

DANIELSON HOLDING CORP

Form 10-K/A

April 22, 2005

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

**Form 10-K/A
Amendment No. 2**

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

For the fiscal year ended December 31, 2004

or

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

For the transition period from to

**Commission file number 6732
DANIELSON HOLDING CORPORATION
(Exact name of registrant as specified in its charter)**

Delaware
*(State or Other Jurisdiction
of Incorporation or Organization)*

95-6021257
*(I.R.S. Employee
Identification No.)*

40 Lane Road, Fairfield, N.J.
(Address of Principal Executive Offices)

07004
(Zip Code)

**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	American Stock Exchange

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

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

Indicate by check mark 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 amendments to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined by Exchange Act Rule 12b-2). Yes No

State the aggregate market value of the voting and non-voting common equity held by nonaffiliates of the registrant computed by reference to the price at which the common equity was last sold, or the average bid and asked prices of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$284,458,822

Outstanding Stock (all classes)

Class	March 9, 2005
Common Stock, \$0.10 par value	73,214,836 shares

**Documents Incorporated By Reference:
None.**

EXPLANATORY NOTE

Danielson Holding Corporation (Danielson) is filing this Amendment No. 2 to its annual report on Form 10-K for the fiscal year ended December 31, 2004 (this Amendment No. 2) to amend its disclosures in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations under the sub-headings Executive Summary, Covanta's Capital Resources and Commitments and Material Weakness in Internal Controls and Procedures and Item 9A Controls and Procedures of its annual report on Form 10-K filed on March 16, 2005, as amended by Amendment No. 1 filed on Form 10-K/A on March 21, 2005 (Amendment No. 1), as well as to provide an amended report of its independent auditors, Sycip Gorres Velayo & Co., of its subsidiary Quezon Power, Inc. The purpose of this Amendment No. 2 is to provide (1) an expanded contractual obligations tabular presentation on page 78, (2) an expanded disclosure of management's conclusions regarding Danielson's disclosure controls and procedures and changes that had been made in Danielson's internal controls over financial reporting, and (3) a revised report of its independent auditors, Sycip Gorres Velayo & Co., which has been revised solely for the purpose of referring to standards of the Public Company Oversight Board (United States) in lieu of the previous reference to auditing standards generally accepted in the United States. The other items of the Annual Report as amended by Amendment No. 1 have not been changed by this Amendment No. 2. The complete text of the items amended is included in this Amendment No. 2 pursuant to Rule 12b-15 promulgated under the Securities Exchange Act of 1934. As a result, this Amendment amends and restates in its entirety only Part II, Items 7 and 9A of the Annual Report and Exhibit 23.2. Reference to Annual Report and Form 10-K in this Amendment No. 2 refer to our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, as amended by both Amendment No. 1 and Amendment No. 2.

Except as otherwise expressly stated for the portions of the items amended in this Amendment No 2, this Amendment No. 2 continues to speak as of the date of the original Annual Report and Danielson has not updated the disclosure contained herein to reflect events that have occurred since the filing of the original Annual Report. Accordingly, this Form 10-K/A should be read in conjunction with Danielson's other filings made with the Securities and Exchange Commission subsequent to the filing of the original Annual Report, including any amendments to those filings.

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PART I

Item 1. BUSINESS

INTRODUCTION

Danielson Holding Corporation (Danielson) is a holding company incorporated in Delaware on April 16, 1992. Prior to entering the energy business through its acquisition of Covanta Energy Corporation (Covanta) in March 2004, substantially all of its operations were conducted in the insurance services industry. Danielson engages in insurance operations through its indirect subsidiaries, National American Insurance Company of California (NAICC) and related entities. Throughout 2004, Danielson also held an equity interest in companies engaged in the marine transportation and services industry through its investment in American Commercial Lines, LLC (ACL) and related entities.

Prior to its acquisition of Covanta, Danielson s strategy has been to grow by making strategic acquisitions. As part of this corporate strategy Danielson has sought acquisition opportunities, such as the acquisition of Covanta, which management believes will enable us to earn an attractive return on our investment.

As a result of the consummation of the Covanta acquisition on March 10, 2004, Danielson s future performance will predominantly reflect the performance of Covanta s operations which are significantly larger than Danielson s other operations. As a result, the nature of Danielson s business, the risks attendant to such business and the trends that it will face will be significantly altered by the acquisition of Covanta. Accordingly, Danielson s prior financial results will not be comparable to future results.

Danielson acquired its 100% ownership interest in ACL in May 2002. On January 31, 2003, ACL and many of its subsidiaries and its immediate direct parent entity, American Commercial Lines Holdings, LLC (ACL Holdings), filed a petition with the U.S. Bankruptcy Court to reorganize under Chapter 11 of the U.S. Bankruptcy Code. ACL Holdings and ACL confirmed a plan of reorganization on December 30, 2004, and emerged from bankruptcy on January 11, 2005. As a result, Danielson s equity interest in ACL was cancelled, and as a part of ACL s plan of reorganization it received in January 2005 warrants to purchase 3% of ACL s new common stock from certain creditors of ACL.

