period | | |
|---------------------------------------|-------------------------------|-------------------------------|
| Total | Less Than One Year | More Than One Year |

| | | | |
|-----------------------------|------------|-----------|------------|
| Letters of credit | \$ 380,670 | \$ 57,983 | \$ 322,687 |
| Surety bonds | 61,981 | | 61,981 |
| Total other commitments net | \$ 442,651 | \$ 57,983 | \$ 384,668 |

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.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

See Note 6. Long-Term Debt of the Notes for specific criteria related to contingent interest, conversion or redemption features of the Debentures.

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, and a domestic water facility. 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. See *Item 1A. Risk Factors* We have provided guarantees and financial support in connection with our projects.

On March 31, 2007, our SEMASS energy-from-waste facility located in Rochester, Massachusetts experienced a fire in the front-end receiving portion of the facility. Damage was extensive to this portion of the facility and operations at the facility were suspended completely for approximately 20 days. As a result of this loss, we recorded an asset impairment of \$17.3 million, pre-tax, during the year ended December 31, 2007, which represented the net book value of the assets destroyed. The cost of repair or replacement, and business interruption losses, are insured under the terms of applicable insurance policies, subject to deductibles. We cannot predict the timing of when we would receive the

proceeds under such policies. During the year ended December 31, 2007, we recorded insurance recoveries of \$17.3 million related to repair and reconstruction, \$2.7 million related to clean-up costs and \$2.0 million related to business interruption losses. Insurance recoveries are recorded as a reduction to the loss related to the write-down of assets where such recoveries relate to repair and reconstruction costs, or as a reduction to operating expenses where such recoveries relate to other costs or business interruption losses. We expect the cost of repair or replacement and business interruption losses we do not recover, representing deductibles under such policies, will not be material.

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COVANTA HOLDING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Concluded)

Note 22. Quarterly Data (Unaudited)

The following table present quarterly unaudited financial data for the periods presented on the consolidated statements of income (in thousands of dollars, except per share amounts):

| Fiscal Quarter | Calendar Quarter Ended | | | | | | | |
|----------------------------|------------------------|------------|------------|------------|---------------|------------|--------------|------------|
| | March 31, | | June 30, | | September 30, | | December 31, | |
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Operating revenue | \$ 330,209 | \$ 305,356 | \$ 355,140 | \$ 334,136 | \$ 352,350 | \$ 311,115 | \$ 395,388 | \$ 317,929 |
| Operating income | 8,280 | 35,518 | 77,212 | 76,688 | 71,627 | 71,643 | 79,491 | 42,911 |
| Net (loss) income | (17,918) | 11,418 | 37,716 | 51,178 | 38,415 | 31,251 | 72,300 | 11,942 |
| (Loss) earnings per share: | | | | | | | | |
| Basic | (0.12) | 0.08 | 0.25 | 0.35 | 0.25 | 0.21 | 0.47 | 0.08 |
| Diluted | (0.12) | 0.08 | 0.24 | 0.35 | 0.25 | 0.21 | 0.47 | 0.08 |

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**COVANTA HOLDING CORPORATION
CONDENSED STATEMENT OF INCOME
HOLDING COMPANY ONLY**

| | For the Years Ended December 31, | | |
|--|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| | (In thousands) | | |
| Operating revenues | \$ | \$ | \$ |
| Operating expenses | | | |
| Operating income | | | |
| Investment income | 21,907 | 2,711 | 800 |
| Interest expense | (5,437) | | |
| Income tax benefit | 14,864 | 3,891 | 274 |
| Net income before equity in net income of subsidiaries | 31,334 | 6,602 | 1,074 |
| Equity in net income of Covanta Energy Corporation subsidiaries | 102,846 | 98,752 | 43,540 |
| Equity in net (loss) income of insurance subsidiaries excluding gain on ACL warrants | (3,667) | 435 | (481) |
| Equity in net income of ACL Holdings LLC (former holder of the ACL warrants) | | | 15,193 |
| Total equity in net income of subsidiaries | 99,179 | 99,187 | 58,252 |
| Net income | \$ 130,513 | \$ 105,789 | \$ 59,326 |

**COVANTA HOLDING CORPORATION
CONDENSED STATEMENT OF FINANCIAL POSITION
HOLDING COMPANY ONLY**

| | As of December 31, | |
|--|---------------------------|-------------|
| | 2007 | 2006 |
| | (In thousands) | |
| ASSETS | | |
| Cash | \$ 38,638 | \$ 52,763 |
| Fixed maturities, available-for-sale at fair value (cost: \$2,495 and \$3,200) | 2,495 | 3,200 |
| Total cash and investments | 41,133 | 55,963 |
| Restricted cash, insurance subsidiary escrow | | 6,660 |

| | | |
|---|--------------|------------|
| Investment in Covanta Energy Corporation subsidiaries | 785,912 | 465,024 |
| Investment in insurance subsidiaries | 15,014 | 17,622 |
| Intercompany receivable | 352,992 | 11,635 |
| Deferred tax asset | 192,870 | 171,904 |
| Prepaid and other assets | 13,831 | 12,328 |
| Total assets | \$ 1,401,752 | \$ 741,136 |

LIABILITIES AND STOCKHOLDERS EQUITY

Liabilities:

| | | |
|-------------------|----------|----------|
| Accounts payable | \$ 1,940 | \$ 1,984 |
| Long term debt | 373,750 | |
| Total liabilities | 375,690 | 1,984 |

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 and 150,000 shares; issued 154,281 and 147,657 shares; outstanding 153,922 and 147,500 shares) | 15,428 | 14,766 |
| Additional paid-in capital | 765,287 | 619,685 |
| Unearned compensation | | |
| Accumulated other comprehensive income | 16,304 | 3,942 |
| Accumulated earnings | 229,079 | 100,775 |
| Treasury stock, at par | (36) | (16) |
| Total stockholders equity | 1,026,062 | 739,152 |
| Total liabilities and stockholders equity | \$ 1,401,752 | \$ 741,136 |

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**COVANTA HOLDING CORPORATION
CONDENSED STATEMENT CASH FLOWS
HOLDING COMPANY ONLY**

| | For the Years Ended December 31, | | |
|---|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| | (In thousands) | | |
| Operating activities: | | | |
| Net income | \$ 130,513 | \$ 105,789 | \$ 59,326 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | | |
| Stock option and unearned compensation expense | | | 2 |
| Deferred tax asset | (20,965) | 1,068 | (6,661) |
| Amortization of deferred financing costs | 1,977 | | |
| Intercompany receivable | (12,138) | 12,818 | (11,495) |
| Equity in net income of Covanta Energy Corporation subsidiaries | (102,846) | (98,752) | (43,540) |
| Equity in net income of ACL Holdings LLC | | | (15,193) |
| Equity in net loss (income) of insurance subsidiaries | 3,667 | (435) | 481 |
| Other | (3,971) | | |
| Changes in other assets and liabilities, net | 7,460 | (18,750) | 7,870 |
| Net cash provided by (used in) operating activities | 3,697 | 1,738 | (9,210) |
| Investing activities: | | | |
| Contribution to Covanta Energy Corporation | (208,519) | | (384,954) |
| Intercompany loans to Covanta Energy Corporation | (316,201) | | |
| Proceeds from sale of marine services subsidiaries | | | 2,500 |
| Proceeds from the sale of investment securities | 705 | 100 | 15,975 |
| Net cash (used in) provided by investing activities | (524,015) | 100 | (366,479) |
| Financing activities | | | |
| Net proceeds from rights offering | | 20,498 | 395,791 |
| Proceeds from the issuance of common stock, net | 135,756 | | |
| Proceeds from issuance of Debentures | 373,750 | | |
| Payments of long-term debt deferred financing costs | (10,785) | | |
| Funds held in escrow | | | (6,471) |
| Proceeds from the exercise of options for common stock | 812 | 1,126 | 2,984 |
| Other financing activities, net | 6,660 | (177) | (49) |
| Net cash provided by financing activities | 506,193 | 21,447 | 392,255 |
| Net (decrease) increase in cash and cash equivalents | (14,125) | 23,285 | 16,566 |
| Cash and cash equivalents at beginning of period | 52,763 | 29,478 | 12,912 |
| Cash and cash equivalents at end of period | \$ 38,638 | \$ 52,763 | \$ 29,478 |

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**Schedule II Valuation and Qualifying Accounts
Receivables Valuation and Qualifying Accounts**

| | Balance at Beginning of Period | Charged to Costs and Expense | Charged to Other Accounts (In thousands) | Deductions | Balance at End of Period |
|---|---|---|---|-------------------|---|
| For the year ended December 31, 2007 | | | | | |
| Allowances deducted in the balance sheet from the assets to which they apply: | | | | | |
| Doubtful receivables current | \$ 4,469 | \$ 1,270 | \$ 19 | \$ 1,405 | \$ 4,353 |
| Doubtful receivables noncurrent | 382 | (80) | | (107) | 409 |
| Total | \$ 4,851 | \$ 1,190 | \$ 19 | \$ 1,298 | \$ 4,762 |
| For the year ended December 31, 2006 | | | | | |
| Allowances deducted in the balance sheet from the assets to which they apply: | | | | | |
| Doubtful receivables current | \$ 4,959 | \$ 2,088 | \$ 1,003 | \$ 3,581 | \$ 4,469 |
| Doubtful receivables noncurrent | 274 | 81 | | (27) | 382 |
| Total | \$ 5,233 | \$ 2,169 | \$ 1,003 | \$ 3,554 | \$ 4,851 |
| For the year ended December 31, 2005 | | | | | |
| Allowances deducted in the balance sheet from the assets to which they apply: | | | | | |
| Doubtful receivables current | \$ 1,455 | \$ 2,502 | \$ 2,344(1) | \$ 1,342 | \$ 4,959 |
| Doubtful receivables noncurrent | 170 | 99 | | (5) | 274 |
| Total | \$ 1,625 | \$ 2,601 | \$ 2,344 | \$ 1,337 | \$ 5,233 |

(1) Acquired with purchase of ARC Holdings

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There were no disagreements with accountants on accounting and financial disclosure.

Item 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of Covanta's disclosure controls and procedures, as required by Rule 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934 (the Exchange Act) as of December 31, 2007. Our disclosure controls and procedures are designed to reasonably assure that information required to be disclosed by us in reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure and is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

Our management, including the Chief Executive Officer and Chief Financial Officer, believes that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must consider the benefits of controls relative to their costs. Inherent limitations within a control system include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some

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persons, by collusion of two or more people, or by unauthorized override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and may not be prevented or detected.

Our management has conducted an assessment of its internal control over financial reporting as of December 31, 2007 as required by Section 404 of the Sarbanes-Oxley Act. Management's report on our internal control over financial reporting is included on page 131. The Independent Registered Public Accounting Firm's report with respect to the effectiveness of our internal control over financial reporting is included on page 132. Management has concluded that internal control over financial reporting is effective as of December 31, 2007.

Changes in Internal Control over Financial Reporting

Our management continually reviews the disclosure controls and procedures and make changes, as necessary, to ensure the quality of our financial reporting. During 2007, we completed the implementation of a new operating system for the recording of information relating to our business. We initiated this effort as part of a routine system upgrade and as part of our integration efforts related to the acquisition of Covanta ARC Holdings, Inc. and its subsidiaries in June 2005. We believe that the new operating system will maintain and enhance our system of internal controls over financial reporting and our ability to record, process, summarize and report information required to be disclosed within the time periods specified in the Securities and Exchange Commission's rules and forms.

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Management's Report on Internal Control over Financial Reporting

The management of Covanta Holding Corporation (Covanta) is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f).

All internal control systems, no matter how well designed, have inherent limitations including the possibility of human error and the circumvention or overriding of controls. Further, because of changes in conditions, the effectiveness of internal controls may vary over time. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Accordingly, even those systems determined to be effective can provide us only with reasonable assurance with respect to financial statement preparation and presentation.

Covanta's management has assessed the effectiveness of internal control over financial reporting as of December 31, 2007, following the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework*. Based on our assessment under the framework in *Internal Control - Integrated Framework*, Covanta's management has concluded that our internal control over financial reporting was effective as of December 31, 2007.

Our independent auditors, Ernst & Young LLP, have issued an attestation report on our internal control over financial reporting. This report appears on page 132 of this report on Form 10-K for the year ended December 31, 2007.

/s/ Anthony J. Orlando

Anthony J. Orlando
President and Chief Executive Officer

/s/ Mark A. Pytosh
Mark A. Pytosh
*Executive Vice President and Chief
Financial Officer*

February 24, 2008

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Covanta Holding Corporation

We have audited Covanta Holding Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Covanta Holding Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Covanta Holding Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Covanta Holding Corporation as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007 and our report dated February 24, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

MetroPark, New Jersey
February 24, 2008

Table of Contents**Item 9B. OTHER INFORMATION**

None.

