2007 Annual Report

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AVISTA Corp.

Other fuel costs increased $14.2 million. This represents fuel that was purchased for generation, but was later sold when conditions indicated that it was not economic to use the fuel in generation as part of the resource optimization process. The associated revenues are reflected as sales of fuel. Other fuel costs exceeded revenues we received from selling the natural gas. We account for this shortfall under the ERM in Washington and the PCA in Idaho. The increase in other fuel costs was primarily due to a reduced percentage of fuel used in generation and higher natural gas fuel prices.

The expense for natural gas purchased for sale to customers increased $35.3 million primarily due to an increase in total therms purchased (increased costs $54.8 million). This was due to an increase in wholesale sales as part of the balancing of loads and resources with the natural gas procurement process, partially offset by a slight decrease in retail sales volumes. This was partially offset by a decrease in the cost of natural gas (decreased costs $19.5 million). During 2006, we amortized $28.4 million of deferred natural gas costs compared to net deferrals of $13.9 million for 2005. The change reflects higher retail rates (through purchased gas cost adjustments) to collect deferred natural gas costs from customers.

ENERGY MARKETING AND RESOURCE MANAGEMENT

The Energy Marketing and Resource Management segment primarily includes the results of Avista Energy. On June 30, 2007, Avista Energy completed the sale of substantially all of its contracts and ongoing operations. Completion of this transaction effectively ended the majority of the operations of this business segment.

The historical activities of Avista Energy included:

- trading electricity and natural gas,
- the optimization of generation assets owned by other entities,
- long-term electric supply contracts,
- natural gas storage, and
- electric transmission and natural gas transportation arrangements.

Avista Energy reports the net margin on derivative commodity instruments held for trading as operating revenues. Revenues from contracts that are not derivatives under SFAS No. 133 and derivative commodity instruments not held for trading are reported on a gross basis in operating revenues. Costs from contracts that are not derivatives under SFAS No. 133 and derivative commodity instruments not held for trading, are reported on a gross basis in resource costs.

The following table presents our net realized gains and net unrealized gains (losses) from Avista Energy for the year ended December 31 (dollars in thousands):

	2007	2006	2005
Net realized gains	$ 17,459	$ 31,904	$ 40,142
Net unrealized gains (losses)	(24,594)	1,510	(38,126)
Total gross margin (operating revenues less resource costs)	$ (7,135)	$ 33,414	$ 2,016

Overall segment results for 2007 compared to 2006

This segment had a net loss of $11.9 million for 2007 compared to net income of $11.6 million for 2006. The difference between the estimated market value and the required accounting for certain contracts and physical assets under management increased the net loss by $6.4 million from this segment for 2007 and reduced net income by $2.2 million for 2006. The lower than expected results from this segment for 2007 were primarily due to:

- underperformance on the power side of the business,
- losses on the power purchase agreement for the Lancaster Plant, and
- a loss on the net assets sold to Shell Energy.

Total assets for this segment decreased $986.5 million from December 31, 2006 to December 31, 2007 as a result of the sale of contracts to Shell Energy and the liquidation of assets not sold to Shell Energy. The remaining assets in this segment of $30.7 million are primarily natural gas storage and deferred income taxes.

Overall segment results for 2006 compared to 2005

The Energy Marketing and Resource Management segment had net income of $11.6 million for 2006 compared to a net loss of $8.6 million for 2005. The increase in net income for 2006 as compared to 2005 was primarily due to the improved results from natural gas trading activities and the continued execution of profitable transactions in power trading and other asset management and optimization activities. The difference between the estimated market value and the required accounting for certain contracts and physical assets under management of Avista Energy reduced our net income by an estimated $2.2 million for 2006. Our net loss for 2005 for this segment was due to losses in Avista Energy's natural gas portfolio. Our net loss for 2005 for this segment was reduced by an estimated $0.4 million due to the effects of differences between the estimated market value and the required accounting for certain energy contracts and physical assets under management of Avista Energy.

Analysis of operating revenues and resource costs for 2007 compared to 2006

Operating revenues decreased $116.0 million to $61.5 million primarily due to a decrease of $60.3 million in net trading margin on contracts accounted for under SFAS No. 133 and a $63.2 million decrease from sales of natural gas to commercial and industrial end-user customers (both through Avista Energy Canada and to Montana customers). This category of revenues decreased significantly in 2007 with the sale of substantially all of Avista Energy's contracts and ongoing operations on June 30, 2007.

Resource costs decreased $75.5 million primarily due to decreased resource costs related to sales of natural gas to commercial and industrial end-user customers, and a change in natural gas inventory. This category of expenses decreased significantly in 2007 with the sale of substantially all of Avista Energy's contracts and ongoing operations on June 30, 2007.

