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Credit Opinion: Avista Corp.

Global Credit Research - 11 Mar 2015

Spokane, Washington, United States

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating	Baa1
First Mortgage Bonds	A2
Senior Secured	A2
Senior Unsecured MTN	(P)Baa1
Avista Corp. Capital II	
Outlook	Stable
BACKED Pref. Stock	Baa2

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Key Indicators

[1]**Avista Corp.**

	12/31/2014	**12/31/2013**	**12/31/2012**	**12/31/2011**
CFO pre-WC + Interest / Interest	**5.2x**	**4.8x**	**4.4x**	**4.8x**
CFO pre-WC / Debt	**18.8%**	**19.4%**	**17.4%**	**19.1%**
CFO pre-WC - Dividends / Debt	**14.3%**	**15.0%**	**13.3%**	**15.1%**
Debt / Capitalization	**44.4%**	**46.9%**	**47.7%**	**47.5%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Low-risk utility in supportive regulatory jurisdictions

Core utility business in Washington provides stable cash flow

Elevated capex, dividend payout and share buybacks are credit negatives

Corporate Profile

Avista Corp. is primarily a regulated electric and gas utility servicing around 367,000 electric and 326,000 gas customers in Washington, Idaho and Oregon. Avista also owns Alaska Energy and Resources Company (AERC;

not rated), parent of Alaska Electric Light and Power Company (AEL&P; not rated) which serves around 16,000 electric customers in Juneau, Alaska.

Avista's utility operations are primarily regulated by the Washington Utilities and Transportation Commission (WUTC), Idaho Public Utilities Commission (IPUC) and the Oregon Public Utility Commission (OPUC). AEL&P's rates are regulated by the Regulatory Commission of Alaska (RCA).

SUMMARY RATING RATIONALE

Avista's Baa1 issuer rating reflects its primary business as a low-risk vertically integrated electric and gas utility in supportive regulatory jurisdictions. The rating also incorporates a steady financial profile that should remain as such with a newly implemented decoupling mechanism in Washington, and a business risk profile that has been enhanced by the 2014 sale of its unregulated energy management services subsidiary in mid-2014. The addition of a small utility in Alaska has added marginal regulatory, operational and cash flow diversity, but remains ratings neutral for the company.

Avista has initiated, and partly executed, a share repurchase program and increasing dividend during a time of heightened capital expenditures, which tempers some of the positive ratings trends. Furthermore, management team has identified areas of intended growth which could be unregulated in nature, but we view this as more long-term and is not incorporated in the Baa1 rating.

DETAILED RATING CONSIDERATIONS

SUPPORTIVE REGULATION PROVIDES RATINGS BALLAST

The primary credit driver for Avista is the degree of regulatory support and cost recovery allowed by its regulatory authorities, and particularly via the WUTC, which regulates roughly 60% of the company's revenue. In December 2014, the WUTC authorized approximately $12.3 million of electric, and $8.5 million gas, revenue increases, effective January 1, 2015. More importantly, the WUTC rate order allowed Avista to implement a revenue decoupling mechanism for both electric and gas customers. The mechanism will be in place for five years, but reviewed after three years and will include an earnings test and demand reduction targets for determining collections/rebates. Avista's annual decoupling charges will be capped at 3% of rates, with unrecovered balances carried forward to future years. We view the implementation of full electric and gas decoupling mechanisms as a significant credit positive for the company, since it will enhance the recovery of fixed costs for the utility and provide for stable and predictable gross margin and cash flow over the next several years. While the company's cash flow has been very stable, historically, the decoupling mechanism should help to reduce some regulatory lag.

While we've seen improvement in the Washington jurisdiction, we note that Avista's recent all-party (and OPUC staff approved) settlement in Oregon was rejected by the OPUC. Avista had filed for over $9.1 million of revenue increases in Oregon, in which the OPUC took exception to three areas: early adoption of a customer credit related to pipe replacement expenditures; rate allocation between customers; and an accounting mechanism which could defer margin based on actual-to-stipulated customer count (i.e., "customer count tracking mechanism"). While we maintain our view that the Oregon regulatory framework is ultimately supportive, the rejection of an all-party settlement is rare and adds an element of unpredictability to the ultimate decision and rate structure of the case. Oregon rates typically provide roughly 10% of Avista's annual revenue, so while it is a credit negative from a predictability standpoint, it is not a material ratings driver. We note that the company and settling parties issued a new stipulation, to address the OPUC concerns, on March 6th.

