Exhibit No. ___ (WEA-3)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-07_____

DOCKET NO. UG-07_____

EXHIBIT NO._____(WEA-3)

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EXHIBIT NO.___(WEA-3)

FUNDAMENTAL ANALYSES

Q. What is the purpose of this exhibit?

A. As a predicate to my economic and capital market analyses, this exhibit examines conditions in the utility industry generally, and for Avista specifically, that investors consider in evaluating their required rate of return. An understanding of these fundamental factors, which drive the risks and prospects for Avista, is essential to develop an informed opinion about investor expectations and requirements that form the basis of a fair rate of return on equity.

A. Operations & Finances

Q. Briefly describe Avista's utility operations.

A. Avista is engaged primarily in the procurement, transmission, and distribution of natural gas and electric energy, as well as other energy-related businesses. The Avista Utilities operating division is comprised of state-regulated utility activities, including retail natural gas and electric distribution and transmission services and energy generation. In addition to providing natural gas and electric utility service within a 26,000 square mile area of eastern Washington and northern Idaho, Avista's utility segment also provides gas distribution service in 4,000 square miles of northeast and southwest Oregon.

Avista's generating facilities include 8 hydroelectric generating stations located in Idaho, Montana, and Washington with a combined capacity of approximately 960 megawatts ("MW"). The electrical output of Avista's hydroelectric plants, which has a significant impact on total energy costs, is dependent on stream flows, which have fallen significantly below normal levels in recent years. Although Avista estimates that hydroelectric generation is capable of supplying 50 percent of total system requirements under normal conditions, the Company has experienced prolonged periods of persistent below-normal water conditions in the past. Fluctuations in the output of the Company's hydroelectric generating facilities due to variable water conditions force Avista to rely more heavily on more costly fossil fuels and wholesale power markets to meet its customers' energy needs.

Additionally, all but one of Avista's hydroelectric facilities are subject to licensing under the Federal Power Act, which is administered by FERC. After agreeing to institute various protections, mitigation, and enhancement measures in order to address environmental concerns, Avista received new operating licenses covering its two largest hydroelectric facilities – Cabinet Gorge and Noxon Rapids – in 2001. The license covering five hydroelectric plants on the Spokane River expires in August 2007. Relicensing is not automatic under federal law, and Avista must demonstrate that it has operated its facilities in the

public interest, which includes adequately addressing environmental concerns. If FERC is unable to issue approval prior to the expiration of the current license for the Spokane River facilities, an annual permit would be issued in order to temporarily extend the current license.

B. Utility Industry

Q. What general conditions have recently characterized the utility industry?

A. Over the past decade, the industry has experienced significant structural change resulting from market forces and decontrol initiatives. At least initially, this process was largely driven by regulatory reforms at the federal level. For example, the National Energy Policy Act of 1992 greatly increased prospective competition for the production and sale of power at the wholesale level, with FERC being an aggressive proponent for actions designed to foster greater competition in markets for wholesale power supply.

Q. How did structural changes impact gas utilities?

A. FERC aspired to make the natural gas industry more competitive and broaden the market for gas supplies through its Order Nos. 436, 500, and 636. Ensuing regulatory and market changes both the demand and supply sides eroded gas utilities' traditional monopoly status. Both pipelines and local distribution companies ("LDCs") have experienced "bypass" as large commercial, industrial, and wholesale customers seek to acquire gas supplies at the lowest

possible cost and, in the process, abandon traditional "full-service" utility suppliers. The dramatic structural changes within the natural gas industry have forced LDCs to confront new complexities and risks entailed in actively contracting for an economical, secure gas supply. Further, changes in transportation rate design shifted greater cost responsibility for pipeline demand costs to low load factor customers and, particularly, LDCs who purchase transportation services from interstate pipelines. Coupled with an increasingly competitive market environment, these structural changes have resulted in greater business risk and operating leverage.

Q. What impact did the Western power crisis have on investors' risk perceptions for firms involved in the electric power industry?

A. These events caused investors to rethink their assessment of the relative risks associated with the electric power industry. A well-publicized energy crisis throughout the West wreaked havoc on the customers, utilities, and policymakers. It also had dramatic repercussions for wholesale power markets and investors and utilities nationwide. In many states, regulators and legislators placed restructuring initiatives for the retail sector of the electric industry on hold as the financial implications of the Western energy crisis brought the uncertainties associated with today's power markets into sharp focus for the investment community and other stakeholders. While the case of California

represents an extreme example, there is every indication that investors' risk perceptions for all electric utilities shifted sharply upward in response to these events.