PART III**Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information regarding our executive officers is incorporated by reference herein from the discussion under *Item 1. Business Executive Officers* of this Annual Report on Form 10-K. We have a Code of Conduct and Ethics for Senior Financial Officers and a Policy of Business Conduct. The Code of Conduct and Ethics applies to our Chief Executive Officer, Chief Financial Officer, Chief Accounting Officer, controller or persons performing similar functions. The Policy of Business Conduct applies to all of our directors, officers and employees and those of our subsidiaries. Both the Code of Conduct and Ethics and the Policy of Business Conduct are posted on our website at www.covantaholding.com on the Corporate Governance page. We will post on our website any amendments to or waivers of the Code of Conduct and Ethics or Policy of Business Conduct for executive officers or directors, in accordance with applicable laws and regulations. The remaining information called for by this Item 10 is incorporated by reference herein from the discussions under the headings Election of Directors, Board Structure and Composition Committees of the Board, and Security Ownership of Certain Beneficial Owners and Management Section 16(a) Beneficial Ownership Reporting Compliance in the definitive Proxy Statement for the 2008 Annual Meeting of Stockholders.

Item 11. EXECUTIVE COMPENSATION

The information required by Item 11 of Form 10-K is incorporated by reference herein from the discussions under the headings Compensation Committee Report, Board Structure and Composition Compensation of the Board, and Executive Compensation in our definitive Proxy Statement for the 2008 Annual Meeting of Stockholders.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K with respect to directors, executive officers and certain beneficial owners is incorporated by reference herein from the discussion under the heading Security Ownership of Certain Beneficial Owners and Management in our definitive Proxy Statement for the 2008 Annual Meeting of Stockholders.

Equity Compensation Plans

The following table sets forth information regarding the number of our securities which could be issued upon the exercise of outstanding options, the weighted average exercise price of those options in the 2004 and 1995 Stock Incentive Plans and the number of securities remaining for future issuance under the 2004 Stock Incentive Plans. Upon adoption of the 2004 Stock Incentive Plans, future issuances under the 1995 Plan were terminated. We do not have any equity compensation plans that have not been approved by our security holders.

| Number of Securities to | Weighted Average Exercise Price of Outstanding | Number of Securities Remaining Available for Future Issuance |
|----------------------------|--|---|
|----------------------------|--|---|

| Plan category | be Issued Upon Exercise of Outstanding Options, Warrants and Rights (A) | Options, Warrants and Rights (B) | Under Equity Compensation Plans (Excluding Securities Reflected in Column A) (C) |
|---|--|---|---|
| Equity Compensation Plans Approved By Security Holders | 2,661,869 | \$ 17.39 | 4,122,938(1) |
| Equity Compensation Plans Not Approved By Security Holders | N/A | N/A | N/A |
| TOTAL | 2,661,869 | \$ 17.39 | 4,122,938 |

(1) Of the 4,122,938 shares that remain available for future issuance, 1,295,735 are currently reserved for issuance under the equity compensation plans.

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Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

On December 6, 2007, the Board of Directors approved a form of indemnification agreement (the Indemnification Agreement) to be entered into with (i) each current and future director and executive officer of either or both of Covanta Holding Corporation and Covanta Energy Corporation, including each named executive officer as identified in the proxy statement for our 2007 annual meeting of stockholders and (ii) certain of our other officers and subsidiaries (each an Indemnitee). The Indemnification Agreement has been entered into with each of the current directors and executive officers. The Indemnification Agreement generally provides, that subject to certain conditions, limitations and exceptions, (i) we will indemnify and hold harmless the Indemnitee to the fullest extent permitted by the General Corporation Law of the State of Delaware from expenses and liabilities incurred by the Indemnitee in connection with third party and derivative legal actions brought against the Indemnitee as a result of his or her service; (ii) we are required to advance all covered expenses incurred by the Indemnitee in a proceeding covered by the Indemnification Agreement, and (iii) to the extent indemnification is not available in any proceeding in which the Indemnitee is jointly liable with us, there is a right of contribution from us based on the relative benefits received by us and the Indemnitee with respect to the transaction from which the proceeding arose.

The information required by Item 13 of Form 10-K is incorporated by reference herein from the discussions under the headings Board Structure and Composition and Certain Relationships and Related Transactions in the definitive Proxy Statement for the 2008 Annual Meeting of Stockholders.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated by reference herein from the discussion under the heading Independent Auditor Fees in the definitive Proxy Statement for the 2008 Annual Meeting of Stockholders.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

(1) *Consolidated Financial Statements of Covanta Holding Corporation:*

Included in Part II of this Report:

Consolidated Statement of Income for the years ended December 31, 2007, 2006 and 2005

Consolidated Balance Sheet as of December 31, 2007 and 2006

Consolidated Statement of Cash Flows for the years ended December 31, 2007, 2006 and 2005

Consolidated Statement of Stockholders' Equity for the years ended December 31, 2007, 2006 and 2005

Notes to Consolidated Financial Statements, for the years ended December 31, 2007, 2006 and 2005

Report of Ernst & Young LLP, Independent Auditors, on the consolidated financial statements of Covanta Holding Corporation for the years ended December 31, 2007, 2006 and 2005

(2) Financial Statement Schedules of Covanta Holding Corporation:

Included in Part II of this report:

Schedule I Condensed Financial Information of Registrant

Schedule II Valuation and Qualifying Accounts

Included as Exhibit F in this Part IV:

Separate financial statements of fifty percent or less owned persons. See Appendix F-1 through F-26.

All other schedules are omitted because they are not applicable, not significant or not required, or because the required information is included in the financial statement notes thereto.

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(3) Exhibits:

EXHIBIT INDEX

| Exhibit No. | Description |
|---|---|
| Plan of Acquisition, Reorganization, Arrangement, Liquidation or Succession. | |
| 2.1 | Investment and Purchase Agreement by and between Covanta Holding Corporation and Covanta Energy Corporation dated as of December 2, 2003 (incorporated herein by reference to Exhibit 2.1 of Covanta Holding Corporation's Current Report on Form 8-K dated December 2, 2003 and filed with the SEC on December 5, 2003, as amended by Covanta Holding Corporation's Current Report on Form 8-K/A dated December 2, 2003 and filed with the SEC on January 30, 2004). |
| 2.2 | Note Purchase Agreement by and between Covanta Holding Corporation and the Purchasers named therein dated as of December 2, 2003 (incorporated herein by reference to Exhibit 2.2 of Covanta Holding Corporation's Current Report on Form 8-K dated December 2, 2003 and filed with the SEC on December 5, 2003, as amended by Covanta Holding Corporation's Current Report on Form 8-K/A dated December 2, 2003 and filed with the SEC on January 30, 2004). |
| 2.3 | Amendment to Investment and Purchase Agreement by and between Covanta Holding Corporation and Covanta Energy Corporation dated February 23, 2004 (incorporated herein by reference to Exhibit 2.3 of Covanta Holding Corporation's Current Report on Form 8-K dated March 10, 2004 and filed with the SEC on March 11, 2004). |
| 2.4 | First Amendment to Note Purchase Agreement and Consent by and among Covanta Holding Corporation and D.E. Shaw Laminar Portfolios, L.L.C., SZ Investments, L.L.C. and Third Avenue Trust, on behalf of The Third Avenue Value Fund Series, dated as of February 23, 2004 (incorporated herein by reference to Exhibit 2.4 of Covanta Holding Corporation's Current Report on Form 8-K dated March 10, 2004 and filed with the SEC on March 11, 2004). |
| 2.5 | Stock Purchase Agreement among Covanta ARC Holdings, Inc., the Sellers party thereto and Covanta Holding Corporation dated as of January 31, 2005 (incorporated herein by reference to Exhibit 2.1 of Covanta Holding Corporation's Current Report on Form 8-K dated January 31, 2005 and filed with the SEC on February 2, 2005). |
| Articles of Incorporation and By-Laws. | |
| 3.1 | Restated Certificate of Incorporation of Covanta Holding Corporation (incorporated herein by reference to Exhibit 3.1 of Covanta Holding Corporation's Current Report on Form 8-K dated January 19, 2007 and filed with the SEC on January 19, 2007). |
| 3.2 | Amended and Restated Bylaws of Covanta Holding Corporation, as amended and effective May 30, 2007 (incorporated herein by reference to Exhibit 3.1(ii) of Covanta Holding Corporation's Current Report on Form 8-K dated May 30, 2007 filed with the SEC on May 31, 2007). |
| Instruments Defining Rights of Security Holders, Including Indentures. | |
| 4.1 | Specimen certificate representing shares of Covanta Holding Corporation's common stock (incorporated herein by reference to Exhibit 4.1 of Covanta Holding Corporation's Amendment No. 3 to Registration Statement on Form S-1 filed with the SEC on December 19, 2005). |
| 4.2 | Registration Rights Agreement dated November 8, 2002 among Covanta Holding Corporation and SZ Investments, L.L.C. (incorporated herein by reference to Exhibit 10.6 of Covanta Holding Corporation's Annual Report on Form 10-K for the year ended December 27, 2002 and filed with the SEC on March 27, 2003). |
| 4.3 | Registration Rights Agreement between Covanta Holding Corporation, D.E. Shaw Laminar Portfolios, L.L.C., SZ Investments, L.L.C., and Third Avenue Trust, on behalf of The Third Avenue Value |

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Fund Series, dated December 2, 2003 (incorporated herein by reference to Exhibit 4.1 of Covanta Holding Corporation's Current Report on Form 8-K dated December 2, 2003 and filed with the SEC on December 5, 2003).

- 4.4 Form of Warrant Offering Agreement between Wells Fargo Bank, National Association and Covanta Holding Corporation (incorporated herein by reference to Exhibit 4.11 of Covanta Holding Corporation's Amendment No. 3 to Registration Statement on Form S-1 filed with the SEC on December 19, 2005).

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| Exhibit No. | Description |
|----------------------------|---|
| 4.5 | Indenture dated as of January 18, 2007 between Covanta Holding Corporation and Wells Fargo Bank, National Association, as trustee. (incorporated herein by reference to Exhibit 4.1 of Covanta Holding Corporation's Registration Statement on Form S-3 (Reg. No. 333-140082) filed with the SEC on January 19, 2007). |
| 4.6 | First Supplemental Indenture dated as of January 31, 2007 between Covanta Holding Corporation and Wells Fargo Bank, National Association, as trustee (including the Form of Global Debenture) (incorporated herein by reference to Exhibit 4.2 of Covanta Holding Corporation's Current Report on Form 8-K dated January 31, 2007 and filed with the SEC on February 6, 2007). |
| Material Contracts. | |
| 10.1 | Tax Sharing Agreement, dated as of March 10, 2004, by and between Covanta Holding Corporation, Covanta Energy Corporation, and Covanta Power International Holdings, Inc. (incorporated herein by reference to Exhibit 10.25 of Covanta Holding Corporation's Annual Report on Form 10-K for the year ended December 31, 2003 and filed with the SEC on March 15, 2004). |
| 10.2 | Corporate Services and Expenses Reimbursement Agreement, dated as of March 10, 2004, by and between Covanta Holding Corporation and Covanta Energy Corporation (incorporated herein by reference to Exhibit 10.26 of Covanta Holding Corporation's Annual Report on Form 10-K for the year ended December 31, 2003 and filed with the SEC on March 15, 2004). |
| 10.3 | Management Services and Reimbursement Agreement, dated March 10, 2004, among Covanta Energy Corporation, Covanta Energy Group, Inc., Covanta Projects, Inc., Covanta Power International Holdings, Inc., and certain Subsidiaries listed therein (incorporated herein by reference to Exhibit 10.30 of Covanta Holding Corporation's Annual Report on Form 10-K for the year ended December 31, 2003 and filed with the SEC on March 15, 2004). |
| 10.4 * | Covanta Energy Savings Plan, as amended by December 2003 amendment (incorporated herein by reference to Exhibit 10.25 of Covanta Holding Corporation's Annual Report on Form 10-K for the year ended December 31, 2004 and filed with the SEC on March 16, 2005). |
| 10.5 * | Covanta Holding Corporation Equity Award Plan for Employees and Officers, as amended (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Report on Form 10-Q for the period ended September 30, 2005 and filed with the SEC on November 9, 2005). |
| 10.6 * | Covanta Holding Corporation Equity Award Plan for Directors (incorporated herein by reference to Exhibit 4.3 of Covanta Holding Corporation's Registration Statement on Form S-8 filed with the SEC on October 7, 2004). |
| 10.7 * | Form of Covanta Holding Corporation Stock Option Agreement for Employees and Officers (incorporated herein by reference to Exhibit 10.5 of Covanta Holding Corporation's Current Report on Form 8-K dated October 5, 2004 and filed with the SEC on October 7, 2004). |
| 10.8 * | Form of Covanta Holding Corporation Restricted Stock Award Agreement (incorporated herein by reference to Exhibit 10.4 of Covanta Holding Corporation's Current Report on Form 8-K dated October 5, 2004 and filed with the SEC on October 7, 2004). |
| 10.9 * | Covanta Holding Corporation 1995 Stock and Incentive Plan (as amended effective December 12, 2000 and as further amended effective July 24, 2002) (incorporated herein by reference to Appendix A to Covanta Holding Corporation's Proxy Statement filed with the SEC on June 24, 2002). |
| 10.10 * | Employment Agreement, dated October 5, 2004, by and between Anthony J. Orlando and Covanta Projects, Inc., Covanta Energy Corporation and Covanta Holding Corporation (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated October 5, 2004 and filed with the SEC on October 7, 2004). |
| 10.11 * | Employment Agreement, dated October 5, 2004, by and between Timothy J. Simpson and Covanta Projects, Inc., Covanta Energy Corporation and Covanta Holding Corporation (incorporated herein by |

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reference to Exhibit 10.3 of Covanta Holding Corporation's Current Report on Form 8-K dated October 5, 2004 filed with the SEC on October 7, 2004).

