



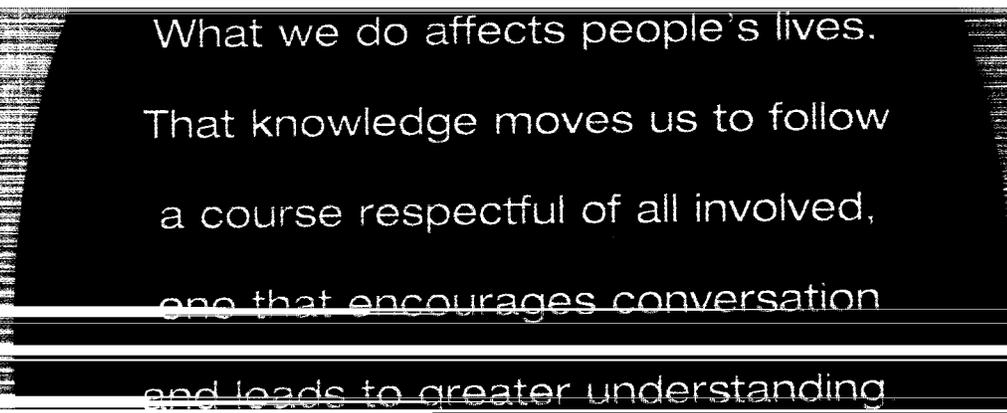
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As a shareholder, you expect a fair return. Community members
demand on responsible stewardship. If you're a customer, you want
the porch light to come on and the furnace to fire. Others -
regulators, partners, employees - have concerns of their own
and Avista stands accountable.

We answer to you.





What we do affects people's lives.
That knowledge moves us to follow
a course respectful of all involved,
one that encourages conversation
and leads to greater understanding

Can you think of a better way
to do business?

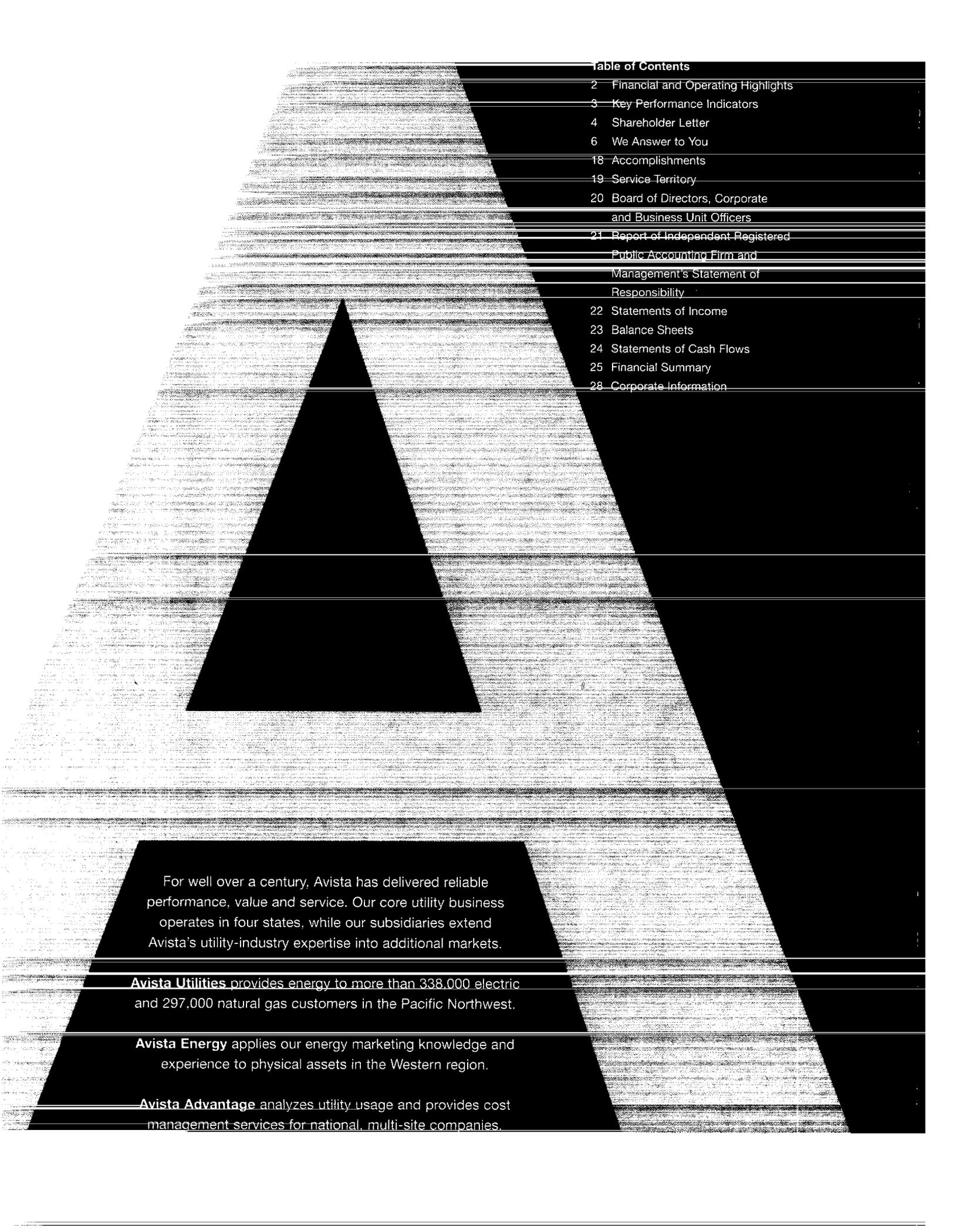


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For well over a century, Avista has delivered reliable performance, value and service. Our core utility business operates in four states, while our subsidiaries extend Avista's utility-industry expertise into additional markets.

Avista Utilities provides energy to more than 338,000 electric and 297,000 natural gas customers in the Pacific Northwest.

Avista Energy applies our energy marketing knowledge and experience to physical assets in the Western region.

Avista Advantage analyzes utility usage and provides cost management services for national, multi-site companies.

Financial and Operating Highlights

(Dollars in Thousands Except Statistics and Per Share Amounts or as Otherwise Indicated)

Financial Results

| | 2005 | 2004 | 2003 |
|--|------------------|------------------|------------------|
| Operating revenues | \$ 1,359,607 | \$ 1,151,580 | \$ 1,123,385 |
| Operating expenses | <u>1,211,676</u> | <u>1,011,110</u> | <u>951,682</u> |
| Gain on sale of utility properties | 4,093 | — | — |
| Income from operations | <u>152,024</u> | <u>140,470</u> | <u>171,703</u> |
| Income from continuing operations | 45,168 | 35,614 | 50,643 |
| Loss from discontinued operations | — | — | (4,949) |
| Net income before cumulative effect of accounting change | 45,168 | 35,614 | 45,694 |
| Cumulative effect of accounting change | — | (460) | (1,190) |
| Net income | 45,168 | 35,154 | 44,504 |
| Preferred stock dividend requirements ⁽¹⁾ | — | — | (1,125) |
| Income available for common stock | <u>\$ 45,168</u> | <u>\$ 35,154</u> | <u>\$ 43,379</u> |
| Earnings per common share from continuing operations, diluted | \$ 0.92 | \$ 0.73 | \$ 1.02 |
| Loss per common share from discontinued operations, diluted | — | — | (0.10) |
| Earnings per common share before cumulative effect of accounting change, diluted | 0.92 | 0.73 | 0.92 |
| Loss per common share from cumulative effect of accounting change, diluted | — | (0.01) | (0.03) |
| Earnings per common share, diluted | <u>\$ 0.92</u> | <u>\$ 0.72</u> | <u>\$ 0.89</u> |
| Earnings per common share, basic | \$ 0.93 | \$ 0.73 | \$ 0.90 |
| Dividends paid per common share | 0.545 | 0.515 | 0.490 |
| Book value per common share | \$ 15.87 | \$ 15.54 | \$ 15.54 |
| Average common shares outstanding | 48,523 | 48,400 | 48,232 |
| Actual common shares outstanding | 48,593 | 48,472 | 48,344 |
| Return on average common equity | 5.9% | 4.7% | 5.9% |
| Common stock closing price | \$ 17.71 | \$ 17.67 | \$ 18.12 |

Operating Results

Avista Utilities

| | | | |
|--|------------|------------|------------|
| Retail electric revenues | \$ 511,864 | \$ 506,428 | \$ 489,168 |
| Retail kWh sales (in millions) | 8,530 | 8,363 | 8,027 |
| Retail electric customers at year-end | 338,369 | 331,014 | 325,554 |
| Wholesale electric revenues | \$ 151,429 | \$ 62,399 | \$ 73,463 |
| Wholesale kWh sales (in millions) | 2,508 | 1,472 | 2,075 |
| Total natural gas revenues | \$ 438,205 | \$ 320,493 | \$ 277,289 |
| Total therms delivered (in thousands) | 562,307 | 495,584 | 490,474 |
| Retail natural gas customers at year-end | 297,277 | 304,850 | 298,296 |

| | | | |
|-----------------------------------|-----------|-----------|-----------|
| Income from continuing operations | \$ 52,479 | \$ 32,467 | \$ 36,241 |
|-----------------------------------|-----------|-----------|-----------|

Energy Marketing and Resource Management

| | | | |
|---|------------|-----------|-----------|
| Gross margin (operating revenues less resource costs) | \$ 2,016 | \$ 38,842 | \$ 60,189 |
| Income (loss) from continuing operations | \$ (8,621) | \$ 9,733 | \$ 20,672 |
| kWh sales (in millions) | 28,377 | 32,629 | 41,579 |
| Natural gas sales (thousands of dekatherms) | 182,874 | 219,719 | 228,397 |

Avista Advantage

| | | | |
|--|-----------|-----------|-----------|
| Revenues | \$ 31,748 | \$ 23,444 | \$ 19,839 |
| Income (loss) from continuing operations | 3,922 | 577 | (1,334) |

Other

| | | | |
|---------------------------------|-----------|-----------|-----------|
| Revenues | \$ 18,532 | \$ 17,127 | \$ 13,581 |
| Loss from continuing operations | (2,612) | (7,163) | (4,936) |

Financial Condition

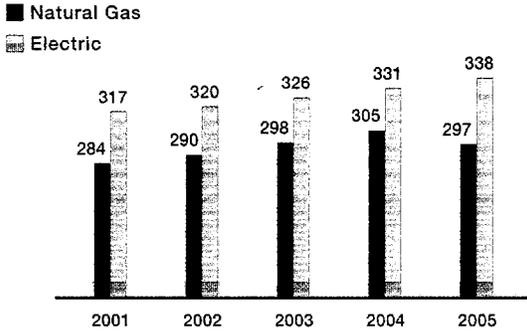
| | | | |
|--|--------------|--------------|--------------|
| Total assets | \$ 4,948,494 | \$ 3,711,621 | \$ 3,640,075 |
| Long-term debt | 989,990 | 901,556 | 925,012 |
| Long-term debt to affiliated trusts | 113,403 | 113,403 | 113,403 |
| Preferred stock (subject to mandatory redemption) ⁽¹⁾ | 26,250 | 28,000 | 29,750 |
| Common equity | 771,128 | 753,205 | 751,252 |

(1) Pursuant to changes in accounting principles, preferred stock was reclassified to liabilities and preferred stock dividend requirements were reclassified to interest expense effective July 1, 2003.

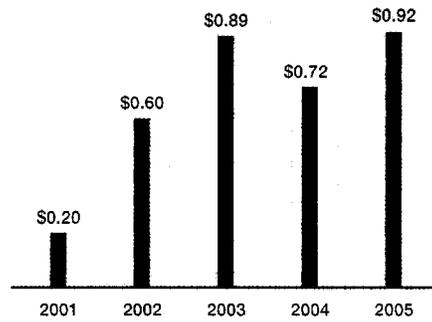
Key Performance Indicators

Total Customers

(In thousands of customers, as of December 31)

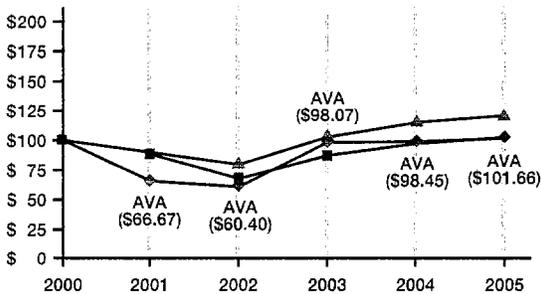


Earnings Per Common Share, Diluted



Total Return to Shareholders

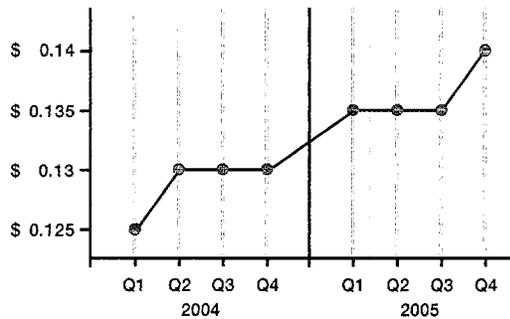
(Includes reinvestment of dividends)



- ◆ Avista Corp. (AVA)
- ▲ S&P 400 Electric Utilities Index
- S&P 500 Index

A \$100 investment in Avista on Dec. 31, 2000, compared to Standard & Poor indices.

Common Stock Dividends



Our unending quest for intelligent solutions to intricate issues – solutions that take into account the interests of all involved – provides value for shareholders and serves our customers well.

What happens next?

I've talked to you in this letter before about my dad and about how he believed the only thing of real value is your word.

That's not a new idea, of course, but he really lived it. He taught me to live it, too.

So in this year's annual report, we're giving you our word. We've opened up the pages to a wide range of our constituents – a customer, an elected official, an investor, an industry analyst, a tribal leader and an employee – and encouraged them to ask us anything.

And we answer their questions – honestly and candidly.

At Avista, we wrestle with many complicated issues, but we always do so mindful of the principles that guide us: trust, integrity, innovation, relationships and collaboration. By holding to those convictions, we're confident that mutually beneficial outcomes result.

As you read on, you might find questions you've thought of yourself. You'll also see more questions on our Web site at www.avistacorp.com.

I hope the Q&A format gives you some sense of the number and diversity of our stakeholders and the considerable challenge we undertake in striving to balance all their interests.

Ofentimes we do that well. Avista Utilities, for instance, had a very good 2005. Customers and shareholders alike benefited from the increased efficiency we achieved by automating meter reading in Oregon and half of our Idaho territory. We helped employees whose positions were eliminated find other ways to apply their skills, and we retained everyone who chose to stay at Avista.

Centralizing our distribution dispatch functions and holding the line on costs throughout our operation bore similarly positive results, furthering Avista Utilities' \$1.07 per diluted share contribution to earnings.

Avista Advantage came through, as well, turning in \$0.08 per diluted share and registering its second year of profitability. This decade-old subsidiary, which handles

utility billing and usage analysis for multi-site companies across the nation, grew from \$23.4 million to \$31.7 million in revenues this year, an increase of 35 percent.

On the other hand, Avista Energy struggled in 2005. While this energy marketing and resource management subsidiary has sent dividends of \$175 million to the corporation over the course of its history – and produced an overall 15 percent return on investment – the markets in which Avista Energy operates have changed. With that in mind, we have to realistically consider the business's long-term prospects.

A company like Avista Energy can't correctly predict market activity every time, and periods of loss are inevitable. And while we believe Avista Energy will provide value in 2006, we must measure our tolerance for less-than-consistent returns.

The Energy Marketing and Resource Management segment – primarily comprising Avista Energy – had a disappointing loss of \$0.18 per diluted share. That obviously affected our cumulative results, and the corporation finished the year with net income available for common stock of \$45.2 million and earnings per diluted share of \$0.92.

On a more positive note, two significant events marked 2005, as well. Marian Durkin joined us as senior vice president, chief legal officer and chief compliance officer, immediately fitting right in with our leadership team. Her insight has proven particularly valuable in addressing the second significant event, the federal repeal of the Public Utility Holding Company Act of 1935 (PUHCA).

The repeal clears the way for Avista to form a holding company, further separating our utility operations from our non-regulated operations. Under the current structure, Avista Utilities isn't a wholly owned subsidiary equivalent to others like Avista Energy and Avista Advantage. Instead, it is legally the parent entity.

By forming a holding company, we position Avista to better respond to the opportunities and risks arising



Gary G. Ely
Chairman, President and
Chief Executive Officer,
Avista Corp.

from the utility industry's changing business and regulatory environment, in a manner that best serves the interests of our shareholders and customers. The new structure would permit investors, analysts and rating agencies to more easily analyze and value Avista's individual lines of business.

Based on these advantages, the board of directors proposes the formation of a holding company. We don't anticipate any substantial cost associated with the change, which must be approved by federal and state regulators and by you, our shareholders. You'll find additional information on this proposal in the proxy statement for this year's annual meeting.

There's more ahead for Avista in 2006, to be sure. Avista Advantage has extended our utility expertise into the telecommunications industry, securing 61 clients already and opening a whole new market for our services. We're also exploring customer requests for international service and evaluating Avista Advantage's potential for growth.

In tackling our challenges at Avista Energy, we're seeking to stabilize returns by expanding our capacity for asset management, capitalizing on our aptitude for running generation facilities, and marketing surplus output for large commercial and industrial customers. And our recent move into the natural gas retail marketing business in Montana should open new

markets and steady natural gas revenues, as similar measures did for our Canadian operations.

We'll keep on installing advanced meter reading equipment in Avista Utilities' territory, reduce other operating costs – with still more technology picking up the slack – and move forward with infrastructure improvements now in progress.

The ongoing, five-year, \$115 million-plus upgrade of our transmission system continues to increase east-west transmission capacity and improve our north-south transfer capability, reinforcing our solid record of electric service reliability.

We're also upgrading our turbine runners to generate an additional 38 megawatts with our existing hydro assets, rebuilding one unit each year for the next six years. The Noxon Rapids Dam on the Clark Fork River in Montana houses five units slated for more than \$31 million in efficiency enhancements over the next seven years.

Finally, we'll continue to work collaboratively with area leaders in community development efforts, and meet the energy needs of our growing customer base which increased an average of 4 percent for natural gas and 3 percent for electricity in 2005. Those figures are almost twice what we experienced just two years ago.

As we implement our strategies to meet growing demand for our services, we will succeed only through the support and intelligence of our employees. They have proven themselves up to the task, and I appreciate their contribution more each year. I thank them – and you – for making Avista the principled and progressive company it is.

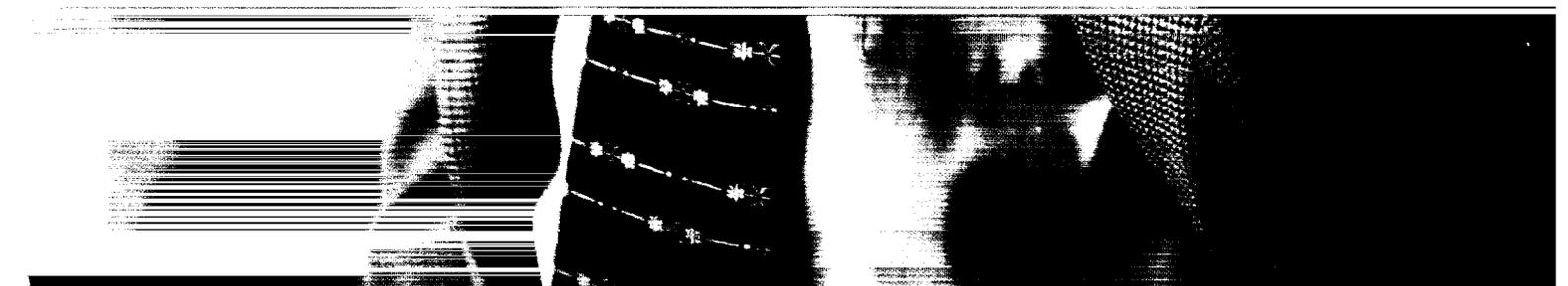
Gary G. Ely
Chairman, President and Chief Executive Officer
March 10, 2006



"Are energy prices rising because of demand and dwindling traditional resources, and, if that's the case, what is Avista doing to support conservation and alternative resources?"

Philip Kercher

Philip Kercher / Manager of Facilities / Sacred Heart Medical Center / Spokane, Washington



With customer needs for energy increasing and prices up nationwide, we have to be smarter and more astute than ever. Conservation and alternative resources are good places to start.

Clearly, in 2005 Avista saw increases in electric power and natural gas wholesale prices in the market. Increases in worldwide oil prices influenced the wholesale markets for many types of energy. The entire industry had to step up to maintain natural gas supply after the year's hurricanes disrupted production. New pipelines facilitated transportation of natural gas to more profitable Eastern markets, driving prices higher in our region as we competed for limited resources. While Avista doesn't own natural gas production fields, we do operate storage facilities and have a strategic purchasing program to mitigate volatile natural gas prices for the benefit of our customers.



Jason Thackston (left)
Director, Gas Supply, Avista Corp.
Dick Storro
Director, Power Supply, Avista Corp.

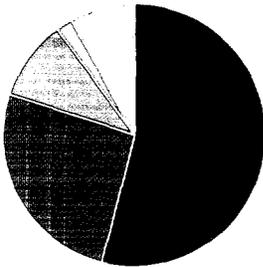
In 2005, generation assets owned by Avista supplied 85 percent of our customers' average energy requirements, which contributes to our relatively low retail electric power rates. Going forward, Avista strives to make the most of our current resources – including promoting the wise and efficient use of energy – while acquiring a responsible mix of different types of available electric resources.

Our 2005 electric integrated resource plan lays out the course we intend to take over the next 20 years to meet more than half of our future energy needs with renewable resources, plant upgrades and conservation efforts. By 2016 alone, we expect to add 400 megawatts of wind power, 80 megawatts of other renewables and another 52 megawatts through upgrades to our existing generation facilities. In the same timeframe, consistent with the company's long history of promoting and providing funds for customer energy efficiency projects, an additional 69 megawatts of conservation is included in the plan. Lastly, we forecast a need for 250 megawatts of coal-based generation.

Coupled with the acquisition of a diverse supply of energy resources is Avista's long-standing legacy of reliable delivery and excellent service to our customers. In 2005, we met our goal of recording no significant natural gas outages and keeping electric outages to an average of under two hours.

Taking care of today and tomorrow. That's what our customers expect.

Integrated Resource Mix
(Numbers are rounded)



- 54% Hydroelectricity
- 26% Natural Gas
- 10% Coal
- 2% Biomass
- 8% Wind / Other

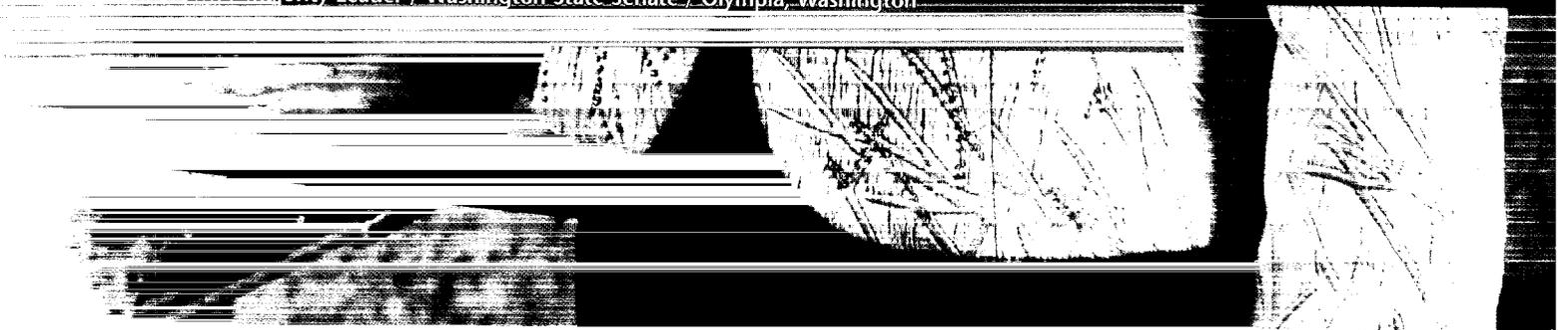
By diversifying the sources of our energy, we create a stable platform that will give us strength in the face of future market fluctuations.

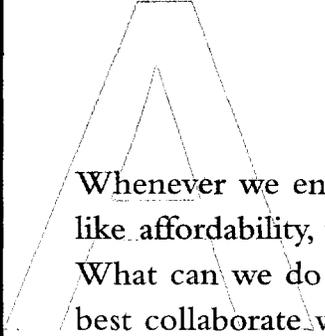


"The citizens of my district are people with modest incomes. What are you doing to keep energy affordable for them?"

Lisa Brown

Lisa Brown / Majority Leader / Washington State Senate / Olympia, Washington





Whenever we encounter a complicated matter like affordability, we ask ourselves two questions: What can we do on our own? And how can we best collaborate with others?

At Avista, we resolve those questions the same way: We turn to our employees. They know the territory and its intricacies better than anyone, and their insight consistently renders smart, sustainable solutions.

Through their efforts, we've amassed one of the most diversified – and cost-effective – energy portfolios in the country. While hydro power offers the lowest-cost generation, below-average water conditions in recent

years have demonstrated the wisdom of varying our resources to ensure sufficient reliability and minimize the need for spot market purchases. So, in a manner similar to that employed by smart investors with their financial portfolios – spreading out economic risk – we complement our hydro projects with natural gas-fired, wind, biomass and coal generation.

You'll see further evidence of our employees' dedication to affordable service in a recent benchmarking study, which found Avista best in our peer group in distribution and transmission operations and second best in our peer group in hydro operations.

Such efficiency keeps costs down, and we applied those principles to even more areas in 2005. We installed the first phase of our advanced meter reading system and implemented a detailed mapping application in our dispatch center. Mobile dispatch – wireless orders and employee routing on global positioning system-enabled rugged laptops – is on deck for 2006.

We reach outside our walls to engage others in keeping energy affordable, too. We offer many programs to help our customers conserve and get the most value for their energy dollars. In addition to our existing energy efficiency rebates, we have a new energy management tool on our Web site and a 30-minute broadcast special called "The Power to Conserve."

Those who still struggle with their energy bills can access grants from several assistance funds backed by customers and corporate donations.

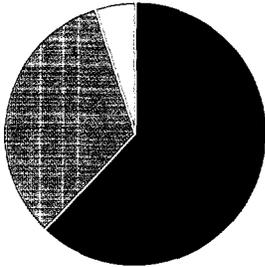
We think compassion and business acumen can live together – and produce positive results for both our customers and our shareholders.



Scott Morris
Senior Vice President, Avista Corp.
and President, Avista Utilities



Energy Assistance Grant Programs



■ **LIHEAP**
(Low Income Home Energy Assistance Program)
Households served: 22,647

▣ **LIRAP**
(Low Income Rate Assistance Program)
Households served: 9,180

□ **Project Share**
Households served: 2,951

Total households served: 34,778

We contribute to several energy assistance programs, and Avista customers benefited from more than \$9 million in grants in 2005.



"Your primary purpose is to provide energy to your customers and make money doing it. How do you decide if a subsidiary is a good fit with that core business?"

Irene Estell

Irene Estell / Retail Shareholder / Falcon Cove, Oregon





Avista puts great stock in our employees' ingenuity. When they see a logical application of our fundamental strengths to a new challenge, we pay attention.

Itron is a great example. In the 1970s, someone at Avista decided there must be a better way to handle one of a utility's most basic functions: reading meters.

Today, Itron stands on its own as the world's leader in meter technology, with more than \$500 million in annual revenue and nearly 3,000 customers in 63 countries.

And now, Avista Advantage is beginning to deliver on its promise, as well.

Like Itron, Avista Advantage arose out of an authoritative grasp of our own industry. Our deep understanding of utility billing became a provider of bill-processing and energy expense management services for more than 350 multi-site organizations across the country.

Avista Advantage processed more than 450,000 invoices a month by the end of 2005, saving customers millions of dollars by identifying billing errors and recommending more favorable rate structures. Customers rewarded us with a 95 percent retention rate.

That success led to Avista Advantage's second year of profitability. We anticipate a strong 2006, too, as we continue the expansion into telecom expense management made possible by our 2005 acquisition of TelAssess.

Now worth more than the corporation put into it, Avista Advantage exemplifies the importance of patience in launching a business. Nevertheless, we expect our subsidiaries to deliver a 15 percent return on our investment over the long term.

While historically Avista Energy has met that standard, 2005 was a difficult year.

In another illustration of employee skills sparking new opportunities, Avista Energy manages generation assets and markets energy in the Pacific Northwest, a region we understand as well as anyone. However, the instability of the natural gas industry nationwide put our people to the test in 2005, and we didn't always make the right call.

But other activities – energy generation management for industrial and utility customers, and natural gas supply for about 200 small and medium-sized commercial and industrial customers – proved more successful. We're positioned for a profitable 2006, as well.

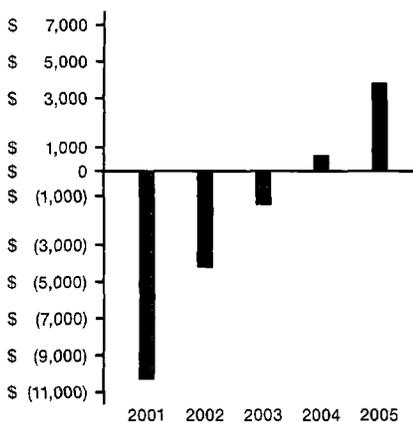
At Avista Energy – as with all things – we'll stick to what we do best.



Malyn Malquist
Senior Vice President and
Chief Financial Officer, Avista Corp.

Avista Advantage Net Income

(Shown in thousands)



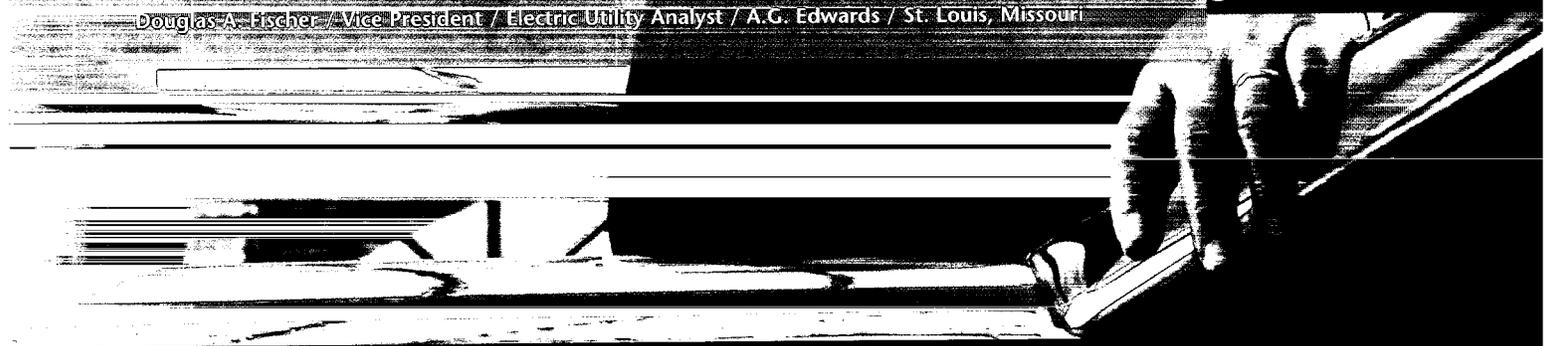
When our people have good ideas, we put our energy behind them. And for Avista Advantage, that's really paid off.



“You have discussed for several years your desire to achieve investment grade ratings on your debt. What is your strategy for reaching this goal, and when do you think you are likely to achieve it?”

Doug Fischer

Douglas A. Fischer / Vice President / Electric Utility Analyst / A.G. Edwards / St. Louis, Missouri





We're acutely aware of the importance of regaining investment grade status, and we're diligently tackling the obstacles that have prevented a quicker recovery.

While we are making progress, a resolution isn't likely until at least 2007. Below-normal hydro conditions in five out of the last six years have left us with an expensive backlog. A mere 5 percent drop in stream flow can add millions of dollars in purchased power costs, tying up cash that could otherwise be used to pay down debt. That explains, in part, our \$148 million energy deferral balances.



Christy Burmeister-Smith
Vice President and Treasurer,
Avista Corp.

Still, we have been able to take advantage of favorable interest rates, issuing \$150 million in 30-year first mortgage bonds at 6.25 percent in the fourth quarter. This long-term financing, coupled with renegotiation of our corporate credit facility, decreases the overall cost of our debt.

In addition to reducing those expenses, we're striving to improve earnings stability, particularly at Avista Energy where expansion of our asset management activities should provide a moderating influence.

We're also working to earn our allowable rates of return, as determined by the state regulatory bodies overseeing our utility operations.

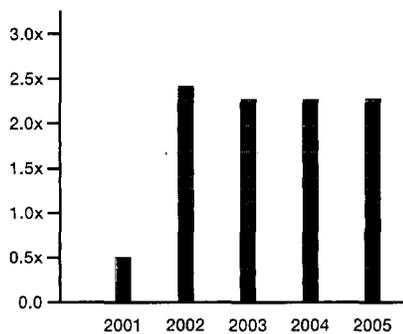
In January 2005, we requested rate recovery in the state of Idaho for the cost of purchasing the second half of Coyote Springs 2, our natural gas-fired generating facility in Boardman, Oregon. The commission quickly turned around a positive response.

The Washington Utilities and Transportation Commission (WUTC) approved our combined electric and natural gas rate case in December, boosting electric revenues by a projected \$21.4 million and natural gas revenues by \$968,000.

But the WUTC declined our proposal to lower the \$9 million deadband – a component of the energy recovery mechanism used to track purchased energy costs and share either the additional expense or savings with customers – to \$3 million. However, they asked us to re-file in January 2006, allowing all parties more time to study the issue. We expect a decision by midyear.

In advancing toward financial health, we remain conscious of our responsibility to shareholders. We've raised our dividend four times in the last three years, and we anticipate the board of directors will consider doing so again in the future. As Avista thrives, so should you.

**Utility Funds from Operations
Interest Coverage**



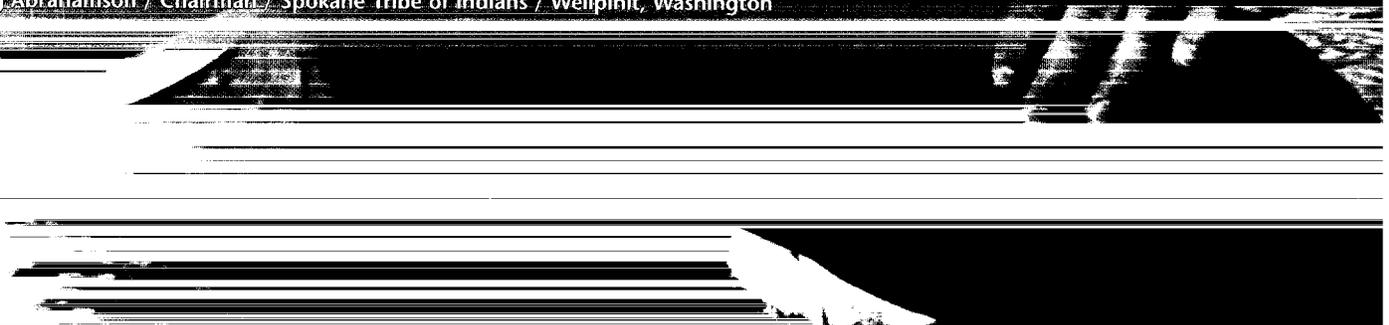
In recent years, we've focused on stabilizing and improving utility cash flow from operations, a key element in regaining our investment grade credit rating.



“What is Avista doing to address water quality on rivers where the company operates hydroelectric dams, specifically as it relates to PM&Es and 401 certification?”

Gregory J. Abrahamson

Greg Abrahamson / Chairman / Spokane Tribe of Indians / Wellpinit, Washington



In the life of our region's rivers, we stand among many. Many people. Many interests. Many beliefs. Accordingly, we look beyond mere compliance to what is right.

While crafting our Spokane River hydroelectric license applications, for instance, we proposed a broad range of protection, mitigation and enhancement (PM&E) measures: support for water quality initiatives, increased water discharge to protect fish, improvements to fishery resources, consideration for recreational opportunities, and care for the natural beauty of the river and its falls.



Bruce Howard
Spokane River License Manager,
Avista Utilities

Those recommendations spring from a three-year collaborative process with hundreds of stakeholders, including tribes, government agencies, citizen groups and others.

The applications, covering five hydro projects on the Spokane River, went to the Federal Energy Regulatory Commission (FERC) in August 2005, two years ahead of our current license's expiration. When granted, any new license will require compliance with 401 certification, state approval of water quality under the federal Clean Water Act.

To that end, we're undertaking a number of projects, including an effort to reduce levels of total dissolved gas – a consequence of water spilling over a dam that may harm fish – during high water periods at Lake Spokane. Conversely, we're looking at ways to increase dissolved oxygen levels during times of low flow.

Our work on the Clark Fork River in Idaho and Montana again reflects a belief in good stewardship.

Pursuant to our licensing agreement there, we joined with federal, state and conservation agencies in 2005 to purchase and preserve the Bull River Wildlife Management Area, 1,800 acres formerly owned by mining and timber interests. Sharing the total cost testifies to our view that good stewardship also includes collaboration and prudent financial management.

Indeed, the economics of our environmental work make sense. The cost of noncompliance and loss of good will can be considerable.

That explains why in 2006 we're taking the lead on polychlorinated biphenyls (PCB) cleanup behind Upriver Dam on the Spokane River, though facilities once owned by an Avista subsidiary were responsible for less than 1 percent of the problem.

It's simply the right thing to do.



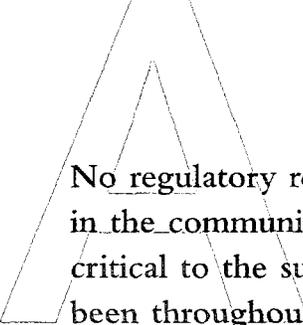
Earning an Outstanding Stewardship of America's Rivers award for six straight years says something about how seriously we take our environmental responsibilities. In conferring the honor, the National Hydropower Association notes our long legacy of protecting and preserving the Clark Fork River, a source of both energy and beauty for our region.



"Avista does a good job encouraging employees to get involved in the community. Is that mandated by some external authority, or is it simply a value promoted by our leadership to maintain good customer relations?"

Cheryl Hagle

Cheryl Hagle / Distribution Dispatcher / Avista Utilities / Spokane, Washington



No regulatory requirement compels Avista to invest in the communities we serve. But it is absolutely critical to the success of our business – as it has been throughout our entire 117-year history.



So, in a certain way, today's leadership doesn't differ much from that of years past. Ingrained in Avista's culture lies the understanding that we operate by the consent of our customers, and earning their good will is merely smart business. It starts with great customer service, of course – holding customers' interests equal to our own.



Roger Woodworth
Vice President, Avista Corp.

But we reach beyond that, seeking to establish trust by lending support to the common good.

Avista employees take special pride in making a difference in our communities through volunteer involvement. You'll find them seemingly everywhere: on the soccer field, in the classroom, at the chamber of commerce, up to their elbows in produce grown in our community garden for the food bank – wherever their interests take them. In 2005 alone, they rang up 58,000 volunteer hours.



As a corporation, we chip in too, particularly on projects that promote community prosperity. In September, the city council endorsed a strategic master plan for the University District, a concentration of higher education and health care research on the east end of downtown Spokane. Through our participation with others in the district's development, we expect the community we serve to enjoy the benefits of its estimated \$200 million to \$300 million annual economic impact.

The Virtual Possibilities Network (VPnet), another venture intended to spur collaboration and growth, is progressing nicely, as well. The 200-mile fiber optic system donated by an Avista subsidiary facilitates research, education and business incubation. The network's member school districts, colleges, universities, health care facilities and others implemented more than 20 projects in 2005, and we anticipate an annual economic benefit to the Eastern Washington and North Idaho region of \$85 million by 2010.

Fostering the vitality of our communities through efforts like these can only leave Avista the better for it. Such mutually beneficial outcomes appeal to us; they generate positive results for our company while at the same time strengthening our credibility among those we serve.

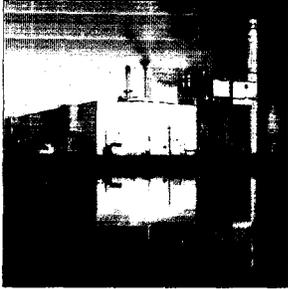
Ours is a complex business, with many stakeholders and many issues at play. By seeking balance – and respecting those differing perspectives – we build relationships with staying power, cultivate an environment primed for growth and encourage prosperity for all.

Sometimes community involvement requires leadership, and other times we support another's vision. When Marshall Chesrown purchased 78 acres of undeveloped property near downtown Spokane, we saw the potential at once. Our team got busy designing service to the site – the planned future home of 2,600 residential units and more than a million square feet of commercial and retail space – and consulting on energy efficient design.



Leadership

With the right leaders in place, Avista's values will endure. Bearing that in mind, Marian Durkin was named senior vice president, general counsel and chief compliance officer; Karen S. Feltes rose to senior vice president; Christy Burmeister-Smith became vice president and treasurer; and Ann Wilson took on a new role as vice president and controller. ■ For the sixth time in nine years, **Avista Utilities** made Oregon Business magazine's list of the 100 best large companies to work for in Oregon. We ranked 26th.



Reliability

In response to rapid load growth in some of our territory, we added 250 megawatts of transfer capability to the regional grid as part of 2005's capital expenditures of more than \$200 million. ■ Completing our purchase of the second half of **Coyote Springs 2** secured another 140 megawatts of generation for Avista customers.



Productivity

The formation of **Distribution Dispatch** marked the end of a four-year effort to link all our distribution feeders to the outage management tool, an application housing geographic information system (GIS) maps of our entire service territory. ■ An analysis of mobile dispatch technology laid the foundation for our next major productivity initiative.



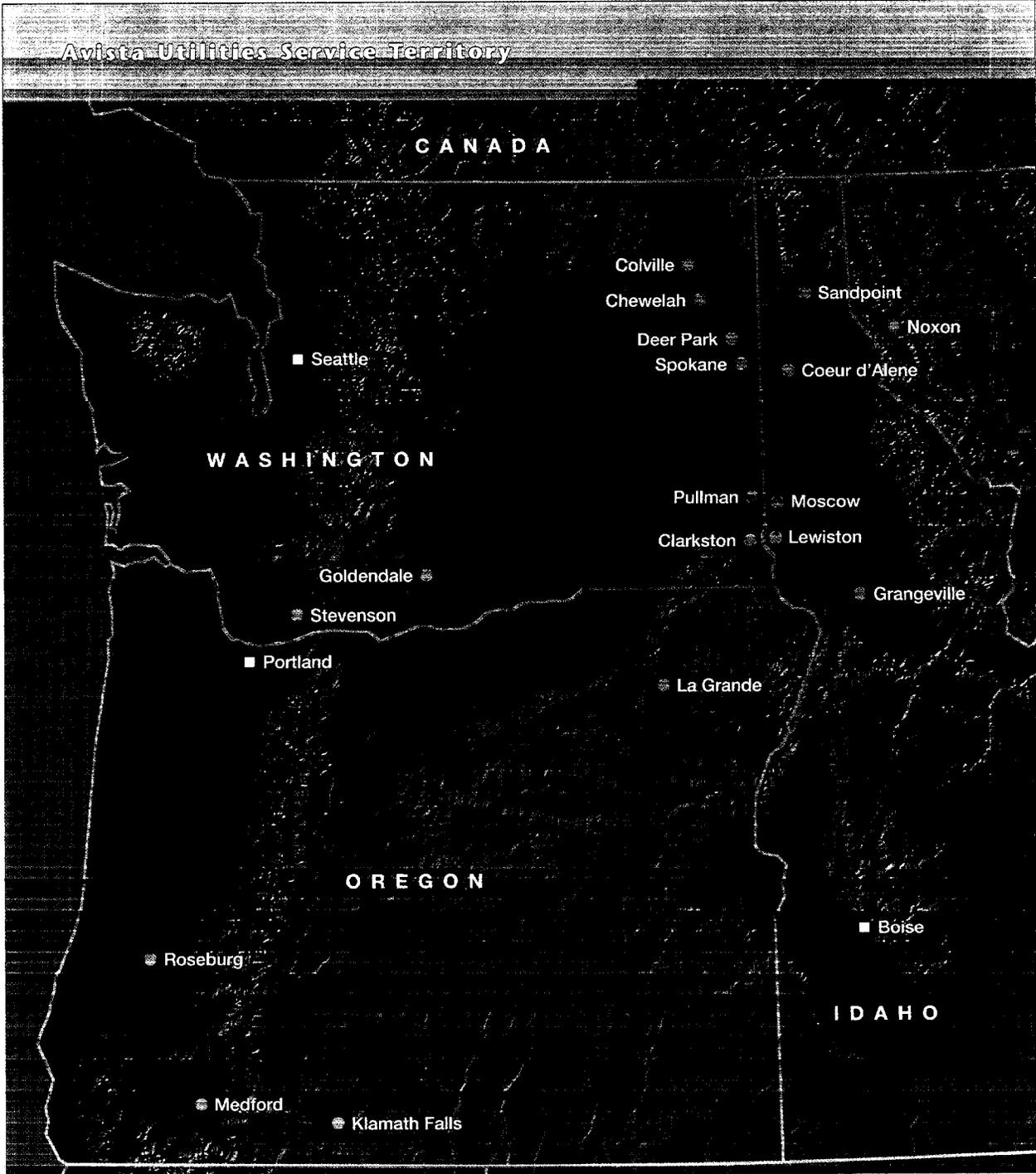
Community

The fiber optic Virtual Possibilities Network (VPnet) grew to 17 participating members. ■ Through our involvement, the community came together to erect the **Lt. Col. Michael P. Anderson memorial statue** in downtown Spokane's Riverfront Park to serve as an inspiration for children to achieve their dreams. The local hero died aboard Space Shuttle Columbia in 2003.



Subsidiary operations

Barrick Goldstrike Mines and Columbia Power Corporation joined the list of organizations turning to Avista Energy for help managing their generation assets. ■ **Avista Advantage's** customer base grew by 7.7 percent, and the number of facilities we serve grew by 33,468 to 174,910.



Our 30,000-square-mile service territory includes energy generation, transmission and distribution operations in four Western states. We provide electricity to more than 338,000 customers in Eastern Washington and North Idaho. Our approximately 297,000 natural gas customers are located in Washington, Idaho and Oregon.

Board of Directors

Erik J. Anderson, 47 – President, Westriver Capital, Kirkland, Washington. Director since 2000.

Kristianne Blake, 52 – Principal, Kristianne Gates Blake, P.S., Spokane, Washington. Director since 2000.

David A. Clack, 71 – Managing Director, Meridian Capital, Spokane, Washington. Director since 1988.

