S&P Global Ratings

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Summary:

Avista Corp.

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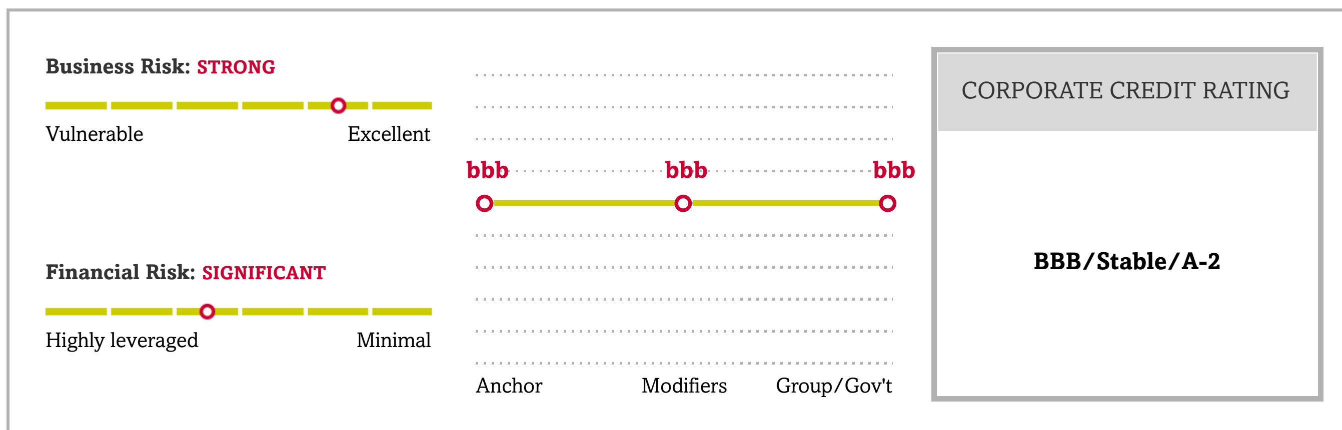

Rationale

Business Risk: Strong	Financial Risk: Significant
• Regulated, vertically integrated electric and natural gas distribution utility. • Non-utility operations are minimal (less than 5% of consolidated EBITDA). • Geographic and operational diversity with large Washington focus. • Fuel supply mix tilted toward hydroelectric power, followed by natural gas. • Regulatory mechanisms provide cash flow stability when Avista purchases power during low-water periods, but do not allow recovery of capital investments between rate cases.	• Capital spending of $400 million - $420 million annually. • Negative discretionary cash flow. • Funding of capital expenditures through a healthy combination of external funding and equity issuance. • Adequate liquidity position provides a cushion due to Avista's reliance on hydroelectric power.

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Outlook: Stable

S&P Global Ratings' stable outlook on Avista Corp. reflects our expectation that over the next two years the company will make efforts to better manage its regulatory risk, fund capital spending in a manner that does not meaningfully increase leverage, preserve adequate liquidity, and maintain comparable financial performance. Under our base-case scenario we expect funds from operations (FFO) to total debt to average around 17%.

Downside scenario

We could lower the rating if business risk rises materially or credit measures diminish such that FFO to debt would be consistently below 15%. This could occur due to increased use of leverage to cover funding shortfalls or adverse regulatory decisions leading to increased regulatory lag or a large deferral.

Upside scenario

We do not contemplate an upgrade in the next two years given the company's current business mix, regulatory risk and financial position. Credit quality could strengthen if cash flow measures considerably improve, specifically FFO to debt of more than 20% on a consistent basis. The company could accomplish this by paying down debt with higher internally generated cash flow, increased equity issuances, asset dispositions or by boosting FFO without adding debt.

Our Base-Case Scenario

Assumptions

- Effective management of regulatory risk especially in Washington where Avista was denied a rate increase.
- Capital spending of $400 million - $420 million annually.
- Dividends of roughly $100 million annually.
- Regular recovery of electric and gas rates in Washington, through surcharges and approval of base rate reset, respectively.
- Average operation and maintenance expenses consistent with historical levels.

