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IDAHO PUBLIC
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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF AVISTA CORPORATION FOR THE AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR ELECTRIC AND NATURAL GAS SERVICE TO ELECTRIC AND NATURAL GAS CUSTOMERS IN THE STATE OF IDAHO	CASE NO. AVU-E-10-01 CASE NO. AVU-G-10-01 DIRECT TESTIMONY OF MARK THIES

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

I. INTRODUCTION

Q. Please state your name, business address, and present position with Avista Corp.

A. My name is Mark Thies. My business address is 1411 East Mission Avenue, Spokane, Washington. I am employed by Avista Corporation as Senior Vice President and Chief Financial Officer.

Q. Would you please describe your education and business experience?

A. I received a Bachelor of Arts degree with majors in Accounting and Business Administration from Saint Ambrose College in Davenport, Iowa, and became a Certified Public Accountant in 1987. I have extensive experience in finance, risk management, accounting and administration within the utility sector, primarily in the Midwest.

I joined Avista in September of 2008 as Senior Vice President and Chief Financial Officer (CFO). Prior to joining Avista, I was Executive Vice President and CFO for Black Hills Corporation, a diversified energy company, providing regulated electric and natural gas service to areas of South Dakota, Wyoming and Montana. I joined Black Hills Corporation in 1997 upon leaving InterCoast Energy Company in Des Moines, Iowa, where I was the manager of accounting. Previous to that I was a senior auditor for Arthur Anderson & Co. in Chicago, Illinois.

Q. What is the scope of your testimony in this proceeding?

A. I will provide a financial overview of the Company and will explain the overall rate of return proposed by the Company in this filing for its electric and natural gas operations. The proposed rate of return is derived from Avista's long-term cost of debt, and common equity, weighted in proportion to the proposed capital structure.

I will address the proposed capital structure, as well as the proposed cost of debt and equity in this filing. Dr. Avera, on behalf of the Company, will provide additional testimony related to the appropriate return on equity for Avista, based on the specific circumstances of the Company, together with the current state of the financial markets.

In brief, I will provide information that shows:

- Avista's plans call for significant capital expenditure requirements for the utility over the next two years to assure reliability in serving our customers and meeting customer growth. Capital expenditures of approximately $420 million[1] are planned for 2010-2011 for customer growth, investment in generation upgrades,

[1] This does not include investment in "Smart Grid" projects. Avista was awarded matching grants from the U.S. Department of Energy for two "Smart Grid" projects. One project will upgrade portions of the utility's electric distribution system to smart grid standards in Spokane, Washington, and the other project is a demonstration project in Pullman, Washington that involves automation of many parts of the electric distribution system using advanced metering, enhanced utility communication and other elements of smart grid technologies.

transmission and distribution facilities for the electric utility business as well as necessary maintenance and replacements of our natural gas utility systems. Capital expenditures of approximately $1.2 billion are planned for the five year period ending December 31, 2014. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms.

- Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB- and Baa3 from Moody's Investors Service (Moody's). Avista must operate at a level that will support a strong investment grade corporate credit rating, meaning "BBB" or "BBB+", in order to access capital markets at reasonable rates, which will decrease long-term borrowing costs to customers. Avista has been placed on "positive" outlook by both S&P and Moody's, which may result in an upgrade as early as August 2010. The regulatory environment will be taken into consideration by the rating agencies when reviewing Avista for a possible upgrade. Maintaining solid credit metrics and credit ratings will also help support a stock price necessary to issue equity to fund capital requirements.

- The Company has proposed an overall rate of return of 8.55%, including a 50% equity ratio and a 10.9% return on equity. Our cost of debt is 6.20%. We believe the 10.9% provides a reasonable balance of the competing objectives of continuing to improve our financial health, and the impacts that increased rates have on our customers.

The Company's initiatives to carefully manage its operating costs and capital expenditures are an important part of improving performance, but are not sufficient without revenues from the general rate request for our electric and natural gas businesses in these cases. Certainty of cash flows from operations can only be achieved with the continuing support of regulators in allowing the timely recovery of costs and the ability to earn a fair return on investment.

Q. Are you sponsoring any exhibits with your direct testimony?

A. Yes. I am sponsoring Exhibit No. 2, Schedules 1 and 2, which were prepared under my direction. Avista's credit ratings by S&P and Moody's as summarized on schedule 1, and Avista's actual capital structure at December 31, 2009 and pro forma capital structure at December 31, 2010 are included on schedule 2, with supporting information on pages 2 through 3.