- 10.12 * Form of Covanta Holding Corporation Amendment to Stock Option Agreement for Employees and Officers (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated March 18, 2005 and filed with the SEC on March 24, 2005).

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| Exhibit No. | Description |
|--------------------|--|
| 10.13 * | Covanta Holding Corporation Amendment to Stock Option Agreement (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated May 25, 2005 and filed with the SEC on May 26, 2005). |
| 10.14 | Summary Description of Covanta Holding Corporation Cash Bonus Program, dated February 2008. |
| 10.15 | Amendment No. 1 to Tax Sharing Agreement, dated as of June 24, 2005, by and between Covanta Holding Corporation, Covanta Energy Corporation and Covanta Power International Holdings, Inc., amending Tax Sharing Agreement between Covanta Holding Corporation, Covanta Energy Corporation and Covanta Power International Holdings, Inc. dated as of March 10, 2004 (incorporated herein by reference to Exhibit 10.8 of Covanta Holding Corporation's Current Report on Form 8-K dated June 24, 2005 and filed with the SEC on June 30, 2005). |
| 10.16 * | Employment Agreement, dated October 5, 2004, by and between John Klett and Covanta Energy Corporation (incorporated herein by reference to Exhibit 10.7 of Covanta Energy Corporation's Current Report on Form 8-K dated October 5, 2004 and filed with the SEC on October 7, 2004). |
| 10.17 * | Employment Agreement, dated October 5, 2004, by and between Seth Myones and Covanta Energy Corporation (incorporated herein by reference to Exhibit 10.9 of Covanta Energy Corporation's Current Report on Form 8-K dated October 5, 2004 and filed with the SEC on October 7, 2004). |
| 10.18 | Rehabilitation Plan Implementation Agreement, dated January 11, 2006, by and between John Garamendi, Insurance Commissioner of the State of California, in his capacity as Trustee of the Mission Insurance Company Trust, the Mission National Insurance Company Trust and the Enterprise Insurance Company Trust, on the one hand, and Covanta Holding Corporation, on the other hand (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated March 2, 2006 and filed with the SEC on March 6, 2006). |
| 10.19 | Amendment to Rehabilitation Plan Implementation Agreement, accepted and agreed to on March 17, 2006 (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated March 17, 2006 and filed with the SEC on March 20, 2006). |
| 10.20 | Amendment to Agreement Regarding Closing (Exhibit A to the Rehabilitation Plan Implementation Agreement), dated January 10, 2006, by and between John Garamendi, Insurance Commissioner of the State of California, in his capacity as Trustee of the Mission Insurance Company Trust, the Mission National Insurance Company Trust, and the Enterprise Insurance Company Trust, on the one hand, and Covanta Holding Corporation, on the other hand (incorporated herein by reference to Exhibit 10.2 of Covanta Holding Corporation's Current Report on Form 8-K dated March 2, 2006 and filed with the SEC on March 6, 2006). |
| 10.21 | Latent Deficiency Claims Administration Procedures Agreement (Exhibit B to the Rehabilitation Plan Implementation Agreement), dated January 11, 2006, by and between John Garamendi, Insurance Commissioner of the State of California, in his capacity as Trustee of the Mission Insurance Company Trust, the Mission National Insurance Company Trust and the Enterprise Insurance Company Trust, on the one hand, and Covanta Holding Corporation on the other hand (incorporated herein by reference to Exhibit 10.3 of Covanta Holding Corporation's Current Report on Form 8-K dated March 2, 2006 and filed with the SEC on March 6, 2006). |
| 10.22 * | Transition and Separation Agreement, dated April 5, 2006, among Craig D. Abolt, Covanta Holding Corporation, Covanta Energy Corporation and Covanta Projects, Inc. (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated April 5, 2006 and filed with the SEC on April 7, 2006). |
| 10.23 | Amended and Restated Credit Agreement, dated as of May 26, 2006, among Covanta Energy Corporation, Covanta Holding Corporation as a guarantor, certain subsidiaries of Covanta Energy Corporation as guarantors, various lenders, Goldman Sachs Credit Partners L.P., as Sole Lead |

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Arranger, Sole Book Runner and Sole Syndication Agent, Administrative Agent and Collateral Agent, JPMorgan Chase Bank, as Co-Documentation Agent, Revolving Issuing Bank and a Funded LC Issuing Bank, UBS Securities LLC, as Co-Documentation Agent, UBS AG, Stamford Branch, as a Funded LC Issuing Bank, and Calyon New York Branch, as Co-Documentation Agent (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated May 26, 2006 and filed with the SEC on May 31, 2006).

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| Exhibit No. | Description |
|--------------------|--|
| 10.24 | Amendment to Second Lien Credit and Guaranty Agreement, dated as of May 26, 2006, among Covanta Energy Corporation, Covanta Holding Corporation and the parties signatory thereto (incorporated herein by reference to Exhibit 10.2 of Covanta Holding Corporation's Current Report on Form 8-K dated May 26, 2006 and filed with the SEC on May 31, 2006). |
| 10.25 | Amendment and Limited Waiver to Intercreditor Agreement, dated as of May 26, 2006, among Covanta Energy Corporation, Goldman Sachs Credit Partners L.P., as Collateral Agent under the First Lien Credit Agreement, Credit Suisse, Cayman Islands Branch, as Administrative Agent for the Second Lien Credit Agreement and as Collateral Agent for the Parity Lien Claimholders (incorporated herein by reference to Exhibit 10.3 of Covanta Holding Corporation's Current Report on Form 8-K dated May 26, 2006 and filed with the SEC on May 31, 2006). |
| 10.26 * | Form of Covanta Holding Corporation Restricted Stock Award Agreement for Directors (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated May 31, 2006 and filed with the SEC on June 2, 2006). |
| 10.27 * | Employment Agreement, dated as of August 17, 2006, among Covanta Holding Corporation, Covanta Energy Corporation and Mark A. Pytosh (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated August 17, 2006 and filed with the SEC on August 17, 2006). |
| 10.28 | Credit and Guaranty Agreement, dated as of February 9, 2007, among Covanta Energy Corporation, Covanta Holding Corporation, certain subsidiaries of Covanta Energy Corporation, as guarantors, the lenders party thereto, JPMorgan Chase Bank, N.A., as Administrative Agent, Collateral Agent, Revolving Issuing Bank and a Funded LC Issuing Bank, UBS AG, Stamford Branch, as a Funded LC Issuing Bank, Lehman Commercial Paper Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as Syndication Agents, and Bank of America, N.A. and Barclays Bank PLC, as Documentation Agents (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated February 9, 2007 and filed with the SEC on February 15, 2007). |
| 10.29 | Pledge and Security Agreement, dated as of February 9, 2007, between each of Covanta Energy Corporation and the other grantors party thereto, and JPMorgan Chase Bank, N.A., as Collateral Agent (incorporated herein by reference to Exhibit 10.2 of Covanta Holding Corporation's Current Report on Form 8-K dated February 9, 2007 and filed with the SEC on February 15, 2007). |
| 10.30 | Pledge Agreement, dated as of February 9, 2007, between Covanta Holding Corporation and JPMorgan Chase Bank, N.A., as Collateral Agent (incorporated herein by reference to Exhibit 10.3 of Covanta Holding Corporation's Current Report on Form 8-K dated February 9, 2007 and filed with the SEC on February 15, 2007). |
| 10.31 | Intercompany Subordination Agreement, dated as of February 9, 2007, among Covanta Energy Corporation, Covanta Holding Corporation, certain subsidiaries of Covanta Energy Corporation, as Guarantor Subsidiaries, certain other subsidiaries of Covanta Energy Company, as Excluded Subsidiaries or Unrestricted Subsidiaries, and JPMorgan Chase Bank, N.A., as Administrative Agent (incorporated herein by reference to Exhibit 10.4 of Covanta Holding Corporation's Current Report on Form 8-K dated February 9, 2007 and filed with the SEC on February 15, 2007). |
| 10.32 | Form of Covanta Holding Corporation Indemnification Agreement, entered into with each of the following: David M. Barse, Ronald J. Broglio, Peter C.B. Bynoe, Linda J. Fisher, Richard L. Huber, Anthony J. Orlando, William C. Pate, Robert S. Silberman, Jean Smith, Clayton Yeutter, Samuel Zell, Mark A. Pytosh, Timothy J. Simpson, Thomas E. Bucks, John M. Klett and Seth Myones (incorporated herein by reference to Exhibit 10.1 of Covanta Holding Corporation's Current Report on Form 8-K dated December 6, 2007 and filed with the SEC on December 12, 2007). |

- 12.1 Computation of Ratio of Earnings to Fixed Charges.
- 21.1 List of Subsidiaries.
- 23.1 Consent of Independent Registered Public Accounting Firm of Covanta Holding Corporation and Subsidiaries: Ernst & Young LLP.
- 23.2 Consent of Independent Registered Public Accounting Firm of Quezon Power, Inc.: Sycip Gorres Velayo & Co., a member practice of Ernst & Young Global.

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| Exhibit No. | Description |
|--------------------|---|
| 31.1 | Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended). |
| 31.2 | Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended). |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 from the Chief Executive Officer and the Chief Financial Officer of Covanta Holding Corporation. |

Not filed herewith, but incorporated herein by reference.

* Management contract or compensatory plan or arrangement.

Pursuant to paragraph 601(b)(4)(iii)(A) of Regulation S-K, the registrant has omitted from the foregoing list of exhibits, and hereby agrees to furnish to the Securities and Exchange Commission, upon its request, copies of certain instruments, each relating to long-term debt not exceeding 10% of the total assets of the registrant and its subsidiaries on a consolidated basis.

(b) *Exhibits:* See list of Exhibits in this Part IV, Item 15(a)(3) above.

(c) *Financial Statement Schedules:* See Part IV, Item 15(a)(2) above.

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Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

COVANTA HOLDING CORPORATION
(Registrant)

By: /s/ Anthony J. Orlando
Anthony J. Orlando
President and Chief Executive Officer

Date: February 26, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Name | Title | Date |
|------------------------|--|----------------------|
| /s/ Anthony J. Orlando | President and Chief Executive Officer and Director (Principal Executive Officer) | February 26, 2008 |
| Anthony J. Orlando | | |
| /s/ Mark A. Pytosh | Executive Vice President and Chief Financial Officer (Principal Financial Officer) | February 26, 2008 |
| Mark A. Pytosh | | |
| /s/ Thomas E. Bucks | Vice President and Chief Accounting Officer (Principal Accounting Officer) | February 26, 2008 |
| Thomas E. Bucks | | |
| /s/ Samuel Zell | Chairman of the Board | February 26, 2008 |
| Samuel Zell | | |
| /s/ David M. Barse | Director | February 26, 2008 |
| David M. Barse | | |
| /s/ Ronald J. Broglio | Director | |

| | | |
|-------------------------|----------|----------------------|
| Ronald J. Broglio | | February 26, 2008 |
| /s/ Peter C. B. Bynoe | Director | February 26, 2008 |
| Peter C. B. Bynoe | | |
| /s/ Linda J. Fisher | Director | February 26, 2008 |
| Linda J. Fisher | | |
| /s/ Richard L. Huber | Director | February 26, 2008 |
| Richard L. Huber | | |
| /s/ William C. Pate | Director | February 26, 2008 |
| William C. Pate | | |
| /s/ Robert S. Silberman | Director | February 26, 2008 |
| Robert S. Silberman | | |
| /s/ Jean Smith | Director | February 26, 2008 |
| Jean Smith | | |
| /s/ Clayton Yeutter | Director | February 26, 2008 |
| Clayton Yeutter | | |

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Quezon Power, Inc.

