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# Avista Corp.

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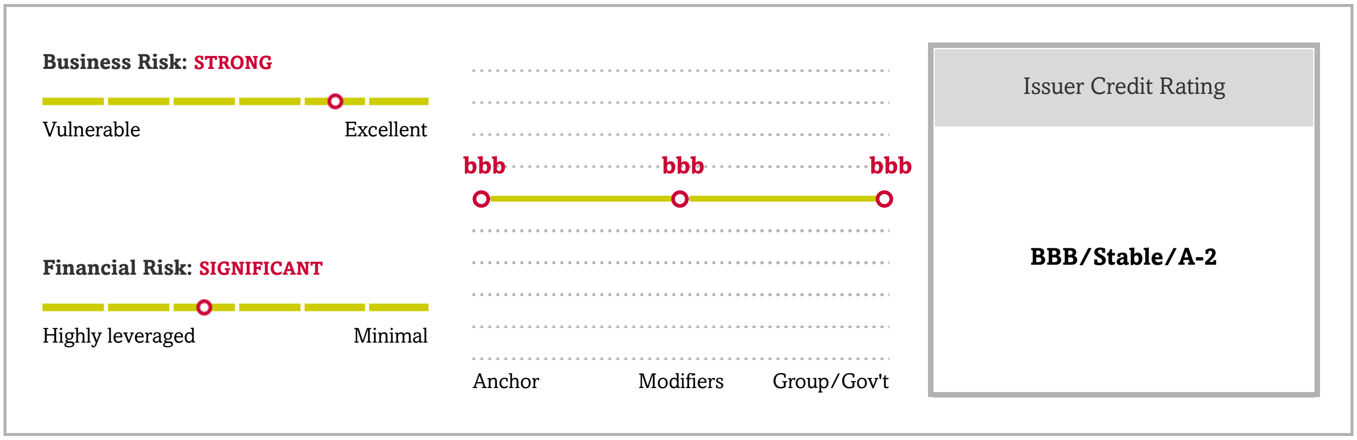


## Credit Highlights

### Overview

| Key strengths | Key risks |
|---|---|
| Mostly lower risk regulated utiity, with nonregulated operations comprising less than 5% of the company's consolidated EBITDA; | Minimal cushion at the current rating level, and we expect regulatory lag to persist until 2023; |
| Modest regulatory, operating, and geographic diversity eventhough Washington and Idaho account for most of Avista's regulated footprint; and | Heavy dependence on hydroelectric generation introduces some fuel replacement risk; and |
| Regulatory mechanisms provide cash flow stability through decoupling and interim adjustments for purchased power and gas costs. | Negative discretionary cash flow over the next few years indicates a reliance on external funding for capital expenditures and dividends. |

***The COVID-19 pandemic will likely lead to additional regulatory lag for Avista Corp.*** Avista recently delayed its planned Washington and Idaho rate case filings until the fourth quarter of 2020. In addition, per the terms of a March 2020 order from its Washington State regulators, Avista will refund $40 million in energy recovery mechanism (ERM) balancing account over a two-year amortization period. This effectively offsets approved electric and gas rate increases of $28.5 million, and $8 million, both of which became effective in April 2020. Overall, while we expect the company will work with its regulators to mitigate the effects of higher expenses related to the pandemic, it will likely result in additional regulatory lag primarily due to delays in its planned rate case filings, and the uncertain timing for recovering any incremental expenses tied to the outbreak. Partially offsetting, is the availability of decoupling in Washington, Idaho, and Oregon, which provides some downside protection from reduced sales volumes.

***There is potential improvement to Avista's business risk, despite a history of regulatory lag.*** Although Avista is currently experiencing a period of regulatory lag, we expect the 2019 passage of a law in Washington State to be favorable for its credit quality. The law allows for the authority for the Washington Utilities and Transportation Commission (WUTC) to approve multiyear rate plans and allow recovery for some utility investments deemed useful up to 48 months after the rate approval. In addition, other factors such as use of its purchased power and gas cost-adjustment mechanisms, and decoupling, support our assessment of the company's current business risk profile.

***We expect forecast credit metrics to remain in the lower end of the significant financial risk category.*** We expect that Avista's funds from operations (FFO) to debt will average in the 14%-16% range over the forecast period, assessed under our medial volatility financial benchmark table. As such, there is minimal cushion in Avista's financial measures compared to our current ratings downside trigger.