Idaho, Avista's third primary regulatory jurisdiction, is viewed as the most supportive of Avista's state regulatory environments. The IPUC allows for a wide variety of interim rate making mechanisms (trackers) and has a track record of credit supportive rate decisions. This allows for a high degree of predictability to roughly 25% of Avista's consolidated revenue.

FINANCIAL METRICS COULD BE PRESSURED AMIDST SHARE BUYBACKS, HIGH CAPEX AND INCREASING DIVIDEND

Avista's key financial metrics, such as cash flow from operations before the changes in working capital (CFO pre-WC) to debt, have been very stable over the past five years, at around 17%. The company consistently produces around $275 million of CFO pre-WC, which excludes the impact of one-time cash flow benefits from tax accounting allowances (the most significant benefit occurring in 2014, where both capital repairs and bonus depreciation boosted CFO through deferred taxes). This compares to roughly $1.6 billion of debt, on average over the past five years.

The primary challenges to Avista's financial metrics will come via a heightened capital spend and high dividend payout. The company's capital expenditures have been on a steady rise since 2010 ($205 million) and is expected to peak at $390 million this year (including $15 million at AEL&P), while maintaining a relatively high $365 million in both 2016 and 2017. Financing these expenditures will require additional debt issuances, especially in light of a share buyback program (approximately 2.5 million shares were repurchased in 2014 for nearly $80 million; the company also has board authorization to repurchase 800,000 more through 1Q15) and an increasing dividend, targeted at a growth of 4% to 5% annually. We note that the company is expecting to keep the dividend within its earnings growth rate, but at a negative free cash flow level of $180 million in 2015, Avista is financing the dividend through debt - a credit negative.

Our expectations for Avista to produce $275 million of CFO, have $390 million in capital expenditures and over $80 million of expected dividends, will leave the company with a significant free cash flow deficit (i.e., about $195 million) in the coming months. The company will make use of the cash flow generated from tax benefits to help fund these expenditures, which may lessen the debt financing required (we expect Avista to capitalize operations in-line with its WUTC allowed capital structure of 47% / 53% equity / debt). Absent the one-time tax boosts to CFO, and considering higher debt levels, Avista could produce at or near 15% CFO pre-WC to debt, which is more reflective of a Baa2 vertically integrated electric and gas utility.

Avista's greatest capital requirements are primarily related to bolstering its transmission and distribution assets, as well as upgrading its hydroelectric generation facilities. The nature of these investments is more basic when compared to many other integrated utilities across the nation who are in the midst of constructing new generation facilities or making significant environmental upgrades. Avista's long power supply position is beneficial to its credit profile as the company is not currently required to make investments in higher-cost, higher-risk assets, like many of its regional peers.

APPETITE FOR GROWTH MAY INTRODUCE GREATER RISK OVER THE LONG-TERM

Avista's business risk profile improved in 2014, through the sale of Avista's primary unregulated business (Ecova, not rated) and through the acquisition of rate regulated utility assets in Alaska. We view both developments as credit positive since it increased the overall contribution and diversity of regulated cash flow to consolidated operations. However, we view both as ratings neutral given the small size of each subsidiary. Furthermore, the addition of AERC offers no real synergies to speak of, along with a new regulatory relationship to maintain, which requires a share of management attention.

As described above, the nature of Avista's capital plan is viewed positively, since it is focused on basic system improvements; however, we continue to caution that should the "plain vanilla" type investment profile cause management to look for growth opportunities in non-traditional areas, this could have the potential to raise the risk profile of Avista's investments, which could overshadow the regulated bias of M&A activity in 2014.

Along these lines, we note that management has identified and drawn attention to creating new growth platforms through a non-utility subsidiary, Salix, Inc. (not rated), a subsidiary of Avista Capital, Incl. (not rated, a wholly-owned subsidiary of Avista). Salix was formed to explore opportunities to extend natural gas use beyond traditional pipeline supplied markets, via expansion of liquefied natural gas (LNG) services throughout the region. Avista's strategy is premised on the low-price and abundant supply of natural gas, which could give LNG an economic advantage over other competing fuels.