During 2004, Danielson owned a direct 5.4% interest in Global Materials Services, LLC (GMS) and a direct 50% interest in Vessel Leasing, LLC (Vessel Leasing). GMS was a joint venture among ACL, Danielson, and a third party, which owned and operated marine terminals and warehouse operations. Vessel Leasing was a joint venture between ACL and Danielson which leases barges to ACL s barge transportation operations. Neither GMS nor Vessel Leasing filed for Chapter 11 protection. Danielson, GMS and Vessel Leasing were not guarantors of ACL s debt nor were they liable for any of ACL s liabilities. On October 6, 2004, Danielson and ACL sold its interests in GMS to the third party joint venture member and on January 13, 2005, Danielson sold its interest in Vessel Leasing to ACL.

As a result of the ACL bankruptcy filing, while Danielson continued to exercise influence over the operating and financial policies of ACL, it no longer maintained control of ACL. Accordingly, beginning with the year ended December 31, 2003, Danielson accounted for its investments in ACL, GMS and Vessel Leasing using the equity method of accounting. Under the equity method of accounting, Danielson reported its share of the equity investees income or loss based on its ownership interest. In determining the proper equity method earnings to be recognized for ACL, Danielson did not recognize losses in excess of its investment s carrying value of zero at December 31, 2003, as Danielson was not liable either directly or as guarantor for such losses.

Danielson had cash and investments, including investments in subsidiaries, at the holding company level of \$117.3 million at December 31, 2004. Danielson s cash amounted to \$12.9 million. Danielson s investments consisted of publicly traded bonds of \$3.3 million. Danielson had a \$81.8 million investment in Covanta. Danielson also had a \$16.8 million investment in insurance subsidiaries and a \$2.5 million investment in Vessel Leasing. Danielson had liabilities at the holding company level of \$5.2 million.

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Danielson estimates as of the end of 2004, that it had aggregate consolidated net operating loss tax carryforwards for federal income tax purposes (NOLs) of approximately \$516 million. See Note 25 of the Notes to Consolidated Financial Statements (hereinafter referred to as Notes to Consolidated Financial Statements) for more detailed information on Danielson's NOLs.

Acquisition of Covanta Energy Corporation

On December 2, 2003, Danielson executed a definitive investment and purchase agreement to acquire Covanta in connection with Covanta's emergence from Chapter 11 proceedings after the non-core and geothermal assets of Covanta were divested. The primary components of the transaction were: (1) the purchase by Danielson of 100% of the equity of Covanta in consideration for a cash purchase price of approximately \$30 million, and (2) agreement as to new letter of credit and revolving credit facilities for Covanta's domestic and international operations, provided by some of the existing Covanta lenders and a group of additional lenders organized by Danielson.

This agreement was amended on February 23, 2004 which reduced the purchase price and released from an escrow account \$0.2 million to purchase Danielson's equity interest in Covanta Lake, Inc. A limited liability company was formed by Danielson and one of Covanta's subsidiaries and this limited liability company acquired an equity interest in Covanta Lake II, Inc., an indirect subsidiary of Covanta, in a transaction separate and distinct from the acquisition of Covanta out of bankruptcy.

As required by the investment and purchase agreement, Covanta filed a proposed plan of reorganization, a proposed plan of liquidation for specified non-core businesses, and the related draft disclosure statement, each reflecting the transactions contemplated under the investment and purchase agreement, with the Bankruptcy Court. On March 5, 2004, the Bankruptcy Court confirmed the Reorganization Plan (as hereafter defined and more fully discussed under Description of Danielson's Business Energy Services Business. On March 10, 2004, Danielson acquired 100% of Covanta's equity in consideration for approximately \$30 million.

With the purchase of Covanta, Danielson acquired a leading provider of waste-to-energy services and independent power production in the United States and abroad. Danielson's equity investment and ownership provided Covanta's businesses with improved liquidity and capital resources to finance its business activities and emerge from bankruptcy.

The aggregate purchase price was \$47.5 million which included the cash purchase price of \$29.8 million, approximately \$6.4 million for professional fees and other estimated costs incurred in connection with the acquisition, and an estimated fair value of \$11.3 million for Danielson's commitment to sell up to 3 million shares of its common stock at \$1.53 per share to certain creditors of Covanta, subject to certain limitations.

Financing the Covanta Acquisition

Danielson obtained the financing necessary for the Covanta acquisition pursuant to a note purchase agreement dated December 2, 2003, with each of SZ Investments, LLC (SZ Investments), Third Avenue Trust, LLC on behalf of Third Avenue Value Fund Series (collectively, TAVF) and D.E. Shaw Laminar Portfolios, LLC (Laminar), referred to collectively as the Bridge Lenders . Pursuant to the note purchase agreement, the Bridge Lenders severally provided Danielson with an aggregate of \$40 million of bridge financing in exchange for notes which were convertible under certain circumstances into shares of Danielson common stock at a price of \$1.53 per share, subject to agreed upon limitations. Danielson used \$30 million of the proceeds from the notes to post an escrow deposit prior to the closing of the transactions contemplated by the investment and purchase agreement with Covanta. At closing, the deposit was used to purchase Covanta. The remainder of the proceeds was made available to pay transaction expenses and for general corporate purposes. These notes were repaid on June 11, 2004 from the conversion of a portion of the notes held by Laminar and from the issuance of 8.75 million shares of Danielson Common Stock to Laminar upon such conversion and from the proceeds of a pro rata rights offering made to all stockholders on May 18, 2004.

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Danielson issued to the Bridge Lenders an aggregate of 5,120,853 shares of Danielson's common stock in consideration for the \$40 million of bridge financing. At the time that Danielson entered into the note purchase agreement, agreed to issue the notes convertible into shares of Danielson common stock and issued the equity compensation to the Bridge Lenders, the trading price of the Danielson common stock was below the \$1.53 per share conversion price of the notes. On December 1, 2003, the day prior to the announcement of the Covanta acquisition, the closing price of Danielson common stock on the American Stock Exchange was \$1.40 per share.