**Outlook: Stable**

The stable outlook reflects our expectation that the potential improvement to Avista Corp.'s regulatory risk management strengthens its business risk profile, mitigating its modestly weaker financial measures. We also expect Avista to maintain FFO to debt of 14%-16% throughout our forecast period.

### Downside scenario

We could lower our ratings on Avista during the next two years if adverse regulatory decisions weaken FFO to debt consistently below 14%, without sufficient countermeasures. We could also lower the ratings if Avista shifts its strategic focus to other business activities that weaken its credit quality.

### Upside scenario

We could raise our rating on Avista if it materially improves its financial measures such that FFO to debt is consistently above 20%.

## Our Base-Case Scenario

**Assumptions**

- Continued use of existing regulatory mechanisms;
- Periodic and timely rate case filings;
- No material weakening in the company's capital structure;
- Capital spending averaging about $415 million annually;
- Dividends in line with historical payout ratio;
- Equity issuance of $70 million in 2020;
- Refinancing of all debt maturities; and
- Negative discretionary cash flow over the forecast period.

**Key Metrics**

| | 2019a | 2020e | 2021f |
|---|---|---|---|
| FFO/debt (%) | 12.3 | 14 | 14.6 |
| Debt/EBITDA (x) | 5.7 | 5.5 | 5.3 |
| FFO/cash interest coverage (x) | 3.9 | 4.4 | 4.5 |

a--Actual. e--Estimated. f--Forecast. FFO--Funds from operations.

## Company Description

Spokane, Wash.-based Avista is a vertically integrated regulated electric and natural gas utility company. It operates through two segments, Avista Utilities and Alaska Electric Light & Power Co. (AEL&P). Avista Utilities provides electric distribution and transmission, natural gas distribution services in parts of eastern Washington and northern Idaho, and natural gas distribution services in parts of northeastern and southwestern Oregon. Avista Utilities also generates electricity in Washington, Idaho, Oregon, and Montana. AEL&P offers electric services to approximately 17,000 customers in the city and borough of Juneau, Alaska. Overall, Avista has about 393,000 electricity customers and approximately 361,000 natural gas customers.

## Business Risk: Strong

Avista's business risk profile reflects its low-risk regulated electric and gas utility operations, which contribute more than 95% to the consolidated EBITDA. Our assessment also reflects the company's geographic diversity, with regulated operations across five states, even though Washington and Idaho account for over 90% of its rate base. The company has material exposure to hydroelectric power (roughly 50% of its fuel supply mix), followed by gas-fired generation, both of which help to keep electricity prices competitive compared with the national average. Dependence on hydropower, however, introduces fuel-replacement risk in low water years.

The company regulatory compact includes an ERM in Washington. The ERM is a regulatory accounting mechanism used to track certain differences between Avista's net power supply costs, compared to the amount that is included in base retail rates, and hence, is trued up periodically. Similarly, the company has a power cost adjustment (PCA) mechanism in Idaho, which allows for deferral of 90% of its energy cost differences for future recovery. And for its regulated gas operations, a purchased gas adjustment (PGA) mechanism, available in all its jurisdictions, helps to mitigate gas price risk. Furthermore, Avista benefits from decoupling mechanisms in the majority of its jurisdictions, which provide some downside protection from reduced sales volumes.

Avista regulatory risk management also include it activities in other jurisdictions. In October 2019, Avista received a commission order on its electric rate case in Idaho and gas rate case in Oregon. The Idaho Public Utility Commission (IPUC) approved a $7.2 million rate decrease and Oregon Public Utility Commission (OPUC) approved a $3.6 million increase to rates. Overall, we view these outcomes as indicative of the company's regulatory risk management, which is mostly in line with its peers. Other factors we consider in our assessment includes the company's size and track record of safety and service reliability.