Roy Lewis Eiguren, 54 – Senior Partner, Givens Pursley LLP, Boise, Idaho. Director since 2002.

Gary G. Ely, 58 – Chairman of the Board, President and CEO, Avista Corp., Spokane, Washington. Director since 2001.

Jack W. Gustavel, 66 – Chairman and CEO, Idaho Independent Bank, Coeur d'Alene, Idaho. Director since 2003.

John F. Kelly, 61 – President and CEO, John F. Kelly & Associates, Paradise Valley, Arizona. Director since 1997.

Jessie J. Knight, Jr., 55 – President and CEO, San Diego Regional Chamber of Commerce. Director since 1999.

Michael L. Noël, 64 – President, Noël Consulting Company, Prescott, Arizona. Director since 2004.

Lura J. Powell, Ph.D., 55 – President and CEO, Advanced Imaging Technologies, Richland, Washington. Director since 2003.

R. John Taylor, 56 – Chairman and CEO, AIA Services Corporation and CropUSA Insurance Agency, Lewiston, Idaho. Director since 1985.

Corporate Governance / Nominating Committee

A well-considered structure for the board of directors translates into effective committee oversight, a balanced board membership, and policies and procedures that reflect Avista's values. The Corporate Governance / Nominating Committee advises the board in such matters.

Erik J. Anderson
Kristianne Blake
Jessie J. Knight, Jr.
Jack W. Gustavel – Chair

Executive Committee

Kristianne Blake
David A. Clack
R. John Taylor
Gary G. Ely – Chair

Audit Committee

We owe those who entrust us with their money the highest standard of probity. By overseeing the integrity of our financial statements and our internal controls for finance, accounting, legal compliance and ethics, the Audit Committee helps us meet that standard.

David A. Clack
Jessie J. Knight, Jr.
Michael L. Noël (financial expert)
Kristianne Blake – Chair

Compensation and Organization Committee

Roy Lewis Eiguren
R. John Taylor
John F. Kelly – Chair

Finance Committee

Jack W. Gustavel
Michael L. Noël
Erik J. Anderson – Chair

Environmental, Safety and Security Committee

A company with operations as complex and geographically dispersed as Avista's has a duty to protect our employees' safety and security and the environmental resources under our care. The Environmental, Safety and Security Committee provides management with policy guidance on these issues.

Roy Lewis Eiguren
Lura J. Powell
David A. Clack – Chair

Corporate and Business Unit Officers

Gary G. Ely, 58 – Chairman of the Board, President and Chief Executive Officer

Malyn K. Malquist, 53 – Senior Vice President and Chief Financial Officer

Scott L. Morris, 48 – Senior Vice President and President of Avista Utilities

Marian M. Durkin, 52 – Senior Vice President, General Counsel and Chief Compliance Officer

Karen S. Feltes, 50 – Senior Vice President and Corporate Secretary

Christy M. Burmeister-Smith, 49 – Vice President and Treasurer

Don F. Kopczynski, 50 – Vice President

David J. Meyer, 52 – Vice President and Chief Counsel for Regulatory and Governmental Affairs

Kelly O. Norwood, 47 – Vice President

Ronald R. Peterson, 53 – Vice President

Ann M. Wilson, 40 – Vice President and Controller

Roger D. Woodworth, 49 – Vice President

Stuart A. Stiles, 45 – President and Chief Executive Officer of Avista Advantage

Dennis P. Vermillion, 44 – President and Chief Operating Officer of Avista Energy

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of
Avista Corporation
Spokane, Washington

We have audited the consolidated balance sheets of Avista Corporation and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. We also have audited management's assessment of the effectiveness of the Company's internal control over financial reporting and the effectiveness of the Company's internal control over financial reporting as of December 31, 2005. Such consolidated financial statements, management's assessment of the effectiveness of the Company's internal control over financial reporting and our reports thereon dated March 6, 2006, expressing unqualified opinions (which opinion on the consolidated financial statements includes an explanatory paragraph for certain changes in accounting and presentation resulting from the impact of recently adopted accounting standards), which are not included herein, are included in Appendix A to the 2005 annual report. The accompanying condensed consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on such condensed consolidated financial statements in relation to the complete consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated balance sheets as of December 31, 2005 and 2004, and the related condensed consolidated statements of income and of cash flows for each of the three years in the period ended December 31, 2005, is fairly stated in all material respects in relation to the basic consolidated financial statements from which it has been derived.

Deloitte & Touche LLP

Seattle, Washington
March 6, 2006

Management's Statement of Responsibility

The condensed consolidated financial statements in this summary annual report were derived from the consolidated financial statements that appear in Appendix A to the 2005 annual report. Management of Avista Corporation is responsible for the accuracy and completeness of the information in this summary annual report. The financial and operating information is derived from company records and includes amounts based on judgment and estimates where necessary. Disclosure controls and procedures in combination with Avista Corporation's internal control over financial reporting provide reasonable assurance that the summary annual report fairly and reasonably presents Avista Corporation's financial position and operating results.

The board of directors appointed Deloitte & Touche LLP, an independent registered public accounting firm, to audit the consolidated financial statements included in Appendix A to the 2005 annual report. Their report on the condensed consolidated financial statements appears above.



Gary G. Ely
Chairman, President and
Chief Executive Officer



Malyn K. Malquist
Senior Vice President and
Chief Financial Officer

Condensed Consolidated Statements of Income*(For the Years Ended December 31 – Dollars in Thousands, Except Per Share Amounts)*

| | 2005 | 2004 | 2003 |
|---|---------------------|---------------------|---------------------|
| Operating Revenues | <u>\$ 1,359,607</u> | <u>\$ 1,151,580</u> | <u>\$ 1,123,385</u> |
| Operating Expenses | | | |
| Resource costs | 815,590 | 618,595 | 584,662 |
| Other operating expenses | 241,131 | 247,796 | 228,418 |
| Depreciation and amortization | 86,911 | 78,425 | 77,811 |
| Utility taxes other than income taxes | <u>68,044</u> | <u>66,294</u> | <u>60,791</u> |
| Total operating expenses | <u>1,211,676</u> | <u>1,011,110</u> | <u>951,682</u> |
| Gain on Sale of Utility Properties | <u>4,093</u> | <u>—</u> | <u>—</u> |
| Income From Operations | <u>152,024</u> | <u>140,470</u> | <u>171,703</u> |
| Other Income (Expense) | | | |
| Interest expense, net of capitalized interest | (91,025) | (91,654) | (91,893) |
| Other income – net | <u>10,030</u> | <u>8,390</u> | <u>6,173</u> |
| Total other income (expense) – net | <u>(80,995)</u> | <u>(83,264)</u> | <u>(85,720)</u> |
| Income From Continuing Operations Before Income Taxes | 71,029 | 57,206 | 85,983 |
| Income Taxes | <u>25,861</u> | <u>21,592</u> | <u>35,340</u> |
| Income From Continuing Operations | 45,168 | 35,614 | 50,643 |
| Loss From Discontinued Operations | <u>—</u> | <u>—</u> | <u>(4,949)</u> |
| Net Income Before Cumulative Effect of Accounting Change | 45,168 | 35,614 | 45,694 |
| Cumulative Effect of Accounting Change (net of tax) | <u>—</u> | <u>(460)</u> | <u>(1,190)</u> |
| Net Income | 45,168 | 35,154 | 44,504 |
| Preferred stock dividend requirements | <u>—</u> | <u>—</u> | <u>(1,125)</u> |
| Income Available for Common Stock | <u>\$ 45,168</u> | <u>\$ 35,154</u> | <u>\$ 43,379</u> |
| Earnings Per Common Share, Basic | | | |
| Earnings from continuing operations | \$ 0.93 | \$ 0.74 | \$ 1.03 |
| Loss from discontinued operations | <u>—</u> | <u>—</u> | <u>(0.10)</u> |
| Earnings before cumulative effect of accounting change | 0.93 | 0.74 | 0.93 |
| Loss from cumulative effect of accounting change | <u>—</u> | <u>(0.01)</u> | <u>(0.03)</u> |
| Total earnings per common share, basic | <u>\$ 0.93</u> | <u>\$ 0.73</u> | <u>\$ 0.90</u> |
| Earnings Per Common Share, Diluted | | | |
| Earnings from continuing operations | \$ 0.92 | \$ 0.73 | \$ 1.02 |
| Loss from discontinued operations | <u>—</u> | <u>—</u> | <u>(0.10)</u> |
| Earnings before cumulative effect of accounting change | 0.92 | 0.73 | 0.92 |
| Loss from cumulative effect of accounting change | <u>—</u> | <u>(0.01)</u> | <u>(0.03)</u> |
| Total earnings per common share, diluted | <u>\$ 0.92</u> | <u>\$ 0.72</u> | <u>\$ 0.89</u> |
| Dividends paid per common share | \$ 0.545 | \$ 0.515 | \$ 0.490 |

Condensed Consolidated Balance Sheets

(As of December 31 - Dollars in Thousands)

Assets

| | 2005 | 2004 |
|---|---------------------|---------------------|
| Cash and cash equivalents | \$ 25,917 | \$ 88,317 |
| Restricted cash | 25,634 | 26,175 |
| Accounts and notes receivable | 502,947 | 313,899 |
| Current energy commodity derivative assets | 918,609 | 284,231 |
| Other current assets | 297,261 | 195,518 |
| Total net utility property | 2,126,417 | 1,956,063 |
| Nonutility properties and investments – net | 77,731 | 78,564 |
| Noncurrent energy commodity derivative assets | 511,280 | 254,657 |
| Other property and investments – net | 61,944 | 69,057 |
| Regulatory assets for deferred income tax | 114,109 | 123,159 |
| Other regulatory assets | 26,660 | 43,428 |
| Noncurrent utility energy commodity derivative assets | 46,731 | 55,825 |
| Power and natural gas deferrals | 147,622 | 148,206 |
| Unamortized debt expense | 48,522 | 53,413 |
| Other deferred charges | 17,110 | 21,109 |
| Total Assets | \$ 4,948,494 | \$ 3,711,621 |

Liabilities and Stockholders' Equity

| | | |
|---|---------------------|---------------------|
| Accounts payable | \$ 511,427 | \$ 325,194 |
| Current energy commodity derivative liabilities | 906,794 | 253,527 |
| Current portion of long-term debt | 39,524 | 85,432 |
| Short-term borrowings | 63,494 | 68,517 |
| Other current liabilities | 208,649 | 149,168 |
| Long-term debt | 989,990 | 901,556 |
| Long-term debt to affiliated trusts | 113,403 | 113,403 |
| Preferred stock (subject to mandatory redemption) | 26,250 | 28,000 |
| Noncurrent energy commodity derivative liabilities | 488,644 | 215,055 |
| Regulatory liability for utility plant retirement costs | 186,635 | 175,575 |
| Deferred income taxes | 488,934 | 488,471 |
| Other noncurrent liabilities and deferred credits | 153,622 | 154,518 |
| Total Liabilities | \$ 4,177,366 | \$ 2,958,416 |
| Common stock – net (48,593,139 and 48,471,511 outstanding shares) | 620,598 | 617,884 |
| Retained earnings and accumulated other comprehensive loss | 150,530 | 135,321 |
| Total Stockholders' Equity | \$ 771,128 | \$ 753,205 |
| Total Liabilities and Stockholders' Equity | \$ 4,948,494 | \$ 3,711,621 |

Condensed Consolidated Statements of Cash Flows

Increase (Decrease) in Cash and Cash Equivalents (For the Years Ended December 31 – Dollars in Thousands)

| | 2005 | 2004 | 2003 |
|--|-------------------------|-------------------------|--------------------------|
| Continuing Operating Activities: | | | |
| Net income | \$ 45,168 | \$ 35,154 | \$ 44,504 |
| Loss from discontinued operations | – | – | 4,949 |
| Cumulative effect of accounting change | – | 460 | 1,190 |
| Purchases of securities held for trading | – | (15,260) | (18,865) |
| Sales of securities held for trading | – | 34,192 | – |
| Noncash items included in net income: | | | |
| Depreciation and amortization | 86,911 | 78,425 | 77,811 |
| Provision for deferred income taxes | 8,865 | 19,168 | 28,395 |
| Power and natural gas cost amortizations, net of deferrals | 9,630 | 11,087 | 3,829 |
| Amortization of debt expense | 7,762 | 8,301 | 7,972 |
| Write-offs and impairment of assets | 1,001 | 21,990 | 4,900 |
| Energy commodity assets and liabilities | 38,126 | 678 | 22,128 |
| Other | (11,460) | 3,770 | (11,214) |
| Changes in working capital components | (57,458) | (79,920) | (39,546) |
| Net Cash Provided by Continuing Operating Activities | <u>128,545</u> | <u>118,045</u> | <u>126,053</u> |
| Continuing Investing Activities: | | | |
| Utility property capital expenditures (excluding AFUDC) | (213,652) | (115,346) | (102,271) |
| Other capital expenditures | (4,044) | (3,126) | (3,388) |
| Decrease (increase) in restricted cash | 541 | (9,703) | (3,489) |
| Proceeds from property sales | 17,211 | 2,466 | 549 |
| Other | 2,351 | (3,421) | (4,739) |
| Net Cash Used in Continuing Investing Activities | <u>(197,593)</u> | <u>(129,130)</u> | <u>(113,338)</u> |
| Continuing Financing Activities: | | | |
| Increase (decrease) in short-term borrowings | (5,023) | (12,008) | 50,525 |
| Proceeds from issuance of long-term debt | 149,633 | 89,761 | 44,795 |
| Redemption and maturity of long-term debt | (111,613) | (66,857) | (124,859) |
| Proceeds from issuance of long-term debt to affiliated trusts | – | 61,856 | – |
| Redemption of long-term debt to affiliated trusts | – | (61,856) | – |
| Redemption of preferred stock | (1,750) | (1,750) | (1,575) |
| Issuance of common stock | 2,066 | 4,061 | 5,497 |
| Cash dividends paid | (26,443) | (24,912) | (24,777) |
| Other | (222) | (17,019) | (4,139) |
| Net Cash Provided by (Used in) Continuing Financing Activities | <u>6,648</u> | <u>(28,724)</u> | <u>(54,533)</u> |
| Net Cash Used in Continuing Operations | (62,400) | (39,809) | (41,818) |
| Net Cash Used in Discontinued Operations | – | – | (3,342) |
| Net Decrease in Cash and Cash Equivalents | (62,400) | (39,809) | (45,160) |
| Cash and Cash Equivalents at Beginning of Period | <u>88,317</u> | <u>128,126</u> | <u>173,286</u> |
| Cash and Cash Equivalents at End of Period | <u>\$ 25,917</u> | <u>\$ 88,317</u> | <u>\$ 128,126</u> |

Financial Summary

The following is a brief discussion and analysis of financial condition and results of operations for Avista Corporation (Avista Corp. or the Company). For a more detailed analysis, please refer to Appendix A to the 2005 annual report.

Summary of Results – Net income was \$45.2 million for 2005 compared to \$35.2 million for 2004. This increase was due to the improved performance of Avista Utilities, as well as Avista Advantage and the Other business segment. This was partially offset by a net loss for Avista Energy (Energy Marketing and Resource Management segment).

Avista Corp.'s operating results and cash flows are derived primarily from Avista Utilities and Avista Energy. Avista Corp. intends to continue to focus on improving earnings and operating cash flows, controlling costs and reducing debt while working to restore an investment grade credit rating.

Avista Utilities is the Company's most significant business segment. Based on Avista Utilities' forecast for electric customer growth of 2.5 percent and natural gas customer growth of 4 percent within its service area, Avista Utilities anticipates retail electric and natural gas load growth will average between 3 and 3.5 percent annually for the next four years. As part of Avista Utilities' strategy to focus on its business in the northwestern United States, in April 2005, the Company completed the sale of its natural gas properties in South Lake Tahoe, California. This was the Company's only regulated utility operation in California.

Avista Utilities operating and financial performance is substantially dependent upon, among other things: 1) weather conditions, including the effect of precipitation and temperatures on the availability of hydroelectric resources and the effect of temperatures on customer demand; 2) the price of natural gas in the wholesale market, including the effect on the price of fuel for generation; 3) the price of electricity in the wholesale market, including the effects of weather conditions, natural gas prices and other factors affecting supply and demand; and 4) favorable regulatory decisions, allowing Avista Utilities to recover its costs, including particularly its purchased power and fuel costs, on a timely basis and to earn a fair return on its investment.

Avista Utilities' hydroelectric generation was 95 percent of normal in 2005. Hydroelectric generation has been below normal (based on a 70-year average) for five of the past six years. The Company cannot determine if this trend of lower-than-normal hydroelectric generation will continue in future years. Avista Utilities forecasts that hydroelectric generation will be near normal in 2006. This is an early forecast, which will change based upon precipitation, temperatures and other variables during the year.

Avista Utilities has increased capital expenditures in order to meet load growth needs and to continue to provide reliable service to its customers. Utility capital expenditures totaled \$213.7 million in 2005, the most significant of which were the acquisition of the remaining interest in Coyote Springs 2, transmission system enhancements, and the repurchase of the Company's corporate headquarters and central operating facility in Spokane. For 2006, the Company has established a utility capital budget of approximately \$160 million. Significant projects include the continued enhancement of Avista Utilities' transmission system and upgrades to generating facilities.

Avista Utilities regularly reviews the need for electric and natural gas rate changes in each state in which it provides service. Avista Utilities has received base rate increases in each of its jurisdictions since October 2003. Most recently, in December 2005, Avista Utilities received approval from the Washington Utilities and Transportation Commission (WUTC) to increase its base electric and natural gas rates effective January 1, 2006. Avista Utilities will continue to file for rate adjustments to provide for recovery of its operating costs and capital investments and to more closely align earned returns with those allowed by regulatory agencies.

Avista Utilities' net income was \$52.5 million for 2005, an increase from \$32.5 million for 2004 primarily due to the general rate increases, as well as the \$4.1 million pre-tax gain on the sale of the South Lake Tahoe natural gas properties. This was partially offset by increases in other operating expenses, particularly with respect to depreciation and amortization from utility plant additions as well as compensation and other employee related expenses. Results for 2004 were reduced by write-offs of \$14.4 million (\$9.4 million, net of tax) related to the Idaho Public Utility Commission general rate case order. Avista Utilities expects net income for 2006 to be similar to 2005.

Avista Energy's business activities include trading electricity and natural gas, as well as 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 Canada is a wholly owned subsidiary of Avista Energy that provides natural gas services to end-user industrial and commercial customers in British Columbia, Canada.

The earnings and cash flows of Avista Energy are by nature subject to significant volatility because they are derived primarily from the day-to-day trading of electricity and natural gas and optimization of assets owned by other entities, as opposed to long-term revenue streams, and because Avista Energy's activities are for the most part subject to mark-to-market accounting. In addition, with respect to the management of natural gas storage and certain other contracts, Avista Energy's earnings are subject to the anomalies caused by the differences between the required accounting and the economic management of these assets and contracts. While Avista Energy has taken measures to enhance profitability and reduce the risk of losses in the future, this business will continue to have volatility in its results.

Avista Energy is subject to certain regulatory proceedings that remain unresolved; however, Avista Energy believes that it has adequate reserves established for refunds that may be ordered. The wholesale energy markets in which Avista Energy operates continue to have volatile market prices and variations in liquidity.

The Energy Marketing and Resource Management segment, which consists primarily of Avista Energy, incurred a net loss of \$8.6 million for 2005 compared to net income of \$9.7 million for 2004. The net loss for 2005 was the first annual net loss for this business segment since 1999. The net loss for 2005 was primarily due to losses in Avista Energy's natural gas portfolio. The volatility in natural gas and electricity prices can result in significant changes in earnings from Avista Energy from year to year. Avista Energy's trading of electricity and natural gas as well as asset optimization activities have been cumulatively profitable since 1999. Asset optimization has resulted in the recovery of a majority of the fixed

and variable costs associated with the power purchase agreement for the Lancaster Project for 2006. In addition, early in 2006, the Company captured a significant amount of value relative to prior years from the economic management of natural gas storage. Earnings associated with these activities, as well as the anticipated future success of trading natural gas and electricity, are expected to return this segment to profitability in 2006.

Avista Advantage remains focused on increasing revenues, controlling operating expenses, continuously enhancing client satisfaction and developing complementary value-added services in a competitive market. During the first quarter of 2005, Avista Advantage acquired TelAssess, Inc. Although not a significant financial transaction, this acquisition provides Avista Advantage a foundation on which to expand beyond existing utility bill information services to provide similar services relating to telecom expense management. Net income for Avista Advantage was \$3.9 million for 2005, an increase from \$0.6 million for 2004 based on increased revenues from an expanding customer base and stabilizing operating expenses from processing efficiencies. The Company expects net income for Avista Advantage to increase in 2006 as compared to 2005.

Over time as opportunities arise, the Company plans to continue to dispose of assets and phase out operations in the Other business segment. However, the Company may, from time to time, invest incremental funds in these businesses to protect its existing investments. The net loss in the Other business segment was \$2.6 million for 2005, a decrease from \$7.2 million (excluding the cumulative effect of accounting change) for 2004 primarily due to decreased losses from asset impairments and write-offs incurred in 2004. The Company expects a similar net loss for 2006 as compared to 2005 for the Other business segment.

Total debt outstanding increased \$37.5 million in 2005 primarily to fund utility capital expenditures that were in excess of net cash flows from operating activities. Avista Corp. issued \$150.0 million of long-term debt during the fourth quarter of 2005 to, among other things, refinance borrowings on its committed line of credit. For 2006, the Company expects net cash flows from operating activities and Avista Corp.'s committed line of credit to provide adequate resources to fund capital expenditures, maturing long-term debt, dividends and other contractual commitments. However, the Company currently expects to issue long-term debt in the fourth quarter of 2006 primarily to fund debt that matures in the first quarter of 2007.

Overall Results of Operations – Total operating revenues increased \$208.0 million due to increases in utility revenues of \$188.7 million, non-utility energy marketing and trading revenues of \$9.6 million and other non-utility revenues of \$9.7 million.

Utility revenues increased due to increases in electric revenues of \$71.0 million and natural gas revenues of \$117.7 million. The increase in natural gas revenues was primarily due to increased natural gas wholesale sales and increases in retail natural gas sales as a result of rate increases. The increase in electric revenues primarily reflects an increase in wholesale revenues and a slight increase in retail revenues, partially offset by a decrease in sales of fuel.

Non-utility energy marketing and trading revenues increased primarily due to increased revenues for Avista Energy Canada,

partially offset by decreased net trading margin on contracts accounted for under Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

Other non-utility revenues increased as a result of increased revenues from Avista Advantage of \$8.3 million and increased revenues from the Other business segment of \$1.4 million. The increase in revenues from Avista Advantage was primarily due to customer growth and the increase from the Other business segment was primarily due to increased sales at Advanced Manufacturing and Development (AM&D).

Total resource costs increased \$197.0 million due to increases in utility resource costs of \$150.6 million and non-utility resource costs of \$46.4 million.

Utility resource costs increased primarily due to increased purchased power costs of \$41.4 million and increased purchased natural gas costs of \$109.9 million. The increase in purchased power and natural gas costs was primarily due to an increase in prices as well as an increase in the volume of purchases.

Non-utility resource costs increased primarily due to increased resource costs for Avista Energy Canada and partially due to an increase in transportation and transmission costs.

Depreciation and amortization increased \$8.5 million for 2005 compared to 2004 due in part to utility plant additions and the resulting increase in depreciation expense. This was also due to a correction for overstated depreciation expense in prior periods recorded during 2004.

Other operating expenses decreased \$6.7 million for 2005 compared to 2004 due to asset impairment charges recorded at Avista Power (Energy Marketing and Resource Management segment) in 2004, decreased compensation expense at Avista Energy (Energy Marketing and Resource Management segment), the impairment of good will at AM&D, the accrual of environmental liabilities at Avista Development, and the write-off of an investment in a natural gas storage project during 2004 (Other business segment). This was partially offset by increased operating expenses for Avista Advantage due to expanding operations and a slight increase in other operating expenses for Avista Utilities. The increase for Avista Utilities was primarily due to an increase in incentive compensation expenses including performance share payouts, partially offset by a decrease in certain other operating expenses. These decreases in certain other operating expenses include the sale of the South Lake Tahoe natural gas operations and write-offs related to the Idaho general rate case incurred in 2004.

Interest expense, net of capitalized interest, decreased \$0.6 million for 2005 compared to 2004 primarily due to a decrease in the effective borrowing rate on long-term debt as a result of previous debt issuances and repurchases, partially offset by an increase in interest expense on short-term borrowings.

Other income-net increased \$1.6 million primarily due to an increase in interest income.

Income taxes increased \$4.3 million for 2005 compared to 2004, primarily due to increased income before income taxes. The effective tax rate was 36.4 percent for 2005 compared to 37.7 percent for 2004. The decrease in the effective tax rate was partially due to tax credits for the Kettle Falls Generation Plant that the

Company began receiving the benefit from in 2005.

During 2004, the Other business segment recorded as a cumulative effect of accounting change a charge of \$0.5 million related to the implementation of Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003, which required Avista Ventures to consolidate several minor entities.

Liquidity and Capital Resources – During 2005, positive cash flows from operating activities of \$128.5 million, proceeds from property sales (primarily the sale of the Company's South Lake Tahoe natural gas properties) of \$17.2 million and an overall reduction in the Company's consolidated cash position of \$62.4 million were used to fund the majority of the Company's cash requirements, including utility capital expenditures of \$213.7 million and dividends of \$26.4 million. To fund the portion of cash needs not met through other sources, total debt increased \$37.5 million in 2005. In addition to dividends, the most significant financing transactions in 2005 were long-term debt issuances of \$149.6 million and \$111.6 million of debt redemptions and maturities. The overall decrease in cash of \$62.4 million in 2005 primarily reflects a decrease in cash at Avista Energy primarily due to an increase of \$28.7 million in cash deposited with counterparties as collateral funds, as well as Avista Energy's net loss for the year.

The Company's consolidated operating cash flows are primarily derived from the operations of Avista Utilities and Avista Energy. The primary source of operating cash flows for Avista Utilities is revenues (including the recovery of previously deferred power and natural gas costs) from sales of electricity and natural gas. Significant uses of cash flows from operations for Avista Utilities include the purchase of electricity and natural gas, other operating expenses, taxes and interest. The primary source and use of operating cash flows for Avista Energy is revenues and costs from realized energy commodity transactions as well as cash collateral deposited to or held from counterparties. Significant operating cash outflows for Avista Energy also include other operating expenses and taxes.

Operating cash flows do not always fully support the capital expenditure needs of Avista Utilities. As such, from time to time, the Company may need to access capital markets in order to fund these needs, as well as to fund maturing debt.

The general rate increases that have been implemented at Avista Utilities since 2002 are allowing the Company to continue to improve its liquidity. In December 2005, the WUTC approved a settlement agreement (with certain conditions) related to Avista Utilities' Washington general rate case that provides for electric and natural gas base rate increases, which are designed to increase annual revenues by \$22.4 million effective January 1, 2006.

The Company monitors on an ongoing basis the potential liquidity impacts of increasing energy commodity prices, particularly with respect to natural gas, for both Avista Utilities and Avista Energy. The Company believes that it has adequate liquidity through current cash and cash equivalents, Avista Corp.'s committed line of credit and Avista Energy's committed line of credit to meet the increased cash needs of higher energy commodity prices. Avista Utilities has regulatory mechanisms in place that provide for

the deferral and recovery of the majority of its power and natural gas supply costs. However, if prices increase, deferral balances will increase, which will negatively affect the Company's cash flow and liquidity.

The Company's stockholders' equity increased \$17.9 million during 2005 primarily due to net income, partially offset by dividends and other comprehensive loss.

Pension Plan – As of December 31, 2005, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. The Company does not expect the current pension plan funding deficit to have a material adverse effect on its financial condition, results of operations or cash flows. The Company believes that it has made significant efforts in addressing the pension plan funding deficit since 2002, primarily through cash contributions to the plan in excess of the amounts that are required to be funded under the Employee Retirement Income Security Act. The Company made \$15 million in cash contributions to the pension plan in each of 2005 and 2004, which brings total pension plan contributions to \$54 million from 2002 through 2005. The Company expects to contribute \$15 million to the pension plan in 2006.

Off-balance Sheet Arrangements – Avista Receivables Corporation (ARC) is a wholly owned, bankruptcy-remote subsidiary of Avista Corp. formed for the purpose of acquiring or purchasing interests in certain accounts receivable, both billed and unbilled, of the Company. Avista Corp., ARC and a third-party financial institution have entered into a Receivables Purchase Agreement. Under the Receivables Purchase Agreement, ARC can sell without recourse, on a revolving basis, up to \$85.0 million of those receivables. As of December 31, 2005, \$85.0 million in accounts receivables were sold under this revolving agreement. This agreement provides the Company with cost-effective funds for working capital requirements, capital expenditures and other general corporate needs.

Potential Holding Company Formation – In February 2006, the Board of Directors of Avista Corp. made the decision to ask shareholders to approve a change in the Company's organization which would result in the formation of a holding company. The proposed holding company would become the parent to the regulated utility Avista Corp. (Avista Utilities) and Avista Capital, which is the parent to the Company's non-utility subsidiaries. The holding company organizational structure is common in the utility industry. The recent repeal of the Public Utility Holding Company Act of 1935 removed certain restrictions on the formation of a public utility holding company for corporations like Avista Corp. that operate in more than one state.

The proposal for the formation of a holding company will be described for shareholders in Avista Corp.'s Proxy Statement–Prospectus to be distributed to shareholders in connection with the annual meeting of shareholders to be held on May 11, 2006. Avista Corp. has filed for regulatory approval from the Federal Energy Regulatory Commission and the utility regulators in Washington, Idaho, Oregon and Montana, conditioned on approval by shareholders. If shareholders approve the proposal, and if state and federal regulatory approvals are received, the holding company organization could be implemented by the end of 2006.

Company Headquarters

Avista Corp.
1411 East Mission Avenue
Spokane, Washington 99202

Avista Corp. on the Internet

Financial results, stock quotes, news releases, documents filed with the Securities and Exchange Commission, and information on the company's products and services are available at Avista Corp.'s Web site. The address is www.avistacorp.com.

Transfer Agent

The Bank of New York is the company's stock transfer, dividend payment and reinvestment plan agent. Answers to many shareholder questions and requests for forms are available by visiting The Bank of New York's Web site at www.stockbny.com.

Inquiries should be directed to:

The Bank of New York
Shareholder Relations Department
P.O. Box 11258
Church Street Station
New York, New York 10286-1258
800.642.7365
shareowners@bankofny.com

Investor Information

A copy of the company's financial reports, including the reports on Forms 10-K and 10-Q filed with the Securities and Exchange Commission, will be provided without charge upon request to:

Avista Corp.
Investor Relations
P.O. Box 3727 MSC-19
Spokane, Washington 99220-3727
800.222.4931

Annual Meeting of Shareholders

Shareholders are invited to attend the company's annual meeting to be held at 10 a.m. PDT on Thursday, May 11, 2006, at Avista Corp. headquarters, 1411 East Mission Avenue in Spokane, Washington.

The annual meeting also will be webcast. Please go to www.avistacorp.com to preregister for the webcast in advance of the annual meeting and to listen to the live webcast. The webcast will be archived at www.avistacorp.com for one year to allow shareholders to listen to it at their convenience.

Exchange Listing

Ticker Symbol: AVA
New York Stock Exchange

Certifications

On June 6, 2005, the Chief Executive Officer of Avista Corp. filed a Section 303A.12(a) Annual CEO Certification with the New York Stock Exchange. The CEO Certification attests that the Chief Executive Officer is not aware of any violations by the Company of NYSE's Corporate Governance Listing Standards.

Avista Corp. has included as exhibits to its annual report on Form 10-K for the year 2005 filed with the Securities and Exchange Commission certifications of Avista Corp.'s Chief Executive Officer and Chief Financial Officer regarding the quality of Avista Corp.'s public disclosure in compliance with Section 302 of the Sarbanes-Oxley Act of 2002.

This annual report contains forward-looking statements regarding the company's current expectations. These statements are subject to a variety of risks and uncertainties that could cause actual results to differ materially from the expectations. These risks and uncertainties include, in addition to those discussed herein, all factors discussed in the company's annual report on Form 10-K for the year 2005. Our 2005 annual report is provided for investors. It is not intended for use in connection with any sale or purchase of or any solicitation of others to buy or sell securities.

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Special thanks to these external companies and individuals of the great
Northwest for their help with this year's annual report:

— [Kaiser Mar Design](#) (design)

— [Kaiser Communications](#) (writing)

— [Kaiser Social Photography](#) (official photography)

— [Kaiser Printing and Shred](#)

— [Kaiser Energy](#) by

— [Kaiser Yards Development](#) - [page 17](#), [Kendall Yards](#)

— [Kaiser Parks](#) - [page 18](#), [Coyote Springs 2](#)

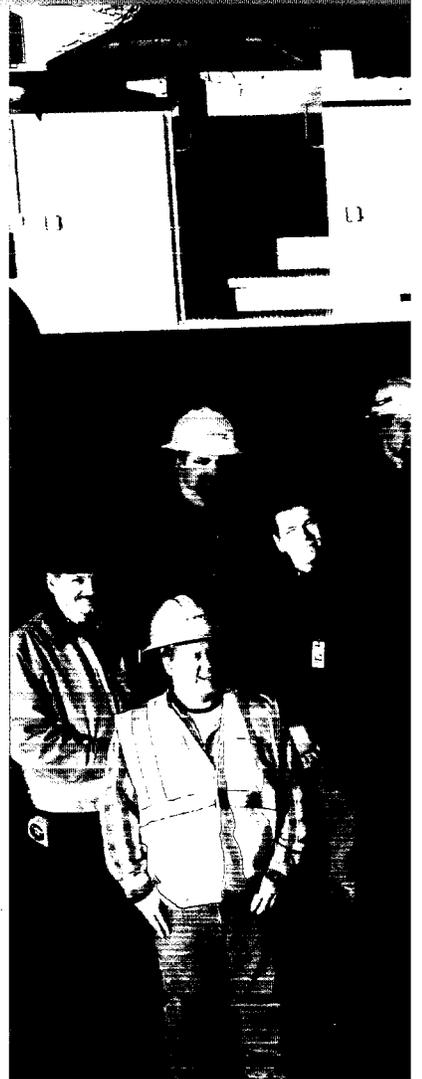
Avista Utilities

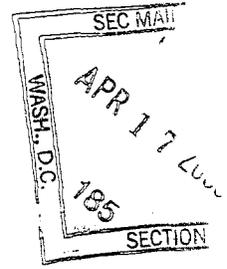
Avista Energy

Avista Advantage



Avista Corp.
1411 East Mission Avenue
Spokane, Washington 99202
509.489.0500
www.avistacorp.com





2005 FINANCIAL REPORT

APPENDIX A



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Web site: www.avistacorp.com

Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

Avista Corporation (Avista Corp. or the Company) from time to time makes forward-looking statements such as statements regarding future financial performance, capital expenditures, dividends, capital structure and other financial items, and assumptions underlying them (many of which are based, in turn, upon further assumptions), as well as strategic goals and objectives and plans for future operations. Such statements are made both in Avista Corp.'s reports filed under the Securities Exchange Act of 1934, as amended (including this Annual Report on Form 10-K), and elsewhere. Forward-looking statements are all statements other than statements of historical fact, including, without limitation, those that are identified by the use of words such as, but not limited to, "will," "may," "could," "should," "intends," "plans," "seeks," "anticipates," "estimates," "expects," "forecasts," "projects," "predicts," and similar expressions.

All forward-looking statements (including those made in this Annual Report on Form 10-K) are subject to a variety of risks and uncertainties and other factors, most of which are beyond the control of Avista Corp. and many of which could have a significant effect on Avista Corp.'s operations, results of operations, financial condition or cash flows and could cause actual results to differ materially from those anticipated in such statements. Such risks, uncertainties and other factors include, among others:

- weather conditions, including the effect of precipitation and temperatures on the availability of hydroelectric resources and the effect of temperatures on customer demand;
- changes in wholesale energy prices that can affect, among other things, cash requirements to purchase electricity and natural gas for retail customers, as well as the market value of derivative assets and liabilities and unrealized gains and losses;
- volatility and illiquidity in wholesale energy markets, including the availability and prices of purchased energy and demand for energy sales;
- the effect of state and federal regulatory decisions affecting the ability of the Company to recover its costs and/or earn a reasonable return, including, but not limited to, the disallowance of previously deferred costs;
- the outcome of pending regulatory and legal proceedings arising out of the "western energy crisis" of 2001 and 2002, and including possible retroactive price caps and resulting refunds;
- changes in the utility regulatory environment in the individual states and provinces in which the Company operates as well as the United States and Canada in general, which can affect allowed rates of return, financings, or industry and rate structures;
- the outcome of legal proceedings and other contingencies concerning the Company or affecting directly or indirectly its operations;
- the potential effects of any legislation or administrative rulemaking passed into law, including the Energy Policy Act of 2005 which was passed into law in August 2005;
- the effect from the potential formation of a Regional Transmission Organization;
- wholesale and retail competition (including, but not limited to, electric retail wheeling and transmission costs);
- changes in global energy markets that can affect, among other things, the price of natural gas purchased for retail customers and purchased as fuel for electric generation;
- the ability to relicense the Spokane River Project at a cost-effective level with reasonable terms and conditions;
- unplanned outages at any Company-owned generating facilities;
- unanticipated delays or changes in construction costs with respect to present or prospective facilities;
- natural disasters that can disrupt energy delivery as well as the availability and costs of materials and supplies and support services;
- blackouts or large disruptions of transmission systems, which can have an impact on the Company's ability to deliver energy to its customers;
- the potential for future terrorist attacks, particularly with respect to utility plant assets;
- changes in the long-term climate of the Pacific Northwest, which can affect, among other things, customer demand patterns and the volume and timing of streamflows to hydroelectric resources;
- changes in future economic conditions in the Company's service territory and the United States in general, including inflation or deflation and monetary policy;
- changes in industrial, commercial and residential growth and demographic patterns in the Company's service territory;
- the loss of significant customers and/or suppliers;
- failure to deliver on the part of any parties from which the Company purchases and/or sells capacity or energy;

- changes in the creditworthiness of customers and energy trading counterparties;
- the Company's ability to obtain financing through the issuance of debt and/or equity securities, which can be affected by various factors including the Company's credit ratings, interest rate fluctuations and other capital market conditions;
- the effect of any potential change in the Company's credit ratings;
- changes in actuarial assumptions, the interest rate environment and the actual return on plan assets with respect to the Company's pension plan, which can affect future funding obligations, costs and pension plan liabilities;
- increasing health care costs and the resulting effect on health insurance premiums paid for employees and on the obligation to provide postretirement health care benefits;
- increasing costs of insurance, changes in coverage terms and the ability to obtain insurance;
- employee issues, including changes in collective bargaining unit agreements, strikes, work stoppages or the loss of key executives, as well as the ability to recruit and retain employees;
- changes in rapidly advancing technologies, possibly making some of the current technology quickly obsolete;
- changes in tax rates and/or policies; and
- changes in, and compliance with, environmental and endangered species laws, regulations, decisions and policies, including present and potential environmental remediation costs.

The Company's expectations, beliefs and projections are expressed in good faith and are believed by the Company to have a reasonable basis including, without limitation, management's examination of historical operating trends, data contained in the Company's records and other data available from third parties. However, there can be no assurance that the Company's expectations, beliefs or projections will be achieved or accomplished. Furthermore, any forward-looking statement speaks only as of the date on which such statement is made. The Company undertakes no obligation to update any forward-looking statement or statements to reflect events or circumstances that occur after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for management to predict all of such factors, nor can it assess the effect of each such factor on the Company's business or the extent to which any such factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

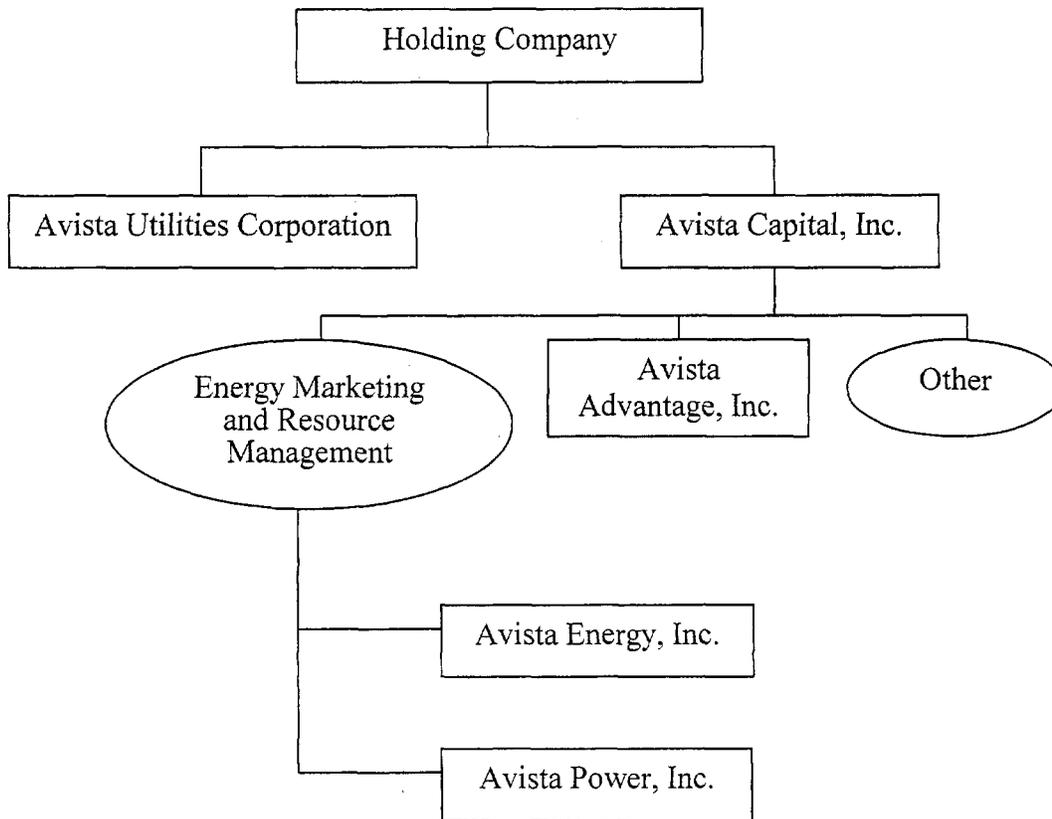
The following discussion and analysis is provided for the consolidated financial condition and results of operations of Avista Corp. and its subsidiaries. This discussion focuses on significant factors concerning the Company's financial condition and results of operations and should be read along with the consolidated financial statements.

Potential Holding Company Formation

In February 2006, the Board of Directors of Avista Corp. made the decision to ask shareholders to approve a change in the Company's organization, which would result in the formation of a holding company. The proposed holding company would become the parent to the regulated utility Avista Corp. (Avista Utilities) and Avista Capital, which is the parent to the Company's non-utility subsidiaries. The holding company organizational structure is common in the utility industry. The recent repeal of the Public Utility Holding Company Act of 1935 removed certain restrictions on the formation of a public utility holding company for corporations like Avista Corp. that operate in more than one state.

The proposal for the formation of a holding company will be described for shareholders in Avista Corp.'s Proxy Statement-Prospectus to be distributed to shareholders in connection with the annual meeting of shareholders to be held on May 11, 2006. Avista Corp. has filed for regulatory approval from the Federal Energy Regulatory Commission (FERC) and the utility regulators in Washington, Idaho, Oregon and Montana, conditioned on approval by shareholders. If shareholders approve the proposal, and if state and federal regulatory approvals are received, the holding company organization could be implemented by the end of 2006.

The following chart presents the expected organization of the Company upon completion of all of the transactions associated with the formation of the holding company:



□ - denotes a business entity; Avista Utilities Corporation and Avista Advantage are also business segments.
 ○ - denotes business segment.

Avista Corp. Business Segments

Avista Corp. has four business segments – Avista Utilities, Energy Marketing and Resource Management, Avista Advantage and Other. Avista Utilities is an operating division of Avista Corp. comprising the regulated utility operations. Avista Utilities generates, transmits and distributes electricity and distributes natural gas. Avista Capital, a wholly owned subsidiary of Avista Corp., is the parent company of all of the subsidiary companies in the non-utility business segments. The Company's total common stockholders' equity was \$771.1 million as of December 31, 2005 of which \$237.7 million represented its investment in Avista Capital.

The Energy Marketing and Resource Management business segment is comprised of Avista Energy, Inc. (Avista Energy) and Avista Power, LLC (Avista Power). Avista Energy is an electricity and natural gas marketing, trading and resource management business, operating primarily in the Western Electricity Coordinating Council (WECC) geographical area, which is comprised of eleven Western states and the provinces of British Columbia and Alberta, Canada. Avista Power's primary asset is its 49 percent interest in a 270 megawatt (MW) natural gas-fired combined cycle combustion turbine plant in northern Idaho (Lancaster Project).

Avista Advantage, Inc. (Avista Advantage) is a provider of facility information and cost management services for multi-site customers throughout North America. Through invoice processing, auditing, payment services and comprehensive reporting, Avista Advantage's solutions are designed to provide companies with critical and easy-to-access information that enables them to proactively manage and reduce their utility, telecom and waste management expenses.

The Other business segment includes Avista Ventures, Inc. (Avista Ventures), Pentzer Corporation (Pentzer), Avista Development and certain other operations of Avista Capital. Included in this business segment is Advanced Manufacturing and Development (AM&D) doing business as METALfx, a subsidiary of Avista Ventures that performs custom sheet metal fabrication of electronic enclosures, parts and systems for the computer, telecom and

medical industries. AM&D also performs contract assembly for radiant floor heating systems. Other significant investments in this segment include commercial office buildings, investments in low income housing and venture capital partnerships, the remaining investment in a previous fuel cell subsidiary of the Company, and notes receivable from the sale of property and investments.

The following table presents results by business segment for the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|---|-----------------|-----------------|-----------------|
| Avista Utilities..... | \$52,479 | \$32,467 | \$36,241 |
| Energy Marketing and Resource Management..... | (8,621) | 9,733 | 20,672 |
| Avista Advantage..... | 3,922 | 577 | (1,334) |
| Other..... | <u>(2,612)</u> | <u>(7,163)</u> | <u>(4,936)</u> |
| Income from continuing operations..... | 45,168 | 35,614 | 50,643 |
| Loss from discontinued operations..... | - | - | (4,949) |
| Net income before cumulative effect of accounting change..... | 45,168 | 35,614 | 45,694 |
| Cumulative effect of accounting change..... | - | (460) | (1,190) |
| Net income..... | 45,168 | 35,154 | 44,504 |
| Preferred stock dividend requirements..... | - | - | (1,125) |
| Income available for common stock..... | <u>\$45,168</u> | <u>\$35,154</u> | <u>\$43,379</u> |

Executive Level Summary

Net income was \$45.2 million for 2005 compared to \$35.2 million for 2004. This increase was due to the improved performance of Avista Utilities, as well as Avista Advantage and the Other business segment. This was partially offset by a net loss for Avista Energy (Energy Marketing and Resource Management segment).