Q. Was there a corresponding impact on the industry's credit standing?

A. Yes. The years following the Western power crisis witnessed steady erosion in credit quality throughout the utility industry, both as a result of revised perceptions of the risks in the industry and the weakened finances of the utilities themselves. For example, during 2002, S&P recorded 182 downgrades in the utility industry, versus only fifteen upgrades,[1] while Moody's downgraded 109 utility issuers and upgraded three.[2] Credit quality continued to decline during 2003, with S&P reporting that downgrades outpaced upgrades by more than fifteen to one in the fourth quarter of 2003.[3] While credit trends in the industry have since stabilized, S&P reported that the majority of the companies in the utility sector now fall in the triple-B rating category and noted a continued negative bias in the credit outlook.[4]

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[1] Standard & Poor's Corporation, "U.S. Power Industry Experiences Precipitous Credit Decline in 2002; Negative Slope Likely to Continue," *RatingsDirect* (Jan. 15, 2003).
[2] Moody's Investors Service, *Credit Perspectives* (Jul. 14, 2003) at 33.
[3] Standard & Poor's Corporation, "U.S. Utilities' Ratings Decline Continued in 2003, But Pace Slows," *RatingsDirect* (Feb. 2, 2004).
[4] Standard & Poor's Corporation, "Few Rating Actions For U.S. Electric, Gas, And Water Utilities In Third Quarter," *RatingsDirect* (Oct. 25, 2006).

Q. Have investors recognized that electric utilities face additional risks because of the impact of industry restructuring on transmission operations?

A. Yes. As S&P recently affirmed, "The U.S. electric power industry is embarking on a period of rapid change."[5] Mirroring this trend, policy evolution in the transmission area has been wide reaching. Investors' focus on regulatory change in their assessment of risks and prospects was recognized early on by S&P:

> The FERC is in the process of changing every aspect of the electric utility landscape, with industry sages anticipating further transmission and wholesale market development guidance, which could affect the segment's credit prospects and quality. ... Uncertainty will exist until operating rules are in place and have stabilized.[6]

Transmission operations have become increasingly complex and investors have recognized that difficulties in obtaining permits and uncertainty over the adequacy of allowed rates of return have contributed to heightened risk and fueled concerns regarding the need for additional investment in the transmission sector of the electric power industry.

At the same time, the development of competitive wholesale power markets has resulted in increased demand for transmission resources. Concerns

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[5] Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).

[6] Standard & Poor's Corporation, "Electric Transmission at the Starting Gate," *RatingsDirect* (May 10, 2002).

regarding the need to encourage further investment in the transmission sector were exemplified by FERC's rulings in Docket No. RM06-4,[7] which established incentive-based rate treatments to promote investment in electric utility infrastructure. While there is little debate that increased investment in the transmission system will be required to fully realize the benefits of effective wholesale power markets, the challenges posed by an increasingly complex marketplace heighten the uncertainties associated with transmission operations while requiring the commitment of significant new capital investment to maintain and enhance service capabilities.

Q. What other considerations affect investors' evaluation of utility stocks?

A. Utilities are confronting increased environmental pressures that could impose significant uncertainties and costs. S&P cited environmental mandates, including emissions, conservation, and renewable resources, as one of the top ten credit issues facing U.S. utilities.[8] Similarly, Moody's noted that "considerable uncertainty" accompanied any assessment of the future requirements associated with environmental compliance.[9] For example, the

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[7] Promoting Transmission Investment through Pricing Reform, Order No. 679, 116 FERC ¶ 61,057 (July 20, 2006); Order No. 679-A, 117 FERC ¶ 61,327 (Dec. 22, 2006).
[8] Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).
[9] Moody's Investors Service, "Regulatory Pressures Increase For U.S. Utilities," *Special Comment* (March 2007).

Washington Clean Energy Initiative (I-937), which came into effect in 2006, mandates specified targets for renewable resources in Avista's resource mix and imposes financial penalties if these goals are not met. Meanwhile, proposed legislation contained in Washington Senate Bill 6001, which may become law in 2007, establishes emissions performance standards and procedures that would have a profound impact on Avista's future planning and resource mix. By effectively eliminating the potential to utilize coal-fired generation, SB 6001 may increase Avista's long-term exposure to potential volatility in the market for natural gas.