**Consolidated Financial Statements
December 31, 2007 and 2006
and Years Ended December 31, 2007, 2006 and 2005
(In United States Dollars)**

and

Report of Independent Auditors

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Management Committee of
Quezon Power, Inc.

We have audited the accompanying consolidated balance sheets of Quezon Power, Inc. (incorporated in the Cayman Islands, British West Indies) and subsidiary as of December 31, 2007 and 2006, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Quezon Power, Inc. and subsidiary as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

/s/ Sycip Gorres Velayo & Co.
a Member Practice of Ernst & Young Global

Makati City, Philippines
February 22, 2008

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Table of Contents**QUEZON POWER, INC.****CONSOLIDATED BALANCE SHEETS**

| | December 31 | |
|--|--------------------|----------------|
| | 2007 | 2006 |
| ASSETS | | |
| Current Assets | | |
| Cash | \$ 85,535,300 | \$ 18,683,459 |
| Accounts receivable net of allowance for bad debts of \$- in 2007 and 2006 (Notes 9 and 11) | 36,713,033 | 73,866,818 |
| Fuel inventories | 21,346,070 | 8,132,162 |
| Spare parts | 15,854,968 | 14,239,098 |
| Due from affiliated companies (Note 7) | 230,056 | 411,156 |
| Deferred income taxes (Note 4) | 258,483 | 2,733,683 |
| Prepaid input value-added taxes (VAT) net (Note 4) | | 3,513,866 |
| Prepaid expenses and other current assets | 4,929,367 | 3,223,205 |
| Total Current Assets | 164,867,277 | 124,803,447 |
| Property, Plant and Equipment net (Notes 3, 6 and 9) | 642,658,744 | 659,075,478 |
| Deferred Financing Costs net (Notes 5 and 6) | 17,497,745 | 16,799,334 |
| Deferred Income Taxes net (Note 4) | 3,643,976 | 20,229,614 |
| Deferred Input VAT net (Note 4) | 388,849 | |
| | \$ 829,056,591 | \$ 820,907,873 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities | | |
| Short-term notes payable (Note 5) | \$ 19,000,000 | \$ 19,000,000 |
| Accounts payable and accrued expenses (Notes 9 and 11) | 69,065,907 | 83,818,004 |
| Due to affiliated companies (Note 7) | 503,351 | 223,998 |
| Current portion of (Note 6): | | |
| Long-term loans payable | 35,389,726 | 38,799,027 |
| Bonds payable | 12,900,000 | 10,750,000 |
| Income taxes payable (Note 4) | 6,343,549 | 7,361,841 |
| Total Current Liabilities | 143,202,533 | 159,952,870 |
| Long-term Notes Payable (Note 5) | 100,000,000 | |
| Long-term Loans Payable - net of current portion (Note 6) | 141,558,903 | 176,948,631 |
| Bonds Payable - net of current portion (Note 6) | 159,100,000 | 172,000,000 |
| Asset Retirement Obligation (Note 2) | 4,537,043 | 4,296,843 |
| Minority Interest | 6,464,126 | 7,090,428 |
| Stockholders Equity (Note 8) | 274,193,986 | 300,619,101 |
| | \$ 829,056,591 | \$ 820,907,873 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**QUEZON POWER, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Years Ended December 31 | | |
|--|--------------------------------|-----------------------|-----------------------|
| | 2007 | 2006 | 2005 |
| OPERATING REVENUES (Note 9) | \$ 280,013,167 | \$ 271,817,485 | \$ 245,570,990 |
| OPERATING EXPENSES | | | |
| Fuel costs | 87,219,812 | 85,773,607 | 68,022,825 |
| Operations and maintenance | 32,278,624 | 32,060,447 | 32,048,502 |
| Depreciation and amortization (Note 3) | 17,319,221 | 17,805,160 | 18,557,511 |
| General and administrative (Note 9) | 3,769,650 | 16,849,783 | 16,069,798 |
| | 140,587,307 | 152,488,997 | 134,698,636 |
| INCOME FROM OPERATIONS | 139,425,860 | 119,328,488 | 110,872,354 |
| OTHER INCOME (CHARGES) | | | |
| Interest income | 2,143,443 | 1,803,600 | 1,169,215 |
| Foreign exchange gains net | 3,311,900 | 952,748 | 182,650 |
| Interest expense (Notes 5 and 6) | (32,631,310) | (34,258,529) | (37,079,185) |
| Amortization of deferred financing costs | (4,381,345) | (4,959,514) | (5,618,118) |
| Others net [Note 9(b)] | (3,013,736) | (2,633,358) | (950,363) |
| | (34,571,048) | (39,095,053) | (42,295,801) |
| INCOME BEFORE INCOME TAX AND MINORITY INTEREST | 104,854,812 | 80,233,435 | 68,576,553 |
| BENEFIT FROM (PROVISION FOR) INCOME TAX (Note 4) | | | |
| Current | (36,946,665) | (18,791,782) | (338,975) |
| Deferred | (19,060,838) | 13,432,123 | 190,607 |
| | (56,007,503) | (5,359,659) | (148,368) |
| INCOME BEFORE MINORITY INTEREST MINORITY INTEREST [Note 1(a)] | 48,847,309 | 74,873,776 | 68,428,185 |
| | (1,145,700) | (1,755,994) | (1,604,489) |
| NET INCOME | \$ 47,701,609 | \$ 73,117,782 | \$ 66,823,696 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**QUEZON POWER, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Years Ended December 31 | | |
|---|--------------------------------|---------------|---------------|
| | 2007 | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income | \$ 47,701,609 | \$ 73,117,782 | \$ 66,823,696 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 17,319,221 | 17,805,160 | 18,557,511 |
| Amortization of deferred financing costs | 4,381,345 | 4,959,514 | 5,618,118 |
| Minority interest | 1,145,700 | 1,755,994 | 1,604,489 |
| Losses (gains) on: | | | |
| Retirement of property, plant and equipment | 1,992,217 | 1,262,715 | |
| Sale of property, plant and equipment | (47,496) | | 1,915 |
| Accretion expense on asset retirement obligation | 240,200 | 243,204 | 226,801 |
| Unrealized foreign exchange gains net | (769,289) | (194,287) | (220,092) |
| Deferred income taxes net | 19,060,838 | (13,432,123) | (190,607) |
| Changes in operating assets and liabilities: | | | |
| Decrease (increase) in: | | | |
| Accounts receivable | 37,149,215 | (31,993,873) | (8,357,875) |
| Fuel inventories | (13,213,908) | 3,972,408 | (4,363,668) |
| Spare parts | (1,615,870) | (445,228) | (1,796,267) |
| Prepaid input VAT | 3,513,866 | 5,560,325 | 537,647 |
| Prepaid expenses and other current assets | (1,729,622) | 1,245,424 | 2,827,170 |
| Increase (decrease) in: | | | |
| Accounts payable and accrued expenses | (14,884,626) | 19,163,765 | 25,953,692 |
| Income taxes payable | (1,018,292) | 7,240,166 | 50,851 |
| Net cash generated from operating activities | 99,225,108 | 90,260,946 | 107,273,381 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Proceeds from sale of property, plant and equipment | 104,712 | | 39,299 |
| Additions to property, plant and equipment | (2,951,920) | (2,931,084) | (7,729,509) |
| Net cash used in investing activities | (2,847,208) | (2,931,084) | (7,690,210) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Cash received from: | | | |
| Long-term notes payable | \$ 100,000,000 | \$ | \$ |
| Short-term notes payable | | 10,666,667 | 23,333,333 |
| Net changes in accounts with affiliated companies | 457,583 | (123,219) | 166,182 |
| Cash dividends paid | (74,126,724) | (62,230,000) | (67,209,380) |
| Cash paid for deferred financing costs | (5,079,756) | | |
| Payments of: | | | |
| Long-term loans payable | (38,799,029) | (41,005,046) | (40,002,310) |

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| | | | |
|--|----------------------|----------------------|----------------------|
| Bonds payable | (10,750,000) | (7,525,000) | (6,450,000) |
| Short-term notes payable | | (3,333,334) | (11,666,666) |
| Minority interest | (1,772,002) | (1,270,000) | (1,371,620) |
| Net cash used in financing activities | (30,069,928) | (104,819,932) | (103,200,461) |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 543,869 | 233,536 | 153,102 |
| NET INCREASE (DECREASE) IN CASH | 66,851,841 | (17,256,534) | (3,464,188) |
| CASH AT BEGINNING OF YEAR | 18,683,459 | 35,939,993 | 39,404,181 |
| CASH AT END OF YEAR | \$ 85,535,300 | \$ 18,683,459 | \$ 35,939,993 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | | |
| Cash paid during the year for: | | | |
| Interest | \$ 33,138,726 | \$ 37,508,960 | \$ 37,360,460 |
| Income taxes | 37,964,957 | 11,551,616 | 288,124 |
| Noncash investing and financing activities: | | | |
| Retirement of property, plant and equipment | 1,992,217 | 1,262,715 | |
| Revision for estimated cash flows of asset retirement obligation | | | 345,740 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**QUEZON POWER, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 and 2005**

| | Capital Stock (Note 8) | Additional Paid-in Capital | Retained Earnings | Total |
|-------------------------------|---------------------------------------|---|------------------------------|----------------|
| Balances at December 31, 2004 | \$ 1,001 | \$ 207,641,266 | \$ 82,474,736 | \$ 290,117,003 |
| Cash dividends | | | (67,209,380) | (67,209,380) |
| Net income for the year | | | 66,823,696 | 66,823,696 |
| Balances at December 31, 2005 | 1,001 | 207,641,266 | 82,089,052 | 289,731,319 |
| Cash dividends | | | (62,230,000) | (62,230,000) |
| Net income for the year | | | 73,117,782 | 73,117,782 |
| Balances at December 31, 2006 | 1,001 | 207,641,266 | 92,976,834 | 300,619,101 |
| Cash dividends | | | (74,126,724) | (74,126,724) |
| Net income for the year | | | 47,701,609 | 47,701,609 |
| Balances at December 31, 2007 | \$ 1,001 | \$ 207,641,266 | \$ 66,551,719 | \$ 274,193,986 |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****1. Organization and Business*****(a) Organization***

Quezon Power, Inc. (the Company; formerly Ogden Quezon Power, Inc.), an exempted company with limited liability, was incorporated in the Cayman Islands, British West Indies on August 4, 1995 primarily: (i) to be a promoter, a general or limited partner, member, associate, or manager of any general or limited partnership, joint venture, trust or other entity, whether established in the Republic of the Philippines or elsewhere and (ii) to engage in the business of power generation and transmission and in any development or other activity related thereto; provided that the Company shall only carry on the business for which a license is required under the laws of the Cayman Islands when so licensed under the terms of such laws. The Philippine Branch (the Branch) was registered with the Philippine Securities and Exchange Commission on March 15, 1996 to carry out the Company's business in the Republic of the Philippines to the extent allowed by law including, but not limited to, developing, designing and arranging financing for a 470-megawatt (net) base load pulverized coal-fired power plant and related electricity transmission line (the Project) located in Quezon Province, Republic of the Philippines. In addition, the Branch is responsible for the organization and is the sole general partner of Quezon Power (Philippines), Limited Co. (the Partnership), a limited partnership in the Philippines. The Partnership is responsible for financing, constructing, owning and operating the Project.

The Branch is the legal and beneficial owner of (i) the entire general partnership interest in the Partnership representing 21% of the economic interest in the Partnership and (ii) a limited partnership interest representing 77% of the economic interest in the Partnership. The remaining 2% economic interest in the Partnership is in the form of a limited partnership interest held by PMR Limited Co. (PMRL). PMRL does not have any equity funding obligation. The accompanying financial statements include the consolidated results of operations of the Company and the Partnership.

Ultimately, 100% of the aggregate capital contributions of the Company to the Partnership were indirectly made by Quezon Generating Company, Ltd. (QGC), a Cayman Islands limited liability company, and Covanta Power Development - Cayman, Inc. (CPD; formerly Ogden Power Development - Cayman, Inc.), an indirect wholly owned subsidiary of Covanta Energy Group, Inc. (formerly Ogden Energy Group, Inc.), a Delaware corporation. The shareholders of QGC are QGC Holdings, Ltd. and Global Power Investment, L.P. (GPI), both Cayman Islands companies. QGC Holdings, Ltd. is a wholly owned subsidiary of InterGen N.V. (formerly InterGen) which was a joint venture between Bechtel Enterprises, Inc. (Bechtel) and Shell Generating Limited (Shell). In August 2005, Shell and Bechtel completed the sale of InterGen N.V and 10 of its power plants including its interest in the Quezon Project to a partnership between AIG Highstar Capital II, L.P. and Ontario Teachers' Pension Plan. The ultimate economic ownership percentages among QGC, CPD and PMRL in the Partnership are 71.875%, 26.125% and 2%, respectively.