Avista Corp.'s operating results and cash flows are derived primarily from Avista Utilities and Avista Energy. Avista Corp. intends to continue to focus on improving earnings and operating cash flows, controlling costs and reducing debt while working to restore an investment grade credit rating.

Avista Utilities is the Company's most significant business segment. Avista Utilities expects to continue to be among the industry leaders in performance, value and service in its electric and natural gas utility businesses. Based on Avista Utilities' forecast for electric customer growth of 2.5 percent and natural gas customer growth of 4 percent within its service area, Avista Utilities anticipates retail electric and natural gas load growth will average between 3 and 3.5 percent annually for the next four years. As part of Avista Utilities' strategy to focus on its business in the northwestern United States, in April 2005, the Company completed the sale of its natural gas properties in South Lake Tahoe, California (see "Note 28 of the Notes to Consolidated Financial Statements"). This was the Company's only regulated utility operation in California.

Avista Utilities operating and financial performance is substantially dependent upon, among other things: 1) weather conditions, including the effect of precipitation and temperatures on the availability of hydroelectric resources and the effect of temperatures on customer demand, 2) the price of natural gas in the wholesale market, including the effect on the price of fuel for generation, 3) the price of electricity in the wholesale market, including the effects of weather conditions, natural gas prices and other factors affecting supply and demand and 4) favorable regulatory decisions, allowing Avista Utilities to recover its costs, including particularly its purchased power and fuel costs, on a timely basis, and to earn a fair return on its investment.

Avista Utilities' hydroelectric generation was 95 percent of normal in 2005. Hydroelectric generation has been below normal (based on a 70-year average) for 5 of the past 6 years. The Company cannot determine if this trend of lower than normal hydroelectric generation will continue in future years. Avista Utilities forecasts that hydroelectric generation will be near normal in 2006. This is an early forecast, which will change based upon precipitation, temperatures and other variables during the year.

Avista Utilities has increased capital expenditures in order to meet load growth needs and to continue to provide reliable service to its customers. Utility capital expenditures totaled \$213.7 million in 2005, the most significant of which were the acquisition of the remaining interest in Coyote Springs 2, transmission system enhancements, and the repurchase of the Company's corporate headquarters and central operating facility in Spokane. For 2006, the Company has established a utility capital budget of approximately \$160 million. Significant projects include the continued enhancement of Avista Utilities' transmission system and upgrades to generating facilities.

Avista Utilities regularly reviews the need for electric and natural gas rate changes in each state in which it provides service. Avista Utilities has received base rate increases in each of its jurisdictions since October 2003. Most recently, in December 2005, Avista Utilities received approval from the Washington Utilities and Transportation Commission (WUTC) to increase its base electric and natural gas rates effective January 1, 2006. Avista Utilities will continue to file for rate adjustments to provide for recovery of its operating costs and capital investments and to more closely align earned returns with those allowed by regulatory agencies.

Avista Utilities' net income was \$52.5 million for 2005, an increase from \$32.5 million for 2004 primarily due to the general rate increases, as well as the \$4.1 million pre-tax gain on the sale of the South Lake Tahoe natural gas properties. This was partially offset by increases in other operating expenses particularly with respect to depreciation and amortization from utility plant additions as well as compensation and other employee related expenses. Results for 2004 were reduced by write-offs of \$14.4 million (\$9.4 million, net of tax) related to the Idaho Public Utility Commission (IPUC) general rate case order. Avista Utilities expects net income for 2006 to be similar to 2005.

Avista Energy's business activities include trading electricity and natural gas, as well as 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 Canada, Ltd. (Avista Energy Canada) is a wholly owned subsidiary of Avista Energy that provides natural gas services to end-user industrial and commercial customers in British Columbia, Canada.

The earnings and cash flows of Avista Energy are by nature subject to significant volatility because they are derived primarily from the day-to-day trading of electricity and natural gas and optimization of assets owned by other entities, as opposed to long-term revenue streams, and because Avista Energy's activities are for the most part subject to mark-to-market accounting. In addition, with respect to the management of natural gas storage and certain other contracts, Avista Energy's earnings are subject to the anomalies caused by the differences between the required accounting and the economic management of these assets and contracts. While Avista Energy has taken measures to enhance profitability and reduce the risk of losses in the future, this business will continue to have volatility in its results.

Avista Energy is subject to certain regulatory proceedings that remain unresolved; however, Avista Energy believes that it has adequate reserves established for refunds that may be ordered. The wholesale energy markets in which Avista Energy operates continue to have volatile market prices and variations in liquidity.

The Energy Marketing Resource Management segment, which consists primarily of Avista Energy, incurred a net loss of \$8.6 million for 2005 compared to net income of \$9.7 million for 2004. The net loss for 2005 was the first annual net loss for this business segment since 1999. The net loss for 2005 was primarily due to losses in Avista Energy's natural gas portfolio. The volatility in natural gas and electricity prices can result in significant changes in earnings from Avista Energy from year-to-year. Avista Energy's trading of electricity and natural gas, as well as asset optimization activities, have been cumulatively profitable since 1999. Asset optimization has resulted in the recovery of a majority of the fixed and variable costs associated with the power purchase agreement for the Lancaster Project for 2006. In addition, early in 2006, the Company captured a significant amount of value relative to prior years, from the economic management of natural gas storage. Earnings associated with these activities, as well as the anticipated future success of trading natural gas and electricity, are expected to return this segment to profitability in 2006.

Avista Advantage remains focused on increasing revenues, controlling operating expenses, continuously enhancing client satisfaction and developing complementary value-added services in a competitive market. During the first quarter of 2005, Avista Advantage acquired TelAssess, Inc. Although not a significant financial transaction, this acquisition provides Avista Advantage a foundation on which to expand beyond existing utility bill information services to provide similar services relating to telecom expense management. Net income for Avista Advantage was \$3.9 million for 2005, an increase from \$0.6 million for 2004 based on increased revenues from an expanding customer base and stabilizing operating expenses from processing efficiencies. The Company expects net income for Avista Advantage to increase in 2006 as compared to 2005.

Over time as opportunities arise, the Company plans to continue to dispose of assets and phase out operations in the Other business segment. However, the Company may, from time to time, invest incremental funds in these businesses to protect its existing investments. The net loss in the Other business segment was \$2.6 million for 2005, a decrease from \$7.2 million (excluding the cumulative effect of accounting change) for 2004 primarily due to

decreased losses from asset impairments and write-offs incurred in 2004. The Company expects a similar net loss for 2006 as compared to 2005 for the Other business segment.

Total debt outstanding increased \$37.5 million in 2005 primarily to fund utility capital expenditures that were in excess of net cash flows from operating activities. Avista Corp. issued \$150.0 million of long-term debt during the fourth quarter of 2005 to, among other things, refinance borrowings on its committed line of credit. For 2006, the Company expects net cash flows from operating activities and Avista Corp.'s committed line of credit to provide adequate resources to fund capital expenditures, maturing long-term debt, dividends and other contractual commitments. However, the Company currently expects to issue long-term debt in the fourth quarter of 2006 primarily to fund debt that matures in the first quarter of 2007.

The Company has management succession plans that work towards ensuring that executive officer and key management positions can be appropriately filled as vacancies occur. The Company has taken similar steps in key technical and craft areas.

Avista Utilities – Electric Resources

As of December 31, 2005, Avista Utilities' facilities had a total net capability of approximately 1,800 MW, of which 54 percent was hydroelectric and 46 percent was thermal. In addition to company owned resources, Avista Utilities has a number of long-term power purchase and exchange contracts that increase its available resources. See "Note 7 of the Notes to Consolidated Financial Statements" for information with respect to Avista Utilities' resource optimization process.

Avista Utilities – Regulatory Matters

General Rate Cases

In recent years, Avista Utilities has generally not earned its authorized rates of return. Avista Utilities regularly reviews the need for electric and natural gas rate changes in each state in which it provides service and will continue to file for rate adjustments to provide for recovery of its operating costs and capital investments and to more closely align earned returns with those allowed by regulatory agencies. The following table summarizes Avista Utilities' authorized rates of return in each jurisdiction:

| <u>Jurisdiction and service</u> | <u>Implementation Date</u> | <u>Authorized Overall Rate of Return</u> | <u>Authorized Return on Equity</u> | <u>Authorized Equity Level</u> |
|-------------------------------------|----------------------------|--|------------------------------------|--------------------------------|
| Washington electric and natural gas | January 2006 | 9.11% | 10.40% | 40% |
| Idaho electric and natural gas | September 2004 | 9.25% | 10.40% | 43% |
| Oregon natural gas | October 2003 | 8.88% | 10.25% | 48% |

In December 2005, the WUTC approved Avista Utilities' combined electric and natural gas general rate case settlement agreement with certain conditions, which were subsequently accepted by the settling parties (Avista Utilities, the WUTC staff, the Northwest Industrial Gas Users and the Energy Project). The WUTC order provided for base rate increases of 7.5 percent for electric and 0.6 percent for natural gas, effective January 1, 2006. The electric base rate increase is designed to increase annual revenues by \$21.4 million. The majority of the increase in electric revenues is related to increased power supply costs. As such, a significant portion of the increase will not increase gross margin or net income, because it will be matched by an increase in resource costs. The natural gas base rate increase is designed to increase annual revenues by approximately \$1.0 million. The WUTC order also provides for further review of the ERM as discussed at "Power Cost Deferrals and Recovery Mechanisms" below.

As part of the general rate case settlement agreement that was modified and approved by the WUTC order, Avista Utilities has agreed to increase the utility equity component to 35 percent by the end of 2007 and 38 percent by the end of 2008. Failure by Avista Utilities to meet those targets could result in a reduction in base rates of 2 percent for each target. The utility equity component was approximately 31 percent as of December 31, 2005.

In January 2005, the WUTC issued its final order with respect to a natural gas general rate case filed by Avista Utilities in Washington. The final order authorized, among other things, an increase in natural gas rates of 3.9 percent, which is designed to increase annual revenues by \$5.4 million.

In October 2004, the IPUC issued its final order with respect to electric and natural gas general rate cases filed by Avista Utilities in Idaho. The final order authorized, among other things, Avista Utilities to increase its electric base rates by 16.9 percent, which is designed to increase annual revenues by \$24.7 million, and increase its natural gas

base rates by 6.4 percent, which is designed to increase annual revenues by \$3.3 million. Due to a decrease implemented concurrently in Avista Utilities' power cost adjustment (PCA) surcharge and certain other minor adjustments, the net increase in electric rates for Idaho customers was 1.9 percent above rates in effect at that time. Based on the final order, Avista Utilities had to write off a total of \$14.4 million of costs in 2004.

Other Regulatory Filings and Rulings

In April 2005, the IPUC issued an order approving the inclusion of the remaining 50 percent of Coyote Springs 2 in base electric rates. The order provides for a 1.9 percent increase in base electric rates, which is designed to increase annual revenues by \$3.2 million. At the same time, the IPUC approved a 1.9 percent reduction in the Company's current PCA rate surcharge. These two requests together resulted in no overall change to customers' existing rates.

The Oregon Public Utility Commission (OPUC) has issued temporary rules and is in the process of formulating final rules related to Oregon Senate Bill 408 (OSB 408). OSB 408 requires the OPUC to direct the utility to establish an automatic adjustment clause to account for the difference between taxes collected in rates and taxes paid to units of government, net of adjustments, when that difference exceeds \$100,000. Taxes paid attributed to Oregon regulated operations are limited to the lesser of consolidated or stand-alone tax payments. The automatic adjustment clause may result in either rate increases or rate decreases and applies only to taxes paid and collected on or after January 1, 2006. Interpretation and application of OSB 408 is complicated by a number of factors, including, but not limited to, the adjustments that are allowed under OSB 408, the Company's organizational structure, and the fact that the Company provides retail natural gas and electric services in multiple state jurisdictions. At this point in time, the Company cannot predict the effect that OSB 408 may have on revenues or net income related to its Oregon natural gas operations.

Power Cost Deferrals and Recovery Mechanisms

Avista Utilities defers the recognition in the income statement of certain power supply costs that are in excess of the level currently recovered from retail customers as authorized by the WUTC and the IPUC. A portion of power supply costs are recorded as a deferred charge on the Consolidated Balance Sheets for future review and the opportunity for recovery through retail rates.

In Washington, the ERM allows Avista Utilities to increase or decrease electric rates periodically with WUTC approval to reflect changes in power supply costs. The ERM currently provides for Avista Utilities to incur the cost of, or receive the benefit from, the first \$9.0 million in annual power supply costs above or below the amount included in base retail rates, which is referred to as the ERM dead band. Under the ERM, 90 percent of the power supply costs exceeding or below the dead band are deferred for future surcharge or rebate to Avista Utilities' customers. The remaining 10 percent of power supply costs are an expense of, or benefit to, the Company. The WUTC rejected the proposal in the rate case settlement agreement to reduce the ERM dead band from \$9.0 million to \$3.0 million. However, Avista Utilities was directed to make a filing with the WUTC by January 31, 2006, with proposed changes to the ERM, including any changes to the ERM dead band. On January 31, 2006, Avista Utilities made its filing with the WUTC proposing that the ERM be continued for an indefinite period of time and that the \$9.0 million ERM dead band be eliminated. This filing also satisfied a previous requirement for Avista Utilities to make a filing by the end of 2006 for a review of the ERM. The elimination of the \$9.0 million ERM dead band would reduce the volatility of Avista Utilities' earnings that has been caused by variations in hydroelectric generation, as well as prices for fuel and purchased power. The WUTC has set a procedural schedule that would allow for an order on any changes to the ERM (including any changes to the dead band) to be issued in late June or July of 2006. The WUTC also stated that any changes to the ERM ordered by the WUTC in 2006 would be effective for the full year (beginning January 1, 2006). The Company expensed the entire ERM dead band during 2005, 2004, 2003 and 2002 (\$4.5 million in 2002 due to mid-year implementation on July 1, 2002).

The rate case settlement agreement approved by the WUTC increases the ERM surcharge from 9.8 percent to 10.8 percent, which allows Avista Utilities to more rapidly recover deferred power costs.

Under the ERM, Avista Utilities agreed to make an annual filing on or before April 1st of each year to provide the opportunity for the WUTC and other interested parties to review the prudence of and audit the ERM deferred power cost transactions for the prior calendar year. The ERM provides for a 90-day review period for the filing; however, the period may be extended by agreement of the parties or by WUTC order. In June 2005, the WUTC issued an order, which approved the recovery of the \$10.8 million of deferred power costs incurred for 2004. In March 2006, the Company will make its filing for deferred power costs incurred in 2005.

Avista Utilities has a PCA mechanism in Idaho that allows it to modify electric rates periodically with IPUC approval. Under the PCA mechanism, Avista Utilities defers 90 percent of the difference between certain actual net

power supply expenses and the authorized level of net power supply expense. As disclosed at "General Rate Cases" above, in October 2004, the IPUC issued its final order with respect to general electric and natural gas rate cases filed by Avista Utilities in Idaho. The IPUC authorized the recovery of remaining deferred power costs over a two-year period through a PCA rate surcharge to customers that was reduced to 4.4 percent. The PCA surcharge was further reduced to 2.5 percent in April 2005 with the approval of the inclusion of the remaining interest in Coyote Springs 2 in base electric rates. The decrease in the PCA rate surcharge extends the recovery period of deferred power costs by an additional year.

The following table shows activity in deferred power costs for Washington and Idaho during 2004 and 2005 (dollars in thousands):

| | Washington | Idaho | Total |
|---|-----------------|-----------------|------------------|
| Deferred power costs as of December 31, 2003 | \$125,705 | \$30,285 | \$155,990 |
| Activity from January 1 – December 31, 2004: | | | |
| Power costs deferred | 10,498 | 15,276 | 25,774 |
| Unrealized gain on fuel contracts (1) | (3,139) | (1,596) | (4,735) |
| Interest and other net additions | 6,354 | 532 | 6,886 |
| Write-off of deferred power costs | - | (11,959) | (11,959) |
| Recovery of deferred power costs through retail rates | <u>(26,210)</u> | <u>(23,040)</u> | <u>(49,250)</u> |
| Deferred power costs as of December 31, 2004 | 113,208 | 9,498 | 122,706 |
| Activity from January 1 – December 31, 2005: | | | |
| Power costs deferred | 4,129 | 3,938 | 8,067 |
| Interest and other net additions | 5,403 | 278 | 5,681 |
| Recovery of deferred power costs through retail rates | <u>(26,549)</u> | <u>(5,727)</u> | <u>(32,276)</u> |
| Deferred power costs as of December 31, 2005 | <u>\$96,191</u> | <u>\$7,987</u> | <u>\$104,178</u> |

(1) Unrealized gains and losses on fuel contracts are not included in the ERM and PCA mechanism until the contracts are settled or realized.

Purchased Gas Adjustments

Natural gas commodity costs in excess of, or which fall below, the amount recovered in current retail rates are deferred and recovered or refunded as a pass-through to customers in future periods with applicable regulatory approval through adjustments to rates. Currently, purchased gas adjustments provide for the deferral and future recovery or refund of 100 percent of the difference between commodity costs and the amount recovered in current retail rates in Washington and Idaho. In Oregon, Avista Utilities has received a tariff revision that provides for 100 percent recovery of known hedges. With respect to the unhedged portion of customer loads, the revised tariff provides for the deferral and future recovery or refund of 90 percent of the difference between actual prices and the amount recovered in current retail rates effective October 1, 2005. The Company has hedged most of its natural gas load requirements in Oregon. During September through November of 2004, natural gas rate increases of 11.7 percent, 14.2 percent and 12.6 percent were implemented in Washington, Idaho and Oregon, respectively. During October and November of 2005, natural gas rate increases of 23.5 percent, 23.8 percent and 22.5 percent were implemented in Washington, Idaho and Oregon, respectively. These natural gas rate increases are designed to pass through increases in purchased natural gas costs to customers with no change in Avista Utilities' gross margin or net income. Total deferred natural gas costs were \$43.4 million and \$28.6 million as of December 31, 2005 and 2004, respectively.

Natural Gas Benchmark Mechanism

See "Natural Gas Benchmark Mechanism" in "Note 1 of the Notes to Consolidated Financial Statements" for a description of the Natural Gas Benchmark Mechanism and related Agency Agreement. Effective April 1, 2005, the Natural Gas Benchmark Mechanism and related Agency Agreement were terminated and the management of natural gas procurement functions was moved from Avista Energy back to Avista Utilities. This was required for Washington customers by WUTC orders issued in February 2004, and Avista Utilities' resulting transition plan approved by the WUTC in April 2004. The Company also elected to move these functions back to Avista Utilities for Idaho and Oregon natural gas customers.

Power Market Issues

Legal and Regulatory Proceedings in Western Power Markets

Avista Energy and Avista Utilities are involved in a number of legal and regulatory proceedings and complaints with respect to power markets in the western United States. Most of these proceedings and complaints relate to the significant increase in the spot market price of energy in western power markets in 2000 and 2001, which allegedly

contributed to or caused unjust and unreasonable prices. These proceedings and complaints include, but are not limited to, refund proceedings and hearings in California and the Pacific Northwest, market conduct investigations by the FERC, and complaints and cross-complaints filed by various parties with respect to alleged misconduct by other parties in western power markets. As a result of these proceedings and complaints, certain parties have asserted claims for refunds and damages from Avista Energy and Avista Utilities, which could result in a negative effect on future earnings. Avista Energy and Avista Utilities have joined other parties in opposing these refund claims and complaints for damages. See further information in "Note 26 of the Notes to Consolidated Financial Statements."

Market Conduct Investigations and Market-Based Rate Authority

As a result of certain revelations about alleged improper practices engaged in by Enron Corporation (Enron) and certain of its affiliates, the FERC initiated investigations in 2002 of many participants in power markets in the western United States, including Avista Corp. doing business as Avista Utilities, and Avista Energy. Avista Utilities and Avista Energy cooperated with the FERC investigation by providing requested documents and other information. Several parties filed documents with the FERC in March 2003 alleging improper market conduct by various parties, including Avista Utilities and Avista Energy, and requesting refunds and other relief. Avista Utilities and Avista Energy filed replies in response to the allegations of the parties.

In March 2003, the FERC policy staff issued its final report on its investigation of western energy markets. In the report, the FERC policy staff recommended the issuance of "show cause" orders to dozens of companies to respond to allegations of possible misconduct in the western energy markets during 2000 and 2001. Of the companies named in the March 2003 FERC policy staff report, Avista Corp. and Avista Energy were among the few that had already been subjects of a FERC investigation. In April 2004, the FERC approved an agreement that resolves the investigation of Avista Corp. and Avista Energy. Other parties filed requests for rehearing and filed motions to intervene in these proceedings. In April 2005, the FERC denied the requests for rehearing and motion to intervene in these proceedings; however, the other parties subsequently filed appeals with the United States Court of Appeals for the Ninth Circuit in response to the FERC's denial of rehearing requests. See further information under "Federal Energy Regulatory Commission Inquiry" in "Note 26 of the Notes to Consolidated Financial Statements."

Every three years or more frequently if certain regulatory triggers are met, Avista Corp. doing business as Avista Utilities, and Avista Energy are required to file for renewal of their respective market-based rate authority with the FERC. Avista Utilities and Avista Energy made their respective filings with the FERC in September 2004. By orders issued in March 2005, the FERC approved the renewal of the market-based rate authority of Avista Utilities and Avista Energy.

Wholesale Energy Markets and Development of Regional Transmission Organizations

In July 2005, the FERC announced that it had officially abandoned its efforts commenced in 2002 to create new national standard wholesale power market rules. However, the FERC continues its efforts with respect to the formation of Regional Transmission Organizations. This could significantly change how transmission facilities are regulated and operated. Avista Corp. has participated with other utilities in the western United States on the possible formation of a Regional Transmission Organization (RTO).

The final proposal for any RTO must be filed with the FERC and approved by the boards of directors of the filing companies and regulators in various states. The Company's decision to move forward with the formation of any RTO serving the Pacific Northwest region, as well as the legal, financial and operating implications of such decisions, will ultimately depend on the terms and conditions related to the formation of the entities and conditions established in the regulatory approval process. The Company cannot predict these implications.

Energy Policy Act of 2005

In August 2005, the Energy Policy Act of 2005 (Energy Policy Act) was passed into law. The Energy Policy Act substantially affects the regulation of energy companies, including Avista Corp. Key provisions of the Energy Policy Act affecting the Company include, but are not limited to, reform of the hydroelectric licensing process, tax credits for incremental hydroelectric production and the implementation of mandatory reliability standards. The Energy Policy Act also has provisions related to the future operation and development of transmission systems and federal support for certain clean power initiatives and renewable energy technologies, including wind power generation. Finally, the Energy Policy Act repealed the Public Utility Holding Company Act of 1935 (PUHCA) and, among other things, granted the FERC and state utility commissions access to the books and records of holding company systems, provides (upon request of a state commission or holding company system) for FERC review of allocations of costs of non-power goods and administrative services and modifies the jurisdiction of the FERC over certain mergers and acquisitions involving public utilities or holding companies.

The implementation of the Energy Policy Act requires proceedings at the state level and the development of regulations by the FERC, the Department of Energy and other federal agencies. In particular, the FERC has initiated rules that, among other things, implement new reliability standards, require that open access be provided to non-regulated transmission utilities, and implement new provisions relating to the repeal of PUHCA.

The Company continues to analyze and implement certain provisions of the Energy Policy Act. Such activities include the proposed formation of a holding company under the new provisions relating to the repeal of the PUHCA.

Results of Operations

Overall Operations

The following provides an overview of changes in the Company's Consolidated Statements of Income. More detailed explanations are provided, particularly with respect to operating revenues and operating expenses in the business segment discussions (Avista Utilities, Energy Marketing and Resource Management, Avista Advantage and Other) that follow this section.

2005 compared to 2004

Utility revenues increased \$188.7 million due to increases in electric revenues of \$71.0 million and natural gas revenues of \$117.7 million. The increase in natural gas revenues was primarily due to increased natural gas wholesale sales and increases in retail natural gas sales as a result of rate increases. The increase in electric revenues primarily reflects an increase in wholesale revenues and a slight increase in retail revenues, partially offset by a decrease in sales of fuel.

Non-utility energy marketing and trading revenues increased \$9.6 million primarily due to increased revenues for Avista Energy Canada, partially offset by decreased net trading margin on contracts accounted for under Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

Other non-utility revenues increased \$9.7 million to \$50.3 million as a result of increased revenues from Avista Advantage of \$8.3 million and increased revenues from the Other business segment of \$1.4 million. The increase in revenues from Avista Advantage was primarily due to customer growth and the increase from the Other business segment was primarily due to increased sales at AM&D.

Utility resource costs increased \$150.6 million primarily due to increased purchased power costs of \$41.4 million and increased purchased natural gas costs of \$109.9 million. The increase in purchased power and natural gas costs was primarily due to an increase in prices, as well as an increase in the volume of purchases.

Utility other operating expenses increased \$1.1 million primarily due to an increase in incentive compensation expenses including performance share payouts, partially offset by a decrease in certain other operating expenses. These decreases in certain other operating expenses include the sale of the South Lake Tahoe natural gas operations and write-offs related the Idaho general rate case incurred in 2004.

Utility depreciation and amortization increased \$8.1 million for 2005 compared to 2004 due in part to plant additions and the resulting increase in depreciation expense. Total utility capital expenditures were \$213.7 million in 2005. The increase in utility depreciation and amortization was also due to a correction for overstated depreciation expense in prior periods recorded during 2004.

Non-utility resource costs increased \$46.4 million primarily due to increased resource costs for Avista Energy Canada and partially due to an increase in transportation and transmission costs.

Other non-utility operating expenses decreased \$7.7 million for 2005 compared to 2004 due to asset impairment charges recorded at Avista Power (Energy Marketing and Resource Management segment) in 2004, decreased compensation expense at Avista Energy (Energy Marketing and Resource Management segment), the impairment of goodwill at AM&D, the accrual of environmental liabilities at Avista Development and the write-off of an investment in a natural gas storage project during 2004 (Other business segment). This was partially offset by increased operating expenses for Avista Advantage due to expanding operations.

Interest expense decreased \$0.8 million for 2005 compared to 2004 primarily due to a decrease in the effective borrowing rate on long-term debt as a result of previous debt issuances and repurchases, partially offset by an increase in interest expense on short-term borrowings.

Interest expense to affiliated trusts increased \$0.4 million due to increasing interest rates and the effect on variable rate debt.

Other income-net increased \$1.6 million primarily due to an increase in interest income.

Income taxes increased \$4.3 million for 2005 compared to 2004, primarily due to increased income before income taxes. The effective tax rate was 36.4 percent for 2005 compared to 37.7 percent for 2004. The decrease in the effective tax rate was partially due to tax credits for the Kettle Falls Generation Plant that the Company began receiving the benefit from in 2005.

During 2004, the Other business segment recorded as a cumulative effect of accounting change a charge of \$0.5 million related to the implementation of Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003 (collectively referred to as FIN 46), which required Avista Ventures to consolidate several minor entities.

2004 compared to 2003

Income from continuing operations was \$35.6 million for 2004 compared to \$50.6 million for 2003. This decrease was primarily due to the Idaho general rate case write-offs of \$14.4 million (\$9.4 million, net of tax) recorded at Avista Utilities, as well as reduced earnings for Avista Energy (Energy Marketing and Resource Management segment) and an increase in the net loss for the Other business segment. This was partially offset by the improved performance of Avista Utilities (excluding the Idaho write-offs) due to general rate increases, as well as net earnings from Avista Advantage for 2004 as compared to a net loss for 2003.

Utility revenues increased \$44.4 million due to an increase in natural gas revenues of \$43.2 million and an increase in electric revenues of \$1.2 million. The increase in natural gas revenues was primarily due to natural gas rate increases and partially due to increased therms sold, primarily as a result of customer growth. The slight increase in electric revenues reflects an increase in retail revenues, partially offset by a decrease in wholesale revenues and sales of fuel.

Non-utility energy marketing and trading revenues decreased \$23.3 million primarily due to decreased net trading margin on contracts accounted for under SFAS No. 133 and a settlement with Enron affiliates during 2003, partially offset by increased revenues for Avista Energy Canada.

Other non-utility revenues increased \$7.2 million to \$40.6 million as a result of increased revenues from Avista Advantage of \$3.6 million and increased revenues from the Other business segment of \$3.6 million. The increased revenues from Avista Advantage was due to customer growth and the increase for the Other business segment was due to increased revenues from AM&D as well as revenues from entities consolidated in 2004 under FIN 46.

Utility resource costs increased \$35.9 million primarily due to an increase in purchased natural gas costs as well as the write-off of \$12.0 million of deferred power costs resulting from the Idaho general rate case order. This increase in purchased natural gas costs was primarily due to an increase in prices and partially due to an increase in the volume purchased due to customer growth.

Other utility operating expenses increased \$14.9 million due to increased distribution and customer service expenses, an increase in labor costs and other employee related expenses, increased liability and damage claims insurance costs, as well as an increase in outside services. The increase was also partially due to the disallowance in the Idaho general rate case of \$2.4 million (net of \$0.3 million of accumulated depreciation) of certain capitalized utility plant costs.

Utility depreciation and amortization increased \$0.7 million for 2004 compared to 2003 primarily due to plant additions and the resulting increase in depreciation expense as well as the consolidation of WP Funding LP under FIN 46 and the resulting inclusion of depreciation expense of the Rathdrum Power Plant. This was partially offset by a correction for overstated depreciation expense in prior periods recorded during 2004. Coyote Springs 2 was placed into service in mid-2003 and increased depreciation expense for 2004 as compared to 2003.

Utility taxes other than income taxes increased \$5.5 million for 2004 compared to 2003 primarily due to increased retail revenues and related taxes, as well as an increase in property taxes.

Non-utility resource costs decreased \$2.0 million primarily due to decreased resource costs for Avista Energy Canada.

Other non-utility operating expenses increased \$4.4 million for 2004 compared to 2003 due the impairment of goodwill at AM&D, the accrual of an environmental liability at Avista Development, the write-off of an investment in a natural gas storage project, the effects from entities consolidated under FIN 46 (Other business segment) and the settlement of an employment contract at Avista Advantage. This was partially offset by decreased compensation expense and professional fees at Avista Energy (Energy Marketing and Resource Management segment).

Interest expense (including interest expense to affiliated trusts) increased \$0.1 million for 2004 compared to 2003 primarily due to the inclusion of the interest expense on \$54.6 million of debt of WP Funding LP, which was consolidated for all of 2004 and only the fourth quarter of 2003 as required by FIN 46, as well as an increase in interest on short-term borrowings and the inclusion of preferred stock dividends as interest expense in accordance with SFAS No. 150, partially offset by a decrease in interest expense on long-term debt due to the repurchase of higher cost debt. Preferred stock dividends of \$1.1 million, distributed prior to the adoption of SFAS No. 150 on July 1, 2003, were classified as a separate line item in the Consolidated Statement of Income for 2003.

Other income-net increased \$2.2 million for 2004 compared to 2003 primarily due to increased income in 2004 on certain investments in the Other business segment and net gains on the disposition of non-operating assets in 2004 compared to net losses in 2003. This was partially offset by the premium paid on the repurchase of Avista Advantage preferred stock, as well as a decrease in interest income and interest on power and natural gas deferrals.

Income taxes decreased \$13.7 million for 2004 compared to 2003, primarily due to decreased income before income taxes. The effective tax rate was 37.7 percent for 2004 compared to 41.1 percent for 2003.

During 2004, the Other business segment recorded as a cumulative effect of accounting change a charge of \$0.5 million related to the implementation of FIN 46, which required Avista Ventures to consolidate several minor entities.

During 2003, Avista Energy recorded as a cumulative effect of accounting change a charge of \$1.2 million (net of tax) related to Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which effectively required the transition of accounting for energy trading activities from EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" to SFAS No. 133.

Avista Utilities

2005 compared to 2004

Net income for Avista Utilities was \$52.5 million for 2005 compared to \$32.5 million for 2004. Avista Utilities' income from operations was \$165.4 million for 2005 compared to \$134.1 million for 2004. This increase was primarily due to increased gross margin (operating revenues less resource costs) as a result of general rate increases and the IPUC related write-offs of \$14.4 million (\$9.4 million, net of taxes) in 2004, as well as the \$4.1 million pre-tax gain related to the sale of Avista Utilities' South Lake Tahoe natural gas properties in 2005. This was partially offset by an increase in depreciation expense, taxes other than income taxes and other operating expenses.

The following table presents Avista Utilities' gross margin for the year ended December 31 (dollars in thousands):

| | Electric | | Natural Gas | | Total | |
|-------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| Operating revenues..... | \$723,112 | \$652,081 | \$438,205 | \$320,493 | \$1,161,317 | \$972,574 |
| Resource costs..... | <u>343,945</u> | <u>300,958</u> | <u>325,651</u> | <u>218,044</u> | <u>669,596</u> | <u>519,002</u> |
| Gross margin..... | <u>\$379,167</u> | <u>\$351,123</u> | <u>\$112,554</u> | <u>\$102,449</u> | <u>\$491,721</u> | <u>\$453,572</u> |

Avista Utilities' operating revenues increased \$188.7 million and resource costs increased \$150.6 million, which resulted in an increase of \$38.1 million in gross margin for 2005 as compared to 2004. The gross margin on electric sales increased \$28.0 million and the gross margin on natural gas sales increased \$10.1 million. The increase in

electric gross margin was partially due to the IPUC's disallowance of \$12.0 million in deferred power costs in 2004. The increase in electric gross margin was also due to the Idaho electric general rate increase implemented in September 2004, as well as customer growth. The increase in the gross margin on natural gas sales was primarily due to the Idaho natural gas general rate increase implemented in September 2004 and the Washington natural gas general rate increase implemented in November 2004, as well as customer growth in the Washington, Idaho and Oregon service territories. The effects of general rate increases and customer growth were partially offset by the sale of the South Lake Tahoe natural gas operations in April 2005.

The following table presents Avista Utilities' electric operating revenues and megawatt-hour (MWh) sales for the year ended December 31 (dollars and MWhs in thousands):

| | Electric Operating Revenues | | Electric Energy MWh sales | |
|---|-----------------------------|------------------|---------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| Residential | \$211,934 | \$209,518 | 3,420 | 3,343 |
| Commercial | 203,480 | 201,775 | 2,994 | 2,919 |
| Industrial..... | 91,552 | 90,288 | 2,091 | 2,076 |
| Public street and highway lighting..... | <u>4,898</u> | <u>4,847</u> | <u>25</u> | <u>25</u> |
| Total retail..... | 511,864 | 506,428 | 8,530 | 8,363 |
| Wholesale | 151,429 | 62,399 | 2,508 | 1,472 |
| Sales of fuel | 41,831 | 63,990 | - | - |
| Other..... | <u>17,988</u> | <u>19,264</u> | <u>-</u> | <u>-</u> |
| Total | <u>\$723,112</u> | <u>\$652,081</u> | <u>11,038</u> | <u>9,835</u> |

Retail electric revenues increased \$5.4 million for 2005 from 2004. This increase was primarily due to an increase in total MWhs sold (increased revenues \$10.0 million), partially offset by a decrease in revenue per MWh (decreased revenues \$4.6 million). The increase in total MWhs sold was primarily due to customer growth and increased use per customer from colder weather during the fourth quarter heating season, partially offset by warmer weather during the first quarter heating season and colder weather during the third quarter cooling season. Total heating degree days at Spokane, Washington for 2005 increased as compared to 2004 with both periods warmer than normal. Total cooling degree days at Spokane, Washington for 2005 decreased as compared to 2004 with both periods warmer than normal. In September 2004, a general electric rate increase was implemented in Idaho. However, this was almost entirely offset by a decrease in the PCA surcharge, such that the net increase in rates to Idaho customers was only 1.9 percent. Although the Idaho general rate case increased gross margin, income from operations and net income for 2005 as compared to 2004, it did not have a significant effect on operating revenues.

Wholesale electric revenues increased \$89.0 million primarily due to an increase in wholesale sales volumes (increased revenues \$62.6 million) and partially due to an increase in wholesale sales prices (increased revenues \$26.4 million). The increase in wholesale sales volumes reflects added generation capacity, earlier-than-normal and better-than-anticipated runoff to hydroelectric generating assets during 2005 and lower than anticipated retail loads, which resulted in excess resources that were sold in the wholesale market.

Sales of fuel decreased \$22.2 million as a greater percentage of fuel purchases were used in generation. Sales of fuel represents natural gas that was not used for generation when electric wholesale market prices were generally below the cost of operating the natural gas-fired thermal generating units.

Other electric revenues decreased \$1.3 million primarily as a result of decreased transmission revenues.

The following table presents Avista Utilities' natural gas operating revenues and therms delivered for the year ended December 31 (dollars and therms in thousands):

| | Natural Gas Operating Revenues | | Natural Gas Therms Delivered | |
|----------------------|--------------------------------|------------------|------------------------------|----------------|
| | 2005 | 2004 | 2005 | 2004 |
| Residential | \$229,737 | \$194,470 | 199,433 | 201,696 |
| Commercial | 126,648 | 104,754 | 122,981 | 122,852 |
| Industrial..... | <u>11,867</u> | <u>9,423</u> | <u>13,534</u> | <u>13,274</u> |
| Total retail..... | 368,252 | 308,647 | 335,948 | 337,822 |
| Wholesale | 58,074 | 152 | 72,903 | 305 |
| Transportation | 7,601 | 8,134 | 152,990 | 154,427 |
| Other..... | <u>4,278</u> | <u>3,560</u> | <u>466</u> | <u>3,030</u> |
| Total | <u>\$438,205</u> | <u>\$320,493</u> | <u>562,307</u> | <u>495,584</u> |

Natural gas revenues increased \$117.7 million for 2005 from 2004 due to an increase in retail natural gas revenues and wholesale natural gas revenues. The \$59.6 million increase in retail natural gas revenues was primarily due to an increase in retail rates (increased revenues \$61.7 million), partially offset by a decrease in volumes (decreased revenues \$2.1 million). During September through November of 2005 and 2004, retail rates for natural gas were increased in response to an increase in natural gas costs. In September and November 2004, general natural gas rate increases were implemented in Idaho and Washington, respectively. The decrease in total therms sold was primarily due to the sale of the South Lake Tahoe properties, partially offset by customer growth in the other service territories and a slight increase in use per customer. The increase in wholesale revenues reflects the balancing of loads and resources and the sale of resources in excess of load requirements as part of the natural gas procurement process that was implemented at Avista Utilities effective April 1, 2005.

The following table presents Avista Utilities' average number of electric and natural gas customers for the year ended December 31:

| | Electric Customers | | Natural Gas Customers | |
|---|--------------------|----------------|-----------------------|----------------|
| | 2005 | 2004 | 2005 | 2004 |
| Residential..... | 294,036 | 288,422 | 265,294 | 268,571 |
| Commercial..... | 37,282 | 36,728 | 31,652 | 31,886 |
| Industrial..... | 1,408 | 1,416 | 307 | 311 |
| Public street and highway lighting..... | 421 | 418 | - | - |
| Total retail..... | 333,147 | 326,984 | 297,253 | 300,768 |
| Wholesale..... | 46 | 43 | 12 | 1 |
| Transportation..... | - | - | 93 | 81 |
| Total customers..... | <u>333,193</u> | <u>327,027</u> | <u>297,358</u> | <u>300,850</u> |

The decrease in the average number of natural gas customers from 2004 to 2005 was due to the sale of Avista Utilities' South Lake Tahoe, California natural gas properties in April 2005. Avista Utilities had approximately 18,750 customers in South Lake Tahoe, California as of December 31, 2004.

The following table presents Avista Utilities' heating and cooling degree days for the year ended December 31:

| | 2005 | 2004 |
|--|-------|-------|
| Heating degree days (1): | | |
| Spokane, Washington actual..... | 6,538 | 6,314 |
| Spokane, Washington 30-year average (2)..... | 6,820 | 6,820 |
| Percent of average..... | 96% | 93% |
| Medford, Oregon actual..... | 4,185 | 3,933 |
| Medford, Oregon 30-year average (2)..... | 4,533 | 4,533 |
| Percent of average..... | 92% | 87% |
| Cooling degree days (3): | | |
| Spokane, Washington actual..... | 409 | 571 |
| Spokane, Washington 30-year average (2)..... | 394 | 394 |
| Percent of average..... | 104% | 145% |

- (1) Heating degree days are a common measure used in the utility industry to analyze the demand for natural gas and electricity during the heating season (generally the first and fourth quarters of a fiscal year and to a lesser extent the second quarter). Heating degree days are the measure of the coldness of weather experienced, based on the extent to which the average of the high and low temperatures for a day falls below 65 degrees Fahrenheit (degree days below historic indicate warmer than average temperatures).
- (2) Computed for the period from 1971 through 2000.
- (3) Cooling degree days are used to analyze the demand for electricity during the summer (generally the third quarter) and indicate when a customer would use electricity for air conditioning. Cooling degree days are the measure of the warmth of weather experienced, based on the extent to which the average of the high and low temperatures for a day exceeds 65 degrees Fahrenheit (degree days above historic indicate warmer than average temperatures).

The following table presents Avista Utilities' resource costs for the year ended December 31 (dollars in thousands):

| | 2005 | 2004 |
|--|------------------|------------------|
| Electric resource costs: | | |
| Power purchased | \$186,703 | \$145,298 |
| Power cost amortizations, net of deferrals | 24,209 | 22,950 |
| Fuel for generation | 93,034 | 38,406 |
| Other fuel costs | 36,636 | 72,602 |
| Other regulatory amortizations, net..... | (6,532) | (2,529) |
| Other electric resource costs | <u>9,895</u> | <u>24,231</u> |
| Total electric resource costs | <u>343,945</u> | <u>300,958</u> |
| Natural gas resource costs: | | |
| Natural gas purchased | 335,796 | 225,908 |
| Natural gas deferrals, net of amortizations..... | (13,912) | (12,136) |
| Other regulatory amortizations, net..... | <u>3,767</u> | <u>4,272</u> |
| Total natural gas resource costs..... | <u>325,651</u> | <u>218,044</u> |
| Total resource costs | <u>\$669,596</u> | <u>\$519,002</u> |

Power purchased for 2005 increased \$41.4 million compared to 2004 primarily due to an increase in the price of power purchases (increased costs \$35.4 million) and partially due to an increase in the volume of power purchases (increased costs \$6.0 million). The increase in the price of power represents overall increases in the wholesale energy markets. The increase in the volume of power purchased is consistent with the increase in retail and wholesale sales, partially offset by an increase in thermal generation.

Net amortization of deferred power costs was \$24.2 million for 2005 compared to \$23.0 million for 2004. During 2005, Avista Utilities recovered (collected as revenue) \$26.5 million of previously deferred power costs in Washington and \$5.7 million in Idaho. There was a decrease in the recovery of previously deferred power costs in Idaho as compared to 2004, which was primarily due to the reduction of the PCA rate surcharge. During 2005, Avista Utilities deferred \$4.1 million and \$3.9 million of power costs in Washington and Idaho, respectively. There was a decrease in the deferral of power costs due to lower actual electric resource costs as compared to the amount included in base rates in 2005 as compared to 2004.

Fuel for generation for 2005 increased \$54.6 million compared to 2004 due to an increase in fuel prices and greater use of thermal generation, which increased 52 percent for 2005 as compared to 2004, primarily due to the addition of the remaining interest in Coyote Springs 2.

Other fuel costs for 2005 decreased \$36.0 million compared to 2004. This natural gas fuel was sold with the associated revenues reflected as sales of fuel. Revenues from selling the natural gas exceeded other fuel costs in 2005. This excess revenue is accounted for under the ERM in Washington and the PCA in Idaho. The decrease in other fuel costs was primarily due to a greater percentage of fuel used in generation.

Other electric resource costs for 2005 decreased \$14.3 million compared to 2004 primarily due to the disallowance of \$12.0 million of deferred power costs in the 2004 Idaho general rate case.

The expense for natural gas purchased for 2005 increased \$109.9 million compared to 2004 due to an increase in the cost of natural gas (increased costs \$54.5 million) and an increase in total therms purchased (increased costs \$55.4 million). The increase in total therms purchased is consistent with an increase in wholesale sales as part of the balancing of loads and resources with the natural gas procurement process. During 2005, Avista Utilities had \$13.9 million of net deferrals of natural gas costs compared to \$12.1 million of net deferrals for 2004. The increase reflects higher natural gas prices, partially offset by increased natural gas rates to recover deferred natural gas costs.

2004 compared to 2003

Net income for Avista Utilities was \$32.5 million for 2004 compared to \$36.2 million for 2003. Avista Utilities' income from operations was \$134.1 million for 2004 compared to \$146.8 million for 2003. This decrease was primarily due to the write-offs of \$14.4 million (\$9.4 million, net of tax) related to the 2004 Idaho general rate case. Excluding the write-offs, net income and income from operations increased primarily due to an increase in gross margin as a result of general rate increases, partially offset by an increase in other operating expenses, depreciation and amortization, and taxes other than income taxes.

The following table presents Avista Utilities' gross margin for the years ended December 31 (dollars in thousands):

| | Electric | | Natural Gas | | Total | |
|--------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 |
| Operating revenues | \$652,081 | \$650,922 | \$320,493 | \$277,289 | \$972,574 | \$928,211 |
| Resource costs | <u>300,958</u> | <u>299,428</u> | <u>218,044</u> | <u>183,669</u> | <u>519,002</u> | <u>483,097</u> |
| Gross margin | <u>\$351,123</u> | <u>\$351,494</u> | <u>\$102,449</u> | <u>\$ 93,620</u> | <u>\$453,572</u> | <u>\$445,114</u> |

Avista Utilities' operating revenues increased \$44.4 million and resource costs increased \$35.9 million, which resulted in an increase of \$8.5 million in gross margin for 2004 as compared to 2003. The gross margin on natural gas sales increased \$8.8 million and the gross margin on electric sales decreased \$0.3 million. The increase in the gross margin on natural gas sales was primarily due to the Idaho natural gas general rate increase implemented in September 2004, the Washington natural gas general rate increase implemented in November 2004 and the Oregon natural gas general rate increase implemented in the fourth quarter of 2003. The slight decrease in electric gross margin was primarily due to the disallowance of \$12.0 million of deferred power costs in the Idaho general rate case, partially offset by the Idaho electric general rate increase implemented in September 2004 as well as customer growth.

