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IDAHO PUBLIC UTILITIES COMMISSION

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,

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[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?

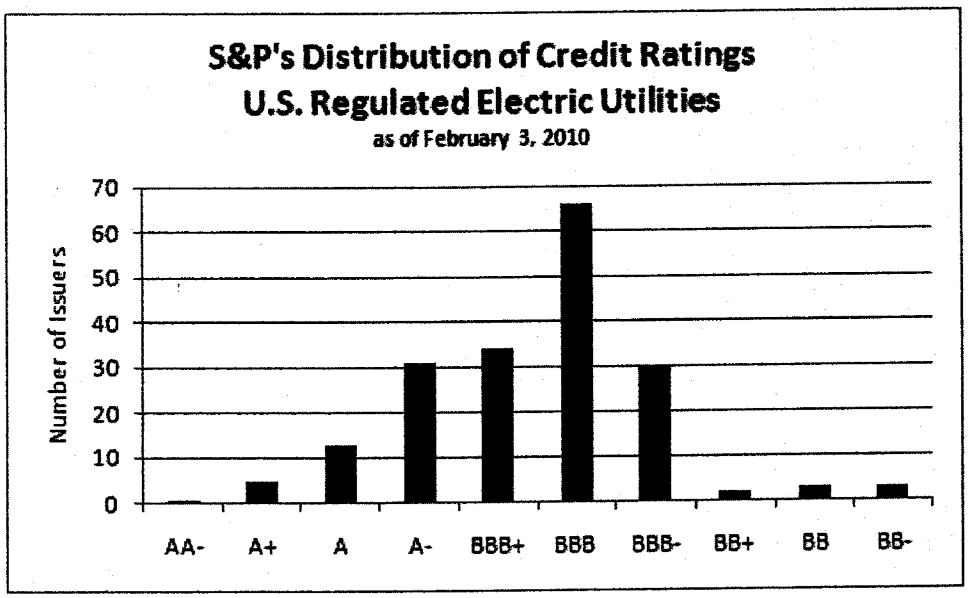
A. Utilities need ready access to capital markets in all types of economic environments. The nature of our business with long-term capital projects, our obligation to serve, and the potential for high volatility in fuel and purchased power markets, necessitates the ability to go to the financial markets 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-	$\boxed{\text{BBB}}$	-
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

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

costs, whether our service is competitive, and the effectiveness of management.

Therefore, while the ratios are utilized in their quantitative evaluation of a company, they are not the only factors that are taken into account.

Q. What risks are Avista and the utility sector facing that may impact credit ratings?

A. Avista's credit ratings are impacted by risks that could negatively affect the Company's cash flows. These risks include, but are not limited to, the level and volatility of wholesale electric market prices and natural gas prices for fuel costs, liquidity in the wholesale market (fewer counterparties and tighter credit restrictions), recoverability of natural gas and power costs, stream flow and weather conditions, changes in legislative and governmental regulations, rising construction and raw material costs, customers' ability to timely pay their bills, and access to capital markets at a reasonable cost.

Credit ratings for the utility sector are also adversely impacted by large capital expenditures for environmental compliance, and the need for new generation and transmission and distribution facilities. The utility sector is in a cycle of significant capital spending, which will likely be funded by significant issuances of debt and equity. This increases the competition for financial capital at a time when the average utility credit rating is just above investment grade (i.e. BBB / BBB+) and Avista is lower at BBB-.

Given the downturn in the economy and the tightened credit markets, the rating agencies are keeping closer tabs on all companies in order to make sure there is sufficient liquidity in case the credit markets are inaccessible. Not having sufficient sources of cash for potential cash requirements could prompt a credit rating downgrade. The rating agencies are concerned about the significant amount of bank credit facilities that will need to be refinanced or addressed in 2010 through 2012. They expect that over $110 billion of bank credit facilities will need to be refinanced during this time. This is expected to create significant competition for bank credit and will result in increased fees as well as a reduction in the size of facilities.

The increased capital spending needs and resulting increased debt and equity issuances make regulation supporting the full and timely recovery of prudently incurred costs even more critical to the utility sector than in previous years.