(b) Allocation of Earnings

Each item of income and loss of the Partnership for each fiscal year (or portion thereof) shall be allocated 21% to the Company, as a general partner; 77% to the Company, as a limited partner; and 2% to PMRL, as a limited partner.

(c) The Project

The Project is a 470-megawatt (net) base load pulverized coal-fired electricity generation facility and related transmission line. The Project receives substantially all of its revenue from a 25-year take-or-pay Power Purchase Agreement (PPA) and a Transmission Line Agreement (TLA) with the Manila Electric Company (Meralco). Construction of the Project commenced in December 1996 and the Project started commercial operations on May 30, 2000. The total cost of the Project was \$895.4 million.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(d) Principal Business Risks

The principal risks associated with the Project include operating risks, dependence on one customer (Meralco), environmental matters, permits, political and economic factors and fluctuations in currency.

The risks associated with operating the Project include the breakdown or failure of equipment or processes and the performance of the Project below expected levels of output or efficiency due to operator fault and/or equipment failure. Meralco is subject to regulation by the Energy Regulatory Commission (ERC) with respect to sales charged to consumers. In addition, pursuant to the Philippine Constitution, the Philippine government at any time may purchase Meralco's property upon payment of just compensation. If the Philippine government was to purchase Meralco's property or the ERC ordered any substantial disallowance of costs, Meralco would remain obligated under the PPA to make the firm payments to the Partnership. Such purchase or disallowance, however, could result in Meralco being unable to fulfill its obligations under the PPA, which would have an adverse material effect on the ability of the Partnership to meet its obligations under the credit facilities [see Notes 6, 9(a) and 9(b)].

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements of the Company include the financial position and results of operations of the Partnership and have been prepared in conformity with U.S. generally accepted accounting principles.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and the Partnership, a 98%-owned and controlled limited partnership. All significant intercompany transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include useful lives of long-lived property, plant and equipment, impairment of accounts receivable, impairment of property, plant and equipment, realizability of the deferred income tax assets and asset retirement obligation.

Accounts Receivable

Accounts receivable are recognized and carried at original invoice amount less an allowance for any uncollectible amounts. An estimate for doubtful accounts is made when collection of the full amount is no longer probable.

Inventories

Fuel inventories and spare parts are valued at the lower of cost or market value, net of any provision for inventory losses. Cost is determined using the moving average cost method.

Property, Plant and Equipment

Property, plant and equipment are carried at cost less accumulated depreciation and amortization. Cost includes the fair value of asset retirement obligation, capitalized interest and amortized deferred financing costs incurred in connection with the construction of the Project. Capitalization of interest and amortization of deferred financing costs ceased upon completion of the Project.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the assets are as follows:

| Category | Number of Years |
|--------------------|------------------------|
| Power plant | 50 |
| Transmission lines | 25 |
| Others | 3 to 5 |

The cost of routine maintenance and repairs is charged to income as incurred while significant renewals and betterments are capitalized. When assets are retired or otherwise disposed of, both the cost and related accumulated depreciation and amortization are removed from the accounts and any resulting gain or loss is credited or charged to current operations.

Deferred Financing Costs

Deferred financing costs represent the costs incurred to obtain project financing and are amortized, using the effective interest rate method, over the term of the related loans.

Derivative Instruments and Hedging Activities

The Company accounts for derivative instruments and hedging activities under Statement of Financial Accounting Standards (SFAS) No. 133 (subsequently amended by SFAS No. 138 and No. 149), *Accounting for Derivative Instruments and Hedging Activities*. This statement, as amended, establishes certain accounting and reporting standards requiring all derivative instruments to be recorded as either assets or liabilities measured at fair value. Changes in derivative fair values are recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting treatment for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the statement of operations and requires the Company to formally document designate and assess the effectiveness of transactions that receive hedge accounting. The Company periodically reviews its existing contracts to determine the existence of any embedded derivatives. As of December 31, 2007 and 2006, there are no significant embedded derivatives accounted for separately.

Input VAT

Prepaid input VAT represents VAT imposed on the Partnership by its suppliers for the acquisition of goods and services required under Philippine taxation laws and regulations.

Deferred input VAT represents unamortized portion of the input VAT imposed on the Partnership for the acquisition of depreciable assets with an estimated useful life of at least one (1) year which are required to be amortized over the life of the related asset or a maximum period of 60 months.

The input VAT is recognized as an asset and will be used to offset the Partnership's current VAT liabilities [see Notes 4 and 11(a)]. Excess input VAT, if any, will be claimed as tax credits. Input taxes are stated at their estimated

net realizable values.

Revenue Recognition

Revenue is recognized when electric capacity and energy are delivered to Meralco [see Note 9(a)]. Commencing on the Commercial Operations Date and continuing throughout the term of the PPA, the Partnership receives payment, net of penalty obligation for each kilowatt hour (kWh) of shortfall deliveries, consisting of a Monthly Capacity Payment, Monthly Operating Payment and Monthly Energy Payment as defined in the PPA.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue from transmission lines consists of Capital Cost Recovery Payment (CCRP) and the Transmission Line Monthly Operating Payment as defined in the TLA. Transmission Line Monthly Operating Payment is recognized as revenue in the period it is intended for.

Income Taxes

The Partnership is registered with the Philippine Board of Investments as a pioneer enterprise under a statutory scheme designed to promote investments in certain industries (including power generation). As such, the Partnership benefited from a six-year income tax holiday on its registered activities starting on January 1, 2000. During 2004, the Partnership was able to move the effective date of its income tax holiday period to May 30, 2000, coinciding with the start of commercial operations. Under the present Philippine taxation laws, a corporate income tax rate of 35% is levied against Philippine taxable income effective November 1, 2005 and 30% starting January 1, 2009 (see Note 4). Prior to November 1, 2005, the corporate income tax rate was 32%. Net operating losses can be carried forward for three immediately succeeding years. The income tax holiday incentive of the Partnership expired on May 29, 2006. The Partnership's income from the registered activities for the period thereafter became subject to the regular corporate income tax rate of 35%.

The Partnership accounts for corporate income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires an asset and liability approach in determining income tax liabilities. The standard recognizes deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial reporting bases of assets and liabilities and their related tax bases. Deferred income tax assets and liabilities are measured using the tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred income tax assets and deferred tax liabilities that will reverse during the income tax holiday period are not recognized.

Effective January 1, 2007, the Partnership adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109. FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is more likely than not of being realized upon ultimate settlement.

The Company is not subject to income taxes as a result of the Company's incorporation in the Cayman Islands. However, the Philippine branch profit remittance tax of 15% will be levied against the total profit applied or earmarked for remittance by the Branch to the Company.

Functional Currency

The functional currency of the Company and the Partnership has been designated as the U.S. dollar because borrowings under the credit facilities are made and repaid in U.S. dollars. In addition, all major agreements are primarily denominated in U.S. dollars or are U.S. dollar linked. Consequently, the consolidated financial statements and transactions of the Company and the Partnership have been recorded in U.S. dollars.

Valuation of Long-lived Assets

Long-lived assets are accounted for in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*. The Partnership periodically evaluates its long-lived assets for events or changes in circumstances that might indicate that the carrying amount of the assets may not be recoverable. The Partnership assesses the recoverability of the assets by determining whether the amortization of such long-lived assets over their estimated lives can be recovered through projected undiscounted future cash flows. The amount of impairment, if

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

any, is measured based on the fair value of the assets. For the years ended December 31, 2007, 2006 and 2005, no such impairment was recorded in the accompanying consolidated statements of operations.

Asset Retirement Obligation

The Partnership accounts for asset retirement obligations in accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations*. The Partnership recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of fair value can be made. In estimating fair value, the Partnership did not use a market risk premium since a reliable estimate of the premium is not obtainable given that the retirement activities will be performed many years into the future and the Partnership has insufficient information on how much a third party contractor would charge to assume the risk that the actual costs will change in the future. The associated asset retirement costs are capitalized as part of the carrying amount of the Power plant. No payments of asset retirement obligation were made as of December 31, 2007 and 2006.

The following table describes all changes to the Partnership's asset retirement obligation liability as of December 31, 2007 and 2006:

| | 2007 | 2006 |
|--|---------------------|--------------|
| Asset retirement obligation at beginning of year | \$ 4,296,843 | \$ 4,053,639 |
| Accretion expense for the year | 240,200 | 243,204 |
| Asset retirement obligation at end of year | \$ 4,537,043 | \$ 4,296,843 |

Impact of Recently Issued Accounting Standards

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 No. 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 No. 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 gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS No. 159 is effective on January 1, 2008. The Company does not expect the adoption of SFAS No. 159 to have a material effect on its result of operations or financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, 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 No. 157 is effective on January 1, 2008. The Company does not expect the adoption of SFAS No. 157 to have a material effect on its result of operations or financial condition.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Property, Plant and Equipment**

| | 2007 | 2006 |
|--|-----------------------|----------------|
| Power plant | \$ 689,918,613 | \$ 689,622,879 |
| Transmission lines | 86,596,580 | 86,596,580 |
| Furniture and fixtures | 4,180,239 | 4,124,997 |
| Transportation equipment | 294,975 | 311,555 |
| Leasehold improvements | 189,553 | 189,543 |
| | 781,179,960 | 780,845,554 |
| Less accumulated depreciation and amortization | 138,521,216 | 121,770,076 |
| | \$ 642,658,744 | \$ 659,075,478 |

Approximately \$99.0 million of interest on borrowings and \$11.8 million of amortization of deferred financing costs have been capitalized as part of the cost of property, plant and equipment and depreciated over the estimated useful life of the Power plant.

No interest on borrowings and amortization of deferred financing costs were capitalized to property, plant and equipment in 2007, 2006 and 2005 since the Project started commercial operations on May 30, 2000.

Total depreciation and amortization related to property, plant and equipment charged to operations amounted to \$17.3 million, \$17.8 million and \$18.6 million in 2007, 2006 and 2005, respectively.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. Income Taxes**

The significant components of the Partnership's deferred income tax assets and liabilities at December 31, 2007 and 2006 are as follows:

| | 2007 | 2006 |
|---|---------------------|---------------|
| Current: | | |
| Deferred income tax assets: | | |
| Provision for probable losses | \$ 2,330,691 | \$ 858,678 |
| Unrealized foreign exchange losses | | 1,252,278 |
| Loss on retirement of property, plant and equipment | | 441,950 |
| Others | 233,155 | 180,777 |
| Current deferred income tax assets | 2,563,846 | 2,733,683 |
| Deferred income tax liability: | | |
| Unrealized foreign exchange gains | 2,305,363 | |
| Net current deferred income tax assets | \$ 258,483 | \$ 2,733,683 |
| Noncurrent: | | |
| Deferred income tax assets: | | |
| Unrealized foreign exchange losses | \$ 4,980,218 | \$ 21,005,149 |
| Asset retirement obligations | 562,631 | 490,023 |
| Noncurrent deferred income tax assets | 5,542,849 | 21,495,172 |
| Deferred income tax liability: | | |
| Excess of tax over book depreciation | 1,898,873 | 1,265,558 |
| Net noncurrent deferred income tax assets | \$ 3,643,976 | \$ 20,229,614 |

Deferred income tax provision is provided for the temporary differences in financial reporting of unrealized foreign exchange gains or losses, accretion and depreciation expenses related to asset retirement obligation, provision for probable losses, loss on retirement of property, plant and equipment and the excess of tax over book depreciation. Under accounting principles generally accepted in the U. S., the deferred financing costs were treated as a deferred asset and amortized, using the effective interest rate method, over the lives of the related loans. Prior to 2006, for Philippine income tax reporting purposes, deferred financing costs and foreign exchange losses are capitalized and depreciated as part of the cost of property, plant and equipment except for the depreciation of capitalized unrealized foreign exchange losses which is not deductible under the Philippine tax base.

The Partnership provided for a full valuation allowance on deferred income tax assets pertaining to capitalized unrealized foreign exchange losses beginning in 2004 in view of a then pending revenue regulation of the Philippine

Bureau of Internal Revenue (BIR) on the use of functional currency other than the Philippine peso which may result in the write-off of these amounts.