The following table presents Avista Utilities' electric operating revenues and megawatt-hour (MWh) sales for the years ended December 31 (dollars and MWhs in thousands):

| | Electric Operating Revenues | | Electric Energy MWh sales | |
|---|-----------------------------|------------------|---------------------------|---------------|
| | 2004 | 2003 | 2004 | 2003 |
| Residential | \$209,518 | \$204,783 | 3,343 | 3,298 |
| Commercial | 201,775 | 201,339 | 2,919 | 2,919 |
| Industrial..... | 90,288 | 78,276 | 2,076 | 1,785 |
| Public street and highway lighting..... | <u>4,847</u> | <u>4,770</u> | <u>25</u> | <u>25</u> |
| Total retail..... | 506,428 | 489,168 | 8,363 | 8,027 |
| Wholesale..... | 62,399 | 73,463 | 1,472 | 2,075 |
| Sales of fuel..... | 63,990 | 71,456 | - | - |
| Other..... | <u>19,264</u> | <u>16,835</u> | - | - |
| Total | <u>\$652,081</u> | <u>\$650,922</u> | <u>9,835</u> | <u>10,102</u> |

Retail electric revenues increased \$17.3 million for 2004 from 2003. This increase was primarily due to an increase in total MWhs sold (increased revenues \$20.4 million), partially offset by a decrease in revenue per MWh (decreased revenues \$3.1 million). Although there were differences with respect to quarter-to-quarter comparisons, total heating and cooling degree days at Spokane, Washington for both 2004 and 2003 were similar with both warmer than normal heating and cooling seasons. As such, electric loads and revenues were not significantly affected by weather when comparing 2004 to 2003 results. The increase in total MWhs sold and corresponding revenues was primarily due to customer growth as well as the Potlatch Corporation contract, which was entered into during mid-2003. The decrease in revenue per MWh was primarily due to a slight change in revenue mix with a greater percentage of revenues from industrial sales. The increase in industrial revenues was primarily due to the Potlatch Corporation contract. In September 2004, a general electric rate increase was implemented in Idaho. However, this was almost entirely offset by a decrease in the PCA surcharge, such that the net increase in rates to Idaho customers was only 1.9 percent. Although the general rate case increased gross margin, income from operations and net income, it did not have a significant effect on operating revenues for 2004 as compared to 2003.

Wholesale electric revenues decreased \$11.1 million primarily due to the implementation of EITF Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3" which requires that wholesale revenues and resource costs from Avista Utilities' settled energy contracts that are "booked out" (not physically delivered) should be reported on a net basis as part of operating revenues effective October 1, 2003. The adoption of this EITF Issue resulted in a reduction in wholesale revenues of approximately \$26.4 million for 2004 as compared to 2003. The remaining change in wholesale revenues reflects higher average sales prices and an increase in wholesale volumes.

Sales of fuel decreased \$7.5 million as a result of the expiration of several higher priced fuel contracts. A greater percentage of fuel purchases were used in generation, which also contributed to the decrease in sales of fuel. Sales of fuel represents natural gas that was not used for generation because electric wholesale market prices were generally below the cost of operating the natural gas-fired thermal generating units.

Other electric revenues increased \$2.4 million primarily due to increased transmission revenues.

The following table presents Avista Utilities' natural gas operating revenues and therm sales for the years ended December 31 (dollars and therms in thousands):

| | Natural Gas Operating Revenues | | Natural Gas Therm Sales | |
|----------------------|-----------------------------------|------------------|----------------------------|----------------|
| | 2004 | 2003 | 2004 | 2003 |
| Residential | \$194,470 | \$166,925 | 201,696 | 198,471 |
| Commercial | 104,754 | 90,523 | 122,852 | 122,115 |
| Industrial..... | <u>9,423</u> | <u>7,475</u> | <u>13,274</u> | <u>12,737</u> |
| Total retail..... | 308,647 | 264,923 | 337,822 | 333,323 |
| Wholesale..... | 152 | 280 | 305 | 675 |
| Transportation | 8,134 | 8,485 | 154,427 | 153,352 |
| Other..... | <u>3,560</u> | <u>3,601</u> | <u>3,030</u> | <u>3,124</u> |
| Total | <u>\$320,493</u> | <u>\$277,289</u> | <u>495,584</u> | <u>490,474</u> |

Natural gas revenues increased \$43.2 million for 2004 from 2003 primarily due to an increase in retail natural gas revenues, partially offset by a slight decrease in transportation and wholesale revenues. The \$43.7 million increase in retail natural gas revenues was primarily due to an increase in retail rates (increased revenues \$39.6 million) and partially due to an increase in volumes (increased revenues \$4.1 million). During 2004 and 2003, retail rates for natural gas were increased in response to an increase in current and projected natural gas costs. In September 2004, a general natural gas rate increase was implemented in Idaho. In November 2004, a general natural gas rate increase was implemented in Washington. Also, during the fourth quarter of 2003, a general natural gas rate increase was implemented in Oregon. The increase in total therms sold was primarily a result of customer growth, as a colder first quarter of 2004 was offset by a warmer fourth quarter of 2004 as compared to 2003.

The following table presents Avista Utilities' average number of electric and natural gas customers for the years ended December 31:

| | Electric Customers | | Natural Gas Customers | |
|---|-----------------------|----------------|--------------------------|----------------|
| | 2004 | 2003 | 2004 | 2003 |
| Residential..... | 288,422 | 283,497 | 268,571 | 261,063 |
| Commercial | 36,728 | 36,279 | 31,886 | 31,312 |
| Industrial..... | 1,416 | 1,414 | 311 | 310 |
| Public street and highway lighting..... | <u>418</u> | <u>422</u> | - | - |
| Total retail..... | 326,984 | 321,612 | 300,768 | 292,685 |
| Wholesale..... | 43 | 47 | 1 | 1 |
| Transportation | - | - | <u>81</u> | <u>84</u> |
| Total customers..... | <u>327,027</u> | <u>321,659</u> | <u>300,850</u> | <u>292,770</u> |

The following table presents Avista Utilities' heating and cooling degree days for the years ended December 31:

| | 2004 | 2003 |
|--|-------|-------|
| Heating degree days (1): | | |
| Spokane, Washington actual | 6,314 | 6,351 |
| Spokane, Washington 30-year average (2)..... | 6,820 | 6,820 |
| Percentage of average..... | 93% | 93% |
| Medford, Oregon actual | 3,933 | 4,046 |
| Medford, Oregon 30-year average (2)..... | 4,533 | 4,533 |
| Percentage of average..... | 87% | 89% |
| Cooling degree days (3): | | |
| Spokane, Washington actual | 571 | 578 |
| Spokane, Washington 30-year average (2)..... | 394 | 394 |
| Percent of average | 145% | 147% |

(1) Heating degree days are a common measure used in the utility industry to analyze the demand for natural gas and electricity during the heating season (generally the first and fourth quarters of a fiscal year and to a lesser extent the second quarter). Heating degree days are the measure of the coldness of weather experienced, based on the extent to which the average of the high and low temperatures for a day falls below 65 degrees Fahrenheit (degree days below historic indicate warmer than average temperatures).

- (2) Computed for the period from 1971 through 2000.
- (3) Cooling degree days are used to analyze the demand for electricity during the summer (generally the third quarter) and indicate when a customer would use electricity for air conditioning. Cooling degree days are the measure of the warmth of weather experienced, based on the extent to which the average of the high and low temperatures for a day exceeds 65 degrees Fahrenheit (degree days above historic indicate warmer than average temperatures).

The following table presents Avista Utilities' resource costs for the years ended December 31 (dollars in thousands):

| | 2004 | 2003 |
|--|------------------|------------------|
| Electric resource costs: | | |
| Power purchased | \$145,298 | \$147,743 |
| Power cost amortizations, net of deferrals | 22,950 | 7,165 |
| Fuel for generation..... | 38,406 | 35,581 |
| Other fuel costs | 72,602 | 96,765 |
| Other regulatory amortizations, net..... | (2,529) | 541 |
| Other electric resource costs | <u>24,231</u> | <u>11,633</u> |
| Total electric resource costs | <u>300,958</u> | <u>299,428</u> |
| Natural gas resource costs: | | |
| Natural gas purchased | 225,908 | 184,014 |
| Natural gas deferrals, net of amortization | (12,136) | (3,336) |
| Other regulatory amortizations, net..... | <u>4,272</u> | <u>2,991</u> |
| Total natural gas resource costs..... | <u>218,044</u> | <u>183,669</u> |
| Total resource costs | <u>\$519,002</u> | <u>\$483,097</u> |

Power purchased for 2004 decreased \$2.4 million compared to 2003 due to the effects of EITF Issue No. 03-11 (decreased costs by \$26.4 million), partially offset by an increase in the price of power purchases (increased costs \$15.1 million) and an increase in the volume of power purchases (increased costs \$8.9 million).

Net amortization of deferred power costs was \$23.0 million for 2004 compared to \$7.2 million for 2003. During 2004, Avista Utilities recovered (collected as revenue) \$26.2 million of previously deferred power costs in Washington and \$23.0 million in Idaho. There was a decrease in the recovery of previously deferred power costs in Idaho, which was primarily due to the reduction of the PCA rate surcharge in the Idaho general rate case. During 2004, Avista Utilities deferred \$10.5 million of power costs in Washington and \$15.3 million in Idaho. The total deferral of power costs decreased in 2004 as compared to 2003 due to an increase in hydroelectric generation and the expiration of higher priced natural gas fuel contracts.

Fuel for generation for 2004 increased \$2.8 million compared to 2003 primarily due to an increase in fuel prices and partially due to a slight increase in thermal generation.

Other fuel costs for 2004 decreased \$24.2 million compared to 2003. This natural gas fuel was sold with the associated revenues reflected as sales of fuel. Other fuel costs exceeded the revenues from selling the natural gas in 2004 and 2003. This excess cost is accounted for under the ERM in Washington and the PCA in Idaho. The decrease in other fuel costs was primarily due to the expiration of higher-priced natural gas fuel contracts. The decrease was also due to a greater percentage of fuel used in generation.

Other electric resource costs for 2004 increased \$12.6 million compared to 2003 primarily due to the disallowance of \$12.0 million of deferred power costs in the Idaho general rate case.

The expense for natural gas purchased for 2004 increased \$41.9 million compared to 2003 due to an increase in the cost of natural gas (increased costs \$37.4 million) and an increase in total therms purchased (increased costs \$4.5 million) consistent with an increase in natural gas sales from customer growth. During 2004, Avista Utilities had \$12.1 million of net deferrals of natural gas costs compared to \$3.3 million for 2003. The increase was primarily due to an increase in natural gas prices.

Energy Marketing and Resource Management

Energy Marketing and Resource Management primarily includes the results of Avista Energy, as well as Avista Power.

Avista Energy's earnings are primarily derived from the following activities:

- Taking speculative positions on future price movements within established risk management policies.
- Optimization of generation assets owned by other entities.
- Capturing price differences between commodities (spark spread) by converting natural gas into electricity through the power generation process.
- Purchasing and storing natural gas for later sales to seek gains from seasonal price variations and demand peaks.
- Transmitting electricity and transporting natural gas between locations, including moving energy from lower priced/demand regions to higher priced/demand markets and hub locations within the WECC.
- Marketing natural gas to end-user industrial and commercial customers.

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, as well as derivative commodity instruments not held for trading, are reported on a gross basis in operating revenues. Costs from contracts, which 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 Avista Energy's net realized gains and net unrealized losses for the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|---|-----------------|-----------------|-----------------|
| Net realized gains | \$40,142 | \$39,520 | \$82,317 |
| Net unrealized losses | (38,126) | (678) | (22,128) |
| Total gross margin (operating revenues less resource costs) | <u>\$ 2,016</u> | <u>\$38,842</u> | <u>\$60,189</u> |

Overall segment results for 2005 compared to 2004

Energy Marketing and Resource Management's net loss was \$8.6 million for 2005 compared to net income of \$9.7 million for 2004. The net loss was primarily due to changes in natural gas prices relative to the positions that Avista Energy had taken in the natural gas market. While Avista Energy's portfolio was within its position limits and in accordance with its risk management practices, losses can and do occur when the market moves contrary to its positions, which occurred during 2005. As markets moved counter to certain contracts, Avista Energy acted to adjust its position consistent with established risk management policies. This process reduced the market risk; however, it had the effect of locking in losses on certain natural gas positions during 2005. While Avista Energy reduced the market risk in its natural gas trading portfolio considerably in the second half of 2005, some losses did continue to occur during the fourth quarter as Avista Energy continued to unwind positions established in earlier periods.

Avista Energy continued to produce positive results on the power side of its business in 2005, which includes trading, marketing and managing the output and availability of generation assets owned by other entities. However, gains from the power side of Avista Energy's business were less in 2005 as compared to 2004.

Total assets for the Energy Marketing and Resource Management segment increased \$1,009.5 million from December 31, 2004 to December 31, 2005 primarily as a result of the increase in commodity prices (particularly natural gas) and the effect on Avista Energy's derivative commodity assets.

Overall segment results for 2004 compared to 2003

Energy Marketing and Resource Management's net income was \$9.7 million for 2004, compared to net income before the cumulative effect of accounting change of \$20.7 million for 2003. During 2003, Avista Energy's earnings were positively affected by the difference in the economic management and the required accounting for certain contracts and physical assets under management (see discussion below), as well as a settlement with certain Enron affiliates. In addition, Avista Energy's earnings were decreased due to lower natural gas trading margins in 2004 as compared to 2003. These decreases were partially offset by portfolio valuation adjustments at Avista Energy of approximately \$2.9 million, net of tax, the most significant of which related to increases in market liquidity in the Western power markets. Avista Energy's commodity portfolio was historically valued using third-party broker

market quotes for the first 24 months and using a model for the long-term portion of the portfolio. Increased market liquidity resulted in the availability of reliable and transparent market prices for a longer time period than had previously been available. Based on this change in market liquidity, Avista Energy began utilizing third-party market price quotes for the first 36 months of the portfolio beginning in the fourth quarter of 2004. Avista Energy continues to use a model to estimate forward price curves for the longer-term portion of the portfolio. The Company believes this change in valuation methodology represents the most accurate valuation of the portfolio.

Analysis of differences in the economic management and the required accounting for certain contracts and physical assets under management

The operations of Avista Energy are managed on an economic basis reflecting all contracts and assets under management at estimated market value, which is different from the required accounting for certain contracts and physical assets under management. Under SFAS No. 133, certain contracts, which are considered derivatives and accounted for at market value, economically hedge other contracts and physical assets under management, which are not considered derivatives and are generally accounted for at the lower of cost or market value. The accounting treatment does not affect the underlying cash flows or economics of these transactions. These differences are generally reversed in future periods as market values change or the contracts are settled or realized. These differences primarily relate to Avista Energy's management of natural gas inventory and Avista Energy's control of natural gas-fired generation through a power purchase agreement.

Avista Energy is affected by earnings volatility associated with its economic management of natural gas inventory. Generally, injections of natural gas into storage take place in the summer months and natural gas is withdrawn from inventory in the winter months. Avista Energy economically hedges the value of natural gas inventory with financial and physical sales, effectively locking in a margin on the natural gas inventory. However, accounting rules require the natural gas inventory to be carried at the lower of cost or market, while the forward sales contracts (which are derivatives) are marked-to-market using forward price curves. Changes in forward price curves result in income or losses on the derivative sales contracts, but generally do not affect the recorded value for natural gas inventory. Therefore, if Avista Energy enters into a forward contract to sell natural gas as an economic hedge against the value of natural gas inventory, and market prices subsequently increase, a loss with respect to the forward contract is recorded in net income. While the market value of the natural gas inventory has also increased, the natural gas inventory remains recorded at the lower of cost or market value. During 2005, increases in the market price of natural gas and changes in inventory balances had a negative effect on net income of \$2.7 million with respect to Avista Energy's economic management of natural gas inventory. During 2004, this activity and changes in natural gas prices had a positive effect on net income of \$0.9 million. During 2003, this activity and changes in natural gas prices had a negative effect on net income of \$1.6 million. In early 2006, Avista Energy made the economic decision to sell its natural gas inventory forward for delivery in the first quarter of 2007. This transaction will allow Avista Energy to capture approximately \$4 million of after-tax economic value. This forward sale will have to be marked to market in 2006, and it will result in earnings volatility. However, this decision is part of the prudent economic management of Avista Energy's assets.

Avista Energy controls natural gas-fired generation through a power purchase agreement related to the Lancaster Project. The power purchase agreement gives Avista Energy the right to purchase natural gas for generation, and convert to electricity for a fixed fee. Avista Energy economically hedges the value of this power purchase agreement by entering into contracts to buy and sell natural gas and electricity during certain time periods in the future. Although the power purchase agreement is not a derivative and not marked-to-market, the contracts to buy and sell natural gas and electricity are derivatives that are recorded at estimated market value. Where possible, Avista Energy has designated the natural gas and electricity contracts as accounting hedges in accordance with SFAS No. 133 in order to reduce the earnings volatility associated with these combinations of accounting treatments. However, not all of these contracts qualify for hedge accounting. Avista Energy will continue to recognize changes in the fair value of those contracts in earnings as unrealized gains and losses. In addition, the ineffective portion of the change in the forward value of qualifying hedges will continue to be recognized in earnings. Similar to natural gas inventory, the power purchase agreement is economically managed as if it is recorded at estimated market value. During 2005, changes in natural gas and electricity prices for the future delivery periods in which the contract had been economically hedged (but not hedged in accordance with SFAS No. 133) had a positive effect on net income of approximately \$1.8 million. During 2004, this activity and changes in prices had a negative effect on net income of approximately \$2.4 million. During 2003, this activity and changes in prices had a positive effect on net income of approximately \$4.7 million.

Avista Energy has other differences between the economic management and the required accounting for certain contracts and physical assets under management, which have not been as significant as those described above.

However, these items could become more significant in the future and Avista Energy could enter into new contracts and agreements that could result in significant differences in future periods.

Analysis of operating revenues, resource costs and gross margin for 2005 compared to 2004

Operating revenues decreased \$108.2 million and resource costs decreased \$71.4 million for 2005 as compared to 2004 resulting in a decrease in gross margin of \$36.8 million. Operating revenues decreased primarily due to decreased revenues under the Agency Agreement with Avista Utilities as natural gas procurement operations were transitioned to Avista Utilities effective April 1, 2005, and decreased net trading margin on contracts accounted for under SFAS No. 133, partially offset by increased revenues for Avista Energy Canada. Resource costs decreased primarily due to decreased resource costs under the Agency Agreement with Avista Utilities, partially offset by increased resource costs for Avista Energy Canada.

Avista Energy's gross margin (operating revenues less resource costs) was \$2.0 million for 2005 compared to \$38.8 million for 2004. The decrease in gross margin was primarily due to the increase in natural gas prices and the resulting impact on Avista Energy's natural gas positions. In addition, unfavorable movements in power prices also had a negative effect on Avista Energy's gross margin for 2005 as compared to 2004.

Net realized gains increased to \$40.1 million for 2005 from \$39.5 million for 2004. The slight increase in net realized gains was due to increased net gains on settled financial transactions and physical electric transactions, partially offset by increased net losses on physical natural gas transactions and increased transmission and transportation fees. The total mark-to-market adjustment for Energy Marketing and Resource Management was a net unrealized loss of \$38.1 million for 2005 compared to a net unrealized loss of \$0.7 million for 2004. The net unrealized loss for 2005 was primarily due to realization of physical electric transactions and price movements that were unfavorable to Avista Energy's positions.

Analysis of operating revenues, resource costs and gross margin for 2004 compared to 2003

Operating revenues decreased \$31.5 million and resource costs decreased \$10.1 million for 2004 as compared to 2003 resulting in a decrease in gross margin of \$21.4 million. Operating revenues decreased primarily due to decreased net trading margin on contracts accounted for under SFAS No. 133, a settlement with Enron affiliates during 2003 and decreased revenues under the Agency Agreement with Avista Utilities, partially offset by increased revenues for Avista Energy Canada. Resource costs decreased primarily due to decreased resource costs for Avista Energy Canada and decreased resource costs under the Agency Agreement with Avista Utilities.

Avista Energy's gross margin (operating revenues less resource costs) was \$38.8 million for 2004 compared to \$60.2 million for 2003. The decrease in gross margin was primarily due to the 2003 effects of the transition to SFAS No. 133 and the settlement with Enron affiliates. During September 2003, Avista Energy implemented hedge accounting for certain transactions. This has partially mitigated the effects from the transition to SFAS No. 133 and reduced the volatility of reporting earnings on a prospective basis. Avista Energy's settlement of various positions with Enron affiliates and the resulting release by Avista Energy of amounts, which had been reserved against such positions, also had a positive effect of \$8.4 million on gross margin for 2003.

Net realized gains decreased to \$39.5 million for 2004 from \$82.3 million for 2003. Net realized gains represent the net gains on contracts that have settled. The decrease in net realized gains was due to an increase in the net losses on physical natural gas transactions, the settlement with Enron affiliates in the prior year, decreased net gains on settled financial transactions and decreased net gains on settled foreign currency transactions. This was partially offset by increased net gains on settled physical electric transactions and a change in the net gain on the valuation of natural gas inventory. The total mark-to-market adjustment for Energy Marketing and Resource Management was a net unrealized loss of \$0.7 million for 2004 compared to a net unrealized loss of \$22.1 million for 2003. The change in the net unrealized loss was primarily due to the effects of the transition to SFAS No. 133. The decrease in the net unrealized loss was also due to the settlement of contracts and the realization of previously unrealized gains during 2003. In 2004, portfolio valuation adjustments at Avista Energy resulting primarily from increases in market liquidity in the Western power markets decreased the net unrealized loss and increased gross margin by \$4.5 million.

Energy trading activities and positions

The following table summarizes information with respect to Avista Energy's trading activities during 2005 (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, 2004 | \$58,965 | \$11,341 | \$70,306 |
| Less contracts settled during 2005 (1) | (86,272) | 46,130 | (40,142) |
| Fair value of new contracts when entered into during 2005 (2) | - | - | - |
| Change in fair value due to changes in valuation techniques (3) | - | - | - |
| Change in fair value attributable to market prices and other market changes | <u>45,989</u> | <u>(41,702)</u> | <u>4,287</u> |
| Fair value of contracts as of December 31, 2005 | <u>\$18,682</u> | <u>\$15,769</u> | <u>\$34,451</u> |

- (1) Contracts settled during 2005 include those contracts that were open in 2004 but settled during 2005 as well as new contracts entered into and settled during 2005. Amount represents net realized gains associated with these settled transactions.
- (2) Avista Energy did not enter into any origination transactions during 2005 in which dealer profit or mark-to-market gain or loss was recorded at inception.
- (3) During 2005, Avista Energy did not experience a change in fair value due to changes in valuation techniques.

The following table discloses summarized information with respect to valuation techniques and contractual maturities of Avista Energy's energy commodity contracts outstanding as of December 31, 2005 (dollars in thousands):

| | Less than one year | Greater than one and less than three years | Greater than three and less than five years | Greater than five years | Total |
|---|-----------------------|---|--|-------------------------------|-----------------|
| Electric assets (liabilities), net | | | | | |
| Prices from other external sources (1) | \$ 620 | \$34,537 | \$ - | \$ - | \$35,157 |
| Fair value based on valuation models (2) | <u>(1,502)</u> | <u>(2,121)</u> | <u>12,892</u> | <u>(25,744)</u> | <u>(16,475)</u> |
| Total electric assets (liabilities), net | <u>\$ (882)</u> | <u>\$32,416</u> | <u>\$12,892</u> | <u>\$(25,744)</u> | <u>\$18,682</u> |
| Natural gas assets (liabilities), net | | | | | |
| Prices from other external sources (1) | \$11,247 | \$4,687 | \$ - | \$ - | \$15,934 |
| Fair value based on valuation models (3) | <u>1,451</u> | <u>(1,421)</u> | <u>(195)</u> | <u>-</u> | <u>(165)</u> |
| Total natural gas assets (liabilities), net | <u>\$12,698</u> | <u>\$3,266</u> | <u>\$(195)</u> | <u>\$ -</u> | <u>\$15,769</u> |

- (1) Fair value is determined based upon actively traded, "over-the-counter" market quotes received from third party brokers. These market quotes are used through 36 months.
- (2) Represents contracts for delivery at basis locations not actively traded in the "over-the-counter" markets. In addition, this includes all contracts with a delivery period greater than 36 months, for which active quotes are not available. These internally developed market curves are determined using a production cost model with inputs for assumptions related to power prices (including, without limitation, natural gas prices, generation on-line, transmission constraints, future demand and weather). Avista Energy performs frequent stress tests on the valuation of the portfolio. While consistent valuation methodologies and updates to the assumptions are used to capture current market information, changes in these methodologies or underlying assumptions could result in significantly different fair values and income recognition. These same pricing techniques and stress tests are used to evaluate a contract prior to taking a position.
- (3) Represents contracts for delivery at basis locations not actively traded in the "over-the-counter" markets. In addition, this includes all contracts with a delivery period greater than 36 months, for which active quotes are not available. These internally developed market curves are based upon published New York Mercantile Exchange prices, as well as basis spreads using historical and broker estimates.

Avista Power

The results for Avista Power did not have a significant effect on the results for the Energy Marketing and Resource Management segment for 2005. In 2004 and 2003, the Company recorded impairment charges for a turbine and related equipment owned by Avista Power. This resulted in charges of \$5.1 million and \$4.9 million for 2004 and 2003, respectively, included in other operating expenses. The effect on net income from these impairment charges was \$3.3 million and \$3.2 million, net of tax, for 2004 and 2003, respectively.

Avista Advantage

2005 compared to 2004

Net income for Avista Advantage was \$3.9 million for 2005 compared to \$0.6 million for 2004. Operating revenues for Avista Advantage increased \$8.3 million and operating expenses increased \$3.1 million as compared to 2004. The increase in operating revenues was primarily due to the expansion of Avista Advantage's customer base. Avista Advantage has approximately 350 customers representing approximately 175,000 billed sites in North America. The number of billed sites increased by approximately 33,000, or 24 percent, in 2005. Avista Advantage continues to have strong customer retention with an average 95 percent retention rate over the past three years. The increase in operating expenses over 2004 primarily reflects increased labor costs necessary to serve an expanding customer base, partially offset by increased efficiencies and the settlement of an employment contract during 2004. Avista Advantage's average cost of processing a bill decreased 6 percent for 2005 as compared to 2004.

2004 compared to 2003

Avista Advantage had net income of \$0.6 million for 2004 compared to a net loss of \$1.3 million for 2003. Operating revenues for Avista Advantage increased \$3.6 million and operating expenses increased \$0.5 million as compared to 2003. The increase in operating revenues was primarily due to the expansion of Avista Advantage's customer base. Avista Advantage had a 29 percent increase in the number of billed sites as of December 31, 2004 as compared to December 31, 2003. The increase in operating expenses reflects the settlement of an employment contract, partially offset by improved efficiencies and a focus on reducing operating expenses. Avista Advantage's cost of processing a bill decreased by 11 percent for 2004 as compared to 2003.

Other Business Segment

2005 compared to 2004

The net loss from this business segment was \$2.6 million for 2005 compared to a net loss of \$7.2 million (excluding the cumulative effect of accounting change) for 2004. The decrease in the net loss was primarily due to the impairment of goodwill at AM&D, the write-off of an investment in a natural gas storage project, the accrual of environmental liabilities at Avista Development and Avista Capital's purchase of Avista Advantage preferred stock at a premium during 2004. Operating revenues from this business segment increased \$1.4 million and operating expenses decreased \$3.6 million, respectively, for 2005 as compared to 2004. The net loss for AM&D was \$0.8 million for 2005 compared to \$1.0 million for 2004 (excluding the impairment of goodwill).

2004 compared to 2003

The net loss before the cumulative effect of accounting change from this business segment was \$7.2 million for 2004 compared to a net loss of \$4.9 million for 2003. The increase in the net loss was primarily due to the impairment of goodwill at AM&D, the write-off of an investment in a natural gas storage project, the accrual of environmental liabilities at Avista Development and Avista Capital's purchase of Avista Advantage preferred stock at a premium. This was partially offset by a decrease in the loss from AM&D (excluding the impairment of goodwill) as well as certain other investments of Avista Ventures. Operating revenues from this business segment increased \$3.6 million and operating expenses increased \$6.8 million, respectively, for 2004 as compared to 2003. The consolidation of several minor entities pursuant to FIN 46 contributed to the increase in operating revenues and operating expenses. The net loss from AM&D decreased to \$1.0 million for 2004 (excluding the impairment of goodwill), from \$2.3 million for 2003.

New Accounting Standards

Effective January 1, 2006, the Company adopted SFAS No. 123R, "Share-Based Payment," which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. The Company expects to record compensation expense (net of tax) of approximately \$0.4 million in 2006 related to the periodic vesting of stock options granted to employees prior to 2005. The Company also expects to record compensation expense (net of tax) of approximately \$1.7 million, \$1.1 million and \$0.5 million in 2006, 2007 and 2008, respectively, for performance share awards granted to employees in 2004, 2005 and the first quarter of 2006. For further information see "Note 2 of the Notes to Consolidated Financial Statements."

Critical Accounting Policies and Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material effect on the consolidated financial statements and thus actual results could differ from the amounts reported and disclosed herein. The following accounting policies represent those that the Company's management believes are particularly important to the consolidated financial statements that require the use of estimates and assumptions:

Avista Utilities Operating Revenues

Operating revenues for Avista Utilities related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. The determination of the energy sales to individual customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each calendar month, the amount of energy delivered to customers since the date of the last meter reading is estimated and the corresponding unbilled revenue is estimated and recorded. The estimate of unbilled revenue is based on the number of customers, current rates, meter reading dates, weather (degree days), as well as actual throughput for natural gas. Any difference between actual and estimated revenue is automatically corrected in the following month when the actual meter reading and customer billing occurs.

Regulatory Accounting

The Company prepares its consolidated financial statements in accordance with the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 requires the Company to reflect the effect of regulatory decisions in its financial statements. SFAS No. 71 requires that certain costs and/or obligations (such as incurred power and natural gas costs not currently recovered through rates, but expected to be recovered in the future) are reflected as deferred charges on the Consolidated Balance Sheets and are not reflected in the statement of income until the period during which matching revenues are recognized. The Company has mechanisms in place in each regulatory jurisdiction, and the Company expects to recover its regulatory assets through future rates. These regulatory assets are subject to review for prudence and recoverability and, as such, certain deferred costs may be disallowed by the respective regulatory agencies. If at some point in the future the Company determines that it no longer meets the criteria for continued application of SFAS No. 71 with respect to all or a portion of the Company's regulated operations, the Company could be required to write off its regulatory assets. The Company could also be precluded from the future deferral of costs not recovered through rates when such costs are incurred, even if the Company expects to recover such costs in the future.

Avista Utilities Energy Commodity Derivative Assets and Liabilities

Avista Utilities enters into forward contracts to purchase or sell a specified amount of energy at a specified time, or during a specified period, in the future. These contracts are entered into as part of Avista Utilities' management of its loads and resources and certain contracts are considered derivative instruments. In conjunction with the issuance of SFAS No. 133, the WUTC and the IPUC issued accounting orders authorizing Avista Utilities to offset any derivative assets or liabilities with a regulatory asset or liability. This accounting treatment is intended to defer the recognition of mark-to-market gains and losses on energy commodity transactions until the period of settlement. The order provides for Avista Utilities to not recognize the unrealized gain or loss on utility derivative commodity instruments in the Consolidated Statements of Income. Realized gains or losses are recognized in the period of settlement, subject to approval for recovery through retail rates. Realized gains and losses, subject to regulatory approval, result in adjustments to retail rates through purchased gas cost adjustments, the ERM and the PCA mechanism. Quoted market prices and forward price curves are used to estimate the fair value of Avista Utilities' derivative commodity instruments. As such, the fair value of Avista Utilities' derivative commodity instruments, which are recorded on the Consolidated Balance Sheet, are sensitive to market price fluctuations that can occur on a daily basis.

Avista Energy Revenues and Trading Activities

Avista Energy's derivative commodity instruments accounted for under SFAS No. 133 are marked to estimated fair market value on a daily basis (mark-to-market accounting), which causes earnings variability. Changes in the market value of outstanding electric, natural gas and related derivative commodity instruments are recognized as unrealized gains or losses in the Consolidated Statements of Income in the period of change. Market prices are utilized in determining the value of electric, natural gas and related derivative commodity instruments, which are reported as assets and liabilities on the Consolidated Balance Sheets. These market prices are used through 36 months. For longer-term positions and certain short-term positions for which market prices are not available, models are used to estimate market values. These models incorporate a variety of estimates and assumptions, the ultimate outcomes of

which are beyond Avista Energy's control including, among others, estimates and assumptions as to demand growth, fuel price escalation, availability of existing generation and costs of new generation. Actual experience can vary significantly from these estimates and assumptions.

Avista Energy has implemented hedge accounting in accordance with SFAS No. 133. Specific natural gas and electric trading derivative contracts have been designated as hedging instruments in cash flow hedging relationships. The hedge strategies represent cash flow hedges of the variable price risk associated with expected purchases of natural gas and sales of electricity. These designated hedging instruments represent hedges of variable price exposures generated from certain contracts, which do not qualify as derivatives under SFAS No. 133. For all derivatives designated as cash flow hedges, Avista Energy documents the relationship between the hedging instrument and the hedged item (forecasted purchases and sales of power and natural gas), as well as the risk management objective and strategy for using the hedging instrument. Avista Energy assesses whether a change in the value of the designated derivative is highly effective in achieving offsetting cash flows attributable to the hedged item, both at the inception of the hedge and on an ongoing basis. Any changes in the fair value of the designated derivative that are effective are recorded in accumulated other comprehensive income or loss, while changes in fair value that are not effective are recognized currently in earnings as operating revenues. Amounts recorded in accumulated other comprehensive income or loss are recognized in earnings during the period that the hedged items are recognized in earnings.

Pension Plans and Other Postretirement Benefit Plans

The Company has a defined benefit pension plan covering substantially all of its regular full-time employees at Avista Utilities and Avista Energy. As of December 31, 2005, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. In 2005, the pension plan funding deficit increased as compared to the end of 2004. As such, the Company increased the additional minimum liability for the unfunded accumulated benefit obligation by \$2.8 million and decreased the intangible asset by \$0.7 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$2.3 million, net of tax, for 2005.

The Finance Committee of the Company's Board of Directors establishes investment policies, objectives and strategies to seek optimum return for the pension plan, while also keeping with the assumption of prudent risk and the Finance Committee's composite return objectives. The Finance Committee reviews and approves changes to the investment policy. The Company has contracted with an investment manager who is responsible for managing the individual investment managers. The investment manager's performance and related individual fund performance is periodically reviewed by the Finance Committee to ensure compliance with investment policy objectives and strategies. Pension plan assets are invested primarily in marketable debt and equity securities. Pension plan assets may also be invested in real estate and other investments, including hedge funds and venture capital funds. In seeking to obtain the desired return to fund the pension plan, the Finance Committee has established investment allocation percentages by asset classes as disclosed in "Note 12 of the Notes to Consolidated Financial Statements."

The Company's pension costs (including its Supplemental Executive Retirement Plan (SERP)) were \$13.4 million, \$14.9 million and \$16.1 million for 2005, 2004 and 2003, respectively. Of these pension costs, approximately 70 percent are expensed and approximately 30 percent are capitalized. The Company's costs for the pension plan are determined in part by actuarial formulas and are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension costs are affected by actual employee demographics (including age, compensation and length of service by employees), the amount of cash contributions the Company makes to the pension plan and the return on pension plan assets. Changes made to the provisions of the pension plan may also affect current and future pension costs. Pension plan costs may also be significantly affected by changes in key actuarial assumptions, including the expected return on pension plan assets, the discount rate used in determining the projected benefit obligation and pension costs, as well as the assumed rate of increase in employee compensation. The change in pension plan obligations associated with these factors may not be immediately recognized as pension costs in the Consolidated Statement of Income, but generally are recognized in future years over the remaining average service period of pension plan participants. As such, costs recorded in any period may not reflect the actual level of cash benefits provided to pension plan participants.

The Company has not made any changes to pension plan provisions in 2005, 2004 and 2003 that have had any significant effect on recorded pension plan amounts. The Company has revised the key assumption of the discount rate in 2004 and 2003 and the key assumption of the expected long-term return on assets in 2005. Such change had an effect on reported pension costs in 2005, 2004 and 2003 and may have an effect on future years given the cost recognition approach described above. However, in determining pension obligation and cost amounts, assumptions can change from period to period, and such changes could result in material changes to future pension costs and funding requirements.

In selecting a discount rate, the Company considers yield rates for highly rated corporate bond portfolios with maturities similar to that of the expected term of pension benefits. The Company used a discount rate of 5.75 percent in 2005 and 2004 for estimating the benefit obligation. The Company reduced the discount rate in 2004 to 5.75 percent from 6.25 percent. The Company reduced the discount rate in 2003 to 6.25 percent from 6.75 percent. These decreases in discount rates have increased the projected benefit obligation, pension liability and pension costs.

The assumed long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. The assumed long-term rate of return was 8.5 percent in 2005, and 8 percent in each of 2004 and 2003. For 2005, 2004 and 2003, the actual return on plan assets, net of fees, was a gain of \$11.3 million (or 6.1 percent), \$16.1 million (or 10.4 percent) and \$32.3 million (or 23.3 percent), respectively. The pension plan asset allocation was modified in 2003 to include hedge, real estate and actively managed large cap growth and value funds and decrease fixed income and small cap equities allocations. The estimated long-term rate of return on assets was analyzed based upon the revised investment portfolio. The assumed long-term rate of return on assets was increased in 2005 based upon the analysis.

The following chart reflects the sensitivities associated with a change in certain actuarial assumptions by the indicated percentage (dollars in thousands):

| Actuarial Assumption | Change in Assumption | Effect on Projected Benefit Obligation | Effect on Pension Liability | Effect on Pension Cost |
|--|----------------------|--|-----------------------------|------------------------|
| Expected long-term return on plan assets | -0.5% | \$ - | \$ -* | \$937 |
| Expected long-term return on plan assets | +0.5% | - | -* | (936) |
| Discount rate | -0.5% | 21,506 | 15,444 | 2,057 |
| Discount rate | +0.5% | (19,306) | (13,964) | (1,868) |

* As the Company has already recorded an additional minimum liability for the unfunded accumulated benefit obligation, changes in the expected return on plan assets would not have an effect on the total pension liability.

The Company also has a SERP that provides additional pension benefits to executive officers of the Company. The SERP is intended to provide benefits to executive officers whose benefits under the pension plan are reduced due to the application of Section 415 of the Internal Revenue Code of 1986 and the deferral of salary under deferred compensation plans. The Company recorded an additional minimum liability for the unfunded accumulated benefit obligation of \$0.6 million, \$1.8 million and \$0.3 million related to the SERP in 2005, 2004 and 2003, respectively. This resulted in a charge to other comprehensive income of \$0.4 million, \$1.2 million and \$0.2 million, net of tax, for 2005, 2004 and 2003, respectively.

The Company provides certain health care and life insurance benefits for substantially all of its retired employees. The Company accrues the estimated cost of postretirement benefit obligations during the years that employees provide services. Assumed health care cost trend rates have a significant effect on the amounts reported for the postretirement plans. A one-percentage-point increase in the assumed health care cost trend rate for each year would increase the accumulated postretirement benefit obligation as of December 31, 2005 by \$1.4 million and the service and interest cost by \$0.1 million. A one-percentage-point decrease in the assumed health care cost trend rate for each year would decrease the accumulated postretirement benefit obligation as of December 31, 2005 by \$1.2 million and the service and interest cost by \$0.1 million.

Contingencies

The Company has unresolved regulatory, legal and tax issues for which there is inherent uncertainty with respect to the ultimate outcome of the respective matter. The Company accounts for contingencies in accordance with SFAS No. 5, "Accounting for Contingencies," as well as other accounting guidance specific to a particular issue. In accordance with SFAS No. 5, a loss contingency is accrued if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss or impairment can be reasonably estimated. The Company also discloses losses that do not meet these conditions for accrual, if there is a reasonable possibility that a loss may be incurred.

For all material contingencies, the Company has made a judgment as to the probability of the loss occurring and as to whether or not the amount of the loss can be estimated, and, if the loss recognition criteria have been met, liabilities have been accrued or assets have been written down. However, no assurance can be given with respect to the ultimate outcome of any particular contingency.

Liquidity and Capital Resources

Review of Cash Flow Statement

Overall During 2005, positive cash flows from operating activities of \$128.5 million, proceeds from property sales (primarily the sale of the Company's South Lake Tahoe natural gas properties) of \$17.2 million and an overall reduction in the Company's consolidated cash position of \$62.4 million were used to fund the majority of the Company's cash requirements, including utility capital expenditures of \$213.7 million and dividends of \$26.4 million. To fund the portion of cash needs not met through other sources, total debt increased \$37.5 million in 2005. In addition to dividends, the most significant financing transactions in 2005 were long-term debt issuances of \$149.6 million and \$111.6 million of debt redemptions and maturities. The overall decrease in cash of \$62.4 million in 2005 primarily reflects a decrease in cash at Avista Energy primarily due to an increase of \$28.7 million in cash deposited with counterparties as collateral funds, as well as Avista Energy's net loss for the year.

Operating Activities Net cash provided by operating activities was \$128.5 million for 2005 compared to \$118.0 million for 2004. Net cash used in working capital components was \$57.5 million for 2005, compared to net cash used of \$79.9 million for 2004. The net cash used during 2005 primarily reflects an increase in accounts receivable and cash deposits with counterparties (representing cash deposited as collateral funds at Avista Energy), partially offset by a net increase in the balance outstanding under the Company's revolving accounts receivable sales facility, and an increase in accounts payable. The \$28.7 million increase in deposits with counterparties was due to high natural gas prices and the posting of cash collateral for margin requirements in addition to letters of credit issued under Avista Energy's credit line. The significant increase in accounts receivable and accounts payable was primarily due to an increase in energy commodity prices, as well as increased natural gas wholesale sales and purchases at Avista Utilities. The net cash used in 2004 primarily reflects a decrease in deposits from counterparties (representing collateral funds returned), which substituted cash collateral with letters of credit. This was partially offset by an increase in accounts payable. Significant changes in non-cash items included a \$37.4 million change in energy commodity assets and liabilities, representing the change to an unrealized loss of \$38.1 million on energy trading activities for Avista Energy for 2005 from an unrealized loss of \$0.7 million for 2004.

Investing Activities Net cash used in investing activities was \$197.6 million for 2005, an increase compared to \$129.1 million for 2004. Avista Corp. increased utility capital expenditures in order to meet load growth needs and to continue to provide reliable service to its customers. Utility capital expenditures totaled \$213.7 million, the most significant of which were the acquisition of the remaining interest in Coyote Springs 2, transmission system enhancements, and the repurchase of the Company's corporate headquarters and central operating facility in Spokane. During 2005, the Company received \$17.2 million from the sale of properties (primarily the sale of its South Lake Tahoe natural gas properties).

Financing Activities Net cash provided by financing activities was \$6.6 million for 2005 compared to net cash used of \$28.7 million for 2004. During 2005, short-term borrowings decreased \$5.0 million, which reflects a decrease in the amount of debt outstanding under Avista Corp.'s line of credit. In the fourth quarter of 2005, the Company issued \$150.0 million (net proceeds of \$149.6 million) of 6.25 percent First Mortgage Bonds due in 2035. During 2005, Avista Corp. redeemed a total of \$26.0 million of medium-term notes scheduled to mature in future years, repaid \$54.6 million of WP Funding LP debt and \$31.0 million of long-term debt matured. Cash dividends paid increased to \$26.4 million (or 54.5 cents per share) for 2005 from \$24.9 million (or 51.5 cents per share) for 2004.

During 2004, short-term borrowings decreased \$12.0 million, which primarily reflected a decrease in the amount of debt outstanding under Avista Corp.'s line of credit. During 2004, the Company repurchased \$36.6 million of long-term debt scheduled to mature in future years at a total premium of \$6.7 million, and \$30.3 million of debt matured. In November 2004, the Company issued \$90.0 million (net proceeds of \$89.8 million) of 5.45 percent First Mortgage Bonds due in 2019. During 2004, the Company had \$61.9 million of cash inflows and outflows related to the issuance and redemption of long-term debt to affiliated trusts. In 2004, Avista Capital purchased the preferred stock of Avista Advantage at a total price of \$4.3 million (including a premium of \$0.9 million).

Overall Liquidity

The Company's consolidated operating cash flows are primarily derived from the operations of Avista Utilities and Avista Energy. The primary source of operating cash flows for Avista Utilities is revenues (including the recovery of previously deferred power and natural gas costs) from sales of electricity and natural gas. Significant uses of cash flows from operations for Avista Utilities include the purchase of electricity and natural gas, other operating expenses, taxes and interest. The primary source and use of operating cash flows for Avista Energy is revenues and costs from

realized energy commodity transactions as well as cash collateral deposited to or held from counterparties. Significant operating cash outflows for Avista Energy also include other operating expenses and taxes.

Operating cash flows do not always fully support the capital expenditure needs of Avista Utilities. As such, from time to time, the Company may need to access capital markets in order to fund these needs as well as fund maturing debt. See further discussion at "Capital Resources."

The Company designs operating and capital budgets to control operating costs and capital expenditures. In addition to operating expenses, the Company has continuing commitments for capital expenditures for construction, improvement and maintenance of facilities. In 2001, the Company incurred substantial levels of indebtedness, both short and long-term, to fund high power and natural gas costs in addition to these continuing requirements and to otherwise maintain adequate levels of working capital. As a result of improved operating cash flow and other sources of funds, since 2002 through 2005, the Company has repurchased \$318.7 million of long-term debt.

The general rate increases that have been implemented at Avista Utilities since 2002 are allowing the Company to continue to improve its liquidity. In December 2005, the WUTC approved a settlement agreement (with certain conditions) related to Avista Utilities' Washington general rate case that provides for electric and natural gas base rate increases, which are designed to increase annual revenues by \$22.4 million effective January 1, 2006. See further details in the section "Avista Utilities - Regulatory Matters."

When Avista Utilities' power and natural gas costs exceed the levels currently recovered from retail customers, its net cash flows are negatively affected. Factors that could cause purchased power costs to exceed the levels currently recovered from customers include, but are not limited to, higher prices in wholesale markets combined with an increased need to purchase power in the wholesale markets. Factors beyond the Company's control that could result in an increased need to purchase power in the wholesale markets include, but are not limited to, increases in demand (either due to weather or customer growth), low availability of streamflows for hydroelectric generation, outages at generating facilities and failure of third parties to deliver on energy or capacity contracts. Avista Utilities' hydroelectric generation was 95 percent of normal in 2005. Including 2005, hydroelectric generation has been below normal (based on a 70-year average) for 5 of the past 6 years. The Company cannot determine if this trend of lower than normal hydroelectric generation will continue in future years. Avista Utilities forecasts that hydroelectric generation will be near normal in 2006. This is an early forecast, which will change based upon precipitation, temperatures and other variables during the year.