In addition, under the note purchase agreement, Laminar agreed to convert an amount of notes to acquire up to an additional 8.75 million shares of Danielson common stock at \$1.53 per share based upon the levels of public participation in the May 18, 2004 rights offering. Based upon the public participation in the rights offering, Danielson issued the maximum of 8.75 million shares to Laminar pursuant to the conversion of approximately \$13.4 million in principal amount of notes. Consequently, the \$20 million principal amount of notes held by Laminar plus accrued but unpaid interest was repaid in full on June 11, 2004 through the issuance of 8.75 million shares of Danielson common stock to Laminar and \$7.9 million of the proceeds from the rights offering.

Danielson has agreed to commence an offering of shares to a class of creditors of Covanta that are entitled to participate in an offering of up to 3.0 million shares of Danielson common stock at a price of \$1.53 per share pursuant to the Covanta Reorganization Plan. Danielson has filed a registration statement with the Securities and Exchange Commission (the SEC) to register the offering, which registration statement has not yet been declared effective by the SEC.

As part of Danielson's negotiations with Laminar and its becoming a five percent stockholder, pursuant to a letter agreement dated December 2, 2003, Laminar has agreed to additional restrictions on the transferability of the shares of Danielson common stock that Laminar holds or will acquire. Further, in accordance with the transfer restrictions contained in Article Fifth of Danielson's charter restricting the resale of Danielson common stock by five percent stockholders, Danielson has agreed with Laminar to provide it with limited rights to resell the Danielson common stock that it holds. Finally, pursuant to its agreement with the Bridge Lenders on July 28, 2004, Danielson has filed a registration statement with the SEC to register the shares of Danielson common stock issued to or acquired by them under the note purchase agreement. The registration statement was declared effective on August 24, 2004.

Samuel Zell, Danielson's former Chief Executive Officer and Chairman of the Board of Directors, and William Pate, current Chairman of Danielson, are affiliated with SZ Investments. David Barse, a Director of Danielson, is affiliated with Third Avenue. The note purchase agreement and other transactions involving the Bridge Lenders were negotiated, reviewed and approved by a special committee of Danielson's Board of Directors composed solely of disinterested directors and advised by independent legal and financial advisors.

DESCRIPTION OF DANIELSON'S BUSINESSES

Set forth below is a description of Danielson's business operations as of December 31, 2004, as presented in the Consolidated Financial Statements included in this report. Danielson is engaged in two primary business segments: the Energy Services business of Covanta and the Insurance Services business. Each of these businesses, and the NOLs at the holding company level, are described below.

Additional information about Danielson's business segments is included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 32 of the Notes to Consolidated Financial Statements.

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Actual results may differ materially from those contained in such forward-looking statements. See Forward Looking Statements below.

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Prior to the Covanta acquisition, Danielson's strategy had been to grow by developing business partnerships and making strategic acquisitions. Following the Covanta acquisition, Danielson's strategy has been to concentrate on increasing value in Covanta's core waste-to-energy business, while ensuring the NOLs at the Danielson level are available to Covanta as contemplated by the Reorganization Plan.

As of December 31, 2004, Danielson had consolidated NOLs of approximately \$516 million. This estimate was based upon federal consolidated income tax losses for the periods through December 31, 2003 and an estimate of the 2004 taxable results. Some or all of the carryforward may be available to offset, for federal income tax purposes, the future taxable income, if any, of Danielson, its wholly-owned subsidiaries and the Mission trusts described in more detail in Note 25 of the Notes to Consolidated Financial Statements. The Internal Revenue Service (IRS) has not audited any of Danielson's 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 NOL carryforward were reported.

Danielson's NOLs will expire, if not used, in the following approximate amounts in the following years (in thousands of dollars):

Year	Amount of Carryforward Expiring
2005	\$ 12,405
2006	92,355
2007	89,790
2008	31,688
2009	39,689
2010	23,600
2011	19,755
2012	38,255
2019	33,635
2022	26,931
2023	108,331
	\$ 516,434

Danielson's ability to utilize its NOLs would be substantially reduced if Danielson were to undergo an ownership change within the meaning of Section 382(g)(1) of the Internal Revenue Code. Danielson will be treated as having had an ownership change if there is more than a 50% increase in stock ownership during a three year testing period by stockholders. In an effort to reduce the risk of an ownership change, Danielson has imposed restrictions on the ability of holders of five percent or more of the Common Stock, as well as the ability of others to become five percent stockholders as a result of transfers of Common Stock. The transfer restrictions were implemented in 1992, and Danielson expects that they will remain in force as long as the NOLs are available to Danielson. Notwithstanding such transfer restrictions, there could be circumstances under which an issuance by Danielson of a significant number of new shares of Common Stock or other new class of equity security having certain characteristics (for example, the right to vote or convert into Common Stock) might result in an ownership change under the Internal Revenue Code.

(B) Energy Services Business

See Note 33 to the Notes to Consolidated Financial Statements for financial information about segments and geographic areas.