In May 2006, the BIR issued Revenue Regulation 6-2006 formally establishing its position on the use of Philippine peso as the currency for tax reporting purposes. Furthermore, in July 2006, the Partnership obtained a ruling from the BIR, effective January 1, 2006, allowing the Partnership to recognize retroactively foreign exchange losses as deductible expense when realized. With this change, the Partnership recognized a deferred income tax asset on the full tax consequence of the unrealized foreign exchange losses which amounted to \$22.3 million as of December 31, 2006 and reversed the valuation allowance on the deferred income tax asset on unrealized foreign exchange losses of \$3.9 million as of December 31, 2005.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In August 2006, the Partnership obtained from the BIR a ruling, effective January 1, 2006, allowing the Partnership to recognize retroactively the amortization of deferred financing costs using the effective interest rate method over the terms of the related loans to be consistent with the Partnership's accounting treatment. Consequently, the Partnership reversed the deferred income tax asset relating to the excess of accounting over tax amortization of deferred financing costs of about \$9.8 million as of December 31, 2005.

Income from nonregistered operations of the Partnership is not covered by its income tax holiday incentives. The current provision for income tax in 2005 pertains to income tax due on interest income from offshore bank deposits and certain other income. Starting May 30, 2006, the Partnership's income tax holiday incentives expired. Consequently, the registered operations became subject to the regular corporate income tax rate of 35%.

A reconciliation of the statutory income tax rates to the effective income tax rates as a percentage of income before income taxes is as follows:

| | 2007 | 2006 | 2005 |
|--|--------------|-------------|-------------|
| Statutory income tax rates | 35.0% | 35.0% | 32.5% |
| Tax effects of: | | | |
| The Company's operations | 4.0 | 6.3 | 5.5 |
| Change in tax rates | 0.5 | 3.0 | 1.0 |
| Change in valuation allowance | | (4.8) | 1.2 |
| Deferred income tax on foreign exchange gains and losses | 17.2 | (19.7) | (1.2) |
| Partnership's operations under income tax holiday and others | | (14.3) | (38.2) |
| Others | (3.3) | 1.2 | (0.6) |
| Effective tax rates | 53.4% | 6.7% | 0.2% |

Republic Act No. 9337

Republic Act (RA) No. 9337 was enacted into law amending various provisions in the existing 1997 National Internal Revenue Code of the Philippines (NIRCP). On October 18, 2005, the Supreme Court (SC) has rendered its final decision declaring the validity of the RA No. 9337. Among the reforms introduced by RA No. 9337, which became effective on November 1, 2005, are as follows:

Increase in the corporate income tax rate from 32% to 35% with a reduction thereof to 30% beginning January 1, 2009;

Grant of authority to the Philippine President to increase the 10% VAT rate to 12% effective January 1, 2006, subject to compliance with certain economic conditions;

Revised invoicing and reporting requirements for VAT;

Expanded scope of transactions subject to VAT;

Provision of thresholds and limitations on the amounts of VAT credits that can be claimed; and;

Increase in unallowable interest rate from 38% to 42% with a reduction thereof to 33% beginning January 1, 2009.

Due to the enactment of RA No. 9337, the effective statutory income tax rate as of December 31, 2006 is at 35%. The deferred income tax assets and liabilities were measured using the appropriate corporate income tax rate on the year it is expected to be reversed or settled.

On January 31, 2006, the BIR issued Revenue Memorandum Circular No. 7-2006 increasing the VAT rate from 10% to 12% effective February 1, 2006.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

RA No. 9361 was enacted into law effective December 13, 2006, amending Section 110B of the 1997 NIRC and abolishing the limitation on the amount of VAT credits that can be claimed.

The Partnership files income tax returns in the Philippine jurisdiction. Under current Philippine tax law, the BIR must perform a tax assessment within three (3) years from the last day prescribed by law for the filing of the tax return for the tax that is being subjected to assessment or from the day the return was filed if filed late. Any assessments issued after the applicable period are deemed to have prescribed, and can no longer be collected from a taxpayer. In 2005, the Partnership received a letter of authority to examine the 2003 income tax return.

The Partnership is no longer subject to income tax examinations by tax authorities for years before 2003. The BIR commenced an examination of Partnership's income tax returns for 2003 through 2005. As of December 31, 2007, the BIR has not challenged the Partnership's tax positions.

The Partnership's adoption of FIN 48 did not result in any adjustment to the opening balance of the accumulated earnings of the Partnership as of January 1, 2007 nor did it have any impact on the Partnership's financial statements for the year ended December 31, 2007. There are no uncertain tax positions both individually and in the aggregate, that if recognized, would materially affect the effective tax rate.

5. Notes Payable***(a) Credit Facility Agreement (CFA)***

The Partnership entered into a \$15.0 million Credit Facility Agreement (CFA) with Banco de Oro Universal Bank (BDO) dated May 11, 2005 for the general working capital requirements of the Partnership. The Partnership drew down on this facility in May 2005 and November 2005.

The Partnership has paid in full the \$3.3 million from the May 2005 drawdown and was able to extend the maturity of the November 2005 drawdown to September 12, 2007.

In November 2006, the Partnership amended its existing CFA with BDO to increase the total commitment of BDO under the credit facility to \$19.0 million under the same commercial terms as in the existing credit agreement. The Partnership availed the remaining balance of the total commitment on November 10, 2006.

In September 2007, the Partnership was able to extend the maturity of the November 2005 and 2006 drawdowns from September 12, 2007 to September 12, 2008.

The outstanding balances of these drawdowns are as follows:

| | Amount Outstanding | | Interest Rate | Term |
|------------------------|---------------------------|--------------|---|--------------------|
| | 2007 | 2006 | | |
| November 2005 drawdown | \$ 8,333,333 | \$ 8,333,333 | Floating rate subject to monthly or quarterly | September 12, 2008 |

| | | | | |
|---------------------------|----------------------|---------------|--|--------------------|
| November 2006 drawdown | 10,666,667 | 10,666,667 | repricing Floating rate subject to monthly or quarterly repricing | September 12, 2008 |
| | \$ 19,000,000 | \$ 19,000,000 | | |

(b) Notes Facility and Purchase Agreement (NFPA)

With the approval from the board of directors (BOD) and consent from the lenders, the Partnership entered into a \$100 million NFPA with Banco de Oro EPCI, Inc., Bank of Philippine Islands, China Banking Corporation, Rizal Commercial Banking Corporation, BDO Capital and Investment Corporation and Banco de Oro EPCI, Inc. Trust Banking Group on November 12, 2007. The net proceeds from the Notes will be used by the Partnership to fund its operational, business, financing and recapitalization requirements.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Notes have a seven-year term and is amortized in 12 semi-annual payments on May 15 and November 15 of each year, with the first payment date being May 15, 2009. The interest is payable semi-annually in arrears on the outstanding principal amount of notes on each interest payment date as defined in the NFPA at 7.70% per annum for the first five years and 8.25% per annum for the remaining years.

The Notes shall constitute direct, unconditional, unsubordinated (except with respect to the Senior Debt under the terms of the Intercreditor and Subordination Agreement) and unsecured obligations of the Partnership, ranking *pari passu* with all its other present and future direct, unconditional, unsubordinated and unsecured obligations (other than subordinated obligations, the Senior Debt and those preferred pursuant to mandatory provisions of Law). The Notes are subject to special and optional redemption by the Partnership in whole. Special redemption allows the Partnership to redeem the loan on November 15, 2012 by paying all sums then due and payable under the Notes, whether by way of interest, principal or penalty, including any applicable fees. Optional redemption allows the Partnership to redeem the loan at any repayment date after the second anniversary of the issue date except on November 15, 2012 by paying the sum of (a) all sums then due and payable under the Notes, whether by way of interest, principal or penalty, including any applicable fees; (b) all unpaid and undue principal then outstanding; and (c) make-whole premium.

Annual future payments for the next five years ending December 31 are as follows:

| | |
|----------------|------------|
| 2008 | \$ |
| 2009 | 6,250,000 |
| 2010 | 6,250,000 |
| 2011 | 6,250,000 |
| 2012 | 6,250,000 |
| and thereafter | 75,000,000 |

6. Debt Financing Agreements

The Partnership was financed through the collective arrangement of the Common Agreement, Eximbank-Supported Construction Credit Facility, Trust Agreement, Uninsured Alternative Credit Agreement, Indenture, Bank Notes, Bank Letters of Credit, Bonds, Interest Hedge Contracts, Eximbank Political Risk Guarantee, OPIC Political Risk Insurance Policy, Eximbank Term Loan Agreement, Intercreditor Agreement, Side Letter Agreements, Security Documents and Equity Documents.

The Common Agreement contains affirmative and negative covenants including, among other items, restrictions on the sale of assets, modifications to agreements, certain transactions with affiliates, incurrence of additional indebtedness, capital expenditures and distributions and collateralization of the Project's assets. The debt is collateralized by substantially all of the assets of the Partnership and a pledge of certain affiliated companies' shares of stock. The Partnership has complied with the provisions of the debt financing agreements, in all material respects, or has obtained a waiver for noncompliance from the lenders [see Notes 11(c) and (d)].

(a) Term Loan Agreement

The debt financing agreements contemplated that the outstanding principal amount of the Eximbank-Supported Construction Loans will be repaid on the Eximbank Conversion Date with the proceeds of a loan from Eximbank under the Eximbank Term Loan.

Under the Eximbank Term Loan Agreement, Eximbank was to provide for a \$442.1 million direct term loan, the proceeds of which could only be used to refinance the outstanding Eximbank-Supported Construction Credit Facility and to pay the Eximbank Construction Exposure Fee to Eximbank. This term loan, which would have had interest at a fixed rate of 7.10% per annum, would have had a 12-year term and would have been amortized in 24 approximately equal semi-annual payments during such term.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In April 2001, in lieu of the Eximbank Term Loan, the Partnership availed of the alternative refinancing of the Eximbank-Supported Construction Loans allowed under the Eximbank Option Agreement through an Export Credit Facility guaranteed by Eximbank and financed by Private Export Funding Corporation (PEFCO). Under the terms of the agreement, PEFCO established credit in an aggregate amount of \$424.7 million which bears interest at a fixed rate of 6.20% per annum and payable under the payment terms identical with the Eximbank Term Loan. Upon compliance with the conditions precedent as set forth in the Term Loan Agreement, the PEFCO Term Loan was drawn and the proceeds were applied to the Eximbank-Supported Construction Loans.

Amendments to the Omnibus Agreement were made to include, among other things, PEFCO as a party to the Agreement in the capacity of a lender.

Annual future amortization payments for the next five years ending December 31 are as follows:

| | |
|------|---------------|
| 2008 | \$ 35,389,726 |
| 2009 | 35,389,726 |
| 2010 | 35,389,726 |
| 2011 | 35,389,726 |
| 2012 | 35,389,725 |

(b) Uninsured Alternative Credit Agreement

The Uninsured Alternative Credit Agreement provides for the arrangement of Construction Loans, Refunding Loans and Cost Overrun Loans (collectively, the Uninsured Alternative Credit Facility Loans) as well as the issuance of the PPA Letter of Credit and the Coal Supply Letter of Credit.

In July 1997, the Partnership terminated commitments in excess of \$30 million in respect of the Construction Loans in connection with the issuance of the bonds. The Construction Loans will have a seven-year term and will be amortized in 14 semi-annual payments during such term commencing on January 15, 2001. Interest will accrue at a rate equal to LIBOR plus a margin of 2.75% to 3.25%.

As of December 31, 2006, approximately \$3.4 million were outstanding with respect to the Construction Loans. The \$3.4 million outstanding as of December 31, 2006 was paid in two equal semi-annual installments in 2007.

There were no outstanding balances at December 31, 2007 and 2006 for the Refunding Loans and Cost Overrun Loans.

(c) Trust and Retention Agreement

The Trust and Retention Agreement provides, among others, for (i) the establishment, maintenance and operation of one or more U.S. dollar and Philippine peso accounts into which power sales revenues and other project-related cash receipts of the Partnership will be deposited and from which all operating and maintenance disbursements, debt service payments and equity distributions will be made; and (ii) the sharing by the lenders on a pari passu basis of the benefit of certain security.

(d) Bonds Payable

Bonds payable represents the proceeds from the issuance of the \$215.0 million in aggregate principal amount of the Partnership's 8.86% Senior Secured Bonds Due 2017 (the Series 1997 Bonds). The interest rate is 8.86% per annum and is payable quarterly on March 15, June 15, September 15 and December 15 of each year (each, a Bond Payment Date), with the first Bond Payment Date being September 15, 1997. The principal amount of the Series 1997 Bonds is payable in quarterly installments on each Bond Payment Date occurring on or after September 15, 2001 with the Final Maturity Date on June 15, 2017. The proceeds of the Series 1997 Bonds

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were applied primarily by the Partnership to the payment of a portion of the development, construction and certain initial operating costs of the Project.