A table of contents for my testimony is as follows:

II. FINANCIAL OVERVIEW

Q. Please provide an overview of Avista's financial situation.

A. The Company has made solid progress in improving its financial health in recent years, as demonstrated by improved financial ratios. Avista has reduced investments in unregulated subsidiaries and redeployed the majority of the proceeds from the sales of the unregulated subsidiaries to the Utility. The Company has been able to improve and balance its debt and equity ratios by paying down debt, issuing additional common stock, and through additional retained earnings. Although we have made progress in improving the Company's financial condition, we are still not as strong as we need to be.

Avista's goal is to operate at a level that will support a strong corporate credit rating of BBB / BBB+, and move away from the bottom notch of the investment grade rating scale. Operating at a higher rating will help reduce long-term costs to customers. It will also reduce collateral requirements and allow us to maintain access to more counterparties for acquisition of natural gas and electricity. We expect that a continued focus on the regulated utility, conservative financing strategies (including the issuance of common equity) and a supportive regulatory environment will contribute to an overall improved financial situation, that will allow us to move up from the current BBB- rating.

Avista was placed on "positive" outlook by both S&P and Moody's in August 2009, which indicates that continued financial improvement and prudent financial management could lead to an upgrade. This may not be achieved, however, if there are significant drought conditions or negative impacts to the company's hydro generating facilities, if the company does not obtain adequate and timely support for recovery of costs from state regulators, if there are significant changes in wholesale energy prices, or if the company's financial metrics otherwise deteriorate.

Q. What additional steps is the Company taking to improve its financial health?

A. We are working to assure we have adequate funds for operations, capital expenditures and debt maturities. We are maintaining a $320 million line of credit and a $75 million line of credit, which will both expire in April 2011, as well as an Accounts Receivable Sales program. We plan to obtain a portion of our capital requirements through equity issuance. We also maintain an ongoing dialogue with the rating agencies regarding the measures taken by the Company to improve our credit rating.

We have reduced our overall cost of debt from approximately 6.9% in 2008 to 6.4% at December 31, 2009, primarily by issuing $250 million of secured debt at a coupon of 5.125%.

We are operating the business efficiently to keep costs as low as practicable for our customers, while at the same time ensuring that our energy service is reliable, and customers are satisfied. An efficient, well-run business is not only important to our customers, but also to investors. Additionally, the Company is working through regulatory processes to recover our costs in a timely manner so that earned returns are closer to those allowed by regulators in each of the states we serve. This is one of the key determinants from the rating agencies' standpoint when they are reviewing our overall credit ratings.

Q. In addition to having credit ratings that will allow Avista to attract debt capital under reasonable terms, is it also necessary to attract capital from equity investors?

A. It is absolutely essential. Avista has two primary sources of external capital – debt and equity investors. Avista currently has approximately $2.3 billion of debt and equity in place to serve its customers. Approximately half of that investment is funded by debt holders, and half is funded by equity investors. There tends to be a lot of emphasis on maintaining credit metrics and credit ratings that will provide access to debt capital under reasonable terms, however, access to equity capital is equally important. In fact, equity investors also focus on cash flows, capital structure and liquidity, as do debt investors.

Additional equity capital generally comes in two forms – retained earnings and new equity issuances. Retained earnings represent the annual earnings (return on equity) of the Company that is not paid out to investors in dividends. The retained earnings are reinvested by the Company in utility plant, and other capital requirements, to serve customers, which avoids the need to issue new debt. Occasionally it is necessary to issue new common stock to maintain a balanced debt and equity capital structure, which allows Avista access to both debt and equity markets under reasonable terms, on a sustainable basis. Because of the large capital requirements at Avista, it is imperative that Avista have ready-access to both the debt and equity markets at reasonable costs.

Q. Are the debt and equity capital markets a competitive market?

A. Yes. Our ability to attract new capital, especially equity capital, under reasonable terms is dependent on our ability to offer a risk/reward opportunity that is better than the equity investors' other alternatives. We are competing with not only other utilities, but businesses in other sectors of the economy. Demand for the stock supports the stock price, which provides the opportunity to issue additional stock under reasonable terms to fund capital investment requirements.

To the extent that the equity investor holds a diversified portfolio of companies that includes utilities and other energy companies, we would be competing with those companies to attract those equity dollars.

In the debt markets, utilities are the third largest issuers, right behind governments and financial services. Therefore, it is a very competitive market and the Company must be able to attract debt investors as well as equity investors.