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Covanta's domestic business is the design, construction and long-term operation of key infrastructure for municipalities and others in waste-to-energy and independent power production. Covanta's largest operations are in waste-to-energy projects, and it currently operates 25 waste-to-energy projects, the majority of which were developed and structured contractually as part of competitive procurements conducted by municipal entities. The waste-to-energy plants combust municipal solid waste as a means of environmentally sound disposal and produce energy that is typically sold as electricity to utilities and other electricity purchasers. Covanta processes approximately four percent of the municipal solid waste produced in the United States and therefore represents a vital part of the nation's solid waste disposal industry.

Waste-to-Energy Projects

The essential purpose of Covanta's waste-to-energy projects is to provide waste disposal services, typically to municipal clients who sponsor the projects (Client Communities). Generally, Covanta provides these services pursuant to long-term service contracts (Service Agreements). The electricity or steam is sold pursuant to long-term power purchase agreements (Energy Contracts) with local utilities or industrial customers, with one exception, and most of the resulting revenues reduce the overall cost of waste disposal services to the Client Communities. Each Service Agreement is different to reflect the specific needs and concerns of the Client Community, applicable regulatory requirements and other factors. The original terms of the Service Agreements are each 20 or more years, with the majority now in the second half of the applicable term. Most of Covanta's Service Agreements may be renewed for varying periods of time, at the option of the client community.

Covanta currently operates the waste-to-energy projects identified below under Domestic Project Summaries. Most of Covanta's operating waste-to-energy projects were developed and structured contractually as part of competitive procurement conducted by municipal entities. As a result, these projects have many common features, which are described in Structurally Similar Waste-to-Energy Projects below. Certain projects which do not follow this model, or have been or may be restructured, are described in Other Waste-to-Energy Project Structures and Project Restructurings during 2004 below.

Covanta receives its revenue in the form of fees pursuant to Service Agreements, and in some cases Energy Contracts, at facilities it owns. Covanta's Service Agreements begin to expire in 2007, and Energy Contracts at Company-owned projects generally expire at or after the date on which that project's Service Agreement expires. As Covanta's contracts expire it will become subject to greater market risk in maintaining and enhancing its revenues. As its Service Agreements at municipally-owned facilities expire, Covanta intends to seek to enter into renewal or replacement contracts to operate several such facilities. Covanta also will seek to bid competitively in the market for additional contracts to operate other facilities as similar contracts of other vendors expire. As Covanta's Service Agreements at facilities it owns begin to expire, it intends to seek replacement or additional contracts, and because project debt on these facilities will be paid off at such time Covanta expects to be able to offer rates that will attract sufficient quantities of waste while providing acceptable revenues to Covanta. At Company-owned facilities, the expiration of existing Energy Contracts will require Covanta to sell its output either into the local electricity grid at prevailing rates or pursuant to new contracts. There can be no assurance that Covanta will be able to enter into such renewals, replacement or additional contracts, or that the terms available in the market at the time will be favorable to Covanta.

Covanta's opportunities for growth by investing in new projects will be limited by existing non-project debt covenants, as well as by competition from other companies in the waste disposal business. For a discussion of such debt covenants see Note 19 to the Notes to Consolidated Financial Statements.

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Structurally Similar Waste-to-Energy Projects

Each Service Agreement is different to reflect the specific needs and concerns of the Client Community, applicable regulatory requirements and other factors. However, the following description sets forth terms that are generally common to these agreements:

Covanta designs the facility, helps to arrange for financing and then constructs and equips the facility on a fixed price and schedule basis.

Covanta operates the facility and generally guarantees it will meet minimum waste processing capacity and efficiency standards, energy production levels and environmental standards. Covanta's failure to meet these guarantees or to otherwise observe the material terms of the Service Agreement (unless caused by the Client Community or by events beyond its control (Unforeseen Circumstances)) may result in liquidated damages charged to Covanta or, if the breach is substantial, continuing and unremedied, the termination of the Service Agreement. In the case of such Service Agreement termination, Covanta may be obligated to pay material damages, including payments to discharge project indebtedness. Covanta or an intermediate holding company typically guarantees performance of the Service Agreement.

The Client Community is generally required to deliver minimum quantities of municipal solid waste to the facility on a put-or-pay basis and is obligated to pay a service fee for its disposal (the Service Fee). 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. This payment is due even if the counterparty delivers less than the full amount of waste promised. Portions of the Service Fee escalate to reflect indices of inflation. In many cases the Client Community must also pay for other costs, such as insurance, taxes and transportation and disposal of the residue to the disposal site. If the facility is owned by Covanta, the Client Community also pays as part of the Service Fee an amount equal to the debt service due to be paid on the bonds issued to finance the facility. 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 that the Client Community pay increased expenses and capital costs resulting from Unforeseen Circumstances, subject to limits which may be specified in the Service Agreement.

The Client Community usually retains a portion of the energy revenues (generally 90%) generated by the facility, and pays the balance to Covanta.

Financing for Covanta's domestic waste-to-energy projects is generally accomplished through tax-exempt and taxable revenue bonds issued by or on behalf of the Client Community. If the facility is owned by a Covanta subsidiary, the Client Community loans the bond proceeds to the subsidiary to pay for facility construction and pays to the subsidiary amounts necessary to pay debt service. For such facilities, project-related debt is included as project debt (short-and long-term) in Covanta's consolidated financial statements. Generally, such debt is secured by the revenues pledged under the respective indentures and is collateralized by the assets of Covanta's subsidiary with the only recourse to Covanta being related to construction and operating performance defaults.