Q. Are these uncertainties the only risks being faced by utilities?

A. No. Apart from these factors, the industry continues to face the normal risks inherent in operating electric and gas utility systems, including the potential adverse effects of inflation, interest rate changes, growth, the general economy, and regulatory uncertainty and lag. As a senior analyst for Fitch Ratings, Ltd. ("Fitch") noted:

> Capital expenditures are on the rise for network reliability, mandated environmental compliance, and resource adequacy. Utilities face rising non-fuel operating and maintenance expenses, particularly for pensions, employee medical expenses, and post-retirement benefits. A trend of declining interest expenses that benefited the sector over the past four years is likely to reverse in the next several years. … In Fitch's view, the sector's credit recovery

is now fading, and investors should exercise greater caution regarding the power and gas sector.[10]

Q. How was Avista impacted by the turmoil in the electric power industry?

A. Like others, Avista was swept up in the maelstrom of the Western energy crisis. Because of Avista's dependence on hydroelectric generation, it has always been exposed to the uncertainties associated with year-to-year fluctuations in water conditions. Nevertheless, the degree of price volatility that Avista was forced to assume was unprecedented and variability in short-term market prices bore no resemblance to fluctuations experienced in the past.

Increased wholesale prices and rate structures that did not capture the full costs of acquiring fuel and purchased power led to depressed earnings, while cash flow shortfalls burdened the Company with increased financing requirements. Avista was forced to use cash flows from operations, various bank borrowings, and short- and long-term debt to fund unrecovered energy supply costs. This led to a sharp deterioration in Avista's financial condition, a severe liquidity crunch, and a dramatic increase in credit risk. As a result, commercial banks were reticent to extend financing for ongoing operations or new construction, and the Company's power and natural gas suppliers were unwilling to transact business absent special credit terms. Because of record low

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[10] Lapson, Ellen, "Rising Unit Costs & Credit Quality: Warning Signals," Public Utilities Fortnightly (Feb. 1, 2006).

stream flows available to Avista's hydroelectric facilities in 2001 and the resulting dependence on wholesale power markets in the West, the chaotic market conditions were felt directly.

Q. Are investors likely to consider the impact of industry uncertainty in assessing their required rate of return for Avista?

A. Absolutely. While utility restructuring has not been actively pursued in Washington, Avista continues to face the prospect of FERC driven changes in the electric transmission function of their business, as well as other fundamental industry reforms. Moreover, because close to one-half of Avista's total energy requirements are provided by hydroelectric facilities, the Company is exposed to a level of uncertainty not faced by most utilities.

Investors recognize that volatile energy markets, unpredictable stream flows, and Avista's reliance on wholesale purchases to meet a portion of its resource needs can create a "perfect storm," exposing the Company to the risk of reduced cash flows and unrecovered power supply costs. Avista's reliance on purchased power to meet shortfalls in hydroelectric generation magnifies the importance of strengthening financial flexibility, which is essential to guarantee access to the cash resources and interim financing required to cover inadequate operating cash flows, as well as fund required investments in the utility system.

Q. Is the potential for energy market volatility an ongoing concern for investors?

A. Most definitely. Investors recognize that the prospect of further turmoil in energy markets cannot be discounted, with S&P reporting continued spikes in wholesale market prices in the aftermath of the crisis.[11] Similarly, Fitch recently noted that "elevated energy commodity prices" contribute to a "challenging environment" for electric utilities.[12] Meanwhile, the FERC Staff has continued to recognize the ongoing potential for market disruption in the West, as a 2005 market assessment report concluded:

> Our review of supply and demand conditions in the west this summer indicates that there may be periods of market tightness most likely expressed as price spikes and possible interruptions.[13]

FERC continues to warn of load pockets vulnerable to periods of high peak demand and unplanned outages of generation or transmission capacity,[14] and ongoing reliability concerns led FERC to establish mandatory standards for the bulk power system.[15]

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[11] Standard & Poor's Corporation, "Fuel and Purchased Power Cost Recovery In The Wake Of Volatile Gas And Power Markets – U.S. Electric Utilities To Watch," (Mar. 22, 2006).
[12] Fitch Ratings, Ltd., "U.S. Power and Gas 2007 Outlook," *Global Power North American Special Report* (Dec. 15, 2006) at 1.
[13] Federal Energy Regulatory Commission, Office of Market Oversight and Investigations, "Summer Energy Market Assessment 2005," (May 4, 2005) at 9.
[14] Federal Energy Regulatory Commission, Office of Market Oversight and Investigations, "Summer Energy Market Assessment 2006," (May 18, 2006) at 5.
[15] See *Open Commission Meeting Statement of Chairman Joseph T. Kelliher,* Items E-13: Mandatory Reliability Standards for the Bulk-Power System (Docket No. RM06-16-000) (March 15, 2007).