Q. How important is the regulatory environment in which a Company operates?

A. The regulatory environment in which a company operates is a major qualitative factor in determining a company's creditworthiness. Moody's stated the following regarding Avista's regulatory environment in an August 2009 credit ratings report:

> Given the highly regulated nature of Avista's operations, the Company's primary credit ratings driver is the degree of supportiveness that the Company receives from its various regulatory authorities.[4]

S&P stated the following:

> Regulation is the most critical aspect that underlies regulated integrated utilities' creditworthiness. Regulatory decisions can profoundly affect financial performance. Our assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory process to be considered supportive of credit quality, it must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag, especially when a utility engages in a sizable capital expenditure program.[5]

S&P also stated the following regarding Avista:

> The company's chief risk is the electric utility's exposure to replacement power costs, particularly in low water years, which its fuel and purchased-power mechanisms in Idaho and Washington partially mitigate. How the company manages its regulatory relationships in its three

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

[5] Standard and Poors, Key Credit Factors: Business and Financial Risks in the Investor-owned Utilities Industry, March 2010

jurisdictions is an important component of credit quality and stability.[6]

Due to the major capital expenditures planned by Avista, a supportive regulatory environment will be critical to Avista's financial health. Additionally, although Avista has electric and natural gas tracking mechanisms (PCA and PGA) to provide recovery of the majority of the variability in commodity costs, these changes in costs must be financed until the costs are recovered from customers. Investors and rating agencies are concerned about regulatory lag and cost-recovery related to these items.

IV. CASH FLOW

Q. What are the Company's sources to fund capital requirements?

A. The Company utilizes cash flow from operations, long-term debt and common stock issuances to fund its capital expenditures. Additionally, on an interim basis, the Company utilizes its credit facilities to fund working capital needs and capital expenditures until longer-term financing can be obtained.

Q. What are the Company's near-term capital requirements?

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[6] Standard and Poors, *Global Credit Portal Avista Corporation*, August 2009

A. As a combination electric and natural gas utility, over the next few years, capital will be required for investment in generation upgrades, transmission and distribution facilities for the electric utility business, customer growth as well as necessary maintenance and replacements of our natural gas systems.

The amount of capital expenditures planned for 2010-2011 is approximately $420 million and approximately $1.2 billion for the five year period ending December 31, 2014. For 2010 alone, these costs equate to a total of $210 million. Total company ratebase at December 31, 2009 was $2.1 billion; therefore, these planned capital additions represent substantial new investments given the relative size of the Company.

A few of the major capital expenditure items on a system basis for 2010 include $57 million for electric transmission and distribution upgrades, $16 million for natural gas system upgrades, $9 million for environmental (associated with the Spokane River relicensing and the 2001 Clark Fork River license implementation issues), $35 million for generation upgrades and $29 million for customer connects.

Major capital expenditures are a normal part of utility operations. Customers are added to the service area, roads are relocated and require existing facilities to be moved, and facilities continue to wear out and need replacement. These and other requirements create the need for significant capital expenditures each year. Access to capital at reasonable rates is dependent upon the Company maintaining a strong capital structure, sufficient interest coverage, and investment grade credit ratings.