Key Metrics

	2016A	2017E	2018E
FFO/total debt (%)	21	16.5-18	15.6-18
Debt/EBITDA (x)	4.3	4.1-4.6	4-4.5
OCF/total debt (%)	16.9	15-16	16-17.5

S&P Global Ratings' adjusted figures. A--Actual. E--Estimate. FFO--Funds from operations. OCF--Operating cash flow.

Business Risk: Strong

Avista's low business risk profile reflects the strength and contribution of its regulated electric and gas utility operations. Avista conducts vertically integrated electric and natural gas distribution utility operations in Washington and Idaho, electric operations in Alaska, and gas distribution in Oregon. Although the company operates in four states,

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Washington and Idaho are the key revenue drivers, with Oregon and Alaska contributing less than 10% of revenues on a combined basis. The customer base of roughly 700,000 electric and gas customers has no meaningful industrial concentration and demonstrates average growth prospects. The company has material exposure to hydro-electric power (roughly 35% - 40% of fuel supply mix), followed by gas-fired generation, both of which help to keep electricity prices competitive compared with the national average but dependence on hydro power introduces fuel replacement risk in low water years. Recovery mechanisms are important to maintain operating cash flow after purchasing power for customers when hydroelectric generation is lower than expected.

The company has an earnings mechanism in Washington subject to minimum thresholds and a deferral band which helps it recover excess power costs while absorbing a portion of the difference. The company also has a power cost adjustment in Idaho, which allows 90% of energy cost differences to be deferred for future recovery. Purchased gas mechanisms for gas distribution units in all three gas jurisdictions, along with hedging, mitigate gas price risk. These regulatory mechanisms help avert large cost-adjustment requests and support the business risk profile. Decoupling mechanisms smooth out operating cash flow in all jurisdictions except Alaska.

Financial Risk: Significant

We assess Avista's financial risk profile as significant using financial ratio benchmarks that are more relaxed compared with those used for typical corporate issuers, given the mostly steady cash flow from regulated utility operations. 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 to pay for capital expenditures and dividends. Our base-case scenario suggests lower financial measures over the next two years, including funds from operations (FFO) to debt of roughly 16% - 18%, reflecting a rate increase denial in Washington earlier this year. The financial measures, although lower than full year 2016 results, remain in the middle range of our significant financial risk profile for 2017 and 2018. Importantly, our forecasts indicate the company will need to get timely base rate recoveries to keep financial measures from slipping to the lower end of the financial profile (which may happen if they do not get the rate increases recently requested as part of general rate cases in Washington and Idaho). Our base case indicates an expected supplemental ratio of operating cash flow to debt of about 15% to about 17%, supporting the significant financial risk profile assessment.

Liquidity: Adequate

Avista has an adequate liquidity assessment because in our view its sources are likely to cover uses by more than 1.1x over the next 12 months and to meet cash outflows, even in the event of a 10% decline in EBITDA. The adequate assessment also reflects the company's generally prudent risk management, sound relationships with banks, and a generally satisfactory standing in credit markets.

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Principal Liquidity Sources	Principal Liquidity Uses
• Cash FFO of about $355 million • Revolving credit facility of $400 million.	• Debt maturities of roughly $110 million, including short term debt • Capital spending of about $410 million • Dividends of roughly $95 million.

Other Credit Considerations

Other modifiers have no impact on the rating outcome.

Group Influence

Avista is subject to our group rating methodology criteria. We view Avista as the parent and driver of the corporate group. As a result, Avista's group and stand-alone credit profiles are the same at 'bbb'.

Recovery Analysis

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

Issue Ratings

- We rate the preferred stock issued by Avista Capital II two notches below the issuer credit rating to reflect the discretionary nature of the dividend and the deeply subordinated claim if a bankruptcy occurs.
- The short-term rating on Avista Corp. is 'A-2' based on its issuer credit rating.

Related Criteria And Research

Related Criteria

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

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- 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 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-

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