Additionally, in recent years utilities and their customers have also had to contend with dramatic fluctuations in gas costs due to ongoing price volatility in the spot markets.[16] S&P concluded that "natural gas prices have proven to be very volatile" and warned of a "turbulent journey" due to the uncertainty associated with future fluctuations in energy costs.[17] Fitch also highlighted the challenges that fluctuations in commodity prices can have for utilities and their investors, concluding, "Historically high and volatile commodity prices will continue to affect nearly the entire power and gas sector."[18]

C. Relative Size

Q. Would investors consider Avista's relative size in their assessment of the Company's risks and prospects?

A. Yes. A firm's relative size has important implications for investors in their evaluation of alternative investments. With a market capitalization of approximately $1.3 billion, Avista is one of the smallest publicly traded electric utility holding companies followed by Value Line. Indeed, the average capitalization of the 61 electric utility holding companies followed by Value Line

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[16] For example, the Energy Information Administration reported that the average price of gas used by electricity generators (regulated utilities and non-regulated power producers) spiked from an average price of $7.18 per Mcf for the first eight months of 2005 to over $11.00 per Mcf in September and October (http://tonto.eia.doe.gov/dnav/ng/ng_pri_sum_dcu_nus_m.htm).

[17] Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).

[18] Fitch Ratings, Ltd., "U.S. Power and Gas 2007 Outlook," *Global Power North American Special Report* (Dec. 15, 2006) at 1.

is approximately $8.2 billion, with Avista's small-cap status placing it within the ninth decile of this industry group.[19]

Q. How does this position as one of the smallest utilities followed by Value Line affect investors' risk perceptions?

A. The magnitude of the size disparity between Avista and other firms in the utility industry has important practical implications with respect to the risks faced by investors. All else being equal, it is well accepted that smaller firms are more risky than their larger counterparts, due in part to their relative lack of diversification and lower financial resiliency. In the case of a smaller utility, its earnings are principally dependent on the economic, social, regulatory, and other factors affecting a more limited constituency. This can result in significant exposure, especially where key employers or industries dominate the economy.

Additionally, due to the lower density and other characteristics of its service territory, a smaller utility serving more sparsely populated rural areas generally incurs higher investment and expenses per customer than is typical for other utility providers. Meanwhile, larger electric utilities generally enjoy improved exposure to financial markets, which enhances their ability to raise additional capital relative to smaller utilities. As a result, they are better

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[19] www.valueline.com (Retrieved Feb. 13, 2007).

prepared to withstand adverse events and possess greater financial flexibility to respond or adapt to changing market conditions, such as those that currently confront the electric utility industry.

Q. Is there empirical evidence in the financial literature that a company's size affects its relative risks?

A. Yes. It is well established in the financial literature that smaller firms are more risky than larger firms.[20] For example, a classic University of Kansas study demonstrated that large firms are assigned higher bond ratings than small firms with similar characteristics,[21] and there is ample empirical evidence that investors in smaller firms realize higher rates of return than in larger firms.[22] Common sense and accepted financial doctrine hold that investors require higher returns from smaller companies, and unless that compensation is provided in the rate of return allowed for a utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot be met.

Q. What does this evidence suggest with respect to Avista's cost of equity relative to the utility proxy group?

A. Because of the additional investment risks associated with Avista's speculative grade corporate ratings, the Company's weakened credit standing

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[20] See, *e.g.*, Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns", *The Journal of Finance* (June 1992).
[21] George E. Pinches, J. Clay Singleton, and Ali Jahankhani, "Fixed Coverage as a Determinant of Electric Utility Bond Ratings", *Financial Management* (Summer 1978).
[22] See for example Rolf W. Banz, "The Relationship Between Return and Market Value of Common Stocks", *Journal of Financial Economics* (September 1981) at 16.

and financial flexibility, and the heightened uncertainty associated with Avista's reliance on hydroelectric generation, investors' required return for Avista exceeds that of the proxy groups used to estimate the cost of equity. Competition for capital resources is intense and investors are free to invest their funds wherever they choose. Denying investors the opportunity to earn a return that is commensurate with Avista's investment risks would perpetuate the Company's anemic credit standing and hamper its future ability to attract capital, especially during periods of adverse capital market conditions. From the standpoint of the capital markets, the West is risky – and Avista's weakened financial profile and continued exposure to wholesale electric and natural gas markets in meeting shortfalls in hydroelectric generation and other variations in resources and loads compound these uncertainties.