Q. What are the Company's long-term capital requirements related to new energy resources?

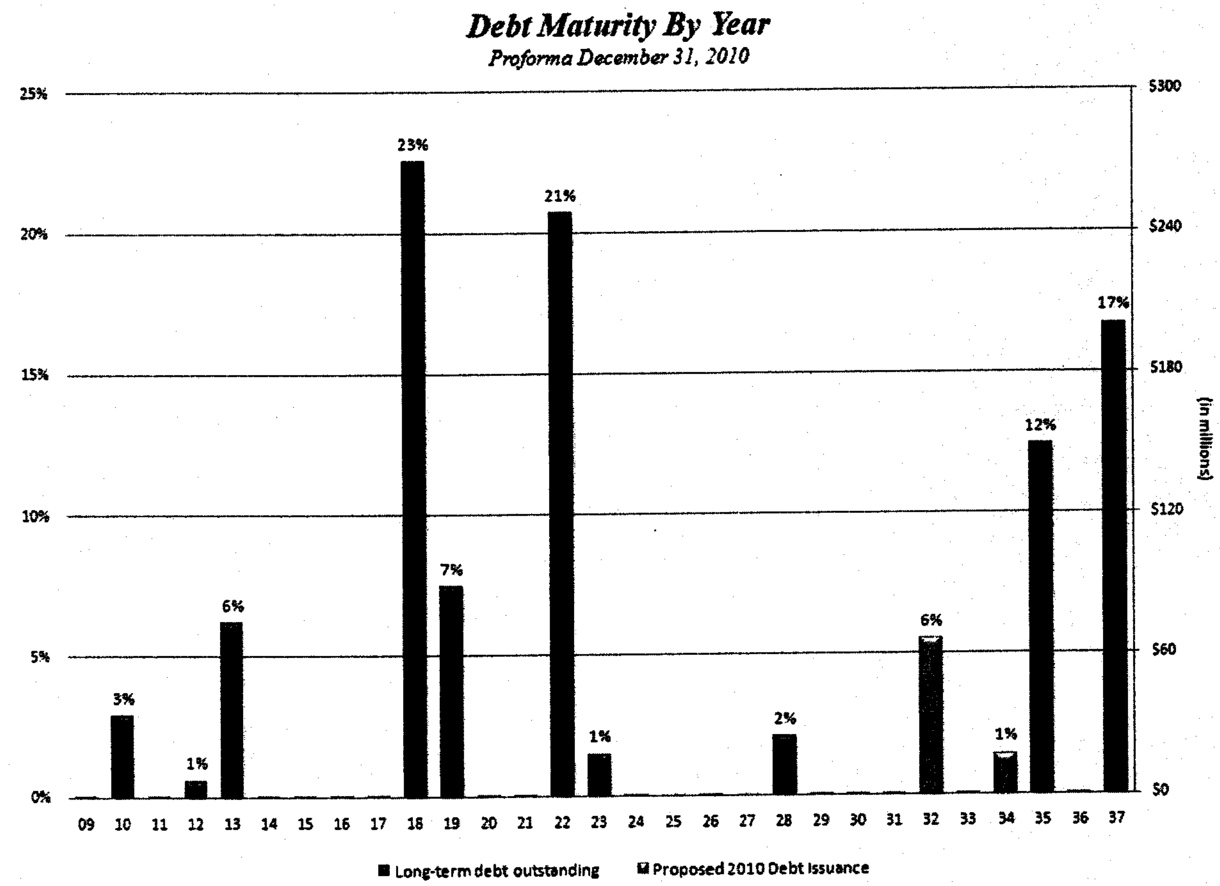
A. Avista's Integrated Resource Plan has identified the potential need for the Company to finance significant expenditures for electric facilities. The preferred strategy outlined in our 2009 Integrated Resource Plan included total expenditures of $1.25 billion by 2020, including investment in wind resources and combined-cycle combustion turbines (to meet customer load) as well as upgrades at hydroelectric stations.

Q. What are the Company's near-term plans related to its debt?

A. The Company issued $280 million of secured debt in 2008, and $250 million of secured debt in 2009. The $250 million secured debt was issued at a coupon of 5.125% in September 2009. The Company's original plan was to issue long-term secured debt in September 2008. Due to the disruption in the financial markets, the Company elected to defer the issuance until September 2009. The Company instead sought out and was able to establish a second bank line of credit to ensure continued adequate liquidity. The Company was able to reduce interest costs by approximately $80 million over a ten year period (approximately $8 million annually) by deferring the issuance of long-term debt from 2008 to 2009.

The Company currently plans to issue up to $83.7 million of secured debt in 2010. The proceeds from the issuance of the securities will be utilized to fund capital expenditures, repay maturing long-term debt and repay funds borrowed under our credit facilities. The Company has $35 million long-term debt scheduled to mature in 2010. Illustration No. 5 below shows the amount of debt maturities for Avista each year:

Illustration No. 5:



Q. What is the status of the Company's lines of credit secured by first mortgage bonds and its accounts receivable program?

A. The Company has a $320 million line of credit, and a $75 million line of credit that both expire in April 2011. Additionally, the Company has a $50 million accounts receivable funding program that expires in March 2011. This agreement has historically been renewed on a year-to-year basis.

The costs related to our $320 million line are expected to increase (when it is refinanced) due to the tightened credit markets and competition for bank credit. The increased costs are evident in our $75 million credit agreement that was completed in November 2009.