Covanta has issued instruments to its Client Communities and other parties which guarantee that Covanta's operating subsidiaries will perform in accordance with contractual terms including, where required, the payment of damages. Such contractual damages could be material, and in circumstances where one or more subsidiary's contract has been terminated for its default, such damages could include amounts sufficient to repay project debt. For facilities owned by Client Communities and operated by Covanta subsidiaries, Covanta's potential maximum liability as of December 31, 2004 associated with the repayment of project debt on such facilities was in excess of \$1 billion. If Covanta is asked to perform under one or more of such guarantees, its liability for damages upon contract termination would be reduced by funds held in trust and proceeds from sales of the facilities securing the project debt which is presently not estimable. To date, Covanta has not incurred material liabilities under such guarantees.

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Other Waste-to-Energy Project Structures

Haverhill, Massachusetts

Covanta's Haverhill, Massachusetts waste-to-energy facility is not operated pursuant to a Service Agreement with a Client Community. In this project, Covanta assumed the project debt and risks relating to waste availability and pricing, risks relating to the continued performance of the electricity purchaser, as well as risks associated with Unforeseen Circumstances. Covanta retains all of the energy revenues from sales of power and disposal fees for waste accepted at this facility. Accordingly, Covanta believes that this project carries both greater risks and greater potential rewards than projects in which there is a Client Community.

During 2003, US Gen New England, Inc. (USGenNE), the power purchaser for the Haverhill project, filed a petition under Chapter 11 of the United States Bankruptcy Code. During the pendency of its bankruptcy, on October 8, 2004, the United States Bankruptcy Court for the District of Maryland entered an order approving the sale by USGenNE of certain of its assets, including its contract to purchase power from the Haverhill project, to Dominion Energy New England, Inc. (Dominion). As a result of USGenNE's sale to Dominion, USGenNE assigned and Dominion assumed such contract and Covanta was paid all outstanding prepetition cure amounts plus interest.

Union, New Jersey

In Union County, New Jersey, a municipally-owned facility has been leased to Covanta, and the Client Community has agreed to deliver approximately 50% of the facility's capacity on a put-or-pay basis. The balance of facility capacity is marketed by Covanta at its risk. Covanta guarantees its subsidiary's contractual obligations to operate and maintain the facility, and on one series of subordinated bonds, its obligations to make lease payments which are the sole source for payment of principal and interest on that series of bonds. As of December 31, 2004, the current outstanding principal amount of the subordinated bonds, sold to refinance a portion of the original bonds used to finance the facility, was \$17.7 million. As a part of restructuring of this project, the Client Community assigned to Covanta the long-term power contract with the local utility. As part of this assignment, the power contract was amended to give Covanta the right to sell all or a portion of the plant's output to other purchasers. Since April 2002, Covanta has sold the majority of its output directly into the regional electricity grid at market pricing with the remainder of the electricity sold under short-term contract when Covanta may enter into contracts with other purchasers if it believes doing so would enhance this project's revenues.

Alexandria, Virginia

Covanta's Alexandria, Virginia waste-to-energy facility is operated pursuant to a Service Agreement with the City of Alexandria, Virginia and Arlington County, Virginia and authorities established by those communities (the Virginia Communities). The Virginia Communities pay a fixed tip fee, subject to certain adjustments, for each ton of waste they are required to deliver on a put-or-pay basis (about 65% of the facility's capacity). The balance of the waste is obtained by Covanta from private haulers pursuant to short-term contracts or on a spot basis. Covanta's operating subsidiary receives all of the electricity revenues received under the facility's power sales agreement and pays the debt service on the bonds issued to finance the facility. The Service Agreement provides that if income available for debt service, as calculated in accordance with the Service Agreement, does not cover debt service, the Virginia Communities will loan Covanta's operating subsidiary the amount of the shortfall. Any such loan is required to be repaid from the project's positive cash flow in succeeding years and would have an ultimate maturity in 2023. The interest rate on any such loan is six percent. Since the Alexandria facility began operating in 1988, the Virginia Communities have been required to extend such loans on four occasions, the last of which was with respect to the operating year ending June 1, 2001. All such loans have been fully repaid within six months, and as of December 31, 2004 there were currently no outstanding loans to Covanta's operating subsidiary.

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The Town of Babylon, New York (Babylon) filed a proof of claim against Covanta Babylon, Inc. (Covanta Babylon) in its bankruptcy proceeding for approximately \$13.4 million in prepetition damages and \$5.5 million in postpetition damages, alleging that Covanta Babylon has accepted less waste than required under the Service Agreement between Babylon and Covanta Babylon at the waste-to-energy facility in Babylon and that Covanta Babylon's Chapter 11 Cases imposed on Babylon additional costs for which Covanta Babylon should be responsible. Covanta filed an objection to Babylon's claim, asserting that it was in full compliance with the express requirements of the Service Agreement and was entitled to adjust the amount of waste it is required to accept to reflect the energy content of the waste delivered. Covanta Babylon also asserted that the costs arising from its Chapter 11 proceedings are not recoverable by Babylon. After lengthy discussions, Babylon and Covanta Babylon reached a settlement pursuant to which, in part, (i) the parties amended the Service Agreement to adjust Covanta Babylon's operational procedures for accepting waste, reduce Covanta Babylon's waste processing obligations, increase Babylon's additional waste service fee to Covanta Babylon and reduce Babylon's annual operating and maintenance fee to Covanta Babylon; (ii) Covanta Babylon paid a specified amount to Babylon in consideration for a release of any and all claims (other than its rights under the settlement documents) that Babylon may hold against the Covanta and in satisfaction of Babylon's administrative expense claims against Covanta Babylon; and (iii) the parties allocated additional costs relating to the project's swap financing as a result of Covanta Babylon's Chapter 11 proceedings until such costs are eliminated. Covanta Babylon subsequently emerged from Chapter 11 pursuant to the Reorganization Plan as described below on March 10, 2004, and the restructuring became effective on March 12, 2004.