The Company monitors on an ongoing basis the potential liquidity impacts of increasing energy commodity prices, particularly with respect to natural gas, for both Avista Utilities and Avista Energy. The Company believes that it has adequate liquidity through current cash and cash equivalents, Avista Corp.'s \$350.0 million committed line of credit and Avista Energy's \$145.0 million committed line of credit to meet the increased cash needs of higher energy commodity prices. Avista Utilities has regulatory mechanisms in place that provide for the deferral and recovery of the majority of its power and natural gas supply costs. However, if prices increase, deferral balances will increase, which will negatively affect the Company's cash flow and liquidity.

Capital Resources

The Company's consolidated capital structure, including the current portion of long-term debt and short-term borrowings consisted of the following as of December 31 (dollars in thousands):

| | 2005 | | 2004 | |
|---|--------------------|------------------|--------------------|------------------|
| | Amount | Percent of total | Amount | Percent of total |
| Current portion of long-term debt..... | \$ 39,524 | 2.0% | \$ 85,432 | 4.4% |
| Short-term borrowings..... | 63,494 | 3.2 | 68,517 | 3.5 |
| Long-term debt to affiliated trusts..... | 113,403 | 5.6 | 113,403 | 5.8 |
| Long-term debt..... | <u>989,990</u> | <u>49.4</u> | <u>901,556</u> | <u>46.2</u> |
| Total debt..... | 1,206,411 | 60.2 | 1,168,908 | 59.9 |
| Preferred stock-cumulative (including current portion)..... | <u>28,000</u> | <u>1.4</u> | <u>29,750</u> | <u>1.5</u> |
| Total liabilities..... | 1,234,411 | 61.6 | 1,198,658 | 61.4 |
| Stockholders' equity..... | <u>771,128</u> | <u>38.4</u> | <u>753,205</u> | <u>38.6</u> |
| Total..... | <u>\$2,005,539</u> | <u>100.0%</u> | <u>\$1,951,863</u> | <u>100.0%</u> |

The Company's total debt increased \$37.5 million from December 31, 2004 to December 31, 2005 due to the issuance of \$150.0 million of long-term debt, partially offset by the redemption and maturity of long-term debt and a decrease in short-term borrowings. The increase in total debt was primarily to fund utility capital expenditures that were in excess of operating cash flows. The Company needs to finance capital expenditures and obtain additional working capital from time to time. The cash requirements needed to service indebtedness, both short-term and long-term, reduces the amount of cash flow available to fund working capital, purchased power and natural gas costs, capital expenditures, dividends and other corporate requirements. The Company's stockholders' equity increased \$17.9 million during 2005 primarily due to net income, partially offset by dividends and other comprehensive loss.

The Company generally funds capital expenditures with a combination of internally generated cash and external financing. The level of cash generated internally and the amount that is available for capital expenditures fluctuates depending on a variety of factors. Cash provided by utility operating activities and cash generated by Avista Energy are expected to be the Company's primary sources of funds for operating needs, dividends and capital expenditures for 2006. Borrowings under Avista Corp.'s committed line of credit may supplement these funds to the extent necessary and Avista Corp. currently expects to issue long-term debt in the fourth quarter of 2006 primarily to fund debt that matures in the first quarter of 2007.

During the fourth quarter of 2005, the Company issued \$150.0 million of 6.25 percent First Mortgage Bonds due in 2035. The proceeds from the issuance were used to repay a portion of the borrowings outstanding under the Company's \$350.0 million committed line of credit and for the payment of corporate obligations.

On December 17, 2004, the Company entered into a committed line of credit with various banks in the amount of \$350.0 million with an expiration date of December 16, 2009. This committed line of credit replaced a \$350.0 million committed line of credit with a 364-day term that had an expiration date of May 5, 2005. The Company can request the issuance of up to \$150.0 million in letters of credit under the committed line of credit. As of December 31, 2005 and 2004, the Company had \$63.0 million and \$68.0 million, respectively, of borrowings outstanding. As of December 31, 2005 and 2004, there were \$44.1 million and \$32.8 million in letters of credit outstanding, respectively. The committed line of credit is secured by \$350.0 million of non-transferable First Mortgage Bonds of the Company issued to the agent bank. Such First Mortgage Bonds would only become due and payable in the event, and then only to the extent, that the Company defaults on its obligations under the committed line of credit. However, if the Company obtains an investment grade senior unsecured rating with a stable outlook from two nationally recognized rating agencies, it has the option to release such security.

The committed line of credit agreement contains customary covenants and default provisions, including covenants not to permit the ratio of "consolidated total debt" to "consolidated total capitalization" of Avista Corp. to be greater than 70 percent at the end of any fiscal quarter. As of December 31, 2005, the Company was in compliance with this covenant with a ratio of 60.2 percent. The committed line of credit also has a covenant requiring the ratio of "earnings before interest, taxes, depreciation and amortization" to "interest expense" of Avista Utilities for the twelve-month period ending December 31, 2005 to be greater than 1.6 to 1. As of December 31, 2005, the Company was in compliance with this covenant with a ratio of 2.46 to 1.

Any default on the line of credit or other financing arrangements of Avista Corp. or any of its significant subsidiaries (including Avista Energy) could result in cross-defaults to other agreements of such entity, and/or to the line of credit or other financing arrangements of any other of such entities, and could induce vendors and other counterparties to demand collateral. In the event of any such default, it would be difficult for the Company to obtain financing on reasonable terms to pay creditors or fund operations, and the Company would likely be prohibited from paying dividends on its common stock. Avista Corp. does not guarantee the indebtedness of any of its subsidiaries. As of December 31, 2005, Avista Corp. and its subsidiaries were in compliance with all of the covenants of their financing agreements.

The Company is restricted under various agreements and its Restated Articles of Incorporation as to the additional preferred stock it can issue. As of December 31, 2005, approximately \$398.3 million of additional preferred stock could be issued at an assumed dividend rate of 6.95 percent with a maturity date later than June 1, 2008.

The Mortgage and Deed of Trust securing the Company's First Mortgage Bonds (including Secured Medium-Term Notes) contains limitations on the amount of First Mortgage Bonds that may be issued based on, among other things, a 70 percent debt-to-collateral ratio, and/or retired First Mortgage Bonds, and a 2 to 1 net earnings to First Mortgage Bond interest ratio. As of December 31, 2005, the Company could issue \$285.5 million of additional First Mortgage Bonds under the Mortgage and Deed of Trust.

In April 2004, the Company filed an amended registration statement on Form S-3 with the Securities and Exchange Commission, which would allow for the issuance of up to \$349.6 million of securities (either debt or common stock). This filing amended and combined three previous registration statements filed by the Company. As of December 31, 2005, the Company had remaining availability of \$109.6 million under this registration statement.

As further discussed at "Avista Utilities - Regulatory Matters," in December 2005, the WUTC issued an order approving the settlement agreement reached in the Company's Washington general rate case with certain conditions. The Company agreed to increase the utility equity component to 35 percent by the end of 2007 and to 38 percent by the end of 2008. Failure by the Company to meet those targets could result in a reduction in base rates of 2 percent for each target. The utility equity component was approximately 31 percent as of December 31, 2005.

Beyond expected earnings, the Company is evaluating additional ways to increase its utility equity ratio. Such measures could include delivering original issue shares under the Company's equity compensation and dividend reinvestment plans, as well as possibly making small common stock issuances, from time to time through underwriters or agents. Regulators in each of the Company's jurisdictions have approved the issuance of up to 2 million shares of common stock, from time to time, over the next two years (not including shares under equity compensation and dividend reinvestment plans, which have been previously approved by regulators).

Inter-Company Debt; Subordination

As part of its on-going cash management practices and operations, Avista Corp. from time to time makes unsecured short-term loans to, and obtains borrowings from, Avista Capital. In turn, Avista Capital from time to time makes unsecured short-term loans to, and obtains borrowings from, its subsidiaries. As of December 31, 2005, Avista Corp. held a short-term subordinated note receivable from Avista Capital in the principal amount of \$39.3 million. In addition, Avista Capital from time to time guarantees the indebtedness and other obligations of its subsidiaries. See "Energy Marketing and Resource Management Operations" for further information. The credit arrangements of Avista Capital's subsidiaries generally provide that any indebtedness owed by such entity to its corporate parent will be subordinated to the indebtedness outstanding under such credit arrangements.

The right of Avista Corp., as a shareholder, to receive assets of any of its direct or indirect subsidiaries upon the subsidiary's liquidation or reorganization (and the consequent right of the holders of debt securities and other creditors of Avista Corp. to participate in those assets) is subordinated to the claims against such assets of that subsidiary's creditors. As a result, the obligations of Avista Corp. to its debt securityholders and other unrelated creditors are effectively subordinated in right of payment to all indebtedness and other liabilities and commitments (including trade payables and lease obligations) of Avista Corp.'s direct and indirect subsidiaries. Similarly, the obligations of Avista Capital to its creditors are effectively subordinated in right of payment to all indebtedness and other liabilities and commitments of its direct and indirect subsidiaries.

Pension Plan

As of December 31, 2005, the Company's pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. The Company does not expect the current pension plan funding deficit to have a material adverse effect on its financial condition, results of operations or cash flows. The Company believes that it has made significant efforts in addressing the pension plan funding deficit since 2002, primarily through cash contributions to the plan in excess of the amounts that are required to be funded under the Employee Retirement Income Security Act. The Company made \$15 million in cash contributions to the pension plan in each of 2005 and 2004, which brings total pension plan contributions to \$54 million from 2002 through 2005. The Company expects to contribute \$15 million to the pension plan in 2006.

Off-Balance Sheet Arrangements

Avista Receivables Corporation (ARC) is a wholly owned, bankruptcy-remote subsidiary of Avista Corp. formed for the purpose of acquiring or purchasing interests in certain accounts receivable, both billed and unbilled, of the Company. On March 22, 2005, Avista Corp., ARC and a third-party financial institution amended a Receivables Purchase Agreement. The most significant amendment was to extend the termination date from May 29, 2005 to March 21, 2006. Under the Receivables Purchase Agreement, ARC can sell without recourse, on a revolving basis, up to \$85.0 million of those receivables. ARC is obligated to pay fees that approximate the purchaser's cost of issuing commercial paper equal in value to the interests in receivables sold. On a consolidated basis, the amount of such fees is included in operating expenses of Avista Corp. As of December 31, 2005, \$85.0 million in accounts receivables were sold under this revolving agreement. This agreement provides the Company with cost-effective funds for working capital requirements, capital expenditures and other general corporate needs. The Company expects to renew this facility before the March 21, 2006 expiration.

Spokane Energy, LLC

In December 1998, the Company received cash proceeds of \$143.4 million from a transaction in which the Company assigned and transferred certain rights under a long-term power sales contract with Portland General Electric Company (PGE) to a funding trust. Pursuant to orders from the WUTC and IPUC, this amount was fully amortized by the end of 2002.

Under this power exchange arrangement, Peaker, LLC (Peaker) purchases capacity from Avista Corp. and sells capacity to Spokane Energy LLC (Spokane Energy), an unconsolidated subsidiary of Avista Corp., formed in 1998 solely for the purpose of facilitating a long-term capacity contract between PGE and Avista Corp. Spokane Energy sells the related capacity to PGE. Peaker acts as an intermediary to fulfill certain regulatory requirements between Spokane Energy and Avista Corp. The transaction is structured such that Spokane Energy bears full recourse risk for a loan (balance of \$106.5 million as of December 31, 2005) that matures in January 2015 with no recourse to Avista Corp. related to the loan. Peaker is obligated to pay approximately \$150,000 per month to Avista Corp. for its capacity purchase. Peaker was formed solely for the purpose of assuming all rights and obligations from Enron Power Marketing, Inc. (EPMI), which assigned the transactions to Peaker in November 2003 as part of its bankruptcy proceedings. Peaker is not affiliated with EPMI.

WP Funding LP

WP Funding LP was formed in 1993 for the purpose of acquiring the natural gas-fired combustion turbine generating facility in Rathdrum, Idaho (Rathdrum CT). FIN 46 required the Company to consolidate WP Funding LP effective for the period ended December 31, 2003 through June 30, 2005. WP Funding LP purchased the Rathdrum CT from Avista Corp. with funds provided by unrelated investors of which 97 percent represented debt and 3 percent represented equity. Avista Corp. operated the Rathdrum CT and leased it from WP Funding LP until September 2005. In September 2005, Avista Corp. terminated (by exercise of a purchase option) the lease agreement with, and acquired the Rathdrum CT from, WP Funding LP. As a result of this transaction, Avista Corp. is no longer including WP Funding LP in its consolidated financial statements. This transaction and deconsolidation did not have a material effect on the Company's total consolidated assets, liabilities, stockholders' equity or results of operations. From a consolidated perspective, the Company replaced the \$56.3 million of WP Funding LP debt and third-party investment with other borrowings by Avista Corp.

Credit Ratings

The following table summarizes the Company's credit ratings as of March 1, 2006:

| | <u>Standard & Poor's</u> | <u>Moody's</u> | <u>Fitch, Inc.</u> |
|----------------------------|------------------------------|----------------|--------------------|
| Avista Corporation | | | |
| Corporate/Issuer rating | BB+ | Ba1 | BB+ |
| Senior secured debt | BBB- | Baa3 | BBB- |
| Senior unsecured debt | BB+ | Ba1 | BB+ |
| Preferred stock | BB- | Ba3 | BB |
| Avista Capital II (1) | | | |
| Preferred Trust Securities | BB- | Ba2 | BB |
| AVA Capital Trust III (1) | | | |
| Preferred Trust Securities | BB- | Ba2 | BB |
| Rating outlook | Stable | Stable | Stable |

(1) Only assets are subordinated debentures of Avista Corporation.

These security ratings are not recommendations to buy, sell or hold securities. The ratings are subject to change or withdrawal at any time by the respective credit rating agencies. Each credit rating should be evaluated independently of any other ratings.

Dividends

The Board of Directors considers the level of dividends on the Company's common stock on a regular basis, taking into account numerous factors including, without limitation, the Company's results of operations, cash flows and financial condition, as well as the success of the Company's strategies and general economic and competitive conditions. The Company's net income available for dividends is derived primarily from the operations of Avista Utilities and Avista Energy.

Covenants under the Company's 9.75 percent Senior Notes that mature in 2008 limit the Company's ability to increase its common stock cash dividend to no more than 5 percent over the previous quarter.

On November 11, 2005, the Board of Directors declared a quarterly dividend of \$0.14 per common share payable on December 15, 2005 to shareholders of record on November 30, 2005. This was an increase of \$0.005 per common share over the previous quarterly dividend declared in August 2005. On February 10, 2006, the Board of Directors declared a quarterly dividend of \$0.14 per common share payable on March 15, 2006 to shareholders of record on February 24, 2006.

Avista Energy holds a significant portion of cash and cash equivalents reflected on the Consolidated Balance Sheets. Covenants in Avista Energy's credit agreement, certain counterparty agreements and market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limiting the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. During 2005, Avista Energy paid \$15.1 million in dividends to Avista Capital.

Avista Utilities Operations

Capital expenditures for Avista Utilities were \$431.3 million for the years 2003 through 2005. During the years 2006 through 2008, utility capital expenditures are currently expected to be in the range of \$160 million to \$175 million per year. In addition to continuing needs for Avista Utilities' distribution system, significant projects include the continued enhancement of Avista Utilities' transmission system and upgrades to generating facilities. These estimates of capital expenditures are subject to continuing review and adjustment. Actual capital expenditures may vary from these estimates due to factors such as changes in business conditions, construction schedules and environmental requirements. Long-term debt maturities and mandatory redemptions of preferred stock are expected to total approximately \$567 million during the period from 2006 through 2008. During 2006, internally generated funds and short-term borrowing arrangements are expected to be sufficient to fund these requirements. However, the Company currently expects to issue long-term debt in the fourth quarter of 2006 primarily to fund debt that matures in the first quarter of 2007. In 2007 and 2008, the Company will most likely need to issue additional long-term debt to fund these obligations, which include long-term debt maturities of approximately \$500 million. The Company has already locked in the interest rate on \$200 million of long-term debt issuances during this period through forward-starting interest rate swap agreements.

Avista Utilities is committed to investment in its generation, transmission and distribution systems with a focus on increasing capacity and improving reliability. Avista Utilities continues to upgrade its hydroelectric plants to increase their availability and capture additional output. Currently, plans call for upgrading one unit each year for the next five years. As outlined in Avista Utilities' 2005 Electric Integrated Resource Plan, which was filed with regulators in Washington and Idaho, quarterly energy deficits are projected to begin in 2007 and annual energy deficits are projected to begin in 2010. To help meet forecasted increases in electric loads, Avista Utilities issued a request for proposals in January 2006 to consider adding approximately 35 average megawatts of long-term renewable energy supplies to begin in the fourth quarter of 2007. In early 2006, Avista Utilities has also entered into an agreement with Idaho Power to jointly investigate possible future coal-based generation resources.

As of December 31, 2005, Avista Utilities had \$3.8 million of restricted cash. The restricted cash relates to deposits for Avista Corp.'s interest rate swap agreements.

Avista Utilities held cash deposits from other parties in the amount of \$9.0 million as of December 31, 2005, which is included in deposits from counterparties on the Consolidated Balance Sheet. These amounts are subject to return if conditions warrant because of continuing portfolio value fluctuations with those parties or substitution of collateral.

See "Notes 5, 15, 16, 17, 18, 21, 22 and 23 of Notes to Consolidated Financial Statements" for additional details related to financing activities.

Energy Marketing and Resource Management Operations

On July 13, 2005, Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, amended its committed credit agreement with a group of banks to increase the aggregate amount from \$110.0 million to \$145.0 million and to extend the expiration date to July 12, 2007. This committed credit facility provides for the issuance of letters of credit to secure contractual obligations to counterparties and for cash advances. This facility is secured by the assets of Avista Energy and Avista Energy Canada and guaranteed by Avista Capital and by CoPac Management, Inc., a wholly owned subsidiary of Avista Energy Canada. The maximum amount of credit extended by the banks for the issuance of letters of credit is the subscribed amount of the facility less the amount of outstanding cash advances, if

any. The amendment to the credit agreement increased the maximum amount for cash advances from \$30.0 million to \$50.0 million. No cash advances were outstanding as of December 31, 2005 and 2004. Letters of credit in the aggregate amount of \$125.3 million and \$91.3 million were outstanding as of December 31, 2005 and 2004, respectively. The cash deposits of Avista Energy at the respective banks collateralized \$18.2 million and \$21.5 million of these letters of credit as of December 31, 2005 and 2004, respectively, which is reflected as restricted cash on the Consolidated Balance Sheets. The increase in letters of credit outstanding is partially due to an increase in commodity prices, particularly with respect to natural gas.

The Avista Energy credit agreement continues to contain covenants and default provisions, including covenants to maintain "minimum net working capital" and "minimum net worth," as well as a covenant limiting the amount of indebtedness that the co-borrowers may incur. The credit agreement also continues to contain covenants and other restrictions related to the co-borrowers' trading limits and positions, including VAR limits, restrictions with respect to changes in risk management policies or volumetric limits, and limits on exposure related to hourly and daily trading of electricity. These covenants, certain counterparty agreements and market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limit the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. Avista Energy was in compliance with the covenants of its credit agreement as of December 31, 2005. Prior to the July 13, 2005 amendment, a reduction in the credit rating of Avista Corp. would have represented an event of default under Avista Energy's credit agreement. The July 13, 2005 amendment to the credit agreement removed this covenant.

Avista Capital provides guarantees for Avista Energy's credit agreement (see discussion above) and, in the course of business, may provide performance guarantees to other parties with whom Avista Energy may be doing business. At any point in time, Avista Capital is only liable for the outstanding portion of the performance guarantee, which was \$37.7 million as of December 31, 2005. The face value of all performance guarantees issued by Avista Capital for energy trading contracts at Avista Energy was \$419.3 million as of December 31, 2005.

As part of its cash management practices and operations, Avista Energy from time to time makes unsecured short-term loans to its parent, Avista Capital. Avista Capital's Board of Directors has limited the total outstanding indebtedness to no more than \$45.0 million. Further, as required under Avista Energy's credit facility, such loans cannot be outstanding longer than 90 days without being repaid. During 2005, Avista Energy's maximum total outstanding short-term loan to Avista Capital was \$40.2 million including accrued interest. As of December 31, 2005, all outstanding loans including accrued interest had been repaid.

Avista Energy manages collateral requirements with counterparties by providing letters of credit, providing guarantees from Avista Capital, depositing cash with counterparties and offsetting transactions with counterparties. Cash deposited with counterparties totaled \$59.4 million as of December 31, 2005, an increase of \$28.7 million from December 31, 2004 due to high natural gas prices and the posting of cash collateral for margin requirements in addition to letters of credit issued under Avista Energy's credit line. Avista Energy held cash deposits from other parties in the amount of \$4.8 million as of December 31, 2005, which is included in deposits from counterparties on the Consolidated Balance Sheet. These amounts are subject to return if conditions warrant because of continuing portfolio value fluctuations with those parties or substitution of collateral.

As of December 31, 2005, Avista Energy had \$22.9 million in cash, as well as \$21.8 million of restricted cash. Avista Energy's total cash (not including restricted cash) decreased \$61.8 million during 2005 primarily due to an increase in cash deposited with counterparties as collateral funds of \$28.7 million, dividends to Avista Capital of \$15.1 million, which flowed up to Avista Corp. and were used for general corporate purposes, as well as Avista Energy's net loss for the year.

Capital expenditures for the Energy Marketing and Resource Management companies were \$5.0 million for the years 2003 through 2005. Capital expenditures for this segment are not expected to be significant to Avista Corp.'s consolidated cash flows and financial condition during the years 2006 through 2008.

Avista Advantage Operations

Capital expenditures for Avista Advantage were \$2.4 million for the years 2003 through 2005. Capital expenditures for the years 2006 through 2008 are not expected to be significant to Avista Corp.'s consolidated cash flows and financial condition and should be funded by Avista Advantage's cash flows from operations.

As of December 31, 2005, Avista Advantage had \$1.4 million of debt outstanding related to capital leases.

Other Operations

Capital expenditures for these companies were \$3.1 million for the years 2003 through 2005. Capital expenditures for the years 2006 through 2008 in this segment are not expected to be significant to Avista Corp.'s consolidated cash flows and financial condition.

As of December 31, 2005, this business segment had \$7.6 million of debt outstanding which included long-term debt, short-term borrowings and capital leases.

Contractual Obligations

The following table provides a summary of the Company's future contractual obligations as of December 31, 2005 (dollars in millions):

| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter |
|---|----------------|--------------|--------------|--------------|--------------|----------------|
| Avista Utilities: | | | | | | |
| Long-term debt maturities (1)..... | \$ 38 | \$176 | \$325 | \$ - | \$ 35 | \$441 |
| Long-term debt to affiliated trusts (1).... | - | - | - | - | - | 113 |
| Interest on debt (2)..... | 95 | 89 | 81 | 77 | 75 | - |
| Short-term borrowings (3)..... | 63 | - | - | - | - | - |
| Accounts receivable sales (4)..... | 85 | - | - | - | - | - |
| Preferred stock redemptions (1)..... | 2 | 26 | - | - | - | - |
| Energy purchase contracts (5)..... | 364 | 162 | 148 | 144 | 144 | 727 |
| Public Utility District contracts (5)..... | 4 | 4 | 4 | 4 | 4 | 64 |
| Operating lease obligations (6)..... | 2 | 1 | 1 | 1 | - | 2 |
| Capital lease obligations (6)..... | 1 | 1 | 1 | - | - | - |
| Other obligations (7)..... | 14 | 14 | 14 | 14 | 14 | 195 |
| Information services contracts..... | 11 | 11 | 12 | 12 | 12 | 26 |
| Pension plan funding (9)..... | 15 | 15 | 15 | 15 | - | - |
| Avista Capital (consolidated): | | | | | | |
| Long-term debt..... | - | - | - | - | - | 7 |
| Short-term borrowings..... | 1 | - | - | - | - | - |
| Energy purchase contracts (8)..... | 1,010 | 232 | 226 | 205 | 196 | 347 |
| Operating lease obligations (6)..... | 3 | 3 | 3 | 3 | 1 | - |
| Capital lease obligations (6)..... | 1 | 1 | - | - | - | - |
| Total contractual obligations..... | \$1,709 | \$735 | \$830 | \$475 | \$481 | \$1,922 |

- (1) For 2006, the Company expects that cash flows from operations and short-term debt will provide sufficient funds for maturing long-term debt and preferred stock redemptions. However, the Company currently expects to issue long-term debt in the fourth quarter of 2006 primarily to fund debt that matures in the first quarter of 2007. In years subsequent to 2006, the Company will most likely need to issue additional long-term debt to fund these obligations.
- (2) Represents the Company's estimate of interest payments on debt. The Company will make interest payments beyond 2010; however, the Company has not made an estimate of such payments at this time.
- (3) Represents \$63 million outstanding under a \$350 million revolving line of credit.
- (4) Represents \$85 million outstanding under a revolving \$85 million accounts receivable sales financing facility.
- (5) Energy purchase contracts were entered into as part of Avista Utilities' obligation to serve its retail natural gas and electric customers' energy requirements. As a result, these costs are generally recovered either through base retail rates or adjustments to retail rates as part of the power and natural gas cost adjustment mechanisms.
- (6) Includes the interest component of the lease obligation.
- (7) Represents operational agreements, settlements and other contractual obligations with respect to generation, transmission and distribution facilities. These costs are generally recovered through base retail rates.
- (8) Represents Avista Energy's contractual commitments to purchase energy commodities as well as commitments related to transmission, transportation and other energy-related contracts in future periods. Avista Energy also has sales commitments related to these contractual obligations in future periods.
- (9) Represents the Company's estimated cash contributions to the pension plan through 2009. The Company cannot reasonably estimate pension plan contributions beyond 2009 at this time.

In addition to the contractual obligations disclosed above, the Company will incur additional operating costs and capital expenditures in future periods for which it is not contractually obligated as part of its normal business operations.

As of December 31, 2005, Avista Corp. did not have any commitments outstanding with equity triggers. Avista Corp. does not expect any material impact from rating triggers; although there are certain rating triggers for Avista Corp. primarily related to changes in pricing under certain financing agreements. Prior to the July 13, 2005 amendment, a reduction in the credit rating of Avista Corp. would have represented an event of default under Avista Energy's credit agreement. The July 13, 2005 amendment to the credit agreement removed this covenant.

Competition

Avista Utilities' retail electric and natural gas distribution business has historically been recognized as a natural monopoly. In each regulatory jurisdiction, rates for retail electric and natural gas services (other than specially negotiated retail rates for industrial or large commercial customers, which are subject to regulatory review and approval) are determined on a "cost of service" basis and are designed to provide, after recovery of allowable operating expenses, an opportunity to earn a reasonable return. Avista Utilities competes with various rural electric cooperatives and public utility districts in and adjacent to its service territories in the provision of service to new retail electric customers. Alternate providers of power may also compete for sales to existing customers. Competition for available electric resources can be critical to utilities as surplus power resources are absorbed by load growth. Avista Utilities' electric and natural gas distribution operations compete with other energy sources including heating oil, propane and other fuels.

The Energy Policy Act of 1992 (1992 Energy Act) removed certain barriers to a competitive wholesale market. The 1992 Energy Act expanded the authority of the FERC to issue orders requiring electric utilities to transmit power and energy to or for wholesale purchasers and sellers, and to require electric utilities to enlarge or construct additional transmission capacity for the purpose of providing these services. It also created "exempt wholesale generators," a class of independent power plant owners that are able to sell generation only at the wholesale level. This permits public utilities and other entities to participate through subsidiaries in the development of independent electric generating plants for sales to wholesale customers.

Participants in the wholesale energy markets include other utilities, federal power marketing agencies, energy marketing and trading companies, independent power producers, financial institutions, and commodity brokers. Avista Corp. actively monitors and participates as appropriate in energy industry developments to maintain and enhance its ability to effectively participate in wholesale energy markets consistent with its business goals.

The subsidiaries in the non-energy businesses, particularly Avista Advantage, are subject to competition as they develop products and services and enter new markets. It is also a challenge for Avista Advantage to maintain its current customer base. Competition from other companies in these non-energy businesses may mean challenges for a company to be the first to market a new product or service to gain the advantage in market share. Challenges for these businesses include the availability of funding and resources to meet capital needs, rapidly advancing technologies, possibly making some of the current technology quickly obsolete, and requiring continual product enhancement.

Business Risk

The Company's operations are exposed to risks including, but not limited to, the price and supply of purchased power, fuel and natural gas, regulatory allowance of the recovery of power and natural gas costs, operating costs and capital investments, streamflow and weather conditions, the effects of changes in legislative and governmental regulations, changes in regulatory requirements, availability of generation facilities, competition, technology and availability of funding. Also, like other utilities, the Company's facilities and operations may be exposed to terrorism risks or other malicious acts. See further reference to risks and uncertainties under "Forward-Looking Statements."

Avista Utilities has mechanisms in each regulatory jurisdiction, which provide for the recovery of the majority of the changes in its power and natural gas costs. The majority of power and natural gas costs that exceed the amount currently recovered through retail rates, excluding the ERM dead band in Washington, are deferred on the Consolidated Balance Sheets for the opportunity for recovery through future retail rates. These deferred power and natural gas costs are subject to review for prudence and recoverability and as such certain deferred costs may be disallowed by the respective regulatory agencies.

Avista Utilities' hydroelectric generation was 95 percent of normal in 2005. Including 2005, hydroelectric generation has been below normal (based on a 70-year average) for 5 of the past 6 years. The Company cannot determine if this trend of lower than normal hydroelectric generation will continue in future years. Avista Utilities forecasts that hydroelectric generation will be near normal in 2006. This is an early forecast, which will change based upon precipitation, temperatures and other variables during the year. The earnings impact of these factors is mitigated by regulatory mechanisms that are intended to defer increased power supply costs for recovery in future periods. Avista Utilities is not able to predict how the combination of energy resources, energy loads, prices, rate recovery and other factors will ultimately drive deferred power costs and the timing of recovery of these costs in future periods. See further information at "Avista Utilities - Regulatory Matters."

Challenges facing Avista Utilities' electric operations include, among other things, streamflows to hydroelectric generating facilities, weather conditions, changes in the availability of and volatility in the prices of power and fuel, the timing and approval of the recovery of deferred power costs, generating unit availability, legislative and governmental regulations, potential tax law changes, and customer response to price increases and surcharges.

During recent years, natural gas prices have been volatile with a general upward trend. Avista Utilities' average prices per dekatherm were \$8.13, \$6.62 and \$5.50 in 2005, 2004 and 2003, respectively. The Company continues to be concerned about the impact that increasing rates have on its customers, which could reduce future demand for natural gas. However, market prices for natural gas continue to be competitive compared to alternative fuel sources for residential, commercial and industrial customers. The Company continues to discuss its natural gas purchase and hedging strategies with its regulators. Avista Utilities believes that natural gas should sustain its market advantage over competing energy sources based on the levels of existing reserves and the potential for natural gas development in the future. Growth has occurred in the natural gas business in recent years due to increased demand for natural gas in new construction, as well as conversions from competing space and water heating energy sources to natural gas.

Challenges facing Avista Utilities' natural gas operations include, among other things, volatility in the price of natural gas, increases in the price of natural gas, changes in the availability of natural gas, legislative and governmental regulations, weather conditions and the timing and approval of recovery for increased natural gas costs. Avista Utilities' natural gas business also faces the potential for certain natural gas customers to by-pass its natural gas system. To reduce the potential for such by-pass, Avista Utilities prices its natural gas services, including transportation contracts, competitively and has varying degrees of flexibility to price its transportation and delivery rates by means of individual contracts, subject to state regulatory review and approval. Avista Utilities has long-term transportation contracts with several of its largest industrial customers, which reduces the risk of these customers by-passing the system in the foreseeable future.

In addition to its asset management activities, Avista Energy trades electricity and natural gas, along with derivative commodity instruments, including futures, options, swaps and other contractual arrangements. As a result of these trading activities, Avista Energy is subject to various risks including commodity price risk and credit risk, as well as possible risks resulting from the imposition of market controls by federal and state agencies. The FERC is conducting proceedings and investigations related to market controls within the western United States that include proposals by certain parties to impose refunds. As a result, certain parties have asserted claims for significant refunds from Avista Energy and lesser refunds from Avista Utilities, which could result in liabilities for refunding revenues recognized in prior periods. Avista Energy and Avista Utilities have joined other parties in opposing these proposals. The refund proceedings provide that any refunds owed could be offset against unpaid energy debts due to the same party. As of December 31, 2005, Avista Energy's accounts receivable outstanding related to defaulting parties in California are fully offset by reserves for uncollected amounts and funds collected from defaulting parties. Avista Energy is pursuing recovery of the defaulted obligations. See "California Refund Proceeding" and "Pacific Northwest Refund Proceeding" in "Note 26 of the Notes to Consolidated Financial Statements" for further information with respect to the refund proceedings.

Avista Utilities and Avista Energy engage in wholesale sales and purchases of energy commodities and, accordingly, are subject to commodity price risk, credit risk and other risks associated with these activities.

Commodity Price Risk. Both Avista Utilities and Avista Energy are subject to energy commodity price risk. Price risk is, in general, the risk of fluctuation in the market price of the commodity needed, held or traded. The price of energy in wholesale markets is affected primarily by fundamental factors related to production costs and by other factors including weather and the resulting retail loads. In the case of electricity, prices can be affected by the adequacy of generating reserve margins, scheduled and unscheduled outages of generating facilities, availability of streamflows for hydroelectric generation on a regional basis, the price and availability of fuel for thermal generating plants, and disruptions of or constraints on transmission facilities, among other things. Natural gas prices are affected by a

number of factors, including but not limited to, the adequacy of North American production, the level of imports, the level of inventories, the demand for natural gas as fuel for electric generation, global energy markets, and the availability of pipeline capacity to transport natural gas from region to region. In addition, oil prices can influence natural gas and electricity prices, because of the fuel-switching capabilities of certain energy users. Demand changes caused by variations in the weather and other factors can also affect market prices for electricity and natural gas. Any combination of these factors that results in a shortage of energy generally causes the market price to move upward. In addition to these factors, wholesale power markets are subject to regulatory constraints including price controls. The FERC imposed a price mitigation plan in the western United States in June 2001 and has subsequently modified various price and market control regulations.

Price risk also includes the risk of fluctuation in the market price of associated derivative commodity instruments (such as options and forward contracts). Price risk may also be influenced to the extent that the performance or non-performance by market participants of their contractual obligations and commitments affect the supply of, or demand for, the commodity.

Credit Risk. Credit risk relates to the risk of loss that Avista Utilities and/or Avista Energy would incur as a result of non-performance by counterparties of their contractual obligations to deliver energy or make financial settlements. Avista Utilities and Avista Energy often extend credit to counterparties and customers and are exposed to the risk that they may not be able to collect amounts owed to them. Changes in market prices may dramatically alter the size of credit risk with counterparties, even when conservative credit limits have been established. Credit risk includes the risk that a counterparty may default due to circumstances relating directly to it and the risk that a counterparty may default due to circumstances that relate to other market participants that have a direct or indirect relationship with such counterparty. Should a counterparty, customer or supplier fail to perform, Avista Utilities or Avista Energy may be required to replace existing contracts with contracts at then-current market prices or to honor the underlying commitment.

Avista Utilities and Avista Energy seek to mitigate credit risk by applying specific eligibility criteria to existing and prospective counterparties and by actively monitoring current credit exposures. These policies include an evaluation of the financial condition and credit ratings of counterparties, collateral requirements or other credit enhancements, such as letters of credit or parent company guarantees, and the use of standardized agreements that allow for the netting or offsetting of positive and negative exposures associated with a single counterparty. However, despite mitigation efforts, defaults by counterparties periodically occur.

Avista Energy and Avista Utilities regularly evaluate counterparties' credit exposure for future settlements and delivery obligations. Avista Energy and Avista Utilities have taken a conservative position by reducing or eliminating open (unsecured) credit limits and implemented other credit risk reduction measures for parties perceived to have increased default risk. Counterparty collateral is used to offset the Company's credit risk where unsettled net positions and future obligations by counterparties to pay Avista Utilities and/or Avista Energy or deliver to Avista Utilities and/or Avista Energy warrant.

Avista Energy has concentrations of suppliers and customers in the electric and natural gas industries including, but not limited to, electric utilities, natural gas distribution companies, and other energy marketing and trading companies. In addition, Avista Energy has concentrations of credit risk related to geographic location, as Avista Energy operates in the western United States and western Canada. These concentrations of counterparties and concentrations of geographic location may affect Avista Energy's overall exposure to credit risk because the counterparties may be similarly affected by changes in economic, regulatory or other conditions.

Credit risk also involves the exposure that counterparties perceive related to the ability of Avista Utilities and Avista Energy to perform deliveries and settlement under physical and financial energy contracts. These counterparties may seek assurances of performance in the form of letters of credit, prepayment or cash deposits, and, in the case of Avista Energy, parent company (Avista Capital) performance guarantees. In periods of price volatility, the level of exposure can change significantly, with the result that sudden and significant demands may be made against the Company's capital resource reserves (credit facilities and cash). Avista Utilities and Avista Energy actively monitor the exposure to possible collateral calls and take steps to minimize capital requirements.

In conjunction with the valuation of their commodity derivative instruments and accounts receivable, Avista Utilities and Avista Energy maintain credit reserves that are based on management's evaluation of the credit risk of the overall portfolio. Based on these policies, exposures and credit reserves, the Company does not anticipate a materially adverse effect on its financial condition or results of operations as a result of counterparty nonperformance.

Other Operating Risks. In addition to commodity price risk, Avista Utilities' commodity positions are subject to operational and event risks including, among others, increases or decreases in load demand, blackouts or disruptions to transmission or transportation systems, fuel quality, forced outages at generating plants and disruptions to information systems and other administrative tools required for normal operations. Avista Utilities also has exposure to weather conditions and natural disasters that can cause physical damage to property, requiring repairs to restore utility service. Terrorism threats, both domestic and foreign, is a risk to the entire utility industry, including Avista Utilities. Potential disruptions to operations or destruction of facilities from terrorism or other malicious acts are not readily determinable. The Company has taken various steps to mitigate terrorism risks and to prepare contingency plans in the event that its facilities are targeted.

Interest Rate Risk. The Company is subject to the risk of fluctuating interest rates in the normal course of business. The Company manages interest rate risk by taking advantage of market conditions when timing the issuance of long-term financings and optional debt redemptions and through the use of fixed rate long-term debt with varying maturities. The interest rate on \$51.5 million of long-term debt to affiliated trusts is adjusted quarterly, reflecting current market rates. Additionally, amounts borrowed under the Company's \$350.0 million committed line of credit have a variable interest rate.

In 2004, Avista Corp. entered into three forward-starting interest rate swap agreements, totaling \$200.0 million, to manage the risk that changes in interest rates may affect the amount of future interest payments. These interest rate swap agreements relate to the anticipated issuances of debt to fund maturing debt in 2007 and 2008. Under the terms of these agreements, the value of the interest rate swaps are determined based upon Avista Corp. paying a fixed rate and receiving a variable rate based on LIBOR. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2005, Avista Corp. had a derivative liability of \$10.0 million and provided cash collateral of \$3.8 million to the interest rate swap counterparties related to these interest rate swaps. The Company estimates that a 10 basis point increase in forward LIBOR interest rates as of December 31, 2005 would have decreased this derivative liability by approximately \$1.3 million, while a 10 basis point decrease would have increased the liability by approximately \$1.3 million.

Foreign Currency Risk. Avista Energy has investments in Canadian companies through Avista Energy Canada and its subsidiary, CoPac Management, Inc. In addition, Avista Energy enters into Canadian dollar denominated transactions in Canada for natural gas commodity and related services. These transactions in aggregate expose Avista Energy to foreign currency risk. Avista Energy attempts to limit its exposure to changing foreign exchange rates through both operational and financial market actions. This includes entering into forward and swap contracts to hedge existing exposures, firm commitments and anticipated transactions. These arrangements are carried at fair value and were not significant as of December 31, 2005. Also, Avista Utilities has foreign currency risk as natural gas procurement operations have been implemented in 2005 and a significant portion of Avista Utilities' natural gas supply is obtained from Canadian sources. This has not had a material effect on Avista Utilities' financial condition, results of operations or cash flows.

Risk Management

Risk Policies and Oversight. Avista Utilities and Avista Energy use a variety of techniques to manage risks for their energy resources and wholesale energy market activities. The Company has risk management policies and procedures to manage these risks, both qualitative and quantitative, for Avista Utilities and Avista Energy. The Company's Risk Management Committee establishes the Company's risk management policies and procedures and monitors compliance. The Risk Management Committee is comprised of certain Company officers and other individuals and is overseen by the Audit Committee of the Company's Board of Directors. The Company's Risk Management Committee reviews the status of risk exposures through regular reports and meetings and it monitors compliance with the Company's risk management policies and procedures on a regular basis. Nonetheless, adverse changes in commodity prices, generating capacity, customer loads, regulation and other factors may result in losses of earnings, cash flows and/or fair values.

Avista Utilities and Avista Energy also operate with a wholesale energy markets credit policy. The credit policy is designed to reduce the risk of financial loss in case counterparties default on delivery or settlement obligations and to conserve the Company's liquidity as other parties may place credit limits or require cash collateral.

Quantitative Risk Measurements. Avista Utilities measures the monthly, quarterly and annual energy volume of its imbalance between projected power loads and resources. Normal operations result in seasonal mismatches between power loads and available resources. Avista Utilities is able to vary the operation of its generating resources to match

parts of its hourly, daily and weekly load fluctuations. Avista Utilities uses the wholesale power markets to sell projected resource surpluses and obtain resources when deficits are projected. Avista Utilities buys and sells fuel for thermal generation facilities based on comparative power market prices and marginal costs of fueling and operating its available generating facilities.

Load/resource imbalances within a rolling 18-month planning horizon are compared against established volumetric guidelines and management determines the timing and specific actions to manage the imbalances. Management also assesses available resource decisions and actions that are appropriate for longer-term planning periods. Expected load and resource volumes for forward periods are based on monthly and quarterly averages that may vary significantly from the actual loads and resources within any individual month or operating day. Future projections of resources are updated as forecasted streamflows and other factors differ from prior estimates. Forward power markets may be illiquid, and market products available may not match Avista Utilities' desired transaction size and shape. Therefore, open imbalance positions exist at any given time.

Avista Utilities' natural gas loads and resources are regularly reviewed by operating management and the Risk Management Committee. The balancing of loads and resources is accomplished through commodity purchases and the use of natural gas storage facilities owned by, or contracted with, Avista Utilities. Timing, pricing and volume decisions are subject to Avista Utilities' hedging practices that include a cross-departmental oversight group.

Avista Energy measures the risk in its electric and natural gas portfolio daily utilizing a Value-at-Risk (VAR) model, which monitors its risk in comparison to established thresholds. VAR measures the expected portfolio loss under hypothetical adverse price movements, over a given time interval within a given confidence level. The VAR computations utilize historical price movements over a specified period to simulate forward price curves in the energy markets and estimate the potential unfavorable impact of price movement in the portfolio. The quantification of market risk using VAR provides a consistent measure of risk across Avista Energy's continually changing portfolio. VAR represents an estimate of reasonably possible net losses in earnings that would be recognized on its portfolio assuming hypothetical movements in future market rates and is not necessarily indicative of actual results that may occur. Avista Energy's VAR computations utilize several key assumptions, including a 95 percent confidence level for the resultant price movement and holding periods of one and three days. The calculation includes derivative commodity instruments held for trading purposes and excludes the effects of embedded physical options in the trading portfolio. For forward transactions that settle beyond the next 12 calendar quarters, Avista Energy applies other risk measurement techniques, including price sensitivity stress tests, to assess the future market risk. Volatility in longer-dated forward markets tends to be significantly less than in near-term markets. Avista Energy also measures its open positions in terms of volumes at each delivery location for each forward time period. The permissible extent of open positions is included in the risk management policy and is measured with stress tests and VAR modeling.

Prior to June 30, 2005, Avista Energy utilized a VAR model to assess market risk for the next 8 calendar quarters. Beginning, in July 2005, Avista Energy began measuring VAR in the next 12 calendar quarters, and continues to apply other risk measurement techniques, including price sensitivity stress tests, to assess the future market risk, beyond twelve calendar quarters. The addition of four calendar quarters to the VAR calculation was due to more transparent pricing in longer-term commodity markets, due to new market participants and increased volumes. This change did not have a material effect on the VAR calculations.

As of December 31, 2005, Avista Energy's estimated potential one-day unfavorable impact on gross margin as measured by VAR was \$0.8 million, compared to \$0.4 million as of December 31, 2004. The average daily VAR for 2005 was \$0.9 million. The high daily VAR was \$3.0 million and the low daily VAR was \$0.3 million during 2005. Avista Energy was in compliance with its one-day VAR limits during 2005. Changes in markets inconsistent with historical trends or assumptions used could cause actual results to exceed predicted limits.

As of December 31, 2005, 84 percent of Avista Corp.'s credit exposure was to investment grade counterparties or noninvestment grade counterparties whose exposure was mitigated by collateral posted to Avista Corp. Of the remaining unmitigated exposure to non-investment grade counterparties, 8 percent represents settlements that were made within thirty days after December 31, 2005.

As of December 31, 2005, 90 percent of Avista Energy's credit exposure was to investment grade counterparties or noninvestment grade counterparties whose exposure was mitigated through collateral posted to Avista Energy. Of the remaining unmitigated exposure to non-investment grade counterparties, approximately 81 percent represents settlements that were made within thirty days after December 31, 2005.

Economic and Load Growth

Avista Utilities, along with others in the service area, encourages regional economic development, including expanding existing businesses and attracting new businesses to the Inland Northwest region. Agriculture, mining and lumber were the primary industries for many years; today health care, education, finance, electronic and other manufacturing, tourism and the service sectors are growing in importance in Avista Utilities' service area. Avista Utilities anticipates moderate economic growth to continue throughout its service area.

Based on Avista Utilities' forecast for electric customer growth of 2.5 percent and natural gas customer growth of 4 percent within its service area, Avista Utilities anticipates retail electric and natural gas load growth will average between 3 and 3.5 percent annually for the next four years. While the number of electric customers is expected to increase, the average annual usage by each residential electric customer is not expected to change significantly. The natural gas load growth is expected through conversions to natural gas from competing space and water heating energy sources, and population increases and business growth in Avista Utilities' service territories. Natural gas loads for space heating vary significantly with annual fluctuations in weather within Avista Utilities' service territories.

The forward-looking projections set forth above regarding retail sales growth are based, in part, upon purchased economic forecasts and publicly available population and demographic studies. The expectations regarding retail sales growth are also based upon various assumptions, including, without limitation, assumptions relating to weather and economic and competitive conditions, internal analysis of company-specific data, such as energy consumption patterns and internal business plans, and an assumption that Avista Utilities will incur no material loss of retail customers due to self-generation or retail wheeling. Changes in actual experience can vary significantly from forward-looking projections.