We view Salix much in the same way we did the development of Ecova, from its nascent stages in the mid-to-late 2000's. We expect that management will take small, measured approaches to the development of its unregulated business, with Salix's overall contribution to the consolidated entity remaining around 10% - 15% of earnings and cash flow. Should Salix grow to be a larger portion of earnings and cash flow, or exhibit more business risk (e.g., as a commodity-based business, unlike the operations of Ecova), we would view this as negative to Avista's credit profile. Currently, Salix and Avista's plans to explore LNG delivery throughout the Pacific Northwest is not impacting the company's ratings.

Liquidity

Avista's external liquidity source consists of a $400 million senior secured revolving credit facility, which expires in April 2019. As of December 31, 2014, there were $105 million of cash borrowings and nearly $33 million in letters of credit outstanding, leaving $262 million of available liquidity under the line of credit. Since Avista currently has unsecured investment grade ratings from two nationally recognized rating agencies, the company has the option to request the banks to relinquish the existing First Mortgage Bond collateral position, but it has chosen not to do so for economic reasons. Despite the collateral staying in place at Avista's discretion, the secured nature of the credit

facilities somewhat constrains Avista's liquidity flexibility, in our opinion, since the typical investment grade issuer (having an unsecured facility) can use collateral as an option to improve bank credit access during periods of unforeseen liquidity stress.

The facility has a $100 million accordion feature and is subject to grid pricing. The $400 million facility does not contain any material adverse change language for borrowings but does so to access the $100 million accordion feature. The facility also includes a debt to capitalization covenant not to exceed 65%. As of December 2014, the company had sufficient headroom available under the debt to capitalization covenant.

AEL&P has a $25 million line of credit which expires in November 2019 and has a consolidated debt to capitalization covenant of 67.5%. As of December 31, 2014, the full amount was available for borrowing and AEL&P was in compliance with its covenant.

Avista's next material debt maturities occur in August 2016 when $90 million of first mortgage bonds is due. AERC's next maturity is in 2019 when its $15 million term loan is scheduled to expire.

Rating Outlook

The stable outlook incorporates our view that Avista's financial profile will maintain CFO pre-WC to debt in the high-teens range and that it will ultimately continue to receive supportive cost recovery from its regulators. The stable outlook also incorporates a view that unregulated operations will remain below 15% of consolidated earnings and cash flow, and that the company's financial policy will maintain a relatively even mix of debt and equity in its capital structure.

What Could Change the Rating - Up

The ratings for Avista could be upgraded if the company were able to produce CFO pre-WC to debt above 20% on a sustainable basis, without the benefits from one-time tax policy adjustments.

What Could Change the Rating - Down

Avista's ratings could be negatively impacted if the level of regulatory support wanes, if the contribution of its unregulated business were to increase disproportionately to those of its regulated operations, or if CFO pre-WC to debt were to fall to 15% for a sustainable period.

Rating Factors

Avista Corp.

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current LTM 12/31/2014**		[3]**Moody's 12-18 Month Forward ViewAs of Date Published**	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	A	A	A	A
b) Consistency and Predictability of Regulation	A	A	A	A
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Baa	Baa	Baa	Baa
b) Sufficiency of Rates and Returns	Baa	Baa	Baa	Baa
Factor 3 : Diversification (10%)				
a) Market Position	Baa	Baa	Baa	Baa
b) Generation and Fuel Diversity	A	A	A	A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	4.8x	A	4.5x - 4.9x	A
b) CFO pre-WC / Debt (3 Year Avg)	18.6%	Baa	15% - 19%	Baa

c) CFO pre-WC - Dividends / Debt (3 Year Avg)	14.2%	Baa	11% - 15%	Baa
d) Debt / Capitalization (3 Year Avg)	46.4%	Baa	45% - 50%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa1		Baa1
HoldCo Structural Subordination Notching	n/a	n/a		n/a
a) Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned		Baa1		Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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