### Peer comparison

**Table 1**

**Avista Corp. -- Peer Comparison**

**Industry Sector: Combo**

| | **Avista Corp.** | **Puget Energy Inc.** | **IDACORP Inc.** | **Northwest Natural Gas Co.** |
|---|---|---|---|---|
| Ratings as of May 27, 2020 | BBB/Stable/A-2 | BBB-/Negative/-- | BBB/Stable/A-2 | A+/Stable/A-1 |
| | --Fiscal year ended Dec. 31, 2019-- | --Fiscal year ended Dec. 31, 2019-- | --Fiscal year ended Dec. 31, 2019-- | --Fiscal year ended Dec. 31, 2019-- |
| (Mil. $) | | | | |
| Revenue | 1,345.6 | 3,401.1 | 1,346.4 | 739.9 |
| EBITDA | 447.0 | 1,332.6 | 535.4 | 244.5 |

**Table 1**

## Avista Corp. -- Peer Comparison (cont.)

**Industry Sector: Combo**

| | Avista Corp. | Puget Energy Inc. | IDACORP Inc. | Northwest Natural Gas Co. |
|---|---|---|---|---|
| Funds from operations (FFO) | 314.3 | 964.2 | 403.9 | 202.0 |
| Interest expense | 109.1 | 376.8 | 117.2 | 41.4 |
| Cash interest paid | 107.0 | 357.8 | 117.4 | 40.0 |
| Cash flow from operations | 408.7 | 549.7 | 366.0 | 190.7 |
| Capital expenditure | 448.8 | 967.9 | 280.6 | 240.2 |
| Free operating cash flow (FOCF) | (40.1) | (418.2) | 85.4 | (49.5) |
| Discretionary cash flow (DCF) | (142.9) | (482.5) | (48.5) | (102.9) |
| Cash and short-term investments | 9.9 | 45.3 | 217.3 | 5.9 |
| Debt | 2,560.9 | 7,123.8 | 2,327.4 | 1,066.3 |
| Equity | 1,939.3 | 4,000.3 | 2,470.6 | 822.2 |
| **Adjusted ratios** | | | | |
| EBITDA margin (%) | 33.2 | 39.2 | 39.8 | 33.0 |
| Return on capital (%) | 5.5 | 5.3 | 8.0 | 8.3 |
| EBITDA interest coverage (x) | 4.1 | 3.5 | 4.6 | 5.9 |
| FFO cash interest coverage (x) | 3.9 | 3.7 | 4.4 | 6.0 |
| Debt/EBITDA (x) | 5.7 | 5.3 | 4.3 | 4.4 |
| FFO/debt (%) | 12.3 | 13.5 | 17.4 | 18.9 |
| Cash flow from operations/debt (%) | 16.0 | 7.7 | 15.7 | 17.9 |
| FOCF/debt (%) | (1.6) | (5.9) | 3.7 | (4.6) |
| DCF/debt (%) | (5.6) | (6.8) | (2.1) | (9.6) |

Sources: S&P Global Ratings, company reports.

# Financial Risk: Significant

We assess Avista's financial risk profile as significant using our medial volatility financial ratio benchmarks given the company's mostly low-risk cash flow sources, and our view of its overall management of regulatory risk. Our base case indicates that capital spending, along with dividend payments, will lead to negative discretionary cash flow over the next few years, necessitating a reliance on external funding for capital expenditures and dividends. Specifically for 2020, we assume about $415 million in capital spending, $110 million in dividends, $70 million in equity issuance, and periodic net electric and gas rate increases.

We expect modestly improving financial measures due to recent rate cases outcomes and our assumptions of favorable tax positions in our forecast, partially offset by continued regulatory lag, including delays in its 2020 rate case filings. However, we expect regulatory lag to gradually dissipate as the company continues to effectively manage its regulatory activities across all of its service territories, including in Washington State, which accounts for over 60% of Avista's regulated rate base. Our base case indicates that Avista's financial measures will remain at the lower end of the range for a financial risk assessment of significant.