Succession Planning

Maintaining the Company's culture, mission, and long-term strategy by having a strong succession planning and management development process is one of the key strategic initiatives at Avista Corp. The Company's executive officer team continues to work towards ensuring that an effective succession planning process is in place for the best interests of the Company's future. The Company has implemented bench strength analysis in its management group as well as in key technical and craft areas. The focus is on organizational leadership capability as well as technical proficiency in complex jobs. The Company has implemented development plans for its future successors that identify areas of strengths and weaknesses. Development plans provide action steps that provide new opportunities to work towards ensuring that successor candidates have the needed experience for running the Company. The Company believes that its succession planning process is providing the right structure to assure that the Company has the ability to fill vacancies with personnel having adequate training and experience.

Environmental Issues and Other Contingencies

Long-term global climate changes, particularly with respect to the Pacific Northwest, could have a significant effect on the Company's business. Changing temperatures and precipitation, including snowpack conditions, affect the availability and timing of hydroelectric generation capacity. Changing temperatures could also increase or decrease customer demand. The Company's operations could also be affected by any legislative or regulatory developments in response to global climate changes, including restrictions on the operation of its power generation resources.

The Company continues to monitor legislative developments at both the state and national level with respect to environmental issues, particularly those related to the potential for further restrictions on the operation of its generating plants. Compliance with such legislation could result in increases in capital expenditures and operating expenses. For other environmental issues and other contingencies see "Note 26 of the Notes to Consolidated Financial Statements."

Quantitative and Qualitative Disclosures About Market Risk

See "Management's Discussion and Analysis of Financial Condition and Results of Operations: – Business Risk and – Risk Management," "Management's Discussion and Analysis of Financial Condition and Results of Operations – Energy Marketing and Resource Management – Energy trading activities and positions," "Note 7 of the Notes to Consolidated Financial Statements" and "Note 22 of the Notes to Consolidated Financial Statements."

CONSOLIDATED STATEMENTS OF INCOME

Avista Corporation

For the Years Ended December 31

Dollars in thousands, except per share amounts

| | 2005 | 2004 | 2003 |
|--|------------------|------------------|------------------|
| Operating Revenues: | | | |
| Utility revenues..... | \$1,161,317 | \$972,574 | \$928,211 |
| Non-utility energy marketing and trading revenues..... | 148,010 | 138,435 | 161,754 |
| Other non-utility revenues..... | 50,280 | 40,571 | 33,420 |
| Total operating revenues..... | <u>1,359,607</u> | <u>1,151,580</u> | <u>1,123,385</u> |
| Operating Expenses: | | | |
| Utility operating expenses: | | | |
| Resource costs..... | 669,596 | 519,002 | 483,097 |
| Other operating expenses..... | 181,478 | 180,418 | 165,478 |
| Depreciation and amortization..... | 80,914 | 72,787 | 72,068 |
| Taxes other than income taxes..... | 68,044 | 66,294 | 60,791 |
| Non-utility operating expenses: | | | |
| Resource costs..... | 145,994 | 99,593 | 101,565 |
| Other operating expenses..... | 59,653 | 67,378 | 62,940 |
| Depreciation and amortization..... | 5,997 | 5,638 | 5,743 |
| Total operating expenses..... | <u>1,211,676</u> | <u>1,011,110</u> | <u>951,682</u> |
| Gain on sale of utility properties..... | 4,093 | - | - |
| Income from operations..... | <u>152,024</u> | <u>140,470</u> | <u>171,703</u> |
| Other Income (Expense): | | | |
| Interest expense..... | (86,512) | (87,265) | (91,505) |
| Interest expense to affiliated trusts..... | (6,202) | (5,782) | (1,480) |
| Capitalized interest..... | 1,689 | 1,393 | 1,092 |
| Other income - net..... | 10,030 | 8,390 | 6,173 |
| Total other income (expense)-net..... | <u>(80,995)</u> | <u>(83,264)</u> | <u>(85,720)</u> |
| Income from continuing operations before income taxes..... | 71,029 | 57,206 | 85,983 |
| Income taxes..... | 25,861 | 21,592 | 35,340 |
| Income from continuing operations..... | <u>45,168</u> | <u>35,614</u> | <u>50,643</u> |
| Loss from discontinued operations, net of taxes of \$(2,985)..... | - | - | (4,949) |
| Net income before cumulative effect of accounting change..... | 45,168 | 35,614 | 45,694 |
| Cumulative effect of accounting change, net of taxes of \$(248) and \$(641)..... | - | (460) | (1,190) |
| Net income..... | 45,168 | 35,154 | 44,504 |
| Preferred stock dividend requirements..... | - | - | (1,125) |
| Income available for common stock..... | <u>\$ 45,168</u> | <u>\$ 35,154</u> | <u>\$ 43,379</u> |
| Weighted-average common shares outstanding (thousands), Basic..... | 48,523 | 48,400 | 48,232 |
| Weighted-average common shares outstanding (thousands), Diluted..... | 48,979 | 48,886 | 48,630 |
| Earnings per common share, basic (Note 24): | | | |
| Earnings from continuing operations..... | \$ 0.93 | \$ 0.74 | \$ 1.03 |
| Loss from discontinued operations..... | - | - | (0.10) |
| Earnings before cumulative effect of accounting change..... | 0.93 | 0.74 | 0.93 |
| Loss from cumulative effect of accounting change..... | - | (0.01) | (0.03) |
| Total earnings per common share, basic..... | <u>\$ 0.93</u> | <u>\$ 0.73</u> | <u>\$ 0.90</u> |
| Earnings per common share, diluted (Note 24): | | | |
| Earnings from continuing operations..... | \$ 0.92 | \$ 0.73 | \$ 1.02 |
| Loss from discontinued operations..... | - | - | (0.10) |
| Earnings before cumulative effect of accounting change..... | 0.92 | 0.73 | 0.92 |
| Loss from cumulative effect of accounting change..... | - | (0.01) | (0.03) |
| Total earnings per common share, diluted..... | <u>\$ 0.92</u> | <u>\$ 0.72</u> | <u>\$ 0.89</u> |
| Dividends paid per common share..... | <u>\$ 0.545</u> | <u>\$ 0.515</u> | <u>\$ 0.490</u> |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Avista Corporation

For the Years Ended December 31

Dollars in thousands

| | 2005 | 2004 | 2003 |
|---|-----------|-----------|-----------|
| Net income..... | \$45,168 | \$35,154 | \$44,504 |
| Other Comprehensive Income (Loss): | | | |
| Foreign currency translation adjustment..... | 268 | 493 | 931 |
| Unrealized gains (losses) on interest rate swap agreements - net of taxes of \$605, \$(1,969) and \$51, respectively..... | 1,123 | (3,656) | 94 |
| Reclassification adjustment for realized gains on interest rate swap agreements deferred as a regulatory liability - net of taxes of \$(1,556)..... | (2,889) | - | - |
| Unfunded accumulated benefit obligation - net of taxes of \$(1,444), \$(4,086) and \$5,097, respectively..... | (2,681) | (7,589) | 9,466 |
| Unrealized gains (losses) on derivative commodity instruments - net of taxes of \$1,693, \$(681) and \$1,245, respectively..... | 3,145 | (1,264) | 2,313 |
| Reclassification adjustment for realized gains on derivative commodity instruments included in net income - net of taxes of \$(898), \$(257) and \$(258), respectively..... | (1,668) | (477) | (480) |
| Unrealized investment losses - net of taxes of \$(34)..... | (64) | - | - |
| Total other comprehensive income (loss)..... | (2,766) | (12,493) | 12,324 |
| Comprehensive income..... | \$ 42,402 | \$ 22,661 | \$ 56,828 |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED BALANCE SHEETS

Avista Corporation

As of December 31

Dollars in thousands

| | 2005 | 2004 |
|---|--------------------|--------------------|
| Assets: | | |
| Current Assets: | | |
| Cash and cash equivalents..... | \$25,917 | \$88,317 |
| Restricted cash..... | 25,634 | 26,175 |
| Accounts and notes receivable-less allowances of \$44,634 and \$44,193, respectively..... | 502,947 | 313,899 |
| Energy commodity derivative assets..... | 918,609 | 284,231 |
| Utility energy commodity derivative assets..... | 69,494 | 12,557 |
| Deposits with counterparties..... | 59,354 | 30,667 |
| Materials and supplies, fuel stock and natural gas stored..... | 54,123 | 43,404 |
| Deferred income taxes..... | 14,519 | 12,288 |
| Assets held for sale..... | 11,850 | 28,479 |
| Other current assets..... | 87,921 | 68,123 |
| Total current assets..... | <u>1,770,368</u> | <u>908,140</u> |
| Net Utility Property: | | |
| Utility plant in service..... | 2,847,043 | 2,666,445 |
| Construction work in progress..... | 64,291 | 51,260 |
| Total..... | <u>2,911,334</u> | <u>2,717,705</u> |
| Less: Accumulated depreciation and amortization..... | 784,917 | 761,642 |
| Total net utility property..... | <u>2,126,417</u> | <u>1,956,063</u> |
| Other Property and Investments: | | |
| Investment in exchange power-net..... | 33,483 | 35,933 |
| Non-utility properties and investments-net..... | 77,731 | 78,564 |
| Non-current energy commodity derivative assets..... | 511,280 | 254,657 |
| Investment in affiliated trusts..... | 13,403 | 13,403 |
| Other property and investments-net..... | 15,058 | 19,721 |
| Total other property and investments..... | <u>650,955</u> | <u>402,278</u> |
| Deferred Charges: | | |
| Regulatory assets for deferred income tax..... | 114,109 | 123,159 |
| Other regulatory assets..... | 26,660 | 43,428 |
| Non-current utility energy commodity derivative assets..... | 46,731 | 55,825 |
| Power and natural gas deferrals..... | 147,622 | 148,206 |
| Unamortized debt expense..... | 48,522 | 53,413 |
| Other deferred charges..... | 17,110 | 21,109 |
| Total deferred charges..... | <u>400,754</u> | <u>445,140</u> |
| Total assets..... | <u>\$4,948,494</u> | <u>\$3,711,621</u> |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED BALANCE SHEETS (continued)

Avista Corporation

As of December 31

Dollars in thousands

| | <u>2005</u> | <u>2004</u> |
|--|--------------------|--------------------|
| Liabilities and Stockholders' Equity: | | |
| Current Liabilities: | | |
| Accounts payable..... | \$511,427 | \$325,194 |
| Energy commodity derivative liabilities..... | 906,794 | 253,527 |
| Deposits from counterparties..... | 13,724 | 6,015 |
| Current portion of long-term debt..... | 39,524 | 85,432 |
| Current portion of preferred stock-cumulative (17,500 shares outstanding)..... | 1,750 | 1,750 |
| Short-term borrowings..... | 63,494 | 68,517 |
| Interest accrued..... | 18,643 | 18,632 |
| Regulatory liability for utility derivatives..... | 66,047 | 4,486 |
| Other current liabilities..... | 108,485 | 118,285 |
| Total current liabilities..... | <u>1,729,888</u> | <u>881,838</u> |
| Long-term debt..... | <u>989,990</u> | <u>901,556</u> |
| Long-term debt to affiliated trusts..... | <u>113,403</u> | <u>113,403</u> |
| Preferred Stock-Cumulative (subject to mandatory redemption): | | |
| 10,000,000 shares authorized: \$6.95 Series K | | |
| 262,500 and 280,000 shares outstanding (\$100 stated value)..... | <u>26,250</u> | <u>28,000</u> |
| Other Non-Current Liabilities and Deferred Credits: | | |
| Non-current energy commodity derivative liabilities..... | 488,644 | 215,055 |
| Regulatory liability for utility plant retirement costs..... | 186,635 | 175,575 |
| Non-current utility energy commodity derivative liabilities..... | 88 | 33,490 |
| Non-current regulatory liability for utility derivatives..... | 46,643 | 22,335 |
| Deferred income taxes..... | 488,934 | 488,471 |
| Other non-current liabilities and deferred credits..... | 106,891 | 98,693 |
| Total other non-current liabilities and deferred credits..... | <u>1,317,835</u> | <u>1,033,619</u> |
| Total liabilities..... | <u>4,177,366</u> | <u>2,958,416</u> |
| Commitments and Contingencies (See Notes to Consolidated Financial Statements) | | |
| Stockholders' Equity: | | |
| Common stock, no par value; 200,000,000 shares authorized; | | |
| 48,593,139 and 48,471,511 shares outstanding..... | 631,084 | 629,056 |
| Note receivable from employee stock ownership plan..... | - | (495) |
| Capital stock expense and other paid in capital..... | (10,486) | (10,677) |
| Accumulated other comprehensive loss..... | (23,299) | (20,533) |
| Retained earnings..... | 173,829 | 155,854 |
| Total stockholders' equity..... | <u>771,128</u> | <u>753,205</u> |
| Total liabilities and stockholders' equity..... | <u>\$4,948,494</u> | <u>\$3,711,621</u> |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Increase (Decrease) in Cash and Cash Equivalents

Avista Corporation

For the Years Ended December 31

Dollars in thousands

| | 2005 | 2004 | 2003 |
|---|-----------|-----------|-----------|
| Continuing Operating Activities: | | | |
| Net income..... | \$ 45,168 | \$ 35,154 | \$ 44,504 |
| Loss from discontinued operations..... | - | - | 4,949 |
| Cumulative effect of accounting change..... | - | 460 | 1,190 |
| Purchases of securities held for trading..... | - | (15,260) | (18,865) |
| Sales of securities held for trading..... | - | 34,192 | - |
| Non-cash items included in net income: | | | |
| Depreciation and amortization..... | 86,911 | 78,425 | 77,811 |
| Provision for deferred income taxes..... | 8,865 | 19,168 | 28,395 |
| Power and natural gas cost amortizations, net of deferrals..... | 9,630 | 11,087 | 3,829 |
| Amortization of debt expense..... | 7,762 | 8,301 | 7,972 |
| Write-offs and impairments of assets..... | 1,001 | 21,990 | 4,900 |
| Energy commodity assets and liabilities..... | 38,126 | 678 | 22,128 |
| Gain on sale of utility properties..... | (4,093) | - | - |
| Other..... | (7,367) | 3,770 | (11,214) |
| Changes in working capital components: | | | |
| Sale of customer accounts receivable under revolving agreement-net..... | 13,000 | - | 7,000 |
| Accounts and notes receivable..... | (203,363) | (6,904) | (4,485) |
| Materials and supplies, fuel stock and natural gas stored..... | (10,642) | (4,023) | (682) |
| Deposits with counterparties..... | (28,687) | 6,181 | (1,175) |
| Other current assets..... | (19,801) | (16,283) | (14,076) |
| Accounts payable..... | 189,115 | 26,909 | (41,352) |
| Deposits from counterparties..... | 7,709 | (91,796) | 5,137 |
| Other current liabilities..... | (4,789) | 5,996 | 10,087 |
| Net cash provided by continuing operating activities..... | 128,545 | 118,045 | 126,053 |
| Continuing Investing Activities: | | | |
| Utility property capital expenditures (excluding AFUDC)..... | (213,652) | (115,346) | (102,271) |
| Other capital expenditures..... | (4,044) | (3,126) | (3,388) |
| Deposit for utility property acquisition..... | - | (5,000) | - |
| Decrease (increase) in restricted cash..... | 541 | (9,703) | (3,489) |
| Changes in other property and investments..... | 2,033 | 517 | (5,953) |
| Repayments received on notes receivable..... | 318 | 1,062 | 1,214 |
| Proceeds from property sales..... | 17,211 | 2,466 | 549 |
| Net cash used in continuing investing activities..... | (197,593) | (129,130) | (113,338) |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

Increase (Decrease) in Cash and Cash Equivalents

Avista Corporation

For the Years Ended December 31

Dollars in thousands

| | 2005 | 2004 | 2003 |
|--|------------------|------------------|-------------------|
| Continuing Financing Activities: | | | |
| Increase (decrease) in short-term borrowings..... | \$(5,023) | \$(12,008) | \$ 50,525 |
| Proceeds from issuance of long-term debt..... | 149,633 | 89,761 | 44,795 |
| Redemption and maturity of long-term debt..... | (111,613) | (66,857) | (124,859) |
| Proceeds from issuance of long-term debt to affiliated trusts..... | - | 61,856 | - |
| Redemption of long-term debt to affiliated trusts..... | - | (61,856) | - |
| Premiums paid for the redemption of long-term debt..... | (826) | (6,710) | (1,709) |
| Long-term debt and short-term borrowing issuance costs..... | (2,153) | (6,149) | (2,430) |
| Cash received in interest rate swap agreement..... | 4,445 | 125 | - |
| Redemption of preferred stock..... | (1,750) | (1,750) | (1,575) |
| Distribution to minority interests..... | (1,688) | - | - |
| Issuance of common stock..... | 2,066 | 4,061 | 5,497 |
| Repurchase of subsidiary preferred stock..... | - | (4,285) | - |
| Cash dividends paid..... | (26,443) | (24,912) | (24,777) |
| Net cash provided by (used in) continuing financing activities..... | <u>6,648</u> | <u>(28,724)</u> | <u>(54,533)</u> |
| Net cash used in continuing operations..... | (62,400) | (39,809) | (41,818) |
| Net cash used in discontinued operations (includes investing activities of \$(261))..... | - | - | (3,342) |
| Net decrease in cash and cash equivalents..... | (62,400) | (39,809) | (45,160) |
| Cash and cash equivalents at beginning of period..... | <u>88,317</u> | <u>128,126</u> | <u>173,286</u> |
| Cash and cash equivalents at end of period..... | <u>\$ 25,917</u> | <u>\$ 88,317</u> | <u>\$ 128,126</u> |
| Supplemental Cash Flow Information: | | | |
| Cash paid during the period: | | | |
| Interest..... | \$ 85,569 | \$ 84,220 | \$ 86,755 |
| Income taxes..... | 26,405 | 11,321 | 11,476 |
| Non-cash financing and investing activities: | | | |
| Property and equipment purchased under capital leases..... | - | 1,365 | 5,312 |
| Unrealized gain (loss) on interest rate swap agreements..... | 1,728 | (5,625) | 145 |
| Intangible asset related to pension plan..... | (654) | (654) | (654) |
| Unfunded accumulated benefit obligation..... | (3,471) | (11,022) | 15,198 |
| Unrealized gain (loss) on derivative commodity instruments..... | 2,272 | (2,677) | 2,819 |
| Unrealized investment losses..... | (98) | - | - |

The Accompanying Notes are an Integral Part of These Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Avista Corporation

For the Years Ended December 31

Dollars in thousands

| | Preferred Stock | | Common Stock | | Note Receivable from Employee Stock Ownership Plan | Capital Stock Expense and Other Paid-in Capital | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
|--|--------------------|----------|--------------|-----------|--|--|--|----------------------|------------|
| | Series K Shares | Amount | Shares | Amount | | | | | |
| Balance as of December 31, 2002 | 332,500 | \$33,250 | 48,044,208 | \$623,092 | (4,146) | \$ (11,928) | \$ (20,364) | \$ 126,137 | \$ 746,041 |
| Net income | | | | | | | | 44,504 | 44,504 |
| Equity compensation plan transactions | | | | | | | | (145) | (73) |
| Employee Investment Plan (401-K) | | | 130,603 | (147) | | 219 | | | 1,462 |
| Dividend Reinvestment Plan | | | 169,198 | 2,381 | | | | | 2,381 |
| Redemption of preferred stock | (17,500) | (1,750) | | | | 175 | | | (1,575) |
| Repayments of note receivable | | | | | 1,722 | | | | 1,722 |
| Other comprehensive income | | | | | | | 12,324 | | 12,324 |
| Cash dividends paid (common stock) | | | | | | | | (23,634) | (23,634) |
| Cash dividends paid (preferred stock) | | | | | | | | (1,125) | (1,125) |
| ESOP dividend tax savings | | | | | | | | 141 | 141 |
| Cumulative effect of accounting change | (315,000) | (31,500) | | | | 584 | | | (30,916) |
| Balance as of December 31, 2003 | - | - | 48,344,009 | \$626,788 | (2,424) | \$ (10,950) | \$ (8,040) | \$ 145,878 | \$ 751,252 |
| Net income | | | | | | | | 35,154 | 35,154 |
| Equity compensation plan transactions | | | | | | | | (409) | (147) |
| Dividend Reinvestment Plan | | | 127,502 | (11) | | 273 | | | 2,279 |
| Repayments of note receivable | | | | | 1,929 | | | | 1,929 |
| Other comprehensive loss | | | | | | | (12,493) | | (12,493) |
| Cash dividends paid (common stock) | | | | | | | | (24,912) | (24,912) |
| ESOP dividend tax savings | | | | | | | | 143 | 143 |
| Balance as of December 31, 2004 | - | - | 48,471,511 | \$629,056 | (495) | \$ (10,677) | \$ (20,533) | \$ 155,854 | \$ 753,205 |
| Net income | | | | | | | | 45,168 | 45,168 |
| Equity compensation plan transactions | | | | | | | | (788) | (793) |
| Dividend Reinvestment Plan | | | 121,628 | (196) | | 191 | | | 2,224 |
| Repayments of note receivable | | | | | 495 | | | | 495 |
| Other comprehensive loss | | | | | | | (2,766) | | (2,766) |
| Cash dividends paid (common stock) | | | | | | | | (26,443) | (26,443) |
| ESOP dividend tax savings | | | | | | | | 38 | 38 |
| Balance as of December 31, 2005 | - | - | 48,593,139 | \$631,084 | \$ - | \$ (10,486) | \$ (23,299) | \$ 173,829 | \$ 771,128 |

The Accompanying Notes are an Integral Part of These Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Avista Corporation (Avista Corp. or the Company) is an energy company engaged in the generation, transmission and distribution of energy as well as other energy-related businesses. Avista Utilities is an operating division of Avista Corp., comprising the regulated utility operations. Avista Utilities generates, transmits and distributes electricity in parts of eastern Washington and northern Idaho. In addition, Avista Utilities has electric generating facilities in western Montana and northern Oregon. Avista Utilities also provides natural gas distribution service in parts of eastern Washington and northern Idaho, as well as parts of northeast and southwest Oregon. In April 2005, the Company completed the sale of its South Lake Tahoe, California natural gas distribution properties (see Note 28 for further information). This was the Company's only regulated utility operation in California. Avista Capital, a wholly owned subsidiary of Avista Corp., is the parent company of all of the subsidiary companies in the non-utility business segments. See Note 29 for business segment information.

The Company's operations are exposed to risks including, but not limited to, the price and supply of purchased power, fuel and natural gas, regulatory recovery of power and natural gas costs and capital investments, streamflow and weather conditions, the effects of changes in legislative and governmental regulations, changes in regulatory requirements, availability of generation facilities, competition, technology and availability of funding. Also, like other utilities, the Company's facilities and operations may be exposed to terrorism risks or other malicious acts. In addition, the energy business exposes the Company to the financial, liquidity, credit and price risks associated with wholesale purchases and sales of energy commodities.

Basis of Reporting

The consolidated financial statements include the assets, liabilities, revenues and expenses of the Company and its subsidiaries, including variable interest entities for which the Company or its subsidiaries are the primary beneficiaries. All significant intercompany balances have been eliminated in consolidation. The accompanying financial statements include the Company's proportionate share of utility plant and related operations resulting from its interests in jointly owned plants (see Note 9).

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. Significant estimates include determining the market value of energy commodity assets and liabilities, pension and other postretirement benefit plan obligations, contingent liabilities, recoverability of regulatory assets and unbilled revenues. Changes in these estimates and assumptions are considered reasonably possible and may have a material effect on the consolidated financial statements and thus actual results could differ from the amounts reported and disclosed herein.

System of Accounts

The accounting records of the Company's utility operations are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the appropriate state regulatory commissions.

Regulation

The Company is subject to state regulation in Washington, Idaho, Montana and Oregon. The Company is also subject to federal regulation by the FERC.

Utility Revenues

Utility revenues related to the sale of energy are generally recorded when service is rendered or energy is delivered to customers. The determination of the energy sales to individual customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each calendar month, the amount of energy delivered to customers since the date of the last meter reading is estimated and the corresponding unbilled revenue is estimated and recorded. Accounts receivable includes unbilled energy revenues of \$13.1 million (net of \$57.1 million of unbilled receivables sold) and \$13.0 million (net of \$48.9 million of unbilled receivables sold) as of December 31, 2005 and 2004, respectively. See Note 5 for information with respect to the sale of accounts receivable. Revenues and resource costs from Avista Utilities' settled energy contracts that are "booked out" (not physically delivered) are reported on a net basis as part of utility revenues.

Non-Utility Energy Marketing and Trading Revenues

Avista Energy follows Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, with respect to the majority of its contracts. Avista Energy reports the net margin on derivative commodity instruments held for trading as non-utility energy marketing and trading revenues. Revenues from contracts that are not derivatives under SFAS No. 133, as well as derivative commodity instruments not held for trading, are reported on a gross basis in non-utility energy marketing and trading revenues. Revenues from Canadian contracts through Avista Energy Canada, which are not held for trading, and are reported on a gross basis in non-utility energy marketing and trading revenues, totaled \$144.6 million, \$116.0 million and \$107.1 million in 2005, 2004 and 2003, respectively. During 2003, Avista Energy recorded as a cumulative effect of accounting change a charge of \$1.2 million (net of tax) related to Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which effectively required the transition of accounting for energy trading activities from EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" to SFAS No. 133.

Other Non-Utility Revenues

Avista Advantage's service revenues are recognized in the period services are rendered. Setup fees are deferred and recognized over the term of the related customer contracts. Interest earnings on funds held for customers are an integral part of Avista Advantage's product offerings and are recognized in revenues as earned.

Revenues in the other business segment are generally derived from the operations of Advanced Manufacturing and Development and are recognized when products are shipped to customers.

Advertising Expenses

The Company expenses advertising costs as incurred. Advertising expenses were not a material portion of the Company's operating expenses in 2005, 2004 and 2003.

Taxes other than income taxes

Taxes other than income taxes include state excise taxes, city occupational and franchise taxes, real and personal property taxes and certain other taxes not based on net income. These taxes are generally based on revenues or the value of property. Utility related taxes collected from customers (primarily state excise taxes and city utility taxes) are recorded as both operating revenue and expense and totaled \$43.1 million, \$35.0 million and \$31.7 million in 2005, 2004 and 2003, respectively.

Other Income-Net

Other income-net consisted of the following items for the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|--|-----------------|----------------|----------------|
| Interest income | \$5,974 | \$4,313 | \$4,810 |
| Interest on power and natural gas deferrals | 7,429 | 7,855 | 8,361 |
| Net gain (loss) on the disposition of non-operating assets.. | 318 | 785 | (334) |
| Net gain (loss) on investments | 156 | 434 | (1,207) |
| Premium on repurchase of subsidiary preferred stock | - | (892) | - |
| Other expense | (6,228) | (6,854) | (7,063) |
| Other income | <u>2,381</u> | <u>2,749</u> | <u>1,606</u> |
| Total | <u>\$10,030</u> | <u>\$8,390</u> | <u>\$6,173</u> |

Income Taxes

The Company and its eligible subsidiaries file consolidated federal income tax returns. Subsidiaries are charged or credited with the tax effects of their operations on a stand-alone basis. The Company's federal income tax returns were examined with all issues resolved, and all payments made, through the 2000 return. The Internal Revenue Service is currently examining the Company's 2001, 2002 and 2003 federal income tax returns.

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, a deferred tax asset or liability is determined based on the enacted tax rates that will be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's consolidated income tax returns. The deferred tax expense for the period

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is equal to the net change in the deferred tax asset and liability accounts from the beginning to the end of the period. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax liabilities and regulatory assets have been established for tax benefits flowed through to customers as prescribed by the respective regulatory commissions.

Stock-Based Compensation

Prior to January 1, 2006, the Company followed the disclosure only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Accordingly, employee stock options were accounted for under Accounting Principle Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees." Stock options are granted at exercise prices not less than the fair value of common stock on the date of grant. Under APB No. 25, no compensation expense was recognized pursuant to the Company's stock option plans. However, the Company recognized compensation expense related to the initial grant (2003) of performance-based share awards. See Note 2 with respect to the revision of SFAS No. 123, which will result in changes to stock compensation recognition beginning in 2006.

If compensation expense for the Company's stock-based employee compensation plans were determined consistent with SFAS No. 123, net income and earnings per common share would have been the following pro forma amounts for the years ended December 31:

| | 2005 | 2004 | 2003 |
|--|-----------------|-----------------|-----------------|
| Net income (dollars in thousands): | | | |
| As reported | \$45,168 | \$35,154 | \$44,504 |
| Add: Total stock-based employee compensation expense included in net income, net of tax..... | 2,211 | - | - |
| Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of tax..... | <u>(2,911)</u> | <u>(2,033)</u> | <u>(2,186)</u> |
| Pro forma | <u>\$44,468</u> | <u>\$33,121</u> | <u>\$42,318</u> |
| Basic and diluted earnings per common share: | | | |
| Basic as reported | \$0.93 | \$0.73 | \$0.90 |
| Diluted as reported | \$0.92 | \$0.72 | \$0.89 |
| Basic pro forma | \$0.92 | \$0.68 | \$0.85 |
| Diluted pro forma | \$0.91 | \$0.68 | \$0.85 |

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss), net of tax, consisted of the following as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|---|-------------------|-------------------|
| Foreign currency translation adjustment..... | \$ 1,407 | \$ 1,139 |
| Unfunded accumulated benefit obligation for the pension plan..... | (19,625) | (16,944) |
| Unrealized loss on interest rate swap agreements..... | (6,586) | (4,820) |
| Unrealized loss on securities available for sale | (64) | - |
| Unrealized gain on derivative commodity instruments..... | <u>1,569</u> | <u>92</u> |
| Total accumulated other comprehensive loss | <u>\$(23,299)</u> | <u>\$(20,533)</u> |

Foreign Currency Translation Adjustment

The assets and liabilities of Avista Energy Canada, Ltd. and its subsidiary, CoPac Management, Inc., are denominated in Canadian dollars and translated to United States dollars at exchange rates in effect on the balance sheet date. Revenues and expenses are translated using an average exchange rate. Translation adjustments resulting from this process are reflected as a component of other comprehensive income (loss) in the Consolidated Statements of Comprehensive Income.

Earnings Per Common Share

Basic earnings per common share is computed by dividing income available for common stock by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing income available for common stock by diluted weighted average common shares outstanding during the period, including common stock equivalent shares outstanding using the treasury stock method, unless such shares are anti-dilutive. Common stock equivalent shares include shares issuable upon exercise of stock options and contingent stock awards. See Note 24 for earnings per common share calculations.

Cash and Cash Equivalents

For the purposes of the Consolidated Statements of Cash Flows, the Company considers all temporary investments with a maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents include cash deposits from counterparties. See Note 8 for further information with respect to cash deposits from counterparties.

Restricted Cash

Restricted cash includes bank deposits of \$18.2 million and \$21.5 million as collateral for letters of credit issued under Avista Energy's credit agreement as of December 31, 2005 and 2004, respectively. See Note 17 for further information with respect to Avista Energy's credit agreement. Restricted cash also includes deposits held in trust of \$1.1 million and \$1.6 million for certain employees of Avista Energy as part of a bonus retention plan as of December 31, 2005 and 2004, respectively. Restricted cash as of December 31, 2005 and 2004 includes \$2.5 million of deposits related to forward contracts at Avista Energy. In addition, restricted cash includes \$3.8 million and \$0.6 million of deposits related to Avista Corp.'s interest rate swap agreements as of December 31, 2005 and 2004, respectively. See Note 18 for further information with respect to Avista Corp.'s interest rate swap agreements.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts to provide for estimated and potential losses on accounts receivable. The Company determines the allowance for utility and other customer accounts receivable based on historical write-offs as compared to accounts receivable and operating revenues. Additionally, the Company establishes specific allowances for certain individual accounts. The following table documents the activity in the allowance for doubtful accounts during the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|--|-----------------|-----------------|-----------------|
| Allowance as of the beginning of the year..... | \$44,193 | \$46,382 | \$46,909 |
| Additions expensed during the year..... | 2,867 | 3,367 | 1,912 |
| Net deductions..... | <u>(2,426)</u> | <u>(5,556)</u> | <u>(2,439)</u> |
| Allowance as of the end of the year..... | <u>\$44,634</u> | <u>\$44,193</u> | <u>\$46,382</u> |

Materials and supplies, fuel stock and natural gas stored

Inventories of materials and supplies, fuel stock and natural gas stored are recorded at the lower of cost or market, primarily using the average cost method and consisted of the following as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|-----------------------------|-----------------|-----------------|
| Materials and supplies..... | \$14,253 | \$12,409 |
| Fuel stock..... | 3,773 | 4,050 |
| Natural gas stored..... | <u>36,097</u> | <u>26,945</u> |
| Total..... | <u>\$54,123</u> | <u>\$43,404</u> |

Assets Held for Sale

Assets held for sale are recorded at the lower of cost or estimated fair value less selling costs. As of December 31, 2005 assets held for sale included \$11.9 million of turbines and related equipment. See Note 4 for the sale of a turbine and related equipment in January 2006. As of December 31, 2004 assets held for sale included \$15.2 million of assets related to Avista Utilities' South Lake Tahoe natural gas properties and \$13.3 million of turbines and related equipment. Liabilities held for sale were not significant as of December 31, 2005 and 2004.

Utility Plant in Service

The cost of additions to utility plant in service, including an allowance for funds used during construction and replacements of units of property and improvements, is capitalized. Costs of depreciable units of property retired plus costs of removal less salvage are charged to accumulated depreciation.

Allowance for Funds Used During Construction

The Allowance for Funds Used During Construction (AFUDC) represents the cost of both the debt and equity funds used to finance utility plant additions during the construction period. In accordance with the uniform system of accounts prescribed by regulatory authorities, AFUDC is capitalized as a part of the cost of utility plant and the debt related portion is credited currently as a non-cash item in the Consolidated Statements of Income in the line item capitalized interest. The Company generally is permitted, under established regulatory rate practices, to recover the capitalized AFUDC, and a fair return thereon, through its inclusion in rate base and the provision for depreciation

after the related utility plant is placed in service. Cash inflow related to AFUDC generally does not occur until the related utility plant is placed in service and included in rate base.

The effective AFUDC rate was 9.72 percent for 2005, 2004 and 2003. The Company's AFUDC rates do not exceed the maximum allowable rates as determined in accordance with the requirements of regulatory authorities.

Depreciation

For utility operations, depreciation expense is estimated by a method of depreciation accounting utilizing unit rates for generation plants and composite rates for other utility plant. Such rates are designed to provide for retirements of properties at the expiration of their service lives. The rates for hydroelectric plants include annuity and interest components, in which the interest component is 9 percent. For utility operations, the ratio of depreciation provisions to average depreciable property was 2.93 percent in 2005, 2.92 percent in 2004 and 2.98 percent in 2003.

The average service lives for the following broad categories of utility property are: electric thermal production - 29 years; hydroelectric production - 77 years; electric transmission - 43 years; electric distribution - 47 years; and natural gas distribution property - 36 years.

The Company recovers certain asset retirement costs through rates charged to customers as a portion of its depreciation expense for which the Company has not recorded asset retirement obligations (see Note 11). The Company had estimated retirement costs of \$186.6 million and \$175.6 million included as a regulatory liability on the Consolidated Balance Sheets as of December 31, 2005 and 2004, respectively. These costs do not represent legal or contractual obligations.

Goodwill

Goodwill arising from acquisitions represents the excess of the purchase price over the estimated fair value of net assets acquired. The Company evaluates goodwill for impairment using a discounted cash flow model on at least an annual basis or more frequently if impairment indicators arise. Goodwill is included in non-utility properties and investments-net on the Consolidated Balance Sheets and totaled \$6.2 million (\$5.2 million in the Other business segment and \$1.0 million in Energy Marketing and Resource Management) as of December 31, 2005 and December 31, 2004.

During the second quarter of 2005, the Company changed the date of its annual goodwill impairment test to November 30 from March 31. The Company selected the date of November 30 as it is closely aligned with the Company's annual budget and forecasting process. In addition, the new date provides the Company additional time to meet accelerated public reporting requirements. The Company believes the change will not delay, accelerate or avoid an impairment charge. Accordingly, the Company believes that the accounting change described above is to an alternative accounting principle that is preferable under the circumstances. The Company completed its annual evaluation of goodwill for potential impairment as of March 31, 2005 and November 30, 2005 and determined that goodwill was not impaired at either time.

Regulatory Deferred Charges and Credits

The Company prepares its consolidated financial statements in accordance with the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." The Company prepares its financial statements in accordance with SFAS No. 71 because (i) the Company's rates for regulated services are established by or subject to approval by an independent third-party regulator; (ii) the regulated rates are designed to recover the Company's cost of providing the regulated services; and (iii) in view of demand for the regulated services and the level of competition, it is reasonable to assume that rates can be charged to and collected from customers at levels that will recover the Company's costs. SFAS No. 71 requires the Company to reflect the impact of regulatory decisions in its financial statements. SFAS No. 71 requires that certain costs and/or obligations (such as incurred power and natural gas costs not currently recovered through rates, but expected to be recovered in the future) are reflected as deferred charges or credits on the Consolidated Balance Sheets. These costs and/or obligations are not reflected in the statement of income until the period during which matching revenues are recognized. If at some point in the future the Company determines that it no longer meets the criteria for continued application of SFAS No. 71 with respect to all or a portion of the Company's regulated operations, the Company could be required to write off its regulatory assets. The Company could also be precluded from the future deferral of costs not recovered through rates at the time such costs are incurred, even if the Company expected to recover such costs in the future.

The Company's primary regulatory assets include power and natural gas deferrals (see "Power Cost Deferrals and Recovery Mechanisms" and "Natural Gas Cost Deferrals and Recovery Mechanisms" below for further information),

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investment in exchange power, regulatory asset for deferred income taxes, unamortized debt expense, regulatory asset for consolidation of variable interest entity, demand side management programs, conservation programs and the provision for postretirement benefits. Those items without a specific line on the Consolidated Balance Sheets are included in other regulatory assets. Other regulatory assets consisted of the following as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|--|-----------------|-----------------|
| Regulatory asset for consolidation of variable interest entity | \$ - | \$19,167 |
| Regulatory asset for postretirement benefit obligation | 3,309 | 3,782 |
| Demand side management and conservation programs | 12,272 | 13,792 |
| Asset retirement obligations | 2,969 | 114 |
| Other | <u>8,110</u> | <u>6,573</u> |
| Total | <u>\$26,660</u> | <u>\$43,428</u> |

Regulatory liabilities include utility plant retirement costs. Deferred credits include, among other items, regulatory liabilities created when the Centralia Power Plant was sold, regulatory liabilities offsetting net utility energy commodity derivative assets (see Note 6 for further information) and the gain on the general office building sale/leaseback. Those items without a specific line on the Consolidated Balance Sheets are included in other current liabilities and other non-current liabilities and deferred credits.

Regulatory assets that are not currently included in rate base, being recovered in current rates or earning a return (accruing interest), totaled \$5.6 million as of December 31, 2005.

Investment in Exchange Power-Net

The investment in exchange power represents the Company's previous investment in Washington Public Power Supply System Project 3 (WNP-3), a nuclear project that was terminated prior to completion. Under a settlement agreement with the Bonneville Power Administration in 1985, Avista Utilities began receiving power in 1987, for a 32.5-year period, related to its investment in WNP-3. Through a settlement agreement with the Washington Utilities and Transportation Commission (WUTC) in the Washington jurisdiction, Avista Utilities is amortizing the recoverable portion of its investment in WNP-3 (recorded as investment in exchange power) over a 32.5 year period beginning in 1987. For the Idaho jurisdiction, Avista Utilities has fully amortized the recoverable portion of its investment in exchange power.

Unamortized Debt Expense

Unamortized debt expense includes debt issuance costs that are amortized over the life of the related debt, as well as premiums paid to repurchase debt, which are amortized over the average remaining maturity of outstanding debt in accordance with regulatory accounting practices under SFAS No. 71. These costs are recovered through retail rates as a component of interest expense.

Natural Gas Benchmark Mechanism

The Idaho Public Utilities Commission (IPUC), WUTC and Oregon Public Utility Commission (OPUC) approved Avista Utilities' Natural Gas Benchmark Mechanism in 1999. The mechanism eliminated the majority of natural gas procurement operations within Avista Utilities and placed responsibility for natural gas procurement operations with Avista Energy, the Company's non-regulated subsidiary. The ownership of the natural gas assets remained with Avista Utilities; however, the assets were managed by Avista Energy through an Agency Agreement. Avista Utilities always managed natural gas procurement for its California operations, which the Company sold in April 2005 (see Note 28).

Effective April 1, 2005, the Natural Gas Benchmark Mechanism and related Agency Agreement were terminated and the management of natural gas procurement functions was moved from Avista Energy back to Avista Utilities. This was required for Washington customers by WUTC orders issued in February 2004, and Avista Utilities' resulting transition plan approved by the WUTC in April 2004. The Company also elected to move these functions back to Avista Utilities for Idaho and Oregon natural gas customers.

In accordance with SFAS No. 71, profits recognized by Avista Energy on natural gas sales to Avista Utilities, including gains and losses on natural gas contracts, are not eliminated in the consolidated financial statements. This is due to the fact that Avista Utilities expects to recover the costs of natural gas purchases to serve retail customers and for fuel for electric generation through future retail rates.

Power Cost Deferrals and Recovery Mechanisms

Avista Utilities defers the recognition in the income statement of certain power supply costs as approved by the WUTC. Deferred power supply costs are recorded as a deferred charge on the Consolidated Balance Sheets for future review and the opportunity for recovery through retail rates. The power supply costs deferred include certain differences between actual power supply costs incurred by Avista Utilities and the costs included in base retail rates. This difference in power supply costs primarily results from changes in short-term wholesale market prices, changes in the level of hydroelectric generation and changes in the level of thermal generation (including changes in fuel prices). Avista Utilities accrues interest on deferred power costs in the Washington jurisdiction at a rate, which is adjusted semi-annually, of 8.1 percent as of December 31, 2005. Total deferred power costs for Washington customers were \$96.2 million and \$113.2 million as of December 31, 2005 and 2004, respectively.

In Washington, the Energy Recovery Mechanism (ERM) allows Avista Utilities to increase or decrease electric rates periodically with WUTC approval to reflect changes in power supply costs. The ERM provides for Avista Utilities to incur the cost of, or receive the benefit from, the first \$9.0 million in annual power supply costs above or below the amount included in base retail rates. Under the ERM, 90 percent of annual power supply costs exceeding or below the initial \$9.0 million are deferred for future surcharge or rebate to Avista Utilities' customers. The remaining 10 percent of power supply costs are an expense of, or benefit to, the Company.

Under the ERM, Avista Utilities makes an annual filing to provide the opportunity for the WUTC and other interested parties to review the prudence of and audit the ERM deferred power cost transactions for the prior calendar year. The ERM provides for a 90-day review period for the filing; however, the period may be extended by agreement of the parties or by WUTC order. In June 2005, the WUTC issued an order, which approved the recovery of the \$10.8 million of deferred power costs incurred for 2004.

Avista Utilities has a power cost adjustment (PCA) mechanism in Idaho that allows it to modify electric rates periodically with IPUC approval. Under the PCA mechanism, Avista Utilities defers 90 percent of the difference between certain actual net power supply expenses and the authorized level of net power supply expense. Avista Utilities accrues interest on deferred power costs in the Idaho jurisdiction at a rate, which is adjusted annually, of 2.0 percent on current year deferrals and 4.0 percent on carryover balances as of December 31, 2005. Total deferred power costs for Idaho customers were \$8.0 million and \$9.5 million as of December 31, 2005 and 2004, respectively.

Natural Gas Cost Deferrals and Recovery Mechanisms

Under established regulatory practices in each respective state, Avista Utilities is allowed to adjust its natural gas rates periodically (with regulatory approval) to reflect increases or decreases in the cost of natural gas purchased. Differences between actual natural gas costs and the natural gas costs already included in retail rates are deferred and charged or credited to expense when regulators approve inclusion of the cost changes in rates. Total deferred natural gas costs were \$43.4 million and \$28.6 million as of December 31, 2005 and 2004, respectively.

Reclassifications

Certain prior period amounts were reclassified to conform to current statement format. These reclassifications were made for comparative purposes and have not affected previously reported total net income or stockholders' equity. In particular, the net change in restricted cash for 2004 and 2003 was reclassified from operating activities to investing activities in the Consolidated Statements of Cash Flows to conform to the Company's 2005 presentation. This resulted in an increase to operating cash flows and a corresponding decrease to investing cash flows of \$9.7 million and \$3.5 million, respectively, from the amounts previously reported for 2004 and 2003.

NOTE 2. NEW ACCOUNTING STANDARDS

In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This statement requires the Company to classify certain financial instruments as liabilities that were historically classified as equity. This statement requires the Company to classify as a liability financial instruments that are subject to mandatory redemption at a specified or determinable date or upon an event that is certain to occur. This statement was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. The restatement of financial statements for prior periods was not permitted. The adoption of this statement required the Company to classify preferred stock subject to mandatory redemption as a

liability on the Consolidated Balance Sheets. The adoption of this statement also required the Company to classify preferred stock dividends subsequent to July 1, 2003 as interest expense in the Consolidated Statements of Income.

In July 2003, the EITF reached consensus on Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3." This EITF Issue requires that revenues and resource costs from Avista Utilities' settled energy contracts that are "booked out" (not physically delivered) should be reported on a net basis as part of operating revenues effective October 1, 2003. Derivatives not held for trading purposes at Avista Energy are reported gross, unless they are "booked out" or the economic substance indicates that net reporting is appropriate. The adoption of this EITF Issue resulted in a reduction in operating revenues and resource costs of approximately \$26.4 million for 2004 as compared to 2003 for Avista Utilities.

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, "Consolidation of Variable Interest Entities," which was revised in December 2003 (collectively referred to as FIN 46). In general, a variable interest entity does not have equity investors with voting rights or it has equity investors that do not provide sufficient financial resources for the entity to support its activities. Variable interest entities are commonly referred to as special purpose entities or off-balance sheet structures; however, FIN 46 applies to a broader group of entities. FIN 46 requires a variable interest entity to be consolidated by the primary beneficiary of that entity. The primary beneficiary is subject to a majority of the risk of loss from the variable interest entity's activities or it is entitled to receive a majority of the entity's residual returns. FIN 46 also requires disclosure of variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 applied immediately to variable interest entities created after January 31, 2003 and applied to certain existing variable interest entities for the first fiscal year or interim period ending after December 15, 2003. Application for all other types of entities was required for periods ending after March 15, 2004.