Q. What is Avista doing to attract equity investment?

A. Avista is carrying a capital structure that provides the opportunity to have financial metrics that offer a risk/reward proposition that is competitive and/or attractive for equity holders.

We have increased our dividend for common shareholders, and have publicly stated that we intend to work toward a dividend payout ratio that is comparable to other utilities in the industry. This is an essential element in providing a competitive risk/reward opportunity for equity investors.

We are operating the business efficiently to keep costs as low as practicable for our customers, while at the same time ensuring that our energy service is reliable, and customers are satisfied.

We are employing tracking mechanisms such as Power Cost Adjustment (PCA) and Purchased Gas Adjustment (PGA), approved by the regulatory commissions, to balance the risk of owning and operating the business in a manner that places us in a position to offer a risk/reward opportunity that is competitive with not only other utilities, but with businesses in other sectors of the economy.

We are seeking rate relief to provide timely recovery of costs and earned returns closer to those allowed by regulators. If we are not able to achieve a reasonable actual earned return on our equity investment, we will not be able to attract equity dollars that are absolutely necessary to support this business going forward.

Dr. Avera provides additional testimony related to the appropriate return on equity for Avista, that would allow the Company access to equity capital under reasonable terms, and on a sustainable basis.

Q. Has regulatory lag reduced the actual return earned by the Company?

A. Yes. Although we have received additional rate increases within the last year in all three states where we do business, we are continuing to experience increases in costs, and increased capital investment requirements. As an example, in our most recent rate case in Idaho we did not receive recovery of increased costs in 2010 associated with items such as labor, vegetation management and information services. What that means is, we are not recovering these increased costs that we are already experiencing, and will continue to experience, until the conclusion of this rate case later this year.

III. CREDIT RATINGS

Q. How important are credit ratings for Avista?

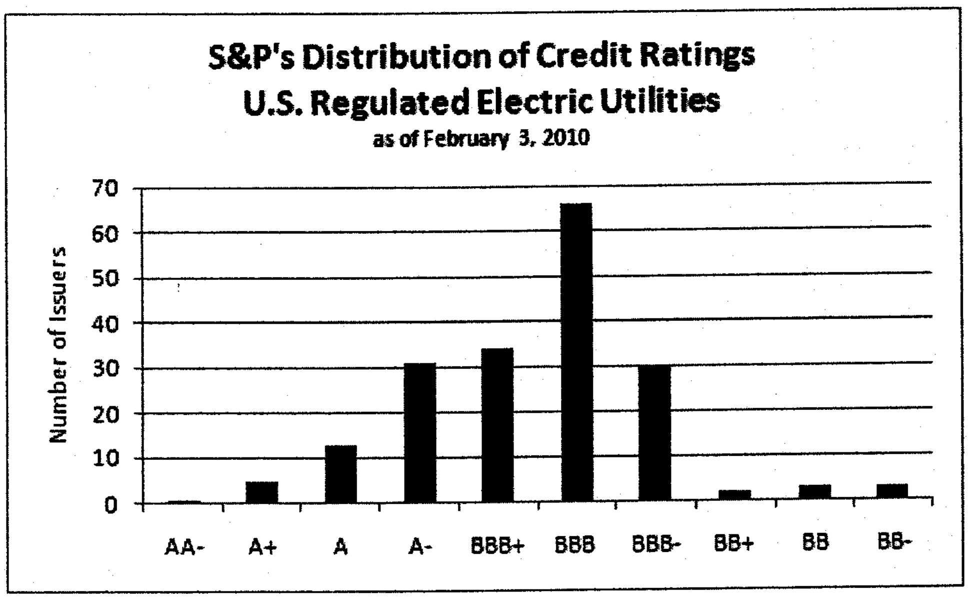
A. Utilities need ready access to capital markets in all types of economic environments. The nature of our business with long-term capital projects, our obligation to serve, and the potential for high volatility in fuel and purchased power markets, necessitates the ability to go to the financial markets under reasonable terms on a regular basis.

Q. Please explain the credit ratings for Avista's debt securities.

A. Rating agencies are independent agencies that assess risks for investors. Two of the most widely recognized rating agencies are S&P and Moody's. These rating agencies assign a credit rating to companies and their securities so investors can more easily understand the risks associated with investing in their debt and preferred stock. Avista's credit ratings are summarized on page 1 of Exhibit No. 2, Schedule 1.

As shown in Illustration No. 1 below, Avista is on the lowest rung of the investment grade credit rating scale. As I noted earlier, I believe it is important that we move up the scale to at least a BBB or BBB+, so that we are not on the edge of the investment grade cliff.