### Financial summary

**Table 2**

**Avista Corp. -- Financial Summary**

**Industry Sector: Combo**

| | --Fiscal year ended Dec. 31-- | | | | |
|---|---|---|---|---|---|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| **(Mil. $)** | | | | | |
| Revenue | 1,345.6 | 1,396.9 | 1,445.9 | 1,442.5 | 1,484.8 |
| EBITDA | 447.0 | 474.5 | 500.4 | 500.7 | 439.8 |
| Funds from operations (FFO) | 314.3 | 350.2 | 435.9 | 417.6 | 359.0 |
| Interest expense | 109.1 | 109.9 | 104.2 | 99.5 | 89.4 |
| Cash interest paid | 107.0 | 109.5 | 106.0 | 96.5 | 90.7 |
| Cash flow from operations | 408.7 | 369.7 | 418.4 | 368.2 | 385.2 |
| Capital expenditure | 448.8 | 431.0 | 419.6 | 415.6 | 402.1 |
| Free operating cash flow (FOCF) | (40.1) | (61.3) | (1.1) | (47.4) | (16.8) |
| Discretionary cash flow (DCF) | (142.9) | (159.3) | (93.6) | (134.6) | (102.4) |
| Cash and short-term investments | 9.9 | 14.7 | 16.2 | 8.5 | 10.5 |
| Gross available cash | 9.9 | 14.7 | 16.2 | 8.5 | 10.5 |
| Debt | 2,560.9 | 2,463.1 | 2,177.1 | 2,110.6 | 1,945.3 |
| Equity | 1,939.3 | 1,774.0 | 1,730.5 | 1,648.5 | 1,554.1 |
| **Adjusted ratios** | | | | | |
| EBITDA margin (%) | 33.2 | 34.0 | 34.6 | 34.7 | 29.6 |
| Return on capital (%) | 5.5 | 6.7 | 8.2 | 9.0 | 8.4 |
| EBITDA interest coverage (x) | 4.1 | 4.3 | 4.8 | 5.0 | 4.9 |
| FFO cash interest coverage (x) | 3.9 | 4.2 | 5.1 | 5.3 | 5.0 |
| Debt/EBITDA (x) | 5.7 | 5.2 | 4.4 | 4.2 | 4.4 |
| FFO/debt (%) | 12.3 | 14.2 | 20.0 | 19.8 | 18.5 |
| Cash flow from operations/debt (%) | 16.0 | 15.0 | 19.2 | 17.4 | 19.8 |
| FOCF/debt (%) | (1.6) | (2.5) | (0.1) | (2.2) | (0.9) |
| DCF/debt (%) | (5.6) | (6.5) | (4.3) | (6.4) | (5.3) |

Sources: S&P Global Ratings, company reports.

## Liquidity: Adequate

As of May 2020, we assess Avista's liquidity as adequate. We expect Avista can cover its needs for the next 12 months even if EBITDA declines by 10%. We expect the company's liquidity sources will exceed uses by more than 1.1x over the next 12 months. Under our stress scenario, we do not expect Avista would require access to the capital markets during that period to meet liquidity needs. Our assessment also reflects the company's generally prudent risk management, sound relationships with banks, and generally satisfactory standing in the credit markets.

| Principal Liquidity Sources | Principal Liquidity Uses |
| --- | --- |
| • Cash balance of $18.9 million;<br>• Cash FFO of about $370 million;<br>• Undrawn credit facilities totaling about $210 million; and<br>• Cash proceeds of $100 million from a term loan issued in April 2020. | • Current debt maturities of $152 million;<br>• Maintenance capital spending of about $300 million; and<br>• Dividend payments of about $110 million. |

### Debt maturities

- 2020: $52 million
- 2022: $250 million
- 2023: $13.5 million
- 2024: $15 million

### Environmental, Social, And Governance

Avista's credit quality is positively influenced by environmental factors compared to peers given its large hydro portfolio. With a total generation fleet capacity of over 2,000 MW, close to 50% of its generation portfolio is from hydro generation. In addition, in 2019, the company announced a goal to serve its customers with 100 percent clean electricity by 2045 and to have a carbon- neutral supply of electricity by the end of 2027. We view social factors as mostly in line with industry peers. This in large part reflects the company's track record of providing safe and reliable electric and gas services for its customers, even though rate affordability is something that we continue to monitor broadly across the sector. Governance factors are also neutral. Avista has independent board of directors, who in our opinion are capably engaged in risk oversight on behalf of its stakeholders.