The implementation of FIN 46 resulted in the consolidation of WP Funding, Limited Partnership (WP Funding LP) and the deconsolidation of capital trusts in 2003. The implementation of FIN 46, as revised in December 2003, resulted in the Company including a partnership as well as several low-income housing project investments held in the Other business segment in its consolidated financial statements beginning in the first quarter of 2004. This resulted in a charge of \$0.5 million recorded as a cumulative effect of accounting change for 2004.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which supersedes APB No. 25 and SFAS No. 123 and their related implementation guidance. This statement establishes revised standards for the accounting for transactions in which the Company exchanges its equity instruments for goods or services with a primary focus on transactions in which the Company obtains employee services in share-based payment transactions. The statement requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. The provisions of this statement are effective beginning in the first quarter of 2006. The Company expects to record compensation expense (net of tax) of approximately \$0.4 million in 2006 related to the periodic vesting of stock options granted to employees prior to 2005. The Company also expects to record compensation expense (net of tax) of approximately \$1.7 million, \$1.1 million and \$0.5 million in 2006, 2007 and 2008, respectively, for performance share awards granted to employees in 2004, 2005 and the first quarter of 2006.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143" (FIN 47). FIN 47 clarifies that the term "conditional asset retirement obligation" refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the Company. Under FIN 47, the Company is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN 47 also clarifies when the Company would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Company adopted FIN 47 as of December 31, 2005, the effects of which are disclosed in Note 11.

NOTE 3. DISCONTINUED OPERATIONS

Amounts reported as discontinued operations for 2003 represent the operations of Avista Labs. In 2003, private equity investors made investments in a new entity, ReliOn, Inc. (formerly AVL B, Inc.), which acquired the assets previously held by Avista Corp.'s fuel cell manufacturing and development subsidiary, Avista Labs. Avista Corp.'s investment in ReliOn, Inc. is accounted for under the cost method. Revenues for Avista Labs were \$0.7 million in 2003 (through June 30). The total loss from discontinued operations for 2003 was comprised of a loss from operations of \$4.0 million, asset impairment charges of \$3.9 million and an income tax benefit of \$3.0 million.

NOTE 4. IMPAIRMENT OF ASSETS

In January 2006, the Company completed the sale of a turbine and related equipment owned by Avista Power (Energy Marketing and Resource Management segment). In 2005, the Company recorded impairment charges of \$1.0 million for the turbine and related equipment, which is included in other operating expenses in the Consolidated Statements of Income. The turbine and related equipment were classified as assets held for sale as of December 31, 2005.

The Company originally planned to use four turbines in a non-regulated generation project. Due to changing market conditions during 2001, the Company decided to no longer pursue the development of this project and reached an agreement to sell three of the turbines. During 2002, 2003 and the first three quarters of 2004, the Company explored various options for use of the fourth turbine. At the end of the third quarter of 2004, the Company reached a conclusion to sell the turbine and related equipment, and recorded an impairment charge of \$5.1 million, which is included in other operating expenses in the Consolidated Statements of Income.

During the fourth quarter of 2003, the Company recorded an impairment charge for the turbine owned by Avista Power (see discussion above). This charge of \$4.9 million for 2003 is included in other operating expenses in the Consolidated Statements of Income.

NOTE 5. ACCOUNTS RECEIVABLE SALE

Avista Receivables Corporation (ARC) is a wholly owned, bankruptcy-remote subsidiary of Avista Corp. formed for the purpose of acquiring or purchasing interests in certain accounts receivable, both billed and unbilled, of the Company. On March 22, 2005, Avista Corp., ARC and a third-party financial institution amended a Receivables Purchase Agreement. The most significant amendment was to extend the termination date from May 29, 2005 to March 21, 2006. Under the Receivables Purchase Agreement, ARC can sell without recourse, on a revolving basis, up to \$85.0 million of those receivables. ARC is obligated to pay fees that approximate the purchaser's cost of issuing commercial paper equal in value to the interests in receivables sold. On a consolidated basis, the amount of such fees is included in other operating expenses of Avista Corp. As of December 31, 2005 and 2004, \$85.0 million and \$72.0 million in accounts receivables were sold, respectively, under this revolving agreement.

NOTE 6. UTILITY ENERGY COMMODITY DERIVATIVE ASSETS AND LIABILITIES

SFAS No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires the recording of all derivatives as either assets or liabilities on the balance sheet measured at estimated fair value and the recognition of the unrealized gains and losses. In certain defined conditions, a derivative may be specifically designated as a hedge for a particular exposure. The accounting for derivatives depends on the intended use of the derivatives and the resulting designation.

Avista Utilities enters into forward contracts to purchase or sell energy. Under these forward contracts, Avista Utilities commits to purchase or sell a specified amount of energy at a specified time, or during a specified period, in the future. Certain of these forward contracts are considered derivative instruments. Avista Utilities also records derivative commodity assets and liabilities for over-the-counter and exchange-traded derivative instruments as well as certain long-term contracts. These contracts are entered into as part of Avista Utilities' management of its loads and resources as discussed in Note 7. In conjunction with the issuance of SFAS No. 133, the WUTC and the IPUC issued accounting orders authorizing Avista Utilities to offset any derivative assets or liabilities with a regulatory asset or liability. This accounting treatment is intended to defer the recognition of mark-to-market gains and losses on energy commodity transactions until the period of settlement. The orders provide for Avista Utilities to not recognize the unrealized gain or loss on utility derivative commodity instruments in the Consolidated Statements of Income. Realized gains or losses are recognized in the period of settlement, subject to approval for recovery through retail rates. Realized gains and losses, subject to regulatory approval, result in adjustments to retail rates through purchased gas cost adjustments, the ERM and the PCA mechanism.

Prior to the adoption of SFAS No. 149 on July 1, 2003, Avista Utilities elected the normal purchases and sales exception for substantially all of its contracts for both capacity and energy under SFAS No. 133. As such, Avista Utilities was not required to record these contracts as derivative commodity assets and liabilities. Under SFAS No. 149, substantially all new forward contracts to purchase or sell power and natural gas used for generation, which

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were entered into on or after July 1, 2003, are recorded as assets or liabilities at market value with an offsetting regulatory asset or liability. Contracts that are not considered derivatives under SFAS No. 133 are generally accounted for at cost until they are settled or realized, unless there is a decline in the fair value of the contract that is determined to be other than temporary. Utility energy commodity derivatives consisted of the following as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|---|----------|----------|
| Current utility energy commodity derivative asset | \$69,494 | \$12,557 |
| Current utility energy commodity derivative liability | 3,447 | 8,071 |
| Net current regulatory liability | 66,047 | 4,486 |
| Non-current utility energy commodity derivative asset | 46,731 | 55,825 |
| Non-current utility energy commodity derivative liability | 88 | 33,490 |
| Net non-current regulatory liability | 46,643 | 22,335 |

Current utility energy commodity derivative liabilities are included in other current liabilities on the Consolidated Balance Sheets.

NOTE 7. ENERGY COMMODITY TRADING

The Company's energy-related businesses are exposed to risks relating to, but not limited to, changes in certain commodity prices, interest rates, foreign currency and counterparty performance. Avista Utilities utilizes derivative instruments, such as forwards, futures, swaps and options in order to manage the various risks relating to these exposures, and Avista Energy engages in the trading of such instruments. Avista Utilities and Avista Energy use a variety of techniques to manage risks for their energy resources and wholesale energy market activities. The Company has risk management policies and procedures to manage these risks, both qualitative and quantitative, for Avista Utilities and Avista Energy. The Company's Risk Management Committee establishes the Company's risk management policies and procedures and monitors compliance. The Risk Management Committee is comprised of certain Company officers and other individuals and is overseen by the Audit Committee of the Company's Board of Directors.

Avista Utilities

Avista Utilities engages in an ongoing process of resource optimization, which involves the pursuit of economic resources to serve load obligations and using existing resources to capture available economic value. Avista Utilities sells and purchases wholesale electric capacity and energy to and from utilities and other entities as part of the process of acquiring resources to serve its retail and wholesale load obligations. These transactions range from a term as short as one hour up to long-term contracts that extend beyond one year. Avista Utilities makes continuing projections of (1) future retail and wholesale loads based on, among other things, forward estimates of factors such as customer usage and weather as well as historical data and contract terms and (2) resource availability based on, among other things, estimates of streamflows, generating unit availability, historic and forward market information and experience. On the basis of these continuing projections, Avista Utilities makes purchases and sales of energy on an annual, quarterly, monthly, daily and hourly basis to match expected resources to expected energy requirements. Resource optimization also includes transactions such as purchasing fuel to run thermal generation and, when economic, selling fuel and substituting electric wholesale market purchases for the operation of Avista Utilities' own resources, as well as other wholesale transactions to capture the value of available generation and transmission resources. This optimization process includes entering into financial and physical hedging transactions as a means of managing risks.

As part of its resource optimization process described above, Avista Utilities manages the impact of fluctuations in electric energy prices by measuring and controlling the volume of energy imbalance between projected loads and resources and through the use of derivative commodity instruments for hedging purposes. Load/resource imbalances within a rolling 18-month planning horizon are compared against established volumetric guidelines and management determines the timing and specific actions to manage the imbalances. Management also assesses available resource decisions and actions that are appropriate for longer-term planning periods. Avista Energy was responsible for the daily management of natural gas supplies to meet the requirements of Avista Utilities' customers in the states of Washington, Idaho and Oregon. Effective April 1, 2005, the management of natural gas procurement functions was moved from Avista Energy back to Avista Utilities. This was required for Washington customers by WUTC orders issued in February 2004, and Avista Utilities' resulting transition plan approved by the WUTC in April 2004. The Company also elected to move these functions back to Avista Utilities for Idaho and Oregon natural gas customers. The natural gas procurement process includes entering into financial and physical hedging transactions as a means of

managing risks. Avista Utilities always managed natural gas procurement for its California operations, which the Company sold in April 2005 (see Note 28).

Avista Energy

Avista Energy is an electricity and natural gas marketing, trading and resource management business. Avista Energy focuses on 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 is also involved in trading electricity and natural gas, including derivative commodity instruments. Avista Energy purchases natural gas and electricity from producers and energy marketing and trading companies. Its customers include commercial and industrial end-users, electric utilities, natural gas distribution companies, and energy marketing and trading companies.

Avista Energy's marketing and energy risk management services are provided through the use of a variety of derivative commodity contracts to purchase or supply natural gas and electric energy at specified delivery points and at specified future dates. Avista Energy trades natural gas and electricity derivative commodity instruments on national exchanges and through other exchanges and brokers, and therefore can experience net open positions in terms of price, volume, and specified delivery point. The open positions expose Avista Energy to the risk that fluctuating market prices may adversely impact its financial condition or results of operations. However, the net open positions are actively managed with policies designed to limit the exposure to market risk and requiring daily reporting to management of potential financial exposure.

Avista Energy measures the risk in its electric and natural gas portfolio daily utilizing a Value-at-Risk (VAR) model, which monitors its risk in comparison to established thresholds. VAR measures the expected portfolio loss under hypothetical adverse price movements over a given time interval within a given confidence level. Avista Energy also measures its open positions in terms of volumes at each delivery location for each forward time period. The permissible extent of open positions is included in the risk management policy and is measured with stress tests and VAR modeling.

Derivative commodity instruments sold and purchased by Avista Energy include: forward contracts, which involve physical delivery of an energy commodity; futures contracts, which involve the buying or selling of natural gas or electricity at a fixed price; over-the-counter swap agreements, which require Avista Energy to receive or make payments based on the difference between a specified price and the actual price of the underlying commodity; and options, which mitigate price risk by providing for the right, but not the requirement, to buy or sell energy-related commodities at a fixed price. Foreign currency risks are primarily related to Canadian exchange rates and are managed using standard instruments available in the foreign currency markets.

Avista Energy's derivative commodity instruments accounted for under SFAS No. 133 are subject to mark-to-market accounting, under which changes in the market value of outstanding electric, natural gas and related derivative commodity instruments are recognized as unrealized gains or losses in the Consolidated Statements of Income in the period of change. Market prices are utilized in determining the value of electric, natural gas and related derivative commodity instruments, which are reported as assets and liabilities on the Consolidated Balance Sheets. These market prices are used through 36 months. For longer-term positions and certain short-term positions for which market prices are not available, a model to estimate forward price curves is utilized. Avista Energy reports the net margin on derivative commodity instruments held for trading as non-utility energy marketing and trading revenues. Revenues from contracts that are not derivatives under SFAS No. 133, as well as derivative commodity instruments not held for trading, are reported on a gross basis in non-utility energy marketing and trading revenues. Costs from contracts, which are not derivatives under SFAS No. 133 and derivative instruments not held for trading, are reported on a gross basis in non-utility resource costs. Contracts in a receivable position, as well as the options held, are reported as assets. Similarly, contracts in a payable position, as well as options written, are reported as liabilities. Net cash flows are recognized in the period of settlement.

Avista Energy has implemented hedge accounting in accordance with SFAS No. 133. Specific natural gas and electric trading derivative contracts have been designated as hedging instruments in cash flow hedging relationships. The hedge strategies represent cash flow hedges of the variable price risk associated with expected purchases of natural gas and sales of electricity. These designated hedging instruments represent hedges of variable price exposures generated from certain contracts, which do not qualify as derivatives under SFAS No. 133. For all derivatives designated as cash flow hedges, Avista Energy documents the relationship between the hedging instrument and the hedged item (forecasted purchases and sales of power and natural gas), as well as the risk management objective and strategy for using the hedging instrument. Avista Energy assesses whether a change in

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the value of the designated derivative is highly effective in achieving offsetting cash flows attributable to the hedged item, both at the inception of the hedge and on an ongoing basis. Any changes in the fair value of the designated derivative that are effective are recorded in accumulated other comprehensive income or loss, while changes in fair value that are not effective are recognized currently in earnings as operating revenues. Amounts recorded in accumulated other comprehensive income or loss are recognized in earnings during the period that the hedged items are recognized in earnings.

The following table presents activity related to Avista Energy's hedge accounting during the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|--|---------|---------|------|
| Gain related to hedge ineffectiveness recorded | | | |
| in operating revenues | \$8,445 | \$1,020 | \$ - |
| Gain reclassified from accumulated other comprehensive income (loss) and recognized in earnings (pre-tax)..... | 2,566 | 735 | 480 |

Of the \$8.4 million in pre-tax hedge ineffectiveness recorded in operating revenues for 2005, \$4.4 million relates to designated hedges that matured during 2005. The balance of \$4.0 million relates to designated hedging relationships that were outstanding as of December 31, 2005.

The following table presents the net gain (loss), net of tax, related to Avista Energy's cash flow hedges as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|--|-----------------|--------------|
| Accumulated other comprehensive income related to natural gas derivatives..... | \$11,583 | \$1,556 |
| Accumulated other comprehensive loss related to electric derivatives | (10,014) | (1,464) |
| Total accumulated other comprehensive income | <u>\$ 1,569</u> | <u>\$ 92</u> |

Avista Energy expects to recognize a gain of \$0.8 million in earnings during the next 12 months, related to amounts currently in accumulated other comprehensive income. The actual amounts that will be recognized in earnings during the next 12 months will vary from the expected amounts as a result of changes in market prices. The maximum term of the designated hedging instruments was 12 months.

Contract Amounts and Terms Under Avista Energy's derivative instruments, Avista Energy either (i) as "fixed price payor," is obligated to pay a fixed price or a fixed amount and is entitled to receive the commodity or a fixed amount, (ii) as "fixed price receiver," is entitled to receive a fixed price or a fixed amount and is obligated to deliver the commodity or pay a fixed amount, (iii) as "index price payor," is obligated to pay an indexed price or an indexed amount and is entitled to receive the commodity or a variable amount or (iv) as "index price receiver," is entitled to receive an indexed price or amount and is obligated to deliver the commodity or pay a variable amount.

The contract or notional amounts and terms of Avista Energy's derivative commodity instruments outstanding as of December 31, 2005 are set forth below (in thousands of MWhs and mmBTUs):

| | Fixed Price Payor | Fixed Price Receiver | Maximum Terms in Years | Index Price Payor | Index Price Receiver | Maximum Terms in Years |
|------------------------------|-------------------|----------------------|------------------------|-------------------|----------------------|------------------------|
| Energy commodities (volumes) | | | | | | |
| Electric | 30,048 | 32,031 | 12 | 2,645 | 4,202 | 3 |
| Natural gas | 279,147 | 271,286 | 4 | 1,544,629 | 1,551,353 | 2 |

The weighted average term of Avista Energy's electric derivative commodity instruments as of December 31, 2005 was approximately 5 months. The weighted average term of Avista Energy's natural gas derivative commodity instruments as of December 31, 2005 was approximately 4 months.

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Estimated Fair Value The estimated fair value of Avista Energy's derivative commodity instruments outstanding as of December 31, 2005, and the average estimated fair value of those instruments held during the year ended December 31, 2005, are set forth below (dollars in thousands):

| | Estimated Fair Value as of December 31, 2005 | | | | Average Estimated Fair Value for the year ended December 31, 2005 | | | |
|----------------|---|---------------------|------------------------|--------------------------|--|---------------------|------------------------|--------------------------|
| | Current Assets | Long-term Assets | Current Liabilities | Long-term Liabilities | Current Assets | Long-term Assets | Current Liabilities | Long-term Liabilities |
| Electric | \$348,709 | \$463,214 | \$349,592 | \$443,649 | \$300,208 | \$362,360 | \$288,297 | \$341,777 |
| Natural gas... | 569,900 | 48,066 | 557,202 | 44,995 | 373,320 | 38,171 | 361,879 | 31,304 |
| Total | <u>\$918,609</u> | <u>\$511,280</u> | <u>\$906,794</u> | <u>\$488,644</u> | <u>\$673,528</u> | <u>\$400,531</u> | <u>\$650,176</u> | <u>\$373,081</u> |

The change in the estimated fair value position of Avista Energy's energy commodity portfolio, net of reserves for credit and market risk for 2005 was an unrealized loss of \$38.1 million and is included in the Consolidated Statements of Income in non-utility energy marketing and trading revenues. The change in the fair value position for 2004 was an unrealized loss of \$0.7 million. In 2003, the unrealized loss was \$22.1 million.

Market Risk

Market risk is, in general, the risk of fluctuation in the market price of the commodity being traded and is influenced primarily by supply and demand. Market risk includes the fluctuation in the market price of associated derivative commodity instruments. Market risk is influenced to the extent that the performance or nonperformance by market participants of their contractual obligations and commitments affect the supply of, or demand for, the commodity. Avista Utilities and Avista Energy manage the market risks inherent in their activities according to risk policies established by the Company's Risk Management Committee.

Credit Risk

Credit risk relates to the risk of loss that Avista Utilities and/or Avista Energy would incur as a result of non-performance by counterparties of their contractual obligations to deliver energy or make financial settlements. Avista Utilities and Avista Energy often extend credit to counterparties and customers and are exposed to the risk that they may not be able to collect amounts owed to them. Changes in market prices may dramatically alter the size of credit risk with counterparties, even when conservative credit limits have been established. Credit risk includes the risk that a counterparty may default due to circumstances relating directly to it and the risk that a counterparty may default due to circumstances that relate to other market participants that have a direct or indirect relationship with such counterparty. Should a counterparty, customer or supplier fail to perform, Avista Utilities or Avista Energy may be required to replace existing contracts with contracts at then-current market prices or to honor the underlying commitment. Avista Utilities and Avista Energy seek to mitigate credit risk by applying specific eligibility criteria to existing and prospective counterparties and by actively monitoring current credit exposures. These policies include an evaluation of the financial condition and credit ratings of counterparties, collateral requirements or other credit enhancements, such as letters of credit or parent company guarantees, and the use of standardized agreements that allow for the netting or offsetting of positive and negative exposures associated with a single counterparty.

Avista Energy has concentrations of suppliers and customers in the electric and natural gas industries including electric utilities, natural gas distribution companies, and other energy marketing and trading companies. In addition, Avista Energy has concentrations of credit risk related to geographic location as Avista Energy operates in the western United States and western Canada. These concentrations of counterparties and concentrations of geographic location may impact Avista Energy's overall exposure to credit risk, either positively or negatively, because the counterparties may be similarly affected by changes in economic, regulatory or other conditions.

Credit risk also involves the exposure that counterparties perceive related to the ability of Avista Utilities and Avista Energy to perform deliveries and settlement under physical and financial energy contracts. These counterparties may seek assurances of performance in the form of letters of credit, prepayment or cash deposits and, in the case of Avista Energy, parent company (Avista Capital) performance guarantees. In periods of price volatility, the level of exposure can change significantly, with the result that sudden and significant demands may be made against the Company's capital resource reserves (credit facilities and cash). Avista Utilities and Avista Energy actively monitor the exposure to possible collateral calls and take steps to minimize capital requirements.

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Other Operating Risks

In addition to market and credit risk, Avista Utilities' commodity positions are subject to operational and event risks including, among others, increases or decreases in load demand, blackouts or disruptions to transmission or transportation systems, fuel quality, forced outages at generating plants and disruptions to information systems and other administrative tools required for normal operations. Avista Utilities also has exposure to weather conditions and natural disasters that can cause physical damage to property, requiring repairs to restore utility service. Terrorism threats, both domestic and foreign, is a risk to the entire utility industry, including Avista Utilities. Potential disruptions to operations or destruction of facilities from terrorism or other malicious acts are not readily determinable. The Company has taken various steps to mitigate terrorism risks and to prepare contingency plans in the event that its facilities are targeted.

NOTE 8. CASH DEPOSITS WITH AND FROM COUNTERPARTIES

Cash deposits from counterparties totaled \$13.7 million and \$6.0 million as of December 31, 2005 and 2004, respectively. These funds are held by Avista Utilities and Avista Energy to mitigate the potential impact of counterparty default risk. These amounts are subject to return if conditions warrant because of continuing portfolio value fluctuations with those parties or substitution of non-cash collateral. Cash deposited with counterparties totaled \$59.4 million and \$30.7 million as of December 31, 2005 and 2004, respectively.

As is common industry practice, Avista Utilities and Avista Energy maintain margin agreements with certain counterparties. Margin calls are triggered when exposures exceed predetermined contractual limits or when there are changes in a counterparty's creditworthiness. Price movements in electricity and natural gas can generate exposure levels in excess of these contractual limits. From time to time, margin calls are made and/or received by Avista Utilities and Avista Energy. Negotiating for collateral in the form of cash, letters of credit, or parent company performance guarantees is a common industry practice.

NOTE 9. JOINTLY OWNED ELECTRIC FACILITIES

The Company has a 15 percent ownership interest in a twin-unit coal-fired generating facility, the Colstrip Generating Project (Colstrip) located in southeastern Montana, and provides financing for its ownership interest in the project. The Company's share of related fuel costs as well as operating expenses for plant in service are included in the corresponding accounts in the Consolidated Statements of Income. The Company's share of utility plant in service for Colstrip was \$323.9 million and accumulated depreciation was \$183.2 million as of December 31, 2005.

NOTE 10. PROPERTY, PLANT AND EQUIPMENT

The balances of the major classifications of property, plant and equipment are detailed in the following table as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|--|--------------------|--------------------|
| Avista Utilities: | | |
| Electric production..... | \$ 988,539 | \$ 924,933 |
| Electric transmission..... | 369,567 | 337,651 |
| Electric distribution..... | 790,630 | 760,400 |
| Construction work-in-progress (CWIP) and other | 119,690 | 109,222 |
| Electric total..... | <u>2,268,426</u> | <u>2,132,206</u> |
| Natural gas underground storage | 18,550 | 18,566 |
| Natural gas distribution..... | 471,574 | 449,155 |
| CWIP and other | 56,465 | 44,691 |
| Natural gas total..... | <u>546,589</u> | <u>512,412</u> |
| Common plant (including CWIP) | 96,319 | 73,087 |
| Total Avista Utilities..... | 2,911,334 | 2,717,705 |
| Energy Marketing and Resource Management (1) | 17,360 | 15,790 |
| Avista Advantage (1)..... | 14,736 | 13,688 |
| Other (1) | 36,624 | 34,757 |
| Total..... | <u>\$2,980,054</u> | <u>\$2,781,940</u> |

(1) Included in non-utility properties and investments-net on the Consolidated Balance Sheets.

Equipment under capital leases at Avista Utilities totaled \$5.6 million and \$5.3 million as of December 31, 2005 and 2004, respectively. The associated accumulated depreciation totaled \$1.1 million and \$0.5 million as of December 31, 2005 and 2004, respectively. Property, plant, and equipment under capital leases at Avista Capital's subsidiaries totaled \$5.2 million and \$5.3 million as of December 31, 2005 and 2004, respectively. The associated accumulated depreciation totaled \$4.1 million and \$3.5 million as of December 31, 2005 and 2004, respectively.

NOTE 11. ASSET RETIREMENT OBLIGATIONS

The Company follows SFAS No. 143, "Accounting for Asset Retirement Obligations" which requires the recording of the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the associated costs of the asset retirement obligation are capitalized as part of the carrying amount of the related long-lived asset. The liability is accreted to its present value each period and the related capitalized costs are depreciated over the useful life of the related asset. Upon retirement of the asset, the Company either settles the retirement obligation for its recorded amount or incurs a gain or loss. As asset retirement costs are recovered through rates charged to customers, the Company records regulatory assets and liabilities for the difference between asset retirement costs currently recovered in rates and asset retirement obligations recorded under SFAS 143. The regulatory assets do not earn a return. The adoption of SFAS No. 143 on January 1, 2003 did not have a material effect on the Company's financial condition, results of operations or cash flows.

As described in Note 2, the Company adopted FIN 47 as of December 31, 2005, which has resulted in the recording of additional asset retirement obligations under SFAS No. 143. Specifically, the Company has recorded liabilities for future asset retirement obligations to (1) restore ponds at Colstrip (2) remove plant and restore the land at the Coyote Springs 2 site at the termination of the land lease (3) remove asbestos at the corporate office building and (4) dispose of PCBs in certain transformers. With the adoption of FIN 47, the Company recorded an asset retirement obligation of \$3.2 million, a regulatory asset of \$2.7 million, capitalized asset retirement costs of \$1.0 million and related accumulated depreciation of \$0.5 million. Due to an inability to estimate a range of settlement dates, the Company cannot estimate a liability for removal and disposal of certain transmission and distribution assets, as well as abandonment and decommissioning of certain hydroelectric generation and natural gas storage facilities.

The following table documents the changes in the Company's asset retirement obligation during the years ended December 31 (dollars in thousands):

| | 2005 | 2004 |
|--|----------------|----------------|
| Asset retirement obligation at beginning of year | \$1,191 | \$ 660 |
| Asset retirement obligation recognized | 3,243 | 483 |
| Asset retirement obligation settled | (28) | (20) |
| Asset retirement obligation accretion expense..... | 123 | 68 |
| Asset retirement obligation at end of year | <u>\$4,529</u> | <u>\$1,191</u> |

The pro forma asset retirement obligation liability balances as if FIN 47 had been adopted on January 1, 2004 (rather than December 31, 2005) are as follows (dollars in thousands):

| | |
|---|---------|
| Pro forma asset retirement obligation as of January 1, 2004 | \$3,538 |
| Pro forma asset retirement obligation as of December 31, 2004 | \$4,246 |

NOTE 12. PENSION PLANS AND OTHER POSTRETIREMENT BENEFIT PLANS

The Company has a defined benefit pension plan covering substantially all of its regular full-time employees at Avista Utilities and Avista Energy. Individual benefits under this plan are based upon the employee's years of service and average compensation as specified in the plan. The Company's funding policy is to contribute at least the minimum amounts that are required to be funded under the Employee Retirement Income Security Act, but not more than the maximum amounts that are currently deductible for income tax purposes. The Company made \$15 million in cash contributions to the pension plan in each of 2005 and 2004, and \$12 million in 2003. The Company expects to contribute \$15 million to the pension plan in 2006.

The Finance Committee of the Company's Board of Directors establishes investment policies, objectives and strategies to seek optimum return for the pension plan, while also keeping with the assumption of prudent risk and the Finance Committee's composite return objectives. The Finance Committee reviews and approves changes to the investment policy. The Company has contracted with an investment manager who is responsible for managing the

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individual investment managers. The investment manager's performance and related individual fund performance is periodically reviewed by the Finance Committee to ensure compliance with investment policy objectives and strategies. Pension plan assets are invested primarily in marketable debt and equity securities. Pension plan assets may also be invested in real estate and other investments, including hedge funds and venture capital funds. In seeking to obtain the desired return to fund the pension plan, the Finance Committee has established investment allocation percentages by asset classes as indicated in the table in this Note.

The assumed long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. The fair value of pension plan assets invested in debt and equity securities was based primarily on market prices. The fair value of pension plan assets invested in real estate was determined based on three basic approaches: (1) current cost of reproducing a property less deterioration and functional economic obsolescence (2) capitalization of the property's net earnings power; and (3) value indicated by recent sales of comparable properties in the market. The fair value of plan assets was determined as of December 31, 2005 and 2004.

As of December 31, 2005 and 2004, the pension plan had assets with a fair value that was less than the present value of the accumulated benefit obligation under the plan. In 2005, the pension plan funding deficit increased as compared to the end of 2004 and as such the Company increased the additional minimum liability for the unfunded accumulated benefit obligation by \$2.8 million and reduced the intangible asset by \$0.7 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$2.3 million, net of taxes of \$1.2 million for 2005. In 2004, the pension plan funding deficit increased as compared to the end of 2003 and as such the Company increased the additional minimum liability for the unfunded accumulated benefit obligation by \$9.2 million and reduced the intangible asset by \$0.7 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in a charge to other comprehensive income of \$6.4 million, net of taxes of \$3.5 million for 2004. In 2003, the pension plan funding deficit decreased as compared to the end of 2002 and as such the Company reduced the additional minimum liability for the unfunded accumulated benefit obligation by \$15.5 million and the intangible asset by \$0.6 million (representing the amount of unrecognized prior service cost) related to the pension plan. This resulted in an increase to other comprehensive income of \$9.7 million, net of taxes of \$5.2 million for 2003.

The Company also has a Supplemental Executive Retirement Plan (SERP) that provides additional pension benefits to executive officers of the Company. The SERP is intended to provide benefits to executive officers whose benefits under the pension plan are reduced due to the application of Section 415 of the Internal Revenue Code of 1986 and the deferral of salary under deferred compensation plans. The Company recorded an additional minimum liability for the unfunded accumulated benefit obligation of \$0.6 million, \$1.8 million and \$0.3 million related to the SERP for 2005, 2004 and 2003, respectively. This resulted in a charge to other comprehensive income of \$0.4 million, \$1.2 million and \$0.2 million, net of tax, for 2005, 2004 and 2003, respectively.

The Company expects that benefit payments under the pension plan and the SERP will total \$14.7 million, \$15.6 million, \$15.6 million, \$16.4 million and \$18.0 million in 2006, 2007, 2008, 2009 and 2010, respectively. For the ensuing five years (2011 through 2015), the Company expects that benefit payments under the pension plan and the SERP will total \$109.6 million.

The Company provides certain health care and life insurance benefits for substantially all of its retired employees. The Company accrues the estimated cost of postretirement benefit obligations during the years that employees provide services. The Company elected to amortize the transition obligation of \$34.5 million over a period of twenty years, beginning in 1993. In 2004, the Company recognized the effect of an amendment to the cost-sharing policy, which limits the employer portion of the premium for all retirees. This amendment reduced the accumulated benefit obligation by \$4.3 million. The Company expects that benefit payments under the postretirement benefit plan will be \$2.7 million, \$2.6 million, \$2.5 million, \$2.3 million and \$2.2 million in 2006, 2007, 2008, 2009 and 2010, respectively. For the ensuing five years (2011 through 2015), the Company expects that benefit payments under the postretirement benefit plan will total \$9.6 million. The Company expects to contribute \$2.7 million to the postretirement benefit plan in 2006, representing expected benefit payments to be paid during the year.

The Company established a Health Reimbursement Arrangement to provide employees with tax-advantaged funds to pay for allowable medical expenses upon retirement. The amount earned by the employee is fixed on the retirement date based on employees' years of service and the ending salary. The liability and expense of this plan are included as post-retirement benefits.

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The Company uses a December 31 measurement date for its pension and postretirement plans. The following table sets forth the pension and postretirement plan disclosures as of December 31, 2005 and 2004 and the components of net periodic benefit costs for the years ended December 31, 2005, 2004 and 2003 (dollars in thousands):

| | Pension Benefits | | Post-retirement Benefits | |
|--|-------------------|-------------------|--------------------------|------------------|
| | 2005 | 2004 | 2005 | 2004 |
| Change in benefit obligation: | | | | |
| Benefit obligation as of beginning of year..... | \$285,738 | \$265,790 | \$31,868 | \$39,185 |
| Service cost | 9,480 | 8,914 | 566 | 480 |
| Interest cost | 16,228 | 16,406 | 1,652 | 2,019 |
| Plan amendment | - | - | - | (4,263) |
| Actuarial loss (gain) | 6,049 | 8,737 | (1,800) | (2,464) |
| Benefits paid..... | (14,932) | (13,309) | (3,293) | (3,042) |
| Expenses paid..... | <u>(817)</u> | <u>(800)</u> | <u>(30)</u> | <u>(47)</u> |
| Benefit obligation as of end of year..... | <u>\$301,746</u> | <u>\$285,738</u> | <u>\$28,963</u> | <u>\$31,868</u> |
| Change in plan assets: | | | | |
| Fair value of plan assets as of beginning of year | \$186,579 | \$167,962 | \$16,862 | \$14,587 |
| Actual return on plan assets..... | 12,460 | 16,816 | 1,236 | 1,882 |
| Employer contributions | 15,000 | 15,000 | 1,183 | 1,964 |
| Benefits paid..... | (14,059) | (12,399) | (873) | (1,524) |
| Expenses paid..... | <u>(817)</u> | <u>(800)</u> | <u>(30)</u> | <u>(47)</u> |
| Fair value of plan assets as of end of year | <u>\$199,163</u> | <u>\$186,579</u> | <u>\$18,378</u> | <u>\$16,862</u> |
| Funded status | \$(102,583) | \$(99,159) | \$(10,585) | \$(15,006) |
| Unrecognized net actuarial loss | 79,667 | 73,604 | 973 | 6,009 |
| Unrecognized prior service cost | 4,405 | 5,058 | - | - |
| Unrecognized net transition obligation/(asset) | - | (499) | 3,536 | 4,041 |
| Accrued benefit cost..... | (18,511) | (20,996) | (6,076) | (4,956) |
| Additional minimum liability | <u>(34,595)</u> | <u>(31,112)</u> | - | - |
| Accrued benefit liability | <u>\$(53,106)</u> | <u>\$(52,108)</u> | <u>\$(6,076)</u> | <u>\$(4,956)</u> |
| Accumulated pension benefit obligation | <u>\$252,269</u> | <u>\$238,687</u> | - | - |
| Accumulated postretirement benefit obligation: | | | | |
| For retirees | | | \$14,662 | \$18,914 |
| For fully eligible employees..... | | | \$5,980 | \$5,672 |
| For other participants | | | \$8,321 | \$7,282 |
| Weighted-average asset allocations as of December 31: | | | | |
| Equity securities | 63% | 63% | 62% | 64% |
| Debt securities | 27% | 26% | 36% | 36% |
| Real estate | 5% | 5% | - | - |
| Other..... | 5% | 6% | 2% | - |
| Target asset allocations as of December 31: | | | | |
| Equity securities | 54-68% | 54-68% | 52-72% | 52-72% |
| Debt securities | 22-28% | 22-28% | 28-48% | 28-48% |
| Real estate | 3-7% | 3-7% | - | - |
| Other..... | 5-13% | 5-13% | - | - |
| Weighted Average Assumptions as of December 31: | | | | |
| Discount rate for benefit obligation..... | 5.75% | 5.75% | 5.75% | 5.75% |
| Discount rate for annual expense..... | 5.75% | 6.25% | 5.75% | 6.25% |
| Expected long-term return on plan assets | 8.50% | 8.00% | 8.50% | 8.00% |
| Rate of compensation increase (1)..... | 4.84% | 4.84% | - | - |
| Medical cost trend pre-age 65 – initial | | | 9.00% | 9.00% |
| Medical cost trend pre-age 65 – ultimate | | | 5.00% | 5.00% |
| Ultimate medical cost trend year pre-age 65 | | | 2010 | 2009 |
| Medical cost trend post-age 65 – initial..... | | | 9.00% | 9.00% |
| Medical cost trend post-age 65 – ultimate | | | 6.00% | 6.00% |
| Ultimate medical cost trend year post-age 65..... | | | 2009 | 2008 |

(1) In 2004, changed to an age-based scale ranging from 2.50 percent to 8.00 percent.

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| | 2005 | 2004 | 2003 | 2005 | 2004 | 2003 |
|---|-----------------|-----------------|-----------------|----------------|----------------|----------------|
| Components of net periodic benefit cost: | | | | | | |
| Service cost | \$ 9,480 | \$ 8,914 | \$ 7,806 | \$ 566 | \$ 480 | \$ 482 |
| Interest cost | 16,228 | 16,406 | 15,705 | 1,652 | 2,019 | 2,477 |
| Expected return on plan assets..... | (15,917) | (13,436) | (10,862) | (1,368) | (1,106) | (842) |
| Transition (asset)/obligation recognition... | (499) | (1,086) | (1,086) | 505 | 505 | 979 |
| Amortization of prior service cost..... | 654 | 654 | 653 | - | - | - |
| Net loss recognition..... | <u>3,442</u> | <u>3,447</u> | <u>3,896</u> | - | <u>245</u> | <u>405</u> |
| Net periodic benefit cost..... | <u>\$13,388</u> | <u>\$14,899</u> | <u>\$16,112</u> | <u>\$1,355</u> | <u>\$2,143</u> | <u>\$3,501</u> |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point increase in the assumed health care cost trend rate for each year would increase the accumulated postretirement benefit obligation as of December 31, 2005 by \$1.4 million and the service and interest cost by \$0.1 million. A one-percentage-point decrease in the assumed health care cost trend rate for each year would decrease the accumulated postretirement benefit obligation as of December 31, 2005 by \$1.2 million and the service and interest cost by \$0.1 million.

The Company and its most significant subsidiaries have salary deferral 401(k) plans that are defined contribution plans and cover substantially all employees. Employees can make contributions to their respective accounts in the plans on a pre-tax basis up to the maximum amount permitted by law. The respective company matches a portion of the salary deferred by each participant according to the schedule in the respective plan. Employer matching contributions of \$4.4 million, \$4.1 million and \$3.8 million were expensed in 2005, 2004 and 2003, respectively.

The Company has an Executive Deferral Plan. This plan allows executive officers and other key employees the opportunity to defer until the earlier of their retirement, termination, disability or death, up to 75 percent of their base salary and/or up to 100 percent of their incentive payments. Deferred compensation funds are held by the Company in a Rabbi Trust. At each of December 31, 2005 and 2004, there were deferred compensation assets of \$11.3 million included in other property and investments-net and corresponding deferred compensation liabilities of \$11.3 million included in other non-current liabilities and deferred credits on the Consolidated Balance Sheets.

NOTE 13. ACCOUNTING FOR INCOME TAXES

As of December 31, 2005 and 2004, the Company had net regulatory assets of \$114.1 million and \$123.2 million, respectively, related to the probable recovery of certain deferred tax liabilities from customers through future rates.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and tax credit carryforwards. The total net deferred income tax liability consisted of the following as of December 31 (dollars in thousands):

| | 2005 | 2004 |
|---|------------------|------------------|
| Deferred income tax assets: | | |
| Allowance for doubtful accounts..... | \$ 16,604 | \$ 16,428 |
| Reserves not currently deductible | 14,213 | 19,450 |
| Alternative minimum tax..... | - | 16,877 |
| Contributions in aid of construction..... | 7,691 | 6,840 |
| Deferred compensation | 5,164 | 5,138 |
| Unfunded accumulated benefit obligation | 9,100 | 8,732 |
| Interest rate swaps..... | 3,485 | 2,269 |
| Other | <u>10,812</u> | <u>10,047</u> |
| Total deferred income tax assets..... | <u>\$ 67,069</u> | <u>\$ 85,781</u> |

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| | 2005 | 2004 |
|--|------------------|------------------|
| Deferred income tax liabilities: | | |
| Differences between book and tax basis of utility plant..... | \$417,841 | 424,907 |
| Power and natural gas deferrals | 51,332 | 53,259 |
| Unrealized energy commodity gains | 12,252 | 24,542 |
| Power exchange contract..... | 37,024 | 39,436 |
| Demand side management programs..... | 3,518 | 3,866 |
| Loss on reacquired debt | 9,325 | 11,315 |
| Other | <u>10,192</u> | <u>4,639</u> |
| Total deferred income tax liabilities | <u>541,484</u> | <u>561,964</u> |
| Net deferred income tax liability..... | <u>\$474,415</u> | <u>\$476,183</u> |

Net current deferred income tax assets were \$14.5 million and \$12.3 million as of December 31, 2005 and 2004, respectively. Net non-current deferred tax liabilities were \$488.9 million and \$488.5 million as of December 31, 2005 and 2004, respectively.

The realization of deferred tax assets is dependent upon the ability to generate taxable income in future periods. The Company evaluated available evidence supporting the realization of its deferred tax assets and determined it is more likely than not that deferred tax assets will be realized.

A reconciliation of federal income taxes derived from statutory federal tax rates (35 percent in 2005, 2004 and 2003) applied to pre-tax income from continuing operations as set forth in the accompanying Consolidated Statements of Income is as follows for the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|---|-----------------|-----------------|-----------------|
| Federal income taxes at statutory rates | \$24,860 | \$20,022 | \$30,094 |
| Increase (decrease) in tax resulting from: | | | |
| Tax effect of regulatory treatment of utility plant differences | 2,870 | 2,273 | 4,046 |
| State income tax expense | 1,139 | 821 | 942 |
| Preferred dividends | 713 | 759 | 383 |
| Settlement of prior year tax returns and adjustment of tax reserves..... | 42 | (2,830) | (389) |
| Manufacturing deduction | (385) | - | - |
| Kettle Falls tax credit | (2,891) | - | - |
| Other-net | <u>(487)</u> | <u>547</u> | <u>264</u> |
| Total income tax expense | <u>\$25,861</u> | <u>\$21,592</u> | <u>\$35,340</u> |
| Income Tax Expense Consisted of the Following: | | | |
| Taxes currently provided..... | \$16,996 | \$ 2,424 | \$ 6,945 |
| Deferred income taxes | <u>8,865</u> | <u>19,168</u> | <u>28,395</u> |
| Total income tax expense | <u>\$25,861</u> | <u>\$21,592</u> | <u>\$35,340</u> |

In August 2005, the Internal Revenue Service (IRS) and Treasury Department issued a revenue ruling, and related regulations that affect the tax treatment by Avista Corp. of certain indirect overhead expenses. Avista Corp. had previously made a tax election to deduct certain indirect overhead costs on the 2002 tax return that were capitalized for financial accounting purposes. This election allowed Avista Corp. to accelerate tax deductions resulting in a reduction of approximately \$40 million in current tax liabilities. This current tax benefit was deferred on the balance sheet in accordance with provisions of SFAS No. 109, "Accounting for Income Taxes" and did not have an effect on net income.

Avista Corp. believes that the revenue ruling and related regulations requires the Company to repay the original tax deductions over a two-year period (in 2005 and 2006) and that the tax deductions claimed on the Company's tax returns were appropriate based on the applicable statutes and regulations in effect at the time. There can be no assurance that the Company's position will prevail. However, it is not expected to have a significant effect on the Company's net income.

NOTE 14. ENERGY PURCHASE CONTRACTS

Avista Utilities has contracts related to the purchase of fuel for thermal generation, natural gas and various agreements for the purchase, sale or exchange of electric energy with other entities. The termination dates of the contracts range from one month to the year 2055. Total expenses for power purchased, natural gas purchased, fuel for generation and other fuel costs, which are included in utility resource costs in the Consolidated Statements of Income, were \$652.2 million, \$482.2 million and \$464.1 million in 2005, 2004 and 2003, respectively. The following table details Avista Utilities' future contractual commitments for power resources (including transmission contracts) and natural gas resources (including transportation contracts) (dollars in thousands):

| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|--------------------------|------------------|------------------|------------------|------------------|------------------|------------------|--------------------|
| Power resources..... | \$104,684 | \$103,869 | \$103,546 | \$104,641 | \$104,674 | \$375,282 | \$ 896,696 |
| Natural gas resources... | 259,100 | 58,133 | 44,067 | 39,711 | 39,460 | 352,155 | 792,626 |
| Total | <u>\$363,784</u> | <u>\$162,002</u> | <u>\$147,613</u> | <u>\$144,352</u> | <u>\$144,134</u> | <u>\$727,437</u> | <u>\$1,689,322</u> |

All of the energy purchase contracts were entered into as part of Avista Utilities' obligation to serve its retail natural gas and electric customers' energy requirements. As a result, these costs are generally recovered either through base retail rates or adjustments to retail rates as part of the power and natural gas cost deferral and recovery mechanisms.

In addition, Avista Utilities has operational agreements, settlements and other contractual obligations with respect to its generation, transmission and distribution facilities. The expenses associated with these agreements are reflected as other operating expenses in the Consolidated Statements of Income.

The following table details future contractual commitments with respect to these agreements (dollars in thousands):

| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|------------------|------------------|
| Contractual obligations..... | <u>\$14,265</u> | <u>\$14,289</u> | <u>\$14,314</u> | <u>\$14,462</u> | <u>\$14,489</u> | <u>\$194,889</u> | <u>\$266,708</u> |

Avista Utilities has fixed contracts with certain Public Utility Districts (PUD) to purchase portions of the output of certain generating facilities. Although Avista Utilities has no investment in the PUD generating facilities, the fixed contracts obligate Avista Utilities to pay certain minimum amounts (based in part on the debt service requirements of the PUD) whether or not the facility is operating. The cost of power obtained under the contracts, including payments made when a facility is not operating, is included in utility resource costs in the Consolidated Statements of Income. Expenses under these PUD contracts were \$9.0 million, \$7.3 million and \$8.5 million in 2005, 2004 and 2003, respectively. Information as of December 31, 2005 pertaining to these PUD contracts is summarized in the following table (dollars in thousands):

| | Company's Current Share of | | | | | Expira- tion Date |
|-----------------------------|----------------------------|------------------------|---------------------|------------------------------|----------------------|-------------------------|
| | Output | Kilowatt Capability | Annual Costs (1) | Debt Service Costs (1) | Bonds Outstanding | |
| Chelan County PUD: | | | | | | |
| Rocky Reach Project | 2.9% | 37,000 | \$1,984 | \$ 987 | \$2,637 | 2011 |
| Douglas County PUD: | | | | | | |
| Wells Project | 3.5 | 30,000 | 1,090 | 640 | 7,635 | 2018 |
| Grant County PUD: | | | | | | |
| Priest Rapids Project | 5.7 | 55,000 | 2,643 | 773 | 11,892 | 2055 |
| Wanapum Project | 8.2 | <u>75,000</u> | <u>3,257</u> | <u>1,795</u> | <u>23,821</u> | 2055 |
| Totals..... | | <u>197,000</u> | <u>\$8,974</u> | <u>\$4,195</u> | <u>\$45,985</u> | |

(1) The annual costs will change in proportion to the percentage of output allocated to Avista Utilities in a particular year. Amounts represent the operating costs for the year 2005. Debt service costs are included in annual costs.