The Series 1997 Bonds are treated as senior secured obligations of the Partnership and rank pari passu in right of payment with all other credit facilities, as well as all other existing and future senior indebtedness of the Partnership (other than a working capital facility of up to \$15.0 million, subject to escalation), and senior in right of payment to all existing and future indebtedness of the Partnership that is designated as subordinate or junior in right of payment to the Series 1997 Bonds. The Series 1997 Bonds are subject to redemption by the Partnership in whole or in part, beginning five years from the date of issuance, at par plus a make-whole premium, calculated using a discount rate equal to the applicable U.S. Treasury rate plus 0.75%.

Annual future amortization payments for the next five years ending December 31 are as follows:

| | |
|----------------|---------------|
| 2008 | \$ 12,900,000 |
| 2009 | 12,900,000 |
| 2010 | 12,900,000 |
| 2011 | 12,900,000 |
| 2012 | 15,050,000 |
| and thereafter | 105,350,000 |

7. Related Party Transactions

Due to the nature of the ownership structure, the majority of the transactions were among the Company, the Partnership and the Partners, their affiliates or related entities.

The following approximate amounts were paid to affiliates of the Partners for the operation and maintenance and management of the Project under the agreements discussed in Note 9:

| | 2007 | 2006 | 2005 |
|----------|----------------------|---------------|---------------|
| Covanta | \$ 35,449,179 | \$ 26,854,303 | \$ 29,524,335 |
| InterGen | 2,289,678 | 1,794,111 | 1,599,178 |

As of December 31, 2007 and 2006, the net amounts due from (to) affiliated companies related to costs and expenses incurred and cash advanced by the Project were (\$273,295) and \$187,158, respectively.

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. Capital Stock**

| | 2007 | | 2006 | |
|----------------------------|---------------------|----------|---------------------|----------|
| | Number of Shares | Amount | Number of Shares | Amount |
| Class A, \$0.01 par value: | | | | |
| Authorized | 1,000,000 | | 1,000,000 | |
| Issued | 26,151 | \$ 262 | 26,151 | \$ 262 |
| Class B, \$0.01 par value: | | | | |
| Authorized | 1,000,000 | | 1,000,000 | |
| Issued | 2,002 | 20 | 2,002 | 20 |
| Class C, \$0.01 par value: | | | | |
| Authorized | 1,000,000 | | 1,000,000 | |
| Issued | 71,947 | 719 | 71,947 | 719 |
| Class D, \$0.01 par value: | | | | |
| Authorized | 10 | | 10 | |
| Issued | 10 | | 10 | |
| | | \$ 1,001 | | \$ 1,001 |

Class A and Class C shares have an aggregate 100% beneficial economic interest and 98% voting interest in the Company divided among the holders of the Class A and Class C shares. Class B shares have a 2% voting interest in the Company. On October 18, 2004, the shareholders of the Company entered into a Third Amended and Restated Development and Shareholders Agreement (D&S Agreement) to, among others, add GPI as party to the D&S Agreement as a shareholder and holder of newly issued Class D shares. Class D shares have no economic interest, no right to dividends and other distributions and no voting rights other than the power to appoint a director and an alternate director.

On February 15, 2008, the Partnership, with the approval from the BOD of QPI, declared and paid dividends amounting to \$40.7 million of which 98% or approximately \$39.9 million is attributable to the Company.

9. Commitments and Contingencies

The Partnership has entered into separate site lease, construction, energy sales, electric transmission, coal supply and transportation, operations and maintenance and project management agreements.

In connection with the construction and operation of the Project, the Partnership is obligated under the following key agreements:

(a) Offtake Agreements General Terms

PPA

The Partnership and Meralco are parties to the PPA (as amended on June 9, 1995 and December 1, 1996). The PPA provides for the sale of electricity from the Partnership's Generation Facility to Meralco. The term extends 25 years from the Commercial Operations Date, as defined in the PPA. As disclosed in Note 1(c), the Commercial Operations Date occurred on May 30, 2000.

The PPA provides that commencing on the Commercial Operations Date, the Partnership is required to deliver to Meralco, and Meralco is required to take and pay for, in each year a minimum guaranteed electrical quantity (MGEQ) of kWhs of net electrical output (NEO). The Partnership's delivery obligations are measured monthly and annually.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Meralco is obligated to pay to the Partnership each month a monthly payment consisting of the following: (i) a Monthly Capacity Payment, (ii) a fixed Monthly Operating Payment, (iii) a variable Monthly Operating Payment and (iv) a Monthly Energy Payment. Under the PPA and related foreign exchange protocols between the parties, Meralco may pay the dollar denominated components of the Monthly Capacity Payment, the Monthly Energy Payment and the Monthly Operating Payment in U.S. dollars or in Philippine pesos based on prevailing exchange rates at the time of payment.

Under the PPA, the Partnership has provided Meralco with a letter of credit in the amount of \$6.5 million to secure its obligations under the PPA.

TLA

Under the TLA dated as of June 13, 1996 (as amended on December 1, 1996) between the Partnership and Meralco, the Partnership accepted responsibility for obtaining all necessary rights-of-way for, and the siting, design, construction, operation and maintenance of the Transmission Line. The term of the TLA will extend for the duration of the term of the PPA, commencing on the date of execution of the TLA and expiring on the 25th anniversary of the Commercial Operations Date. Under the TLA, Meralco is obligated to make a monthly CCRP and a Monthly Operating Payment to the Partnership.

b) Offtake Agreements Re-Negotiation and CCRP History

Initial PPA Discussions

During the initial operating period (May 2000 through October 2001), the Plant did not provide the required NEO to Meralco. Under the terms of the PPA, Meralco was entitled to specified shortfall payments for each kWh of shortfall which would have reimbursed Meralco for a portion of the Monthly Capacity Payment and Monthly Fixed Operating Payment.

In mid-2001, Meralco requested that the Partnership renegotiate certain terms of the PPA. In addition, Meralco withheld payments of approximately \$10.8 million (\$2.3 million of which was otherwise payable to Meralco as shortfall penalties in accordance with the PPA). A provision had already been recognized for the \$8.5 million Meralco withheld amount for which there were no offsetting shortfall penalties payable. The nature of the proposed changes, agreements in principle and agreements that were executed but never became effective has evolved since 2001.

In 2002, the parties agreed in principle to the following changes to the PPA (which did not become effective):

The parties would increase the amount of shortfall payments to be equal to the per kWh full Capacity Payment and the Fixed Operating Payment, thereby placing availability risk with the Partnership.

The Partnership would provide Meralco a \$40.1 million rebate payable over 6 years.

Meralco would pay the Monthly Capacity Payment, the Monthly Fixed Operating Payment and the Monthly Variable Operating Payment based on the availability of the Plant.

Meralco would reimburse the Partnership for extra fuel costs due to low dispatch of the Plant.

As consideration for full settlement, the Partnership would pay the \$8.5 million withheld amount to Meralco.

Transmission Line Capital Cost Disallowance and Partial CCRP Deferral

In 2003, the ERC issued a preliminary order dated March 20, 2003 disallowing a portion of the capital cost associated with the construction of the transmission line. While confirming that the Partnership would be entitled to payment by Meralco of the full CCRP despite the ERC order, Meralco requested and the Partnership agreed to the deferral of a portion of the CCRP on a temporary basis and subject to resolution of all outstanding issues.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In 2004, the ERC issued its final order dated September 20, 2004 disallowing approximately 30% of the capital cost associated with the construction of the transmission line. That order allowed Meralco to recover \$60.7 million of transmission line costs out of the total \$88.8 million actual costs incurred by the Partnership and disallowed \$28.1 million of the total composed mainly of schedule extension costs. The impact of that decision on Meralco was to reduce the annual CCRP that may be recovered by Meralco from its customers from \$13.2 million to \$9.0 million. The monthly impact amounted to approximately \$350,000 per month.

At approximately the same time, the Partnership reduced the temporary CCRP deferral amount. Meralco also paid excess past deferrals to the Partnership.

In 2004, based on the aforementioned ERC orders, Meralco requested a reduction of the CCRP from March 26, 2003 through its remaining term in lieu of the \$40.1 million six-year PPA rebate.

In 2005, Meralco again requested the Partnership to consider possible alternatives to evolving amendments to the PPA and the TLA. This prompted a reevaluation by the Partnership of the provisions to be recognized as a result of the renegotiations of the PPA and the TLA. As a result of this reevaluation, the Partnership recognized a contingency to reflect management's best estimate of the probable loss from the reasonably expected CCRP reduction amendment to the TLA. This estimate assumed that a full resolution with Meralco can be agreed and that the required approvals will be received.

The total CCRP deferred for collection amounted to \$20.3 million and \$16.1 million as of December 31, 2007 and 2006, respectively.

PPA and TLA Settlement

On February 21, 2008 (the Amendment Date), the parties signed the following key agreements to resolve outstanding issues on the PPA-related terms that have remained unresolved since 2001 and the Transmission line capital cost disallowance and partial CCRP deferral:

Amendment No. 2 to the TLA

This TLA Amendment reduces the CCRP by approximately 30% from the Amendment Date and retroactively reduced each CCRP from March 27, 2003 through the Amendment Date by approximately \$350,000.

A side letter agreement to the PPA relating to excess generation arrangements

This side letter agreement sets out an arrangement that allows Meralco to dispatch the Plant and increase the Partnership's near-term revenues based on sales of excess generation output at the discounted per kWh tariff for such generation. Meralco agreed to a base generation and a Target Excess Generation (TEG) of the Plant during each December 26 to December 25 Annual Period ending 2008 to 2017 (each, a Guarantee Year).

The TEG is equal to 74,000,000 kWh per annum. Meralco will pay for each kWh of excess generation during the Guarantee Years in accordance with the existing terms of the PPA relating to excess generation. If the TEG is not reached in a Guarantee Year, Meralco will pay the Partnership an amount (an Advance Payment) reflecting the

difference in the TEG and Actual Excess Generation (AEG) based on the following formula:

$$\text{Advance Payment} = \$2,850,000 \quad [\$2,850,000 \times (\text{AEG} / \text{TEG})]$$

Where AEG is greater than the TEG, Meralco will be entitled to bank each such excess kWh for use in calculating AEG in a subsequent Guarantee Year. The Excess Generation Side Letter does not alter Meralco's obligation to pay for each kWh it actually receives at either the base tariff rate or the excess generation tariff rate. The terms of the side letter relating to excess generation apply irrespective of actual performance of the Plant.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the Annual Periods ending 2018 to 2025, the Partnership will be obligated to repay the aggregate Advance Payments to Meralco in eight approximately equal annual installments without interest. The Partnership will not be obligated to repay any amounts that constituted payments for actual deliveries of power by it to Meralco.

A side letter agreement to the PPA relating to collection by the Partnership of approximately \$8.5 million.

Under this side letter, Meralco agrees to pay to the Partnership \$8.5 million, in five approximately equal monthly installments, without interest and penalties. This amount represents the aggregate amount withheld during 2001, net of shortfall payments payable by the Partnership. The first installment will be paid on the tenth (10th) day of the calendar month which begins after the Amendment Date.

The financial effects of the above key agreements are recognized in the consolidated financial statements as of December 31, 2007. The financial effects include the following: (i.) reversal of the accounts receivable amounting to \$20.3 million, representing the total CCRP deferred for collection, against the related contingency account, and this, in effect did not impact the 2007 results of operations, and (ii.) recognition of the \$8.5 million receivable, representing the aggregate amount withheld during 2001, which resulted to an upside effect of \$8.5 million in the 2007 results of operations. The upside effect is presented as part of the General and administrative expense account in the statement of operations.

c) Coal Supply Agreements

In order to ensure that there is an adequate supply of coal to operate the Generation Facility, the Partnership has entered into two coal supply agreements (CSA) with the intent to purchase approximately 70% of its coal requirements from PT Adaro Indonesia (Adaro) and the remainder of its coal requirements from PT Kaltim Prima Coal (Kaltim Prima, and together with Adaro, the Coal Suppliers). The agreement with Adaro (the Adaro CSA) will continue to be in effect until October 1, 2022. If the term of the Coal Cooperation Agreement between Adaro and the Ministry of Mines and Energy of the Government of the Republic of Indonesia is extended beyond October 1, 2022, the Partnership may elect to extend the Adaro CSA until the earlier of the expiration of the PPA or the expiration of the extended Coal Cooperation Agreement, subject to certain conditions. The agreement with Kaltim Prima (the Kaltim Prima CSA) has a scheduled termination date 15 years after the Commercial Operations Date.

The Partnership may renew the Kaltim Prima CSA for two additional five-year periods by giving not less than one year prior written notice. The second renewal period will be subject to the parties agreeing to the total base price to be applied during that period.