The facilities have been sized to allow the Company to maintain adequate liquidity to cover working capital requirements, manage counterparty collateral requirements, and avoid issuing securities in unfavorable markets. We believe our current agreements provide us adequate liquidity and flexibility to face volatile financial markets and volatile energy commodity prices.

Many purchases of natural gas, or contracts for pipeline capacity to provide natural gas transportation, require collateral, and/or prepayments, based upon the Company's credit rating. Upgrades to Avista's credit ratings during 2007 and 2008 have reduced the amount of collateral required to be posted with counterparties. If Avista is upgraded above its current credit ratings, the Company should see an increase in the number of counterparties willing to do business with us and the collateral requirements are expected to decrease even further, resulting in reduced costs.

The lines of credit and accounts receivable program are our primary sources of immediate cash for borrowing to meet these needs and the lines of credit support the issuance of letters of credit. These credit facilities are required to manage daily cash flow since the timing of cash receipts versus cash disbursements is never totally balanced.

Q. Is there pending legislation that may impact the Company's collateral requirements?

A. Yes. In December 2009 the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the House Bill) which would establish regulatory jurisdiction by the Commodity Futures Trading Commission (CFTC) for certain swaps (which includes a variety of derivative instruments) and the users of such swaps. Under the House Bill, "major swap participants" would be required to register with the CFTC and, among other things, maintain minimum capital and margin requirements. "Major swap participants" would include entities with large swap positions, excluding swaps held primarily for hedging commercial risk. Since we use derivative instruments primarily for hedging commercial risks, it is unlikely that we would be subject to the proposed CFTC regulation.

The House Bill would also require a broad category of swaps to be cleared and traded on registered exchanges or special derivatives exchanges. Such clearing requirements could impose a significant change from our current practices of bilateral transactions and negotiated credit terms. Clearing requirements could involve greater liquidity as collateral. However, there would be an exemption, available on an individual basis, for an end user that is not a major swap participant, and we believe we would qualify for such an exemption.

Although the House Bill may not have a material direct adverse effect on us, concern remains that our counterparties who are not exempt would pass along increased costs and margin requirements through higher prices and reductions in unsecured credit limits. In addition, there can be no assurance that any final legislation affecting derivatives, if enacted, would retain the exemptions contained in the House Bill.

Q. What are Avista's plans regarding common equity and why is this important?

A. Avista will continue to monitor the common equity ratio of its capital structure, and assess the need to issue additional common equity. Avista entered into an amended and restated sales agency agreement in December 2009 to issue up to 1.25 million shares of our common stock from time to time. Avista originally entered into a sales agency agreement to issue up to 2 million shares of its common stock in December 2006. In 2008, we issued 750,000 shares of common stock under this sales agency agreement. We are planning to issue up to $45 million of common stock in 2010 in order to finance a portion of our capital expenditures and maturing long-term debt and to support our common equity ratio. To the extent that we are not able to access the equity market, there will be increased pressure on our lines of credit, and an increased need to issue long term debt, which is likely to unfavorably impact our cost of debt and debt-to-equity-ratio. It is important to the rating agencies for Avista to maintain a balanced debt/equity ratio in order to minimize the risk of default on required debt interest payments.

As Dr. Avera explains in his testimony, the 50 percent common equity ratio requested by Avista in this case is consistent with the range of equity ratios maintained by the firms in the Utility Proxy Group.

Dr. Avera notes that electric utilities are facing, among other things, rising cost structures, the need to finance significant capital investment plans, and uncertainties over accommodating future environmental mandates. A more conservative financial profile, in the form of a higher common equity ratio, is consistent with increasing uncertainties and the need to maintain the continuous access to capital that is required to fund operations and necessary system investment.

In his testimony Dr. Avera states that:

> My conclusion is reinforced by the investment community's focus on the need for a greater layer to accommodate higher operating risks and the pressures of funding significant capital investments. This is reinforced by the need to consider the impact of uncertain capital market conditions, as well as off-balance sheet commitments such as purchased power agreements, which carry with them some level of imputed debt (P. 7, L.'s 6-14).

This is especially the case for Avista, which faces the dual challenge of financing significant capital expansion plans while at the same time endeavoring to improve its credit standing. Avista is committed to maintaining an appropriate level of equity to support a strong credit rating.