Illustration No. 1:



Additionally, as shown in Illustration No. 2 below, Avista has the lowest corporate credit rating among its Northwest peers.

Illustration No. 2:

Avista Corporation Peer Comparison - S&P Corporate Issuer Rating

	Avista	IDACORP	Portland General Electric	Northwestern	Puget Sound Energy
Corporate Issuer Rating	BBB-	BBB	BBB	BBB	BBB

Q. Please explain the implications of the credit ratings in terms of the Company's ability to access financial markets.

A. Credit ratings impact investor demand and expected return. More specifically, when the Company issues debt, the credit rating helps determine the interest rate at which the debt will be issued. The credit rating also determines the type of investor who will be interested in purchasing the debt. For each type of investment a potential investor could make, the investor looks at the quality of that investment in terms of the risk they are taking and the priority they would have in the event that the organization experiences severe financial stress. Investment risks include the likelihood that a company will not meet all of its debt obligations in terms of timeliness and amounts owed for principal and interest. Secured debt receives the highest ratings and priority for repayment and, hence, has the lowest relative risk. In challenging credit markets, where investors are less likely to buy corporate bonds (as opposed to U.S. Government bonds), a higher credit rating will attract more investors, and a lower credit rating could reduce or eliminate the number of potential investors. Thus, lower credit ratings may result in a company having more difficulty accessing financial markets and/or incur significantly higher financing costs.

Q. What credit rating does Avista Corporation believe is appropriate?

A. The move to investment grade for Avista was a significant step in improving the Company's ability to access capital at a reasonable cost. However, a credit rating at the bottom of investment grade is not appropriate for Avista. In adverse conditions – whether unique to Avista or by all market participants – a downgrade from BBB- (investment grade) to BB+ (non-investment grade) is significantly harder to overcome than a downgrade from BBB to BBB-. As Avista experienced, it took approximately six years for the Company to regain its investment grade rating from S&P after it was downgraded during the energy crisis. The difference between investment grade and non-investment grade is not only a matter of debt pricing, it can be a matter of not having the ability to access markets. To avoid adverse circumstances, Avista should operate at a level that will support a strong corporate investment grade credit rating, meaning a "BBB" or "BBB+," using S&P's rating scale. As shown in illustration 1 above, BBB+/BBB is the average rating of U.S. regulated electric utilities. The Company's goal is to have a credit rating of at least average (our current credit rating is below average).

As noted in Dr. Avera's testimony, the Chairman of the New York State Public Service Commission noted in his role as spokesman for the National Association of Regulatory Utility Commissioners the following:

> While there is a large difference between A and BBB, there is an even brighter line between Investment Grade (BBB-/Baa3 bond ratings by S&P/Moody's, and higher) and non-Investment Grade (Junk) (BB+/Ba1 and lower). The cost of issuing non-investment grade debt, assuming the market is receptive to it, has in some cases been hundreds of basis points over the yield on investment grade securities. To me this suggests that you do not want to be rated at the lower end of the BBB range because an unexpected shock could move you outside the investment grade range. (P. 28, L.'s 10-21).

A solid investment grade credit rating would also allow the Company to post less collateral with counterparties than would otherwise be required with a lower credit rating. This results in lower costs. It also increases financial flexibility since the credit line capacity would not be reduced for outstanding letters of credit.

Financially healthy utilities have lower financing costs which, in turn, benefit customers. In addition, financially healthy utilities are better able to invest in the needed infrastructure over time to serve their customers, and to withstand the challenges and risks facing the industry.

Q. What financial metrics are used by the rating agencies to establish credit ratings?

A. S&P's financial ratio benchmarks used to rate companies such as Avista are set forth in Illustration No. 3 below.

Illustration No. 3:

Standard & Poor's Financial Risk Indicative Ratios

	FFO/Debt (%)	FFO/Interest (x)	Debt/Capital (%)
Minimal	Greater than 60	(a)	Less than 25
Modest	45 - 60	(a)	25 - 35
Intermediate	30 - 45	(a)	35 - 45
Significant	20 - 30	(a)	45 - 60
Aggressive	12 - 20	(a)	50 - 60
Highly leveraged	Less than 12	(a)	Greater than 60
12 Months Ended 12/31/09 Ratios:			
Avista Adjusted [b]	13.9%	3.71x	57.5%

[a] Not available, however, S&P has indicated that it is a benchmark ratio used for the Utility industry.