Our gross margin (operating revenues less resource costs) from Avista Energy was a loss of $7.1 million for 2007 compared to a gain of $33.4 million for 2006. The decrease was primarily due to underperformance on the power side of the business, losses on the power purchase agreement for the Lancaster Plant, and the difference between the estimated market value and the

required accounting for certain contracts and physical assets under management.

The remaining operating revenues and resource costs for this segment primarily represent payments for the power purchase agreement for the Lancaster Plant. The majority of the rights and obligations of this agreement were assigned to Shell Energy through the end of 2009. Beginning in 2010 through 2026, the rights and obligations of the power purchase agreement for the Lancaster Plant will be contracted to Avista Energy. We expect that these rights and obligations will be transferred to our regulated utility, subject to future approval by the WUTC and the IPUC.

Analysis of operating revenues and resource costs for 2006 compared to 2005

Operating revenues from this segment increased $10.1 million and resource costs decreased $21.3 million resulting in an increase in our gross margin of $31.4 million.

Operating revenues increased primarily due to an increase of $32.6 million in net trading margin on contracts accounted for under SFAS No. 133, partially offset by decreased revenues of:

- $3.9 million from sales of natural gas to commercial and industrial end-user customers (a decrease through Avista Energy Canada offset by an increase in revenues from Montana customers), and
- $19.4 million under the Agency Agreement with Avista Utilities as natural gas procurement operations were transitioned to Avista Utilities effective April 1, 2005.

Resource costs decreased primarily due to decreased resource costs:

- under the Agency Agreement with Avista Utilities,
- related to sales of natural gas to commercial and industrial end-user customers (a decrease through Avista Energy Canada, partially offset by increases for Montana customers), and
- for transportation and transmission costs.

This was partially offset by a change in natural gas inventory.

Our gross margin (operating revenues less resource costs) from Avista Energy was a gain of $33.4 million for 2006 compared to $2.0 million for 2005. The increase was primarily due to:

- unrealized losses associated with the accounting for our management of natural gas inventory in 2005, and
- improved results from our natural gas trading activities (which had significant losses in 2005).

Our net realized gains from Avista Energy decreased to $31.9 million for 2006 from $40.1 million for 2005. The decrease in our net realized gains was primarily due to:

- decreased net gains on physical electric transactions, and
- increased net losses on settled financial transactions.

This was partially offset by decreased net losses on physical natural gas transactions.

Our total mark-to-market adjustment from this segment was a net unrealized gain of $1.5 million for 2006 compared to a net unrealized loss of $38.1 million for 2005.

Energy trading activities and positions

The following table summarizes information for trading activities at Avista Energy during 2007 (dollars in thousands):

	Electric Assets net of Liabilities	Natural Gas Assets net of Liabilities	Total Unrealized Gain (Loss)
Fair value of contracts as of December 31, 2006	$ 34,044	$ (507)	$ 33,537
Less contracts settled during 2007 [(1)]	(25,080)	7,792	(17,288)
Less contracts sold to Shell Energy [(2)]	(13,571)	5,670	(7,901)
Fair value of new contracts when entered into during 2007 [(3)]	–	–	–
Change in fair value due to changes in valuation techniques [(4)]	–	–	–
Change in fair value attributable to market prices and other market changes	4,607	(12,955)	(8,348)
Fair value of contracts as of December 31, 2007	$ –	$ –	$ –

(1) *Contracts settled during 2007 include those contracts that were open in 2006 but settled during 2007 as well as new contracts entered into and settled during 2007. Amount represents net realized gains associated with these settled transactions.*

(2) *Represents the estimated fair value of the contracts sold to Shell Energy on June 30, 2007.*

(3) *We did not enter into any origination transactions during 2007 in which we recognized any dealer profit or mark-to-market gain or loss at inception.*

(4) *During 2007, we did not experience a change in fair value due to changes in valuation techniques.*

ADVANTAGE IQ

2007 compared to 2006

Net income for Advantage IQ was $6.7 million for 2007 compared to $6.3 million for 2006. Operating revenues increased $7.6 million and operating expenses increased $7.1 million. The increase in operating revenues was primarily due to the expansion of Advantage IQ's customer base as well as an increase in interest earnings on funds held for customers. As of December 31, 2007, Advantage IQ had 403 customers representing 199,000 billed sites in North America. The number of billed sites decreased slightly from December 31, 2006. This decrease was due to the loss of a customer that had a significant number of billed sites, and represented approximately 1 percent of annualized revenues. The increase in operating expenses primarily reflects increased labor and other operational costs necessary to serve an expanding customer base, which included consulting services. In 2007, Advantage IQ processed bills totaling $12.5 billion, an increase of $1.7 billion, or 16 percent, as compared to 2006.