Q. What are Avista's plans regarding preferred equity and other financing structures (for example, hybrid instruments)?

A. Avista does not have any preferred equity or other financing structures outstanding at December 31, 2009. Currently, Avista does not plan to issue preferred equity or other financing structures, but will continue to evaluate the appropriateness of these financing vehicles.

V. CAPITAL STRUCTURE

Q. Please explain the capital structure proposed by Avista in this case.

A. Avista's current capital structure consists of a blend of long-term debt and common equity necessary to support the assets and operating capital of the Company. The proportionate shares of Avista Corp.'s actual capital structure on December 31, 2009, are shown on page 1 of Exhibit No. 2, Schedule 2. A pro forma capital structure is also shown on page 1, which reflects expected changes for the period ending December 31, 2010. Supporting workpapers provide additional details related to these adjustments on pages 2 through 3.

The rate of return to be applied to rate base in this proceeding is equal to the weighted average cost of capital, taking into account the pro forma adjusting items. As shown on page 1 of Exhibit No. 2, Schedule 2, Avista Utilities is proposing an overall rate of return of 8.55%.

VI. COST OF DEBT

Q. How have you determined the cost of debt?

A. Cost of debt in the Company's proposed capital structure includes long-term debt. As shown on page 1 of Exhibit No. 2, Schedule 2, the actual weighted average cost of long-term debt outstanding on December 31, 2009 was 6.37%. The size and mix of debt changes over time based upon the actual financing completed. We have made certain pro forma adjustments to update the debt cost through

December 31, 2010 to 6.20%, which is a reduction from the 6.6% currently allowed in rates. Pro forma adjustments to long-term debt reflect expected maturities of outstanding long-term debt and issuance of new debt to fund those.

VII. COST OF COMMON EQUITY

Q. What rate of return on common equity is the Company proposing in this proceeding?

A. The Company is proposing a 10.9% return on common equity (ROE), which falls at the lower end of Dr. Avera's recommended range of required return on equity. Dr. Avera testifies to analyses related to the cost of common equity with an ROE range of 10.9% to 12.5% and 11.1% to 12.7% (after accounting for the impact of common equity flotation costs). In his testimony Dr. Avera states that:

> Because Avista's requested ROE of 10.9 percent falls at the very bottom of my "bare bones" cost of equity range, it represents a conservative estimate of investors' required rate of return. (P. 5, L.'s 4-7).

Q. Dr. Avera suggests an ROE range of 10.9% to 12.5%. Why is Avista requesting an ROE at the lower end of the range?

A. As I have testified, Avista has made solid progress towards improving its financial health. If Avista can earn a 10.9% ROE, I believe our financial condition would continue to improve and would further strengthen the credit ratings ratios.

Furthermore, as the Company has worked toward improving its financial condition over the last several years, it has done so with the customer in mind. Avista is attempting to balance the ability to continue to improve our financial health and access capital markets under reasonable terms with the impacts that increased retail rates have on its customers. In this case, although we believe an ROE greater than 10.9% is supported and is warranted, we also believe the 10.9% provides a reasonable balance of the competing objectives.

Q. Please summarize the proposed capital structure and the cost components for debt and common equity.

A. As also shown on page 1 of Exhibit No. 2, Schedule 2, the following illustration shows the capital structure and cost components proposed by the Company.

Illustration No. 6:

AVISTA CORPORATION Cost of Capital December 31, 2010	Amount	Percent of Total Capital	Cost	Component
Long-Term Debt	$1,160,800,000	50.00%	6.20%	3.10%
Common Equity	1,151,660,792	50.00%	10.90%	5.45%
Total	$2,312,460,792	100.00%		**8.55%**

Q. Does that conclude your pre-filed direct testimony?

A. Yes.

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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 EXHIBIT NO. 2 MARK T. THIES

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

AVISTA CORPORATION
Long-term Securities Credit Ratings

	Standard & Poor's		Moody's	
Last Upgraded	February 2008		December 2007 and the First Mortgage Bonds and Secured Medium-term Notes were further upgraded to Baa1 from Baa2 in August 2009	
Credit Outlook	Positive		Positive	
	A+		**A1**	
	A		**A2**	
	A-		**A3**	
	BBB+	First Mortgage Bonds Secured Medium-Term Notes	**Baa1**	First Mortgage Bonds Secured Medium-Term Notes
	BBB		**Baa2**	
	BBB-	Avista Corp./Corporate rating	**Baa3**	Avista Corp./Issuer rating
	INVESTMENT GRADE			
	BB+		**Ba1**	Trust-Originated Preferred Securities
	BB	Trust-Originated Preferred Securities	**Ba2**	
	BB-		**Ba3**	