Lake County, Florida

In late 2000, Lake County, Florida (Lake County) commenced a lawsuit in Florida state court against Covanta Lake, Inc. (Covanta Lake,) relating to the waste-to-energy facility operated by Covanta in Lake County, Florida (the Lake Facility). In the lawsuit, Lake County sought to have its Service Agreement with Covanta Lake declared void and in violation of the Florida Constitution. That lawsuit was stayed by the commencement of the Chapter 11 Cases. Lake County subsequently filed a proof of claim seeking in excess of \$70 million from Covanta Lake and Covanta.

After months of negotiations that failed to produce a settlement between Covanta Lake and Lake County, on June 20, 2003, Covanta Lake filed a motion with the Bankruptcy Court seeking entry of an order (i) authorizing Covanta Lake to assume, effective upon confirmation of a plan of reorganization for Covanta Lake, its Service Agreement with Lake County, (ii) finding no cure amounts due under the Service Agreement, and (iii) seeking a declaration that the Service Agreement is valid, enforceable and constitutional and remains in full force and effect. Contemporaneously with the filing of the assumption motion, Covanta Lake filed an adversary complaint asserting that Lake County is in arrears to Covanta Lake in the amount of more than \$8.5 million. Shortly before trial commenced in these matters, Covanta and Lake County reached a tentative settlement calling for a new agreement specifying the parties' obligations and restructuring of the project. That tentative settlement and the proposed restructuring involved, among other things, termination of the existing Service Agreement and the execution of a new waste disposal agreement which provides for a put-or-pay obligation on Lake County's part to deliver 163,000 tons per year of acceptable waste to the Lake Facility and a different fee structure; a replacement guarantee from Covanta in a reduced amount; the payment by Lake County of all amounts due as pass through costs with respect to Covanta Lake's payment of property taxes; the payment by Lake County of a specified amount in 2004, 2005 and 2006 in reimbursement of certain capital costs; the settlement of all pending litigation; and a refinancing of the existing bonds.

The Lake settlement was contingent upon, among other things, receipt of all necessary approvals, as well as a favorable outcome to the Debtors' separate objection to the proof of claims filed by F. Browne Gregg, a third-party claiming an interest in the existing Service Agreement that would be terminated under the

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proposed settlement. In August 2004, the Bankruptcy Court ruled on the Debtors' claims objections, finding in favor of the Debtors. Based on the foregoing, the Debtors determined to propose a plan of reorganization for Covanta Lake.

The Debtors subsequently reached a final settlement with Mr. Gregg, entered into a new long-term waste disposal agreement with Lake County on terms substantially similar to the tentative settlement, refinanced the project debt and confirmed the Covanta Lake plan of reorganization in December 2004. Covanta Lake emerged from bankruptcy on December 12, 2004.

Warren County, New Jersey

The Covanta subsidiary (Covanta Warren) which operates Covanta's waste-to-energy facility in Warren County, New Jersey (the Warren Facility) and the Pollution Control Financing Authority of Warren County (Warren Authority) have been engaged in negotiations for an extended time concerning a potential restructuring of the parties' rights and obligations under various agreements related to Covanta Warren's operation of the Warren Facility. Those negotiations were in part precipitated by a 1997 federal court of appeals decision invalidating certain of the State of New Jersey's waste-flow laws, which resulted in significantly reduced revenues for the Warren Facility. Since 1999, the State of New Jersey has been voluntarily making all debt service payments with respect to the project bonds issued to finance construction of the Warren Facility, and Covanta Warren has been operating the Warren Facility pursuant to an agreement with the Warren Authority which modifies the existing Service Agreement for the Warren Facility.

Although discussions continue, to date Covanta Warren and the Warren Authority have been unable to reach an agreement to restructure the contractual arrangements governing Covanta Warren's operation of the Warren Facility. Based upon the foregoing, Covanta has not yet determined to propose a plan of reorganization or plan of liquidation for Covanta Warren at this time, and instead has determined that Covanta Warren should remain a debtor-in-possession.

In order to emerge from bankruptcy without uncertainty concerning potential claims against Covanta related to the Warren Facility, Covanta rejected its guarantees of Covanta Warren's obligations relating to the operation and maintenance of the Warren Facility. Covanta anticipates that if a restructuring is consummated, Covanta may at that time issue a new parent guarantee in connection with that restructuring and emergence from bankruptcy.

In the event the parties are unable to timely reach agreement upon and consummate a restructuring of the contractual arrangements governing Covanta Warren's operation of the Warren Facility, Covanta may, among other things, elect to litigate with counterparties to certain agreements with Covanta Warren, assume or reject one or more executory contracts related to the Warren Facility, attempt to file a plan of reorganization on a non-consensual basis, or liquidate Covanta Warren. In such an event, creditors of Covanta Warren may not receive any recovery on account of their claims.

Covanta expects that the outcome of this restructuring will not negatively affect its ability to implement its business plan or have a material impact on its operating results and financial position.