## Reconciliation

**Table 3**

| Avista Corp.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts | | | | | | | |
|---|---|---|---|---|---|---|---|
| | --Fiscal year ended Dec. 31, 2019-- | | | | | | |
| **Avista Corp. reported amounts (mil. $)** | | | | | | | |
| | **Debt** | **EBITDA** | **Operating income** | **Interest expense** | **S&P Global Ratings' adjusted EBITDA** | **Cash flow from operations** | **Capital expenditure** |
| | 2,133.12 | 416.38 | 210.39 | 100.18 | 446.99 | 398.21 | 442.51 |
| **S&P Global Ratings' adjustments** | | | | | | | |
| Cash taxes paid | -- | -- | -- | -- | (25.79) | -- | -- |
| Cash interest paid | -- | -- | -- | -- | (99.06) | -- | -- |
| Reported lease liabilities | 124.24 | -- | -- | -- | -- | -- | -- |
| Operating leases | -- | 4.43 | 0.26 | 0.26 | (0.26) | 4.16 | -- |
| Postretirement benefit obligations/deferred compensation | 169.66 | -- | -- | 0.15 | -- | -- | -- |
| Accessible cash and liquid investments | (9.90) | -- | -- | -- | -- | -- | -- |
| Capitalized interest | -- | -- | -- | 4.17 | (4.17) | (4.17) | (4.17) |
| Share-based compensation expense | -- | 11.35 | -- | -- | -- | -- | -- |
| Power purchase agreements | 90.50 | 13.96 | 3.46 | 3.46 | (3.46) | 10.50 | 10.50 |
| Asset-retirement obligations | 16.07 | 0.88 | 0.88 | 0.88 | -- | -- | -- |
| Nonoperating income (expense) | -- | -- | 23.83 | -- | -- | -- | -- |
| Debt: Other | 37.24 | -- | -- | -- | -- | -- | -- |
| Total adjustments | 427.82 | 30.61 | 28.42 | 8.92 | (132.74) | 10.49 | 6.33 |
| **S&P Global Ratings' adjusted amounts** | | | | | | | |
| | **Debt** | **EBITDA** | **EBIT** | **Interest expense** | **Funds from operations** | **Cash flow from operations** | **Capital expenditure** |
| | 2,560.93 | 446.99 | 238.81 | 109.10 | 314.25 | 408.70 | 448.84 |

Sources: S&P Global Ratings, company reports.

### Capital structure

Avista's capital structure consists of about $1.9 billion of long-term debt, most of which is secured.

### Analytical conclusions

We rate the preferred stock issued by Avista Capital II two notches below the issuer credit rating to reflect the deferability of the dividends, and because it is deeply subordinated to other instruments in the capital structure, consistent with our criteria. The short-term rating on Avista Corp. is 'A-2' based on its issuer credit rating.

## Issue Ratings - Recovery Analysis

Avista's first-mortgage bonds benefit from a first-priority lien on substantially all of the utility's owned or subsequently acquired real property. Collateral coverage of more than 1.5x supports a recovery rating of '1+' and an 'A-' issue level rating, two notches above the issuer credit rating.

## Ratings Score Snapshot

**Issuer Credit Rating**

BBB/Stable/A-2

**Business risk: Strong**

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Satisfactory

**Financial risk: Significant**

- **Cash flow/leverage:** Significant

**Anchor: bbb**

**Modifiers**

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

**Stand-alone credit profile : bbb**

## Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- Criteria | Corporates | Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Insurance | General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

**Business And Financial Risk Matrix**

| | **Financial Risk Profile** | | | | | |
|---|---|---|---|---|---|---|
| **Business Risk Profile** | Minimal | Modest | Intermediate | **Significant** | Aggressive | Highly leveraged |
| Excellent | aaa/aa+ | aa | a+/a | a- | bbb | bbb-/bb+ |
| **Strong** | aa/aa- | a+/a | a-/bbb+ | **bbb** | bb+ | bb |
| Satisfactory | a/a- | bbb+ | bbb/bbb- | bbb-/bb+ | bb | b+ |
| Fair | bbb/bbb- | bbb- | bb+ | bb | bb- | b |
| Weak | bb+ | bb+ | bb | bb- | b+ | b/b- |
| Vulnerable | bb- | bb- | bb-/b+ | b+ | b | b- |

**Ratings Detail (As Of May 29, 2020)***

| | |
|---|---|
| **Avista Corp.** | |
| Issuer Credit Rating | BBB/Stable/A-2 |
| Senior Secured | A- |
| **Issuer Credit Ratings History** | |
| 10-Dec-2018 | BBB/Stable/A-2 |
| 15-Jun-2018 | BBB/Watch Pos/A-2 |
| 19-Jul-2017 | BBB/Positive/A-2 |

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.