AVISTA CORPORATION Cost of Capital December 31, 2010						
		Amount	Percent of Total Capital		Cost	Component
Long Term Debt		$1,160,800,000	50.00%		6.20%	3.10%
Common Equity		1,151,660,792	50.00% (1)		10.90% (2)	5.45%
	Total	$2,312,460,792	100.00%			8.55%

AVISTA CORPORATION Embedded Cost of Capital December 31, 2009					
		Amount	Percent of Total Capital	Cost	Component
Long Term Debt		$1,129,100,000	51.42%	6.37%	3.28%
Common Equity		1,066,938,893	48.58%	10.50%	5.10%
	Total	$2,196,038,893	100.00%		8.38%

(1) Common equity percentage of total capital is 49.80% in the Dec6 forecast model

(2) Proposed Return on Common Equity - See Avera testimony

Notes:

Refer to supporting documentation for detailed calculations

All costs are shown before tax

Assumptions:

A Started with 12-31-2009 actuals

B Forecasted through 12-31-2010

C The forecasted debt and equity amounts come from the forecast Dec6 model

D Equity is adjusted for Other Comprehensive Income and capital stock expense ($16,060,000 as of December 31, 2010 and $15,651,454 as of December 31, 2009)

E Forecasted issuance of $45 million of additional equity during 2010

AVISTA CORPORATION
Cost of Long-Term Debt Detail
December 31, 2010

Line No.	Description	Coupon Rate	Maturity Date	Settlement Date	Principal Amount	Issuance Costs	Loss/Reacq Expenses	Net Proceeds	Yield to Maturity	Principal Outstanding 12-31-2010	Effective Cost	Line No.
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	
1	SMTN Series A	Series Costs	08-31-2010	05-01-1993		373,693				$ -	$ -	1
2	SMTN Series A	6.67%	07-12-2010	07-12-1993	5,000,000	35,081	690,464	4,274,455	8.275%	-	-	2
3	SMTN Series A	7.18%	08-11-2023	08-12-1993	7,000,000	54,364		6,945,636	7.244%	7,000,000	507,064	3
4	SMTN Series A	7.37%	05-10-2012	05-10-1993	7,000,000	49,114	1,227,883	5,723,003	9.455%	7,000,000	661,877	4
5	SMTN Series A	7.39%	05-11-2018	05-11-1993	7,000,000	54,364	1,227,883	5,717,753	9.287%	7,000,000	650,114	5
6	SMTN Series A	7.53%	05-05-2023	05-06-1993	5,500,000	42,712	963,011	4,494,277	9.359%	5,500,000	514,744	6
7	SMTN Series A	7.45%	06-11-2018	06-09-1993	15,500,000	170,597	2,140,440	13,188,963	8.953%	15,500,000	1,387,715	7
8	SMTN Series A	7.54%	05-05-2023	05-07-1993	1,000,000	7,766	175,412	816,822	9.375%	1,000,000	93,747	8
9	SMTN Series B	6.90%	07-01-2010	06-09-1995	5,000,000	37,944		4,962,056	6.982%	-	-	9
10	5.70% FMB's	5.70%	07-01-2037	12-15-2006	150,000,000	8,663,162		141,336,838	6.120%	150,000,000	9,179,740	10
11	6.125% FMB's	6.13%	09-01-2013	09-08-2003	45,000,000	1,055,140	815,824	43,129,036	6.703%	45,000,000	3,016,248	11
12	5.45% FMB's	5.45%	12-01-2019	11-18-2004	90,000,000	1,432,081		88,567,919	5.608%	90,000,000	5,047,001	12
13	6.25% FMB's	6.25%	12-01-2035	11-17-2005	150,000,000	-2,137,016		152,137,016	6.145%	150,000,000	9,217,853	13
14	5.125% FMB's	5.125%	04-01-2022	09-22-2009	250,000,000	-7,701,222		257,701,222	4.795%	250,000,000	11,987,116	14
15	5.95% FMB's	5.95%	06-01-2018	04-02-2008	250,000,000	19,476,419		230,523,581	7.034%	250,000,000	17,585,352	15