Projects under Development

Hillsborough County, Florida

Covanta designed, constructed and now operates and maintains this 1,200 ton per day mass burn waste-to-energy facility located in and owned by Hillsborough County. Due to the growth in the amount of solid waste generated in Hillsborough County, Hillsborough County has informed Covanta of its desire to expand the facility's waste processing and electricity generation capacities, a possibility contemplated by the existing contract between Covanta and Hillsborough County. As part of the proposed agreement to implement this expansion Covanta would receive a long-term operating contract extension. Negotiations are ongoing and contracts for construction of the expansion and operation and maintenance of the expanded facility are still to be finalized and approved by the parties. In addition, environmental and other project related permits will need to be secured and financing completed. At this time, there can be no assurance that any definitive agreements

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will be finalized or approved by the parties, the relevant permits will be received or that Hillsborough County will, in fact, expand the facility.

Lee County, Florida

Covanta designed, constructed and now operates and maintains this 1,200 ton per day mass burn waste-to-energy facility located in and owned by Lee County. Due to the growth in the amount of solid waste generated in Lee County, Lee County has informed Covanta of its desire to enlist Covanta to manage the expansion of the facility's waste processing and electricity generation capacities, a possibility contemplated by the existing contract between Covanta and Lee County. As part of the proposed agreement to implement this expansion Covanta would receive a long term operating contract extension. Negotiations are ongoing and contracts for construction of the expansion and operation and maintenance of the expanded facility are still to be finalized and approved by the parties. In addition, financing for the expansion project must be completed. Lee County has received the principal environmental permit for the expansion. At this time, there can be no assurance that any definitive agreements will be finalized or approved by the parties or that Lee County will, in fact, expand the facility.

Honolulu, Hawaii

This 2,160 ton per day refuse derived fuel facility was designed and constructed by an entity not related to Covanta. Subsequently, Covanta purchased the rights to operate and maintain the facility on behalf of the City and County of Honolulu. The City and County of Honolulu have informed Covanta of their desire to expand the facility's waste processing capacity, a possibility contemplated by the existing contract between Covanta and the City and the County of Honolulu. As part of the proposed agreement to implement the expansion Covanta would receive a long-term operating contract extension. Negotiations are ongoing and contracts for construction of the expansion and operation and maintenance of the expanded facility are still to be finalized and approved by the parties. In addition, environmental and other project related permits will need to be secured and financing completed. At this time, there can be no assurance that any definitive agreements will be finalized or approved by the parties, the relevant permits will be received or that the City and the County of Honolulu will, in fact, expand the facility

Independent Power Projects

Since 1989, Covanta has been engaged in developing, owning and/or operating independent power production facilities utilizing a variety of energy sources including water (hydroelectric), natural gas, coal, waste wood (biomass), landfill gas, heavy fuel oil and diesel fuel. Covanta currently owns, has ownership in and operates 13 such facilities. The electrical output from each facility, with one exception, is sold to local utilities. Covanta's revenue from the independent power production facilities is derived primarily from the sale of energy and capacity under energy contracts. During 2003, Covanta sold its interests in its Geothermal Energy Project Business.

The regulatory framework for selling power to utilities from independent power facilities (including waste-to-energy facilities) after current contracts expire is in flux, given the energy crisis in California in 2000 and 2001, the over-capacity of generation at the present time in many markets and the uncertainty as to the adoption of new federal energy legislation. Various states and Congress are considering a wide variety of changes to regulatory frameworks, but none has been established definitively at present.

Hydroelectric

Covanta owns a 50% equity interest in two run-of-river hydroelectric facilities, Koma Kulshan and Weeks Falls, which have a combined gross capacity of 17 MW. Both Koma Kulshan and Weeks Falls are located in Washington State and both sell energy and capacity to Puget Sound Power & Light Company under long-term energy contracts. A subsidiary of Covanta provides operation and maintenance services to the Koma Kulshan partnership under a cost plus fixed fee agreement.

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During the first quarter of 2004, Covanta operated the New Martinsville facility in West Virginia, a 40 MW run-of-river project pursuant to a short-term Interim Operations and Maintenance Agreement which expired March 31, 2004. Covanta chose not to renew the lease on the project, the term of which expired in October 2003.

Waste Wood

Covanta owns 100% interests in Burney Mountain Power, Mt. Lassen Power, and Pacific Oroville Power, three wood-fired generation facilities in northern California. A fourth facility, Pacific Ultrapower Chinese Station, is owned by a partnership in which the Company holds a 50% interest. Fuel for the facilities is procured from local sources primarily through short-term supply agreements. The price of the fuel varies depending on time of year, supply and price of energy. These projects have a gross generating capacity of 67 MW and sell energy and capacity to Pacific Gas & Electric under energy contracts. Until July 2001 these facilities were receiving Pacific Gas & Electric's short run avoided cost for energy delivered. However, beginning in July 2001 these facilities entered into five-year fixed-price periods pursuant to energy contract amendments.

Landfill Gas

Covanta has interests in and/or operates seven landfill gas projects which produce electricity by burning methane gas produced in landfills. The Otay, Oxnard, Salinas, Stockton, Toyon and Santa Clara projects are located in California, and the Gude project is located in Maryland. The seven projects have a total gross capacity of 19.9 MW. The Gude facility energy contract has expired and the facility is currently selling its output into the regional utility grid. The remaining six projects sell energy and contracted capacity to various California utilities. The Salinas, Stockton and Santa Clara energy contracts expire in 2007. The Otay and Oxnard energy contracts expire in 2011. Upon the expiration of the energy contracts, it is expected that these projects will enter into new power off take arrangements or the projects will be shut down. During the fourth quarter of 2004, Covanta sold its interests in the Penrose and Toyon landfill gas projects, located in California and a subsidiary of Covanta will continue to operate the Toyon project under an agreement which expires in 2007.