[b] Calculated as of 12/31/09 based on last known S&P methodology

The ratios above are utilized to determine the financial risk profile. Currently, Avista is in the "Aggressive" category. The financial risk category along with the business risk profile (Avista is in the Excellent category) is then utilized in Illustration No. 4 below to determine a company's rating. S&P currently has Avista's corporate credit rating as a BBB-. Based upon an aggressive financial risk profile and excellent business risk profile, Avista should have a corporate credit rating of BBB (as indicated in the following table). S&P has placed Avista on "positive" outlook, which indicates that continued financial improvement and prudent financial management could lead to an upgrade. This may not be achieved, however, if the Company does not obtain adequate and timely support for recovery of costs from state regulators, there are significant drought conditions or negative impacts to the Company's hydro generating facilities, there are significant changes in wholesale energy prices, or the Company's financial metrics otherwise deteriorate.

Illustration No. 4:

Standard & Poor's Business and Financial Risk Profile Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA	AA	A	A-	BBB	-
Strong	AAA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	-	BBB-	BB+	BB	BB-	B
Weak	-	-	BB	BB-	B+	B-
Vulnerable	-	-	-	B+	B	CCC+

Moody's uses a similar methodology to analyze and determine utility credit ratings and has also placed Avista Corporation on "positive" outlook.

Q. If Avista is not upgraded at its next review by the credit rating agencies, how long may it take for Avista to be upgraded?

A. S&P and Moody's are both scheduled to review Avista's credit ratings in August 2010. If Avista is not upgraded at that time, Avista could be placed on an outlook of "stable". If Avista is placed on a stable outlook, it may take an additional 3 years before Avista is upgraded one notch.

Q. Please describe how S&P's Financial Risk ratios are calculated and what they mean?

A. The first ratio, "Funds from operations/total debt (%)", calculates the amount of cash flow from operations as a percent of total debt. The ratio indicates the company's ability to fund debt obligations. The second ratio, "Funds from operations/interest coverage (x)", calculates the amount of cash from operations that is available to cover interest requirements. This ratio indicates how well a company's earnings can cover interest payments on its debt. The third ratio, "Total debt/total capital (%)", is the amount of debt in our total capital structure. The ratio is an indication of the extent to which the company is using debt to finance its operations. S&P looks at many other financial ratios; however, these are the three most important ratios they use when analyzing our financial profile.

Q. Do rating agencies make adjustments to the financial ratios that are calculated directly from the financial statements of the Company?

A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet commitments (for example, the accounts receivable program, purchased power agreements and the unfunded status of pension and other post-retirement benefits) that negatively impact the ratios. In 2008, S&P made adjustments to Avista's debt totaling approximately

$247 million related to the accounts receivable program, purchased power and post-retirement benefits. The adjusted financial ratios for Avista are included in Illustration No. 3 above.

Q. Where does Avista fall within those coverage ratios?

A. Progress in increasing the cash flow ratios in recent years has been slower than anticipated due to higher capital expenditures that require cash up front before we can recover the costs from customers and below normal stream flows affecting hydro generation. Each has an impact on the Company by reducing the amount of available cash flow from operations, requiring external financing and ultimately resulting in higher debt and lower cash flow ratios. In fact, S&P stated the following in an August 2009 credit review of Avista Corporation:

> Progress could be derailed by a worsening recessionary environment, very adverse hydro conditions that lead to large deferral balances, or rate case activity that does not yield timely and sufficient regulatory relief in Idaho and Washington.[2]

Additionally, Moody's stated the following in its August 2009 credit review of Avista Corporation:

> What could change the rating down: Failure to obtain adequate and timely support for recovery of costs from any of the commissions having

[2] Standard and Poor's, *Global Credit Portal Avista Corporation,* August 2009

jurisdiction in Avista's operating territories could pressure ratings. Significant drought conditions or negative impacts of any kind to the company's hydro generating facilities would be a significant credit negative.[3]

In order to improve the cash flow ratios, Avista must reduce its debt to total capitalization ratio and increase its available cash funds from operations.

Q. Do the rating agencies look at any other factors when evaluating a company's credit quality?

A. Yes. In addition to financial ratios and metrics, rating agencies also look at a number of qualitative factors which directly or indirectly may affect a company's cash flow.

These factors include:

- Regulation
- Markets
- Operations
- Competitiveness, and
- Management

In evaluating these factors, the rating agencies look for regulatory actions that are supportive of cost recovery and that eliminate or minimize volatility of cash flows. They also consider the strength and growth of the economy in our service territory, operations' ability to control

[3] Moody's Investor Services, *Credit Opinion: Avista Corp. Global Credit Research,* August 2009