16	7.25% FMB's	7.25%	12-16-2013	12-16-2008	30,000,000	420,306		29,579,694	7.592%	30,000,000	2,277,590	16
17	PCB's Kettle Falls	6.00%	12-01-2023	07-29-1993	4,100,000	135,855	146,393	3,817,752	6.523%	4,100,000	267,441	17
18	MTN's Series C	Series Costs	06-15-2013	06-15-1998		650,179				-	43,345	18
19	MTN's Series C	6.37%	06-19-2028	06-19-1998	25,000,000	158,304	188,649	24,653,047	6.475%	25,000,000	1,618,863	19
20	MTN's Series C	8.02%	10-26-2010	10-26-1999	25,000,000	161,287	707,527	24,131,186	8.513%	-	-	20
21	PCB Colstrip 17M [1]	5.36%	03-01-2034	09-15-2010	17,000,000	4,051,718		12,948,282	7.541%	17,000,000	1,281,999	21
22	PCB Colstrip 66.7 [1]	5.36%	06-01-2032	09-15-2010	66,700,000	2,001,000	1,329,522	63,369,478	5.765%	66,700,000	3,845,488	22
23									6.173%	1,120,800,000	69,183,300	23
24												24
25	Repurchase [2]	7.74%	12-31-2017	06-30-2006	6,875,000		483,582	6,391,418	8.721%	-	[3] 70,127	25
26	Repurchase [2]	8.17%	06-30-2015	06-30-2005	26,000,000		1,735,796	24,264,204	9.206%	-	[3] 272,925	26
27	Repurchase [2]	8.41%	06-30-2014	06-30-2004	36,590,000		7,358,680	29,231,320	11.903%	-	[3] 1,297,201	27
28	Repurchase [2]	8.68%	09-30-2012	06-30-2003	52,485,000		2,819,860	49,665,140	9.564%	-	[3] 481,186	28
29	Repurchase [2]	8.76%	09-30-2010	06-30-2002	203,590,000		9,958,782	193,631,218	9.628%	-	[3] -	29
30										1,120,800,000	71,304,739	30
31												31
32	TOPrS [4]	1.81%	06-01-2037	06-03-1997	40,000,000	1,296,086	-2,500,000	41,203,914	1.703%	40,000,000	681,283	32
33												33
34							TOTAL LONG-TERM DEBT		6.201%	$ 1,160,800,000	$ 71,986,022	34
35												35
36												36

1 Forecasted debt issuances
2 The coupon rate used is the cost of debt at the time of the repurchases
3 The amounts are calculated using the IRR function
4 Information comes from page 3 of Schedule 2

AVISTA CORPORATION
Cost of Long Term Variable Rate Debt Detail
December 31, 2010

1		Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10	Avg of
2	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)
3	Trust Preferred	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	40,000,000
4	Total Short Term Debt	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000	$40,000,000
5															
6	Number of Days in Month		31	28	31	30	31	30	31	31	30	31	30	31	365
7	Forecasted Rates Trust Preferred		1.63%	1.63%	1.63%	1.63%	1.63%	1.63%	1.75%	1.75%	1.75%	2.13%	2.13%	2.13%	
8	Trust Preferred Interest Expense		55,972	50,556	55,972	54,167	55,972	54,167	60,278	60,278	58,333	73,194	70,833	73,194	722,917
9	Total Interest Expense		55,972	50,556	55,972	54,167	55,972	54,167	60,278	60,278	58,333	73,194	70,833	73,194	722,917
10										Average borrowing rate used in the calculation of the effective costs below					1.81%

11											
12		Coupon	Maturity	Settlement	Principal	Issuance	Loss/Reacq	Net	Yield to	Outstanding	Effective
13	Description	Rate	Date	Date	Amount	Costs	Expenses	Proceeds	Maturity	12-31-2010	Cost
14	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)
15	Trust Preferred	1.81%	06-01-2037	06-03-1997	40,000,000	1,296,086	-2,500,000	41,203,914	1.703%	40,000,000	681,283