Water Operations

Covanta designed, built and now continues to operate and maintain a 24 million gallon per day (mgd) potable water treatment facility and associated transmission and pumping equipment that supplies water to residents and businesses in Bessemer, Alabama, a suburb of Birmingham. Under a long-term contract with the Governmental Services Corporation of Bessemer, Covanta received a fixed price for design and construction of the facility, and it is paid a fixed fee plus pass-through costs for delivering processed water to Bessemer's water distribution system.

Between 2000 and 2002, Covanta was awarded contracts to supply its patented DualSand[®] microfiltration system (DSS) to twelve municipalities in upstate New York as the primary technological improvement necessary to upgrade their existing water and wastewater treatment systems. Five of these upgrades were made in connection with the United States Environmental Protection Agency and New York City Department of Environmental Protection (NYCDEP), a \$1.4 billion program to protect and enhance the drinking water supply, or watershed, for New York City. These DSS contracts for upgrades have been completed and non-material payment issues are currently being discussed by, and may be litigated between, Covanta and NYCDEP in order to close out these contracts. Covanta does not expect to enter into further contracts for such projects in the New York City watershed.

Domestic Project Dispositions in 2004

Tampa Bay, Florida

During 2003, Covanta Tampa Construction, Inc. (CTC) completed construction of a 25 mgd desalination-to-drinking water facility under a contract with Tampa Bay Water (TBW) near Tampa,

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Florida. Covanta Energy Group, Inc. guaranteed CTC's performance under its construction contract with TBW. A separate subsidiary, Covanta Tampa Bay, Inc. (CTB), entered into a contract with TBW to operate the Tampa Water Facility after construction and testing is completed by CTC. As construction of the Tampa Water Facility neared completion, the parties had material disputes between them. These disputes led to TBW issuing a default notice to CTC and shortly thereafter CTC filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.

In February 2004, Covanta and TBW reached a tentative compromise of their disputes which was approved by the Bankruptcy Court. On July 14, 2004, the Bankruptcy Court confirmed a plan of reorganization for CTC and CTB, which incorporated the terms of the settlement between Covanta and TBW. That plan became effective on August 6, 2004 when CTC and CTB emerged from bankruptcy. After payment of certain creditor claims under the CTC and CTB plan, Covanta realized approximately \$4 million of the proceeds from the settlement with TBW. Under the terms of The Plan CTB will not operate the Tampa Water Facility, and the Company will have no continuing obligations with respect to this project.

Transfers of Waste Water Project Contracts

Covanta formerly operated and maintained wastewater treatment facilities on behalf of seven small municipal and industrial customers in upstate New York. During 2004, Covanta disposed of these assets through assignment, transfer or contract expiration. In addition, some of these contracts are short-term agreements which were by their terms terminated by the counterparty on notice that the counterparty no longer desired to continue receiving service from Covanta.

Sales of Certain Landfill Gas Assets

During the fourth quarter of 2004, Covanta sold its ownership interests in two small landfill gas projects, the Penrose project and the Toyon project, located in southern California. These sales occurred following a determination by Covanta that it would either cease operating these projects or sell them to third parties who would upgrade them to meet new regulatory requirements and run them to generate renewable energy. Covanta received a total of approximately \$0.5 million for the two projects.

Table of Contents*Domestic Project Summaries*

Summary information with respect to Covanta's domestic projects(1) that are currently operating, is provided in the following table:

			Waste Processing Capacity (TON/DAY)	Gross Electric Output (MW)	Nature of Interest(1)	Date of Acquisition/ Commencement of Operations
A.	MUNICIPAL SOLID WASTE					
1.	Marion County	Oregon	550	13.1	Owner/Operator	1987
2.	Hillsborough County	Florida	1,200	29.0	Operator	1987
3.	Hartford(5)(6)	Connecticut	2,000	68.5	Operator	1987
4.	Bristol	Connecticut	650	16.3	Owner/Operator	1988
5.	Alexandria/ Arlington	Virginia	975	22.0	Owner/Operator	1988
6.	Indianapolis(2)	Indiana	2,362	6.5	Owner/Operator	1988
7.	Warren County(5)	New Jersey	400	11.8	Owner/Operator	1988
8.	Hennepin County(5)	Minnesota	1,212	38.7	Operator	1989
9.	Stanislaus County	California	800	22.4	Owner/Operator	1989
10.	Babylon	New York	750	16.8	Owner/Operator	1989
11.	Haverhill	Massachusetts	1,650	44.6	Owner/Operator	1989
12.	Wallingford(5)	Connecticut	420	11.0	Owner/Operator	1989
13.	Kent County	Michigan	625	16.8	Operator	1990
14.	Honolulu(4)(5)	Hawaii	1,851	57.0	Lessee/Operator	1990
15.	Fairfax County	Virginia	3,000	93.0	Owner/Operator	1990
16.	Huntsville(2)	Alabama	690		Operator	1990
17.	Lake County	Florida	528	14.5	Owner/Operator	1991
18.	Lancaster County	Pennsylvania	1,200	33.1	Operator	1991
19.	Pasco County	Florida	1,050	29.7	Operator	1991
20.	Huntington(3)	New York	750	24.3		