The Partnership is subject to minimum take obligations of 900,000 Metric Tonnes (MT) for Adaro and 360,000 MT for Kaltim Prima.

In 2003, the Partnership and its Coal Suppliers started discussions on the use of an alternative to the Australian-Japanese benchmark price, which is the basis for adjusting the energy-base price under the Partnership's CSA. On November 18, 2004, the Adaro CSA was amended to reflect the change in the benchmark price. Both parties agreed to use the six-month rolling average of the ACR Asia Index with a certain discount as the new benchmark price applied retroactively to April 1, 2003.

With respect to Kaltim Prima, the Project and Kaltim Prima finalized in March 2006 the price adjustment for coal shipments during the period April 2005 up to March 2006 which was consistent with the amounts already provided for in 2005. The Partnership and Kaltim Prima agreed to continue to use the Australian-Japanese benchmark price.

d) Operations and Maintenance Agreement

The Partnership and Covanta Philippines Operating, Inc. (the Operator; formerly Ogden Philippines Operating, Inc.), a Cayman Islands corporation and a wholly owned subsidiary of Covanta Projects, Inc. (CPI; formerly Ogden Projects, Inc.), a subsidiary of CEGI, have entered into the Plant Operation and Maintenance

Table of Contents**QUEZON POWER, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Agreement dated December 1, 1995 (as amended on February 29, 1996, December 10, 1996 and October 18, 2004, the O&M Agreement) under which the Operator assumed responsibility for the operation and maintenance of the Project pursuant to a cost-reimbursable contract. CPI, pursuant to an O&M Agreement Guarantee, guarantees the obligations of the Operator. The initial term of the O&M Agreement extends 25 years from the Commercial Operations Date. Two automatic renewals for successive five year periods are available to the Operator, provided that (i) the PPA has been extended; (ii) no default by the Operator exists; and (iii) the O&M Agreement has not been previously terminated by either party. The Partnership is obligated to compensate the Operator for services under the O&M Agreement, to reimburse the Operator for all reimbursable costs one month in advance of the incurrence of such costs and to pay the Operator a base fee and certain bonuses. In certain circumstances, the Operator could be required to pay liquidated damages depending on the operating performance of the Project, subject to contractual limitations. Beginning on Provisional Acceptance, as defined in the O&M Agreement, the Partnership is obligated to pay the Operator a monthly fee of \$160,000, subject to escalation.

The Operator may earn additional fees or reduced fees based on defined results with respect to output or reduced operating costs. The 2004 amendments to the O&M Agreement brought several changes including changes in the terms concerning material breach of the O&M Agreement; introduction of surviving service fees to the Operator in case the agreement is pre-terminated; changes in the methodology of computing additions or reduction in fees when NEO is greater or less than the MGEQ of each contract year; and introduction of banked hours that can be applied to future reductions in fees or exchanged for cash subject to a five (5) year expiration period. The adjustments in Operator's fee, including the cash value of all banked hours accrued during a contract year, shall not exceed \$1.0 million, adjusted pursuant to an escalation index. These amendments in the O&M Agreement were effective beginning December 26, 2003.

e) Management Services Agreement

The Partnership has entered into the Project Management Services Agreement, dated as of September 20, 1996 (as amended, the Management Services Agreement), with InterGen Management Services (Philippines), Ltd. (as assignee of International Generating Company, Inc.), an affiliate of InterGen N.V., (the Manager), pursuant to which, the Manager is providing management services for the Project. Pursuant to the Management Services Agreement, the Manager nominates a person to act as a General Manager of the Partnership, and, acting on behalf of the Partnership, to be responsible for the day-to-day management of the Project. The initial term of the Management Services Agreement extends for a period ending 25 years after the Commercial Operations Date, unless terminated earlier, with provisions for extension upon mutually acceptable terms and conditions. InterGen N.V., pursuant to a Project Management Services Agreement Guarantee dated December 10, 1996, guarantees the obligations of the Manager.

The Partnership is obligated to pay the Manager an annual fee equal to \$400,000 subject to escalation after the first year relative to an agreed-upon index payable in 12 equal monthly installments.

Similar to the O&M Agreement, amendments to the Management Services Agreement were made in 2004. Significant changes to the Management Services Agreement include, among others, amendments to the duties of the Manager, General Manager, rights of the Partnership, acting through the BOD of QPI, to audit the Manager's procedures and past practices, changes in termination provisions and the introduction of a Surviving Management Fee in case the agreement is pre-terminated. The amendments to the Management Services Agreement also have a retroactive effect beginning December 26, 2003.

f) Project Site Lease, Transmission Line Site Lease and Foreshore Lease Agreements

Due to Philippine legal requirements that limit the ownership interests in real properties and foreshore piers and utilities to Philippine nationals and in order to facilitate the exercise by Meralco of its power of condemnation should it be obligated to exercise such powers on the Partnership's behalf, Meralco owns the Project Site and leases the Project Site to the Partnership. Meralco has also agreed in the Foreshore Lease Agreement dated January 1,

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1997, as amended, to lease from the Philippine government the foreshore property on which the Project piers were constructed, to apply for and maintain in effect the permits necessary for the construction and operation of the Project piers and to accept ownership of the piers.

The Company has obtained rights-of-way for the Transmission Line for a majority of the sites necessary to build, operate and maintain the Transmission Line. Meralco has agreed, pursuant to a letter agreement dated December 19, 1996, that notwithstanding the provisions of the TLA that anticipates that Meralco would be the lessor of the entire Transmission Line Site, Meralco will only be the Transmission Line Site Lessor with respect to rights-of-way acquired through the exercise of its condemnation powers.

The Company, as lessor, and the Partnership, as lessee, have entered into the Transmission Line Site Leases, dated December 20, 1996, with respect to real property required for the construction, operation and maintenance of the Transmission line other than rights-of-way to be acquired through the exercise of Meralco's condemnation powers. The initial term of each of the Project Site Leases and each of the Transmission Line Site Leases (collectively, the Site Leases) extends for the duration of the PPA, commencing on the date of execution of such Site Leases and expiring 25 years following the Commercial Operations Date. The Partnership has the right to extend the term of any Site Lease for consecutive periods of five years each, provided that the extended term of such Site Lease may not exceed 50 years in the aggregate.

g) Community Memorandum of Agreement

The Partnership has entered into a Community Memorandum of Agreement (MOA) with the Province of Quezon, the Municipality of Mauban, the Barangay of Cagsiay and the Department of Environmental and Natural Resources (DENR) of the Philippines. Under the MOA, the Partnership is obligated to consult with local officials and residents of the Municipality and Barangay and other affected parties about Project related matters and to provide for relocation and compensation of affected families, employment and community assistance funds. The funds include an electrification fund, development and livelihood fund and reforestation, watershed, management health and/or environmental enhancement fund. Total estimated amount to be contributed by the Partnership over the 25-year life and during the construction period is approximately \$16.0 million. In accordance with the MOA, a certain portion of this amount will be in the form of advance financial assistance to be given during the construction period.

In addition, the Partnership is obligated to design, construct, maintain and decommission the Project in accordance with existing rules and regulations. The Partnership deposited the amount of 5.0 million (about \$94,000) to an Environmental Guarantee Fund for rehabilitation of areas affected by damage in the environment, monitoring compensation for parties affected and education activities.

10. Fair Value of Financial Instruments

The required disclosures under SFAS No. 107, *Disclosure about Fair Value of Financial Instruments*, follow:

The financial instruments recorded in the consolidated balance sheets include cash, accounts receivable, due from (to) affiliated companies, notes payable, accounts payable and accrued expenses, loans payable and bonds payable. Because of their short-term maturities, the carrying amounts of cash, accounts receivable, due from (to) affiliated companies, notes payable and accounts payable and accrued expenses approximate their fair values.

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The fair value of long-term debt was based on the following:

| Debt Type | Fair Value Assumptions |
|--------------------|---|
| Term loan and NFPA | Estimated fair value is based on the discounted value of future cash flows using the applicable risk free rates for similar types of loans adjusted for credit risk. |
| Bonds payable | Estimated fair value is based on the discounted value of future cash flows using the latest available yield percentage of the Partnership's bonds prior to balance sheet dates. |

Following is a summary of the estimated fair value (in millions) as of December 31, 2007 and 2006 of the Partnership's financial instruments other than those whose carrying amounts approximate their fair values:

| | 2007 | | 2006 | |
|---------------|------------------------|--------------------|------------------------|--------------------|
| | Carrying Values | Fair Values | Carrying Values | Fair Values |
| Term loan | \$ 176.9 | \$ 168.4 | \$ 212.3 | \$ 204.2 |
| Bonds payable | 172.0 | 172.9 | 182.8 | 192.6 |
| NFPA | 100.0 | 93.9 | | |

11. Other Matters**(a) Electric Power Industry Reform Act (EPIRA)**

RA No. 9136, the EPIRA, and the covering Implementing Rules and Regulations (IRR) provides for significant changes in the power sector, which include among others:

- (i) The unbundling of the generation, transmission, distribution and supply and other disposable assets of a company, including its contracts with independent power producers and electricity rates;
- (ii) Creation of a Wholesale Electricity Spot Market; and
- (iii) Open and non-discriminatory access to transmission and distribution systems.

The law also requires public listing of not less than 15% of common shares of generation and distribution companies within 5 years from the effective date of the EPIRA. It provides cross ownership restrictions between transmission and generation companies and between transmission and distribution companies and a cap of 50% of its demand that a distribution utility is allowed to source from an associated company engaged in generation except for contracts entered into prior to the effective date of the EPIRA. In 2005, the Partnership has requested for clarification from the ERC on the applicability of the public offering requirement under the provisions of the EPIRA since it is in the form

of a limited partnership and not a stock corporation. As of February 22, 2008, the Partnership has not yet received any confirmation from ERC on this matter.

There are also certain sections of the EPIRA, specifically relating to generation companies, which provide for:

(i) a cap on the concentration of ownership to only 30% of the installed capacity of the grid and/or 25% of the national installed generating capacity; and

(ii) VAT zero-rating of sale of generated power.

Starting November 1, 2005, by virtue of RA No. 9337, sale of generated power was subject to VAT (see Note 4).

The Partnership is complying with the applicable provisions of the EPIRA and its law.

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QUEZON POWER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Concluded)

(b) Clean Air Act

The Clean Air Act and the related IRR contain provisions that have an impact on the industry as a whole, and to the Partnership in particular, that need to be complied with within 44 months from the effective date or by July 2004. Based on the assessment made on the Partnership's existing facilities, the Partnership believes it complies with the provisions of the Clean Air Act and the related IRR.

(c) Insurance Coverage Waiver

The Partnership was able to improve insurance coverage for the April 2007 to November 2008 insurance coverage period. However, the insurance coverage amounts required by the lenders under the debt financing agreements still have not been met due to market unavailability on commercially reasonable terms, based on determinations of the Partnership's insurance advisor and the lenders' insurance advisor. Consequently, the Partnership requested, and was granted by the requisite lender representatives, a waiver of certain insurance requirements. This waiver is effective until November 30, 2008.

On January 22, 2008, the Partnership revised the Industrial All Risk Insurance Coverage obtained in June 2007. The revision provided for the extension of the period of insurance from November 30, 2008 to June 1, 2009. The revised insurance contract is effective December 1, 2007. The Partnership is in the process of obtaining a corresponding extension of the waiver from November 30, 2008 to June 1, 2009 to match the insurance coverage period.

(d) PPA Default Waiver

In 2002, the Partnership successfully obtained consent from the requisite percentage of senior lenders to waive on an interim basis the non-payment by Meralco of the \$8.5 million receivable [see Note 9(b)]. This interim waiver by the Partnership had the effect of temporarily abating the effect of Meralco's non-payment. All conditions to the lenders' consent for the interim waiver have been fulfilled or removed.

In 2005, the Partnership elected to, in accordance with the project financing agreements, write-off the \$8.5 million withheld amount as an adjustment to receivables in the ordinary course of business.

On February 21, 2008, the Partnership and Meralco agreed for the reinstatement of the \$8.5 million receivable as part of the settlement of the PPA and TLA negotiation. This is covered by a side letter agreement to the PPA [see Note 9(b)].

(e) Environmental Compliance Certificate (ECC) on Quezon Power Plant 500 MW Coal-Fired Expansion Project

On June 4, 2007, the DENR issued an ECC to the Partnership. The ECC covers the proposed Quezon Power Plant 500 MW (Maximum Gross) Coal-Fired Expansion Project to be located within the existing 110 hectare facility of the Partnership in Barangay Cagsiay I, Mauban, Quezon. The proposed expansion includes the construction of cooling water intake, outfall structures and smokestack, extension of the existing conveyor system, and installation of an additional boiler, demineralization plant, turbine unit and other support facilities.