The estimated aggregate amounts of required minimum payments (Avista Utilities' share of existing debt service costs) under these PUD contracts are as follows (dollars in thousands):

| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|------------------------|----------------|----------------|----------------|----------------|----------------|-----------------|-----------------|
| Minimum payments | <u>\$3,587</u> | <u>\$3,938</u> | <u>\$3,966</u> | <u>\$3,986</u> | <u>\$3,605</u> | <u>\$63,961</u> | <u>\$83,043</u> |

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In addition, Avista Utilities will be required to pay its proportionate share of the variable operating expenses of these projects.

Avista Energy's contractual commitments to purchase energy commodities as well as commitments related to transmission, transportation and other energy-related contracts in future periods are as follows (dollars in thousands):

| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|-----------------------|-------------|-----------|-----------|-----------|-----------|------------|-------------|
| Energy contracts | \$1,009,668 | \$231,795 | \$225,693 | \$205,182 | \$196,331 | \$346,907 | \$2,215,576 |

Avista Energy also has sales commitments related to these contractual obligations in future periods.

NOTE 15. LONG-TERM DEBT

The following details the interest rate and maturity dates of long-term debt outstanding as of December 31 (dollars in thousands):

| Maturity Year | Description | Interest Rate | 2005 | 2004 |
|---------------|--|---------------|------------|-----------|
| 2005 | Secured Medium-Term Notes | 6.39%-6.68% | \$ - | \$ 29,500 |
| 2005 | WP Funding LP Note..... | 8.38% | - | 54,572 |
| 2006 | Secured Medium-Term Notes | 7.89%-7.90% | 30,000 | 30,000 |
| 2007 | First Mortgage Bonds | 7.75% | 150,000 | 150,000 |
| 2007 | Secured Medium-Term Notes | 5.99% | 13,850 | 13,850 |
| 2008 | Secured Medium-Term Notes | 6.06%-6.95% | 45,000 | 45,000 |
| 2010 | Secured Medium-Term Notes | 6.67%-8.02% | 35,000 | 35,000 |
| 2012 | Secured Medium-Term Notes | 7.37% | 7,000 | 7,000 |
| 2013 | First Mortgage Bonds | 6.13% | 45,000 | 45,000 |
| 2018 | Secured Medium-Term Notes | 7.26%-7.45% | 22,500 | 27,500 |
| 2019 | First Mortgage Bonds | 5.45% | 90,000 | 90,000 |
| 2023 | Secured Medium-Term Notes | 7.18%-7.54% | 13,500 | 24,500 |
| 2028 | Secured Medium-Term Notes | 6.37% | 25,000 | 25,000 |
| 2032 | Pollution Control Bonds | 5.00% | 66,700 | 66,700 |
| 2034 | Pollution Control Bonds | 5.13% | 17,000 | 17,000 |
| 2035 | First Mortgage Bonds (1)..... | 6.25% | 150,000 | - |
| | Total secured long-term debt..... | | 710,550 | 660,622 |
| 2006 | Unsecured Medium-Term Notes..... | 8.14% | 8,000 | 8,000 |
| 2007 | Unsecured Medium-Term Notes..... | 7.90%-7.94% | 12,000 | 12,000 |
| 2008 | Unsecured Senior Notes..... | 9.75% | 279,735 | 279,735 |
| 2022 | Unsecured Medium-Term Notes..... | 8.15% | - | 5,000 |
| 2023 | Unsecured Medium-Term Notes..... | 7.99% | - | 5,000 |
| 2023 | Pollution Control Bonds | 6.00% | 4,100 | 4,100 |
| | Total unsecured long-term debt..... | | 303,835 | 313,835 |
| | Other long-term debt and capital leases..... | | 11,506 | 13,047 |
| | Interest rate swaps | | 5,236 | 1,092 |
| | Unamortized debt discount..... | | (1,613) | (1,608) |
| | Total | | 1,029,514 | 986,988 |
| | Current portion of long-term debt | | (39,524) | (85,432) |
| | Total long-term debt..... | | \$ 989,990 | \$901,556 |

(1) During the fourth quarter of 2005, the Company issued \$150.0 million of 6.25 percent First Mortgage Bonds due in 2035. The proceeds from the issuance were used to repay a portion of the borrowings outstanding under the Company's \$350.0 million committed line of credit and for the payment of corporate obligations.

The following table details future long-term debt maturities, including long-term debt to affiliated trusts (see Note 16) (dollars in thousands):

| Year | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|-----------------------|----------|-----------|-----------|------|----------|------------|-------------|
| Debt maturities | \$38,000 | \$175,850 | \$324,735 | \$ - | \$35,000 | \$554,203 | \$1,127,788 |

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In April 2004, the Company filed an amended registration statement on Form S-3 with the Securities and Exchange Commission, which would allow for the issuance of up to \$349.6 million of securities (either debt or common stock). This filing amended and combined three previous registration statements filed by the Company. As of December 31, 2005, the Company had remaining availability of \$109.6 million under this registration statement.

Substantially all utility properties owned by the Company are subject to the lien of the Company's various mortgage indentures. The Mortgage and Deed of Trust securing the Company's First Mortgage Bonds (including Secured Medium-Term Notes) contains limitations on the amount of First Mortgage Bonds, which may be issued based on, among other things, a 70 percent debt-to-collateral ratio, and/or retired First Mortgage Bonds, and a 2 to 1 net earnings to First Mortgage Bond interest ratio. As of December 31, 2005, the Company could issue \$285.5 million of additional First Mortgage Bonds under the Mortgage and Deed of Trust. See Note 17 for information regarding First Mortgage Bonds issued to secure the Company's obligations under its \$350.0 million committed line of credit.

NOTE 16. LONG-TERM DEBT TO AFFILIATED TRUSTS

In April 2004, the Company issued Junior Subordinated Debt Securities, with a principal amount of \$61.9 million to AVA Capital Trust III, an affiliated business trust formed by the Company. Concurrently, AVA Capital Trust III issued \$60.0 million of Preferred Trust Securities to third parties and \$1.9 million of Common Trust Securities to the Company. All of these securities have a fixed interest rate of 6.50 percent for five years (through March 31, 2009). Subsequent to the initial five-year fixed rate period, the securities will either have a new fixed rate or an adjustable rate. These debt securities may be redeemed by the Company on or after March 31, 2009 and will mature on April 1, 2034.

The Company used the proceeds from the Junior Subordinated Debt Securities to redeem \$61.9 million of 7.875 percent Junior Subordinated Deferrable Interest Debentures, Series A, originally issued in 1997 to Avista Capital I, an affiliated business trust formed by the Company. Avista Capital I used these proceeds to redeem \$60.0 million of Preferred Trust Securities issued to third parties and \$1.9 million of Common Trust Securities issued to the Company.

In 1997, the Company issued Floating Rate Junior Subordinated Deferrable Interest Debentures, Series B, with a principal amount of \$51.5 million to Avista Capital II, an affiliated business trust formed by the Company. Avista Capital II issued \$50.0 million of Preferred Trust Securities with a floating distribution rate of LIBOR plus 0.875 percent, calculated and reset quarterly. The annual distribution rate paid during 2005 ranged from 3.275 percent to 5.285 percent. As of December 31, 2005, the annual distribution rate was 5.285 percent. Concurrent with the issuance of the Preferred Trust Securities, Avista Capital II issued \$1.5 million of Common Trust Securities to the Company. These debt securities may be redeemed at the option of Avista Capital II on or after June 1, 2007 and mature on June 1, 2037; however, this is limited by an agreement under the Company's 9.75 percent Senior Notes that mature in 2008. In December 2000, the Company purchased \$10.0 million of these Preferred Trust Securities.

The Company has guaranteed the payment of distributions on, and redemption price and liquidation amount with respect to, the Preferred Trust Securities to the extent that AVA Capital Trust III and Avista Capital II have funds available for such payments from the respective debt securities. Upon maturity or prior redemption of such debt securities, the Preferred Trust Securities will be mandatorily redeemed. As a result of the implementation of FIN 46 in 2003, the Company no longer includes these capital trusts in its consolidated financial statements as of December 31, 2003 and thereafter. The sole assets of the capital trusts are \$113.4 million of junior subordinated deferrable interest debentures of Avista Corp. and the deconsolidation of these entities resulted in these debentures being reflected on the Consolidated Balance Sheets. Interest expense to affiliated trusts in the Consolidated Statements of Income represents interest expense on these debentures.

NOTE 17. SHORT-TERM BORROWINGS

On December 17, 2004, the Company entered into a committed line of credit agreement with various banks in the amount of \$350.0 million with an expiration date of December 16, 2009. This committed line of credit replaced a \$350.0 million committed line of credit with a 364-day term that had an expiration date of May 5, 2005. The Company can request the issuance of up to \$150.0 million in letters of credit under the committed line of credit. As of December 31, 2005 and 2004, there were \$44.1 million and \$32.8 million in letters of credit outstanding, respectively. The committed line of credit is secured by \$350.0 million of non-transferable First Mortgage Bonds of the Company issued to the agent bank. Such First Mortgage Bonds would only become due and payable in the event, and then only to the extent, that the Company defaults on its obligations under the committed line of credit.

The committed line of credit agreement contains customary covenants and default provisions, including covenants not to permit the ratio of “consolidated total debt” to “consolidated total capitalization” of Avista Corp. to be greater than 70 percent at the end of any fiscal quarter. As of December 31, 2005, the Company was in compliance with this covenant with a ratio of 60.2 percent. The committed line of credit also has a covenant requiring the ratio of “earnings before interest, taxes, depreciation and amortization” to “interest expense” of Avista Utilities for the twelve-month period ending December 31, 2005 to be greater than 1.6 to 1. As of December 31, 2005, the Company was in compliance with this covenant with a ratio of 2.46 to 1.

Balances and interest rates of bank borrowings under the Company’s revolving committed lines of credit were as follows as of and for the years ended December 31 (dollars in thousands):

| | 2005 | 2004 | 2003 |
|--|----------|----------|----------|
| Balance outstanding at end of period..... | \$63,000 | \$68,000 | \$80,000 |
| Maximum balance outstanding during the period..... | 167,000 | 170,000 | 85,000 |
| Average balance outstanding during the period..... | 61,181 | 54,858 | 26,034 |
| Average interest rate during the period..... | 4.45% | 3.14% | 2.99% |
| Average interest rate at end of period..... | 5.48 | 3.52 | 3.70 |

On July 13, 2005, Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, amended its committed credit agreement with a group of banks to increase the aggregate amount from \$110.0 million to \$145.0 million and to extend the expiration date to July 12, 2007. This committed credit facility provides for the issuance of letters of credit to secure contractual obligations to counterparties and for cash advances. This facility is secured by the assets of Avista Energy and Avista Energy Canada and guaranteed by Avista Capital and by CoPac Management, Inc., a wholly owned subsidiary of Avista Energy Canada. The maximum amount of credit extended by the banks for the issuance of letters of credit is the subscribed amount of the facility less the amount of outstanding cash advances, if any. The amendment to the credit agreement increased the maximum amount for cash advances from \$30.0 million to \$50.0 million. No cash advances were outstanding as of December 31, 2005 and 2004. Letters of credit in the aggregate amount of \$125.3 million and \$91.3 million were outstanding as of December 31, 2005 and 2004, respectively. The cash deposits of Avista Energy at the respective banks collateralized \$18.2 million and \$21.5 million of these letters of credit as of December 31, 2005 and 2004, respectively, which is reflected as restricted cash on the Consolidated Balance Sheets.

The Avista Energy credit agreement continues to contain covenants and default provisions, including covenants to maintain “minimum net working capital” and “minimum net worth,” as well as a covenant limiting the amount of indebtedness that the co-borrowers may incur. The credit agreement also continues to contain covenants and other restrictions related to the co-borrowers’ trading limits and positions, including VAR limits, restrictions with respect to changes in risk management policies or volumetric limits, and limits on exposure related to hourly and daily trading of electricity. These covenants, certain counterparty agreements and market liquidity conditions result in Avista Energy maintaining certain levels of cash and therefore effectively limit the amount of cash dividends that are available for distribution to Avista Capital and ultimately to Avista Corp. Avista Energy was in compliance with the covenants of its credit agreement as of December 31, 2005. Prior to the July 13, 2005 amendment, a reduction in the credit rating of Avista Corp. would have represented an event of default under Avista Energy’s credit agreement. The July 13, 2005 amendment to the credit agreement removed this covenant.

NOTE 18. INTEREST RATE SWAP AGREEMENTS

In 2004, Avista Corp. entered into three forward-starting interest rate swap agreements, totaling \$200.0 million, to manage the risk that changes in interest rates may affect the amount of future interest payments. These interest rate swap agreements relate to the anticipated issuances of debt to fund debt that matures in 2007 and 2008. Under the terms of these agreements, the value of the interest rate swaps are determined based upon Avista Corp. paying a fixed rate and receiving a variable rate based on LIBOR for a term of seven years beginning in 2007 and a term of ten years beginning in 2008. The interest rate swap agreements entered in 2004 provide for mandatory cash settlement of these contracts in 2008 and 2009. In June 2005, Avista Corp. entered into a forward-starting interest rate swap agreement in the amount of \$50.0 million related to the anticipated issuance of debt to fund debt that matured during the second half of 2005. This interest rate swap agreement was cash settled in 2005 and the Company received \$4.4 million, which has been deferred as a regulatory liability (part of long-term debt) and will be amortized over the 30-year life of the new debt issued in accordance with regulatory accounting practices.

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These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2005, Avista Corp. had a long-term derivative liability of \$10.0 million. As of December 31, 2005, there was an unrealized loss of \$6.5 million recorded as accumulated other comprehensive loss on the Consolidated Balance Sheets. The Company may request regulatory accounting orders to defer the impact of unrealized gains and losses. If such accounting orders were obtained, the Company would record a regulatory asset or liability, which would eliminate the effect of any unrealized gains and losses on these interest rate swap agreements in the Consolidated Statements of Comprehensive Income. If regulatory accounting orders are not obtained prior to the mandatory cash settlements, the amount included in accumulated other comprehensive income or loss at the cash settlement date will be reclassified to a regulatory liability (part of long-term debt) in accordance with regulatory accounting practices under SFAS No. 71. This gain or loss will be amortized over the remaining life of the forecasted debt issued.

Rathdrum Power, LLC (RP LLC), an unconsolidated entity that is 49 percent owned by Avista Power, operates a 270 MW natural gas-fired combustion turbine plant in northern Idaho (Lancaster Project). Avista Power's investment in RP LLC, which is included in non-utility properties and investments-net on the Consolidated Balance Sheets, is accounted for under the equity method and totaled \$18.4 million as of December 31, 2005. As of December 31, 2005, RP LLC had \$112.9 million of debt outstanding that is not included in the consolidated financial statements of the Company. There is no recourse to the Company with respect to this debt. RP LLC has entered into interest rate swap agreements to manage the risk that changes in interest rates may affect the amount of future interest payments. RP LLC agreed to pay fixed rates of interest with the differential paid or received under the interest rate swap agreements recognized as an adjustment to interest expense. These interest rate swap agreements are considered hedges against fluctuations in future cash flows associated with changes in interest rates in accordance with SFAS No. 133. As of December 31, 2005, there was an unrealized loss of \$0.1 million recorded as accumulated other comprehensive loss on the Consolidated Balance Sheets.

NOTE 19. LEASES

The Company has multiple lease arrangements involving various assets, with minimum terms ranging from one to forty-five years. Certain lease arrangements require the Company, upon the occurrence of specified events, to purchase the leased assets. The Company's management believes the likelihood of the occurrence of the specified events under which the Company could be required to purchase the leased assets is remote. Rental expense under operating leases for 2005, 2004 and 2003 was \$7.2 million, \$9.9 million and \$14.2 million, respectively.

In November 2005, the Company terminated its lease agreement related to its corporate headquarters and central operating facility. Lease payments were approximately \$2.3 million per year. In conjunction with the termination of the lease agreement, the Company purchased its corporate headquarters and central operating facility.

Future minimum lease payments required under operating leases having initial or remaining noncancelable lease terms in excess of one year as of December 31, 2005 were as follows (dollars in thousands):

| Year ending December 31: | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|--------------------------------|---------|---------|---------|---------|---------|------------|----------|
| Minimum payments required..... | \$4,770 | \$4,248 | \$4,130 | \$3,756 | \$1,467 | \$2,362 | \$20,733 |

The payments under Avista Utilities' capital leases are \$1.1 million in 2006, \$1.0 million in each of 2007 and 2008, and \$0.1 million in 2009. The payments under the Avista Capital subsidiaries' capital leases are \$0.5 million in each of 2006, 2007 and 2008, and \$0.4 million in 2009.

NOTE 20. GUARANTEES

The \$145.0 million committed credit agreement of Avista Energy and its subsidiary, Avista Energy Canada, as co-borrowers, is guaranteed by Avista Capital and by CoPac Management, Inc., and secured by the assets of Avista Energy and Avista Energy Canada. This credit agreement expires on July 12, 2007. This agreement also provides for the issuance of letters of credit to secure contractual obligations to counterparties. No cash advances were outstanding as of December 31, 2005 and 2004. Letters of credit in the aggregate amount of \$125.3 million and \$91.3 million were outstanding as of December 31, 2005 and 2004, respectively.

The Company has guaranteed the payment of distributions on, and redemption price and liquidation amount with respect to, the Preferred Trust Securities issued by its affiliates, AVA Capital Trust III and Avista Capital II, to the extent that these entities have funds available for such payments from the respective debt securities.

In the course of the energy trading business, Avista Capital provides guarantees to other parties with whom Avista Energy may be doing business. At any point in time, Avista Capital is only liable for the outstanding portion of the guarantee, which was \$37.7 million and \$24.5 million as of December 31, 2005 and 2004, respectively. The face value of all performance guarantees issued by Avista Capital for energy trading contracts at Avista Energy was \$419.3 million and \$391.7 million as of December 31, 2005 and 2004, respectively. Most guarantees do not have set expiration dates; however, either party may terminate the guarantee at any time with minimal written notice.

Avista Power, through its equity investment in RP LLC, is a 49 percent owner of the Lancaster Project, which commenced commercial operation in September 2001. Commencing with commercial operations, all of the output from the Lancaster Project is contracted to Avista Energy through 2026 under a power purchase agreement. Avista Corp. has guaranteed the power purchase agreement with respect to the performance of Avista Energy.

NOTE 21. PREFERRED STOCK-CUMULATIVE (SUBJECT TO MANDATORY REDEMPTION)

In September 2005, the Company made a mandatory redemption of 17,500 shares of preferred stock for \$1.75 million. In September 2004, the Company made a mandatory redemption of 17,500 shares of preferred stock for \$1.75 million. In March 2003, the Company repurchased 17,500 shares of preferred stock for \$1.6 million, satisfying its redemption requirement for 2003. On September 15, 2006, the Company must redeem 17,500 shares at \$100 per share plus accumulated dividends through a mandatory sinking fund. As such, redemption requirements are \$1.75 million for 2006. The remaining shares must be redeemed on September 15, 2007 for \$26.25 million. The Company has the right to redeem an additional 17,500 shares on each September 15 redemption date; however, this right is limited by an agreement under the Company's 9.75 percent Senior Notes that mature in 2008. Upon involuntary liquidation, all preferred stock will be entitled to \$100 per share plus accrued dividends.

The Company adopted SFAS No. 150 effective July 1, 2003. The adoption of this statement requires the Company to classify preferred stock subject to mandatory redemption as liabilities and preferred stock dividends as interest expense. The restatement of prior periods was not permitted.

NOTE 22. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying values of cash and cash equivalents, restricted cash, accounts and notes receivable, accounts payable and short-term borrowings are reasonable estimates of their fair values. Energy commodity derivative assets and liabilities, as well as derivatives related to interest rate swap agreements, are reported at estimated fair value on the Consolidated Balance Sheets.

The fair value of the Company's long-term debt (including current-portion, but excluding capital leases) as of December 31, 2005 and 2004 was estimated to be \$1,063.0 million, or 105 percent of the carrying value of \$1,014.4 million, and \$1,054.7 million, or 108 percent of the carrying value of \$975.5 million, respectively. The fair value of the Company's mandatorily redeemable preferred stock as of December 31, 2005 and 2004 was estimated to be \$28.6 million, or 102 percent of the carrying value of \$28.0 million, and \$32.0 million, or 107 percent of the carrying value of \$29.8 million, respectively. The fair value of the Company's long-term debt to affiliated trusts as of December 31, 2005 and 2004 was estimated to be \$104.6 million, or 95 percent of the carrying value of \$110.0 million, and \$108.3 million, or 98 percent of the carrying value of \$110.0 million, respectively. The carrying value as of December 31, 2005 and 2004 does not include \$3.4 million of debt that is considered common equity by the affiliated trusts. These estimates were primarily based on available market information.

NOTE 23. COMMON STOCK

In April 1990, the Company sold 1,000,000 shares of its common stock to the Trustee of the Investment and Employee Stock Ownership Plan for Employees of the Company (Plan) for the benefit of the participants and beneficiaries of the Plan. In payment for the shares of common stock, the Trustee issued a promissory note payable to the Company in the amount of \$14.1 million. Dividends paid on the stock held by the Trustee, plus Company contributions to the Plan, if any, were used by the Trustee to make interest and principal payments on the promissory note. The balance of the promissory note receivable from the Trustee was repaid during 2005. Prior to 2005, the balance outstanding on the promissory note was reflected as a reduction of stockholders' equity. The shares of common stock were allocated to the accounts of participants in the Plan as the note was repaid. During 2005, 2004 and 2003, the cost recorded for the Plan was \$1.7 million, \$6.2 million and \$6.9 million, respectively. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the

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Trustee was less than \$0.1 million, \$0.4 million and less than \$0.1 million, respectively, during 2005. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the Trustee was \$0.2 million, \$1.7 million and less than \$0.1 million, respectively, during 2004. Interest on the note payable to the Company, cash and stock contributions to the Plan and dividends on the shares held by the Trustee was \$0.3 million, \$1.7 million and \$0.1 million, respectively, during 2003.

In November 1999, the Company adopted a shareholder rights plan pursuant to which holders of common stock outstanding on February 15, 1999, or issued thereafter, were granted one preferred share purchase right (Right) on each outstanding share of common stock. Each Right, initially evidenced by and traded with the shares of common stock, entitles the registered holder to purchase one one-hundredth of a share of preferred stock of the Company, without par value, at a purchase price of \$70, subject to certain adjustments, regulatory approval and other specified conditions. The Rights will be exercisable only if a person or group acquires 10 percent or more of the outstanding shares of common stock or commences a tender or exchange offer, the consummation of which would result in the beneficial ownership by a person or group of 10 percent or more of the outstanding shares of common stock. Upon any such acquisition, each Right will entitle its holder to purchase, at the purchase price, that number of shares of common stock or preferred stock of the Company (or, in the case of a merger of the Company into another person or group, common stock of the acquiring person or group) that has a market value at that time equal to twice the purchase price. In no event will the Rights be exercisable by a person that has acquired 10 percent or more of the Company's common stock. The Rights may be redeemed, at a redemption price of \$0.01 per Right, by the Board of Directors of the Company at any time until any person or group has acquired 10 percent or more of the common stock. The Rights expire on March 31, 2009.

The Company has a Dividend Reinvestment and Stock Purchase Plan under which the Company's shareholders may automatically reinvest their dividends and make optional cash payments for the purchase of the Company's common stock at current market value.

From March 2000 through May 2003, the Company issued shares of its common stock to the Employee Investment Plan rather than having the Plan purchase shares of common stock on the open market. In the fourth quarter of 2000, the Company also began issuing new shares of common stock for the Dividend Reinvestment and Stock Purchase Plan. Shares issued under these plans in 2005, 2004 and 2003 are disclosed in the Consolidated Statements of Stockholders' Equity.

The payment of dividends on common stock is restricted by provisions of certain covenants applicable to preferred stock and long-term debt contained in the Company's Articles of Incorporation and various mortgage indentures. Covenants under the Company's 9.75 percent Senior Notes that mature in 2008 limit the Company's ability to increase its common stock cash dividend to no more than 5 percent over the previous quarter.

NOTE 24. EARNINGS PER COMMON SHARE

The following table presents the computation of basic and diluted earnings per common share for the years ended December 31 (in thousands, except per share amounts):

| | 2005 | 2004 | 2003 |
|--|-----------------|-----------------|-----------------|
| Numerator: | | | |
| Income from continuing operations | \$45,168 | \$35,614 | \$50,643 |
| Loss from discontinued operations | - | - | (4,949) |
| Net income before cumulative effect of accounting change ... | 45,168 | 35,614 | 45,694 |
| Cumulative effect of accounting change..... | - | (460) | (1,190) |
| Net income | 45,168 | 35,154 | 44,504 |
| Preferred stock dividend requirements | - | - | (1,125) |
| Income available for common stock..... | <u>\$45,168</u> | <u>\$35,154</u> | <u>\$43,379</u> |

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| | 2005 | 2004 | 2003 |
|---|---------------|---------------|---------------|
| Denominator: | | | |
| Weighted-average number of common shares outstanding-basic..... | 48,523 | 48,400 | 48,232 |
| Effect of dilutive securities: | | | |
| Contingent stock awards..... | 198 | 209 | 244 |
| Stock options..... | <u>258</u> | <u>277</u> | <u>154</u> |
| Weighted-average number of common shares outstanding-diluted..... | <u>48,979</u> | <u>48,886</u> | <u>48,630</u> |
| Earnings per common share, basic: | | | |
| Earnings from continuing operations..... | \$0.93 | \$0.74 | \$1.03 |
| Loss from discontinued operations..... | - | - | (0.10) |
| Earnings before cumulative effect of accounting change.. | 0.93 | 0.74 | 0.93 |
| Loss from cumulative effect of accounting change..... | - | (0.01) | (0.03) |
| Total earnings per common share, basic..... | <u>\$0.93</u> | <u>\$0.73</u> | <u>\$0.90</u> |
| Earnings per common share, diluted: | | | |
| Earnings from continuing operations..... | \$0.92 | \$0.73 | \$1.02 |
| Loss from discontinued operations..... | - | - | (0.10) |
| Earnings before cumulative effect of accounting change.. | 0.92 | 0.73 | 0.92 |
| Loss from cumulative effect of accounting change..... | - | (0.01) | (0.03) |
| Total earnings per common share, diluted..... | <u>\$0.92</u> | <u>\$0.72</u> | <u>\$0.89</u> |

Total stock options outstanding that were not included in the calculation of diluted earnings per common share were 695,500, 730,100 and 1,306,200 for 2005, 2004 and 2003, respectively. These stock options were excluded from the calculation because they were antidilutive based on the fact that the exercise price of the stock options was higher than the average market price of Avista Corp. common stock during the respective period. In addition, contingent stock awards of 318,900 and 156,800 were outstanding as of December 31, 2005 and 2004, respectively, which were not included in basic or diluted shares because the performance conditions were not satisfied.

NOTE 25. STOCK COMPENSATION PLANS**Avista Corp.**

In 1998, the Company adopted and shareholders approved an incentive compensation plan, the Long-Term Incentive Plan (1998 Plan). Under the 1998 Plan, certain key employees, directors and officers of the Company and its subsidiaries may be granted stock options, stock appreciation rights, stock awards (including restricted stock) and other stock-based awards and dividend equivalent rights. The Company has available a maximum of 3.5 million shares of its common stock for grant under the 1998 Plan, including 1.0 million shares approved by shareholders in 2005. Beginning in 2000, non-employee directors began receiving options under this plan.

In 2000, the Company adopted a Non-Officer Employee Long-Term Incentive Plan (2000 Plan), which was not required to be approved by shareholders. The provisions of the 2000 Plan are essentially the same as those under the 1998 Plan, except for the exclusion of directors and executive officers of the Company. The Company has available a maximum of 2.5 million shares of its common stock for grant under the 2000 Plan. The Company currently does not plan to issue any further options or securities under this plan.

The Board of Directors has determined that it is no longer in the Company's best interest to issue stock options under the 1998 Plan and the 2000 Plan. Other forms of compensation are in place including the issuance of performance shares to certain officers and other key employees.

Prior to January 1, 2006, the Company accounted for stock based compensation using APB No. 25, which requires the recognition of compensation expense on the excess, if any, of the market price of the stock at the date of grant over the exercise price of the option. As the exercise price for options granted under the 1998 Plan and the 2000 Plan was equal to the market price at the date of grant, there was no compensation expense recorded by the Company. However, the Company has recognized compensation expense related to the initial grant (2003) of performance share awards that vested on December 31, 2005. SFAS No. 123 requires the disclosure of pro forma net income and earnings per common share had the Company adopted the fair value method of accounting for stock options. Under this statement, the fair value of stock-based awards is calculated with option pricing models. These models require the use of subjective assumptions, including stock price volatility, dividend yield, risk-free interest

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rate and expected time to exercise. The fair value of options is estimated on the date of grant using the Black-Scholes option-pricing model. See Note 1 for disclosure of pro forma net income and earnings per common share. In December 2004, the FASB issued SFAS No. 123R, which supersedes APB No. 25 and SFAS No. 123 and their related implementation guidance. The statement requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued beginning in 2006. See Note 2 for further information.

In 2005, the Company granted 163,600 performance shares to certain officers and other key employees under the 1998 Plan, of which 163,100 awards were outstanding as of December 31, 2005. In 2004, the Company granted 156,800 performance shares to certain officers and other key employees under the 1998 Plan and the 2000 Plan, of which 155,800 awards were outstanding as of December 31, 2005. In 2003, the Company granted 162,600 performance shares to certain officers and other key employees under the 1998 Plan and the 2000 Plan, of which 152,914 awards were outstanding as of December 31, 2005. The performance shares are payable at the Company's option in either cash or common stock three years from the date of grant. The amount of cash paid or common stock issued will range from 0 to 150 percent of the performance shares granted depending on the change in the value of the Company's common stock relative to an external benchmark. Based on the change in value of the Company's common stock relative to an external benchmark during the 3-year performance cycle, the Company issued 183,497 shares of common stock in early 2006 related to the performance shares granted in 2003. This resulted in compensation expense of \$3.6 million recorded during 2005. In February 2006, the Company granted 132,266 performance shares and 34,660 restricted shares to certain officers and other key employees under the 1998 Plan.

Shares of common stock issued from the exercise of stock options under the 1998 Plan and the 2000 Plan were acquired on the open market prior to 2006. Beginning in 2006, the Company will issue new shares for the exercise of stock options. As of December 31, 2005, there were 2.7 million shares available for future stock grants under the 1998 Plan and the 2000 Plan.

The following summarizes stock options activity under the 1998 Plan and the 2000 Plan for the years ended December 31:

| | 2005 | 2004 | 2003 |
|--|------------------|------------------|------------------|
| Number of shares under stock options: | | | |
| Options outstanding at beginning of year | 2,332,198 | 2,481,886 | 2,684,350 |
| Options granted | - | - | 24,000 |
| Options exercised | (192,377) | (99,138) | (37,439) |
| Options canceled | (44,610) | (50,550) | (189,025) |
| Options outstanding at end of year | <u>2,095,211</u> | <u>2,332,198</u> | <u>2,481,886</u> |
| Options exercisable at end of year | <u>1,968,629</u> | <u>1,896,648</u> | <u>1,614,455</u> |
| Weighted average exercise price: | | | |
| Options granted | \$ - | \$ - | \$12.41 |
| Options exercised | \$13.50 | \$13.79 | \$11.43 |
| Options canceled | \$20.42 | \$18.46 | \$17.78 |
| Options outstanding at end of year | \$15.68 | \$15.58 | \$15.57 |
| Options exercisable at end of year | \$16.03 | \$16.62 | \$17.18 |
| Weighted average fair value of options granted during the year | \$ - | \$ - | \$ 4.30 |
| Principal assumptions used in applying the Black-Scholes model: | | | |
| Risk-free interest rate | - | - | 3.17% |
| Expected life, in years | - | - | 7 |
| Expected volatility | - | - | 37.10% |
| Expected dividend yield | - | - | 3.87% |

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Information with respect to options outstanding and options exercisable as of December 31, 2005 was as follows:

| Range of Exercise Prices | Number of Shares | Options Outstanding | | Options Exercisable | |
|--------------------------|------------------|---------------------------------|--|---------------------|---------------------------------|
| | | Weighted Average Exercise Price | Weighted Average Remaining Life (in years) | Number of Shares | Weighted Average Exercise Price |
| \$10.17-\$11.68 | 459,411 | \$10.26 | 6.2 | 332,828 | \$10.27 |
| \$11.69-\$14.61 | 523,500 | 11.83 | 5.2 | 523,500 | 11.83 |
| \$14.62-\$17.53 | 416,800 | 17.12 | 4.0 | 416,800 | 17.12 |
| \$17.54-\$20.45 | 266,000 | 18.73 | 2.2 | 266,000 | 18.73 |
| \$20.46-\$23.38 | 403,300 | 22.56 | 4.1 | 403,300 | 22.56 |
| \$26.30-\$28.47 | <u>26,200</u> | 27.39 | 4.1 | <u>26,200</u> | 27.39 |
| Total | <u>2,095,211</u> | \$15.68 | 5.0 | <u>1,968,628</u> | \$16.03 |

Avista Capital Companies

Certain subsidiaries of Avista Capital have employee stock incentive plans under which certain employees and directors of the subsidiaries are granted options to purchase subsidiary shares at prices no less than the fair market value on the date of grant. Options outstanding under these plans generally vest over periods of between three and five years from the date granted and terminate ten years from the date granted. Employee stock incentive plans related to the Avista Capital subsidiaries are not significant to the consolidated financial statements.

Non-Employee Director Stock Plan

In February 2005, the Board of Directors elected to terminate the 1996 Director Plan. With the termination of the 1996 Director Plan, directors may elect each year to receive their annual retainer in cash, in common stock, or in a combination of both cash and common stock.

NOTE 26. COMMITMENTS AND CONTINGENCIES

In the course of its business, the Company becomes involved in various claims, controversies, disputes and other contingent matters, including the items described in this Note. Some of these claims, controversies, disputes and other contingent matters involve litigation or other contested proceedings. With respect to these proceedings, the Company intends to vigorously protect and defend its interests and pursue its rights. However, no assurance can be given as to the ultimate outcome of any particular matter because litigation and other contested proceedings are inherently subject to numerous uncertainties. In addition to issues specifically identified in this Note and with respect to matters that affect the regulated utility operations, the Company intends to seek, to the extent appropriate, regulatory approval of recovery of incurred costs through the rate making process.

Federal Energy Regulatory Commission Inquiry

On April 19, 2004, the Federal Energy Regulatory Commission (FERC) issued an order approving the contested Agreement in Resolution of Section 206 Proceeding (Agreement in Resolution) reached by Avista Corp. doing business as Avista Utilities, Avista Energy and the FERC's Trial Staff with respect to an investigation into the activities of Avista Utilities and Avista Energy in western energy markets during 2000 and 2001. In the Agreement in Resolution, the FERC Trial Staff stated that its investigation found: (1) no evidence that any executives or employees of Avista Utilities or Avista Energy knowingly engaged in or facilitated any improper trading strategy; (2) no evidence that Avista Utilities or Avista Energy engaged in any efforts to manipulate the western energy markets during 2000 and 2001; and (3) that Avista Utilities and Avista Energy did not withhold relevant information from the FERC's inquiry into the western energy markets for 2000 and 2001. As part of the Agreement in Resolution, Avista Utilities agreed to continue to record conversations of energy traders for two years and to improve its account settlement process. Avista Utilities and Avista Energy agreed to maintain an annual training program on the applicable FERC Code of Conduct for all employees engaged in the trading of electric energy and capacity. The Agreement in Resolution imposes no monetary remedies or penalties against Avista Utilities or Avista Energy. In April 2005 and June 2005, the California Parties and the City of Tacoma, respectively, filed petitions for review of the FERC's decisions approving the Agreement in Resolution with the United States Court of Appeals for the Ninth Circuit. Based on the FERC's order approving the Agreement in Resolution and the FERC's denial of rehearing requests, the Company does not expect that this proceeding will have any material adverse effect on its financial condition, results of operations or cash flows.

Class Action Securities Litigation

On November 10, 2005, an amended class action complaint was filed in the United States District Court for the Eastern District of Washington against Avista Corp., Thomas M. Matthews, the former Chairman of the Board, President and Chief Executive Officer of Avista Corp., Gary G. Ely, the current Chairman of the Board, President and Chief Executive Officer of Avista Corp., and Jon E. Eliassen, the former Senior Vice President and Chief Financial Officer of Avista Corp. Several class action complaints were originally filed in September through November 2002 in the same court against the same parties. In February 2003, the court issued an order, which consolidated the complaints and in August 2003, the plaintiffs filed a consolidated amended class action complaint. On June 13, 2005, the Company filed a motion for reconsideration of its earlier motion to dismiss this complaint, based, in part, on a recent United States Supreme Court decision with respect to the pleading requirements surrounding a sufficient showing of loss causation. On October 19, 2005, the Court granted the Company's motion to dismiss this complaint. The order to dismiss was issued without prejudice, which allowed the plaintiffs to amend their complaint. The amended complaint filed on November 10, 2005 alleges damages due to the decrease in the total market value of the Company's common stock during the class period, which was approximately \$2.6 billion. These alleged losses stemmed from violations of federal securities laws through alleged misstatements and omissions of material facts with respect to the Company's energy trading practices in western power markets. The plaintiffs assert that alleged misstatements and omissions regarding these matters were made in the Company's filings with the Securities and Exchange Commission and other information made publicly available by the Company, including press releases. The class action complaint asserts claims on behalf of all persons who purchased, converted, exchanged or otherwise acquired the Company's common stock during the period between November 23, 1999 and August 13, 2002. On January 6, 2006, the Company filed a motion to dismiss the November 10, 2005 complaint. The Company's motion to dismiss has been set for hearing in March 2006. The Company continues to assert that, among other deficiencies in the complaint, the plaintiff has failed to show sufficient loss causation. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

California Refund Proceeding

In July 2001, the FERC ordered an evidentiary hearing to determine the amount of refunds due to California energy buyers for purchases made in the spot markets operated by the California Independent System Operator (CalISO) and the California Power Exchange (CalPX) during the period from October 2, 2000 to June 20, 2001 (Refund Period) in the California spot power market. The findings of the FERC administrative law judge were largely adopted in March 2003 by the FERC. The refunds ordered are based on the development of a mitigated market clearing price methodology. If the refunds required by the formula would cause a seller to recover less than its actual costs for the refund period, the FERC has held that the seller would be allowed to document these costs and limit its refund liability commensurately. In September 2005, Avista Energy submitted its cost filing claim pursuant to the FERC's August 2005 order and demonstrated an overall revenue shortfall for sales into the California spot markets during the Refund Period after the mitigated market clearing price methodology is applied to its transactions. In January 2006, the FERC issued its Order On Cost Filings accepting Avista Energy's cost filing claim, subject to a compliance filing and the utilization of final CalISO, CalPX and Automated Power Exchange Corporation data. Once the CalISO receives updated cost offset filings from Avista Energy and other sellers, it will continue its efforts to prepare revised settlement statements for spot market sales to California during the refund period.

In 2001, Pacific Gas & Electric (PG&E) and Southern California Edison (SCE) defaulted on payment obligations to the CalPX and the CalISO. As a result, the CalPX and the CalISO failed to pay various energy sellers, including Avista Energy. Both PG&E and the CalPX declared bankruptcy in 2001. In March 2002, SCE paid its defaulted obligations to the CalPX. In April 2004, PG&E paid its defaulted obligations into an escrow fund in accordance with its bankruptcy reorganization. Funds held by the CalPX and in the PG&E escrow fund are not subject to release until the FERC issues an order directing such release in the California refund proceeding. As of December 31, 2005, Avista Energy's accounts receivable outstanding related to defaulting parties in California were fully offset by reserves for uncollected amounts and funds collected from defaulting parties.

In addition, in June 2003, the FERC issued an order to review bids above \$250 per MW made by participants in the short-term energy markets operated by the CalISO and the CalPX from May 1, 2000 to October 2, 2000. Market participants with bids above \$250 per MW during the period described above have been required to demonstrate why their bidding behavior and practices did not violate applicable market rules. If violations were found to exist,

the FERC would require the refund of any unjust profits and could also enforce other non-monetary penalties, such as the revocation of market-based rate authority. Avista Energy was subject to this review. In May 2004, the FERC provided notice that Avista Energy was no longer subject to this investigation. In March and April 2005, the California Parties and PG&E, respectively, petitioned for review of the FERC's decision by the United States Court of Appeals for the Ninth Circuit. In addition, many of the other orders that the FERC has issued in the California refund proceedings are now on appeal before the Ninth Circuit. Some of those issues have been consolidated as a result of a case management conference conducted in September 2004. In October 2004, the Ninth Circuit ordered that briefing proceed in two rounds. The first round is limited to three issues: (1) which parties are subject to the FERC's refund jurisdiction in light of the exemption for government-owned utilities in section 201(f) of the Federal Power Act (FPA); (2) the temporal scope of refunds under section 206 of the FPA; and (3) which categories of transactions are subject to refunds. Oral argument on those issues took place in April 2005. In September 2005, the Ninth Circuit held that the FERC did not have the authority to order refunds for sales made by municipal utilities in the California Refund Case; no decision has yet been issued on the other issues argued in April 2005. The time for seeking rehearing in the municipal utilities case has been extended until 45 days after disposition of the case presenting the other issues. The second round of issues and their corresponding briefing schedules have not yet been set by the Ninth Circuit Court of Appeals.

Because the resolution of the California refund proceeding remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that the California refund proceeding will have a material adverse effect on its financial condition, results of operations or cash flows due to netting against counterparty defaults. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Pacific Northwest Refund Proceeding

In July 2001, the FERC initiated a preliminary evidentiary hearing to develop a factual record as to whether prices for spot market sales in the Pacific Northwest between December 25, 2000 to June 20, 2001 were just and reasonable. During the hearing, Avista Utilities and Avista Energy vigorously opposed claims that Pacific Northwest markets were dysfunctional, that rates for spot market sales were unjust and unreasonable and that the imposition of refunds would be appropriate. In September 2001, the FERC's Administrative Law Judge presiding over the evidentiary hearing issued a decision favorable to the Company's position and recommended that the FERC not order refunds and instead dismiss the entire proceeding. In June 2003, the FERC terminated the Pacific Northwest refund proceedings, after finding that the equities do not justify the imposition of refunds. In November 2003, the FERC affirmed its order. Seven petitions for review, including one filed by Puget Sound Energy, Inc. (Puget), are now pending before the United States Court of Appeals for the Ninth Circuit. Opening briefs were filed in January 2005. Petitioners other than Puget challenged the merits of the FERC's decision not to order refunds. Puget's brief is directed to the procedural flaws in the underlying docket. Puget argues that because its complaint was withdrawn as a matter of law in July 2001, the FERC erred in relying on it to serve as the basis to initiate the preliminary investigation into whether refunds for individually negotiated bilateral transactions in the Pacific Northwest were appropriate. In February 2005, intervening parties, including Avista Energy and Avista Utilities, filed in support of Puget and also filed in opposition to the other six petitioners. Briefing was completed in May 2005. Oral arguments are expected, but have not yet been set. Because the resolution of the Pacific Northwest refund proceeding remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that the Pacific Northwest refund proceeding will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Reliant Energy, Inc. and Duke Energy Corporation Cross-Complaints

In April 2002, several subsidiaries of Reliant Energy, Inc. (Reliant) and Duke Energy Corporation (Duke) filed cross-complaints against Avista Energy and numerous other participants in the California energy markets. The cross-complaints seek indemnification for any liability that may arise from original complaints filed against Reliant and Duke with respect to charges of unlawful and unfair business practices in the California energy markets under California law. On November 9, 2005, both Duke and Reliant submitted to the Court stipulations with Avista Energy to conditionally dismiss, with prejudice, the cross complaints that had been filed against Avista Energy, subject to reinstatement if proposed settlements between Duke and Reliant and the plaintiffs are not approved by the Court. Avista Energy did not pay any amount to Duke or to Reliant to obtain these dismissals. The clerk of the court entered Reliant's request for dismissal on December 19, 2005 and entered Duke's request for dismissal on January 5, 2006.

On December 14, 2005, the Court granted final approval of the Duke settlement with the plaintiffs. The Court's order granting final approval of the Duke settlement will become final on March 14, 2006, absent any appeal. On January 6, 2006, the Court granted preliminary approval of the Reliant settlement with the plaintiffs. A hearing on final approval of the Reliant settlement is set for April 28, 2006. If the Court does not grant final approval of the Reliant settlement, Reliant may elect to reactivate its cross-complaint. Similarly, should the Court for any reason fail to approve the Reliant settlement by May 31, 2006, Avista Energy may withdraw from the stipulation agreement by giving ten days advance written notice.

Based on the stipulation of dismissal, if approved, the Company does not expect that this matter will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

California Attorney General Complaint

In May 2002, the FERC conditionally dismissed a complaint filed in March 2002 by the Attorney General of the State of California (California AG) that alleged violations of the Federal Power Act by the FERC and all sellers (including Avista Corp. and its subsidiaries) of electric power and energy into California. The complaint alleged that the FERC's adoption and implementation of market-based rate authority was flawed and, as a result, individual sellers were liable for sales of energy at rates that were "unjust and unreasonable." In May 2002, the FERC issued an order dismissing the complaint but directing sellers to re-file certain transaction summaries. It was not clear that Avista Corp. and its subsidiaries were subject to this directive but the Company took the conservative approach and re-filed certain transaction summaries in June and July of 2002. In July 2002, the California AG requested a rehearing on the FERC order, which request was denied in September 2002. Subsequently, the California AG filed a Petition for Review of the FERC's decision with the United States Court of Appeals for the Ninth Circuit. In September 2004, the United States Court of Appeals for the Ninth Circuit upheld the FERC's market-based rate authority, but found the requirement that all sales at market-based rates be contained in quarterly reports filed with the FERC to be integral to a market-based rate tariff. The California AG has interpreted the decision as providing authority to the FERC to order refunds in the California refund proceeding for an expanded refund period. The Court's decision leaves to the FERC the determination as to whether refunds are appropriate. In October 2004, Avista Energy joined with others in seeking rehearing of the Court's decision to remand the case back to the FERC for further proceedings. The Ninth Circuit has yet to rule on the request for rehearing. Based on information currently known to the Company's management, the Company does not expect that this matter will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Port of Seattle Complaint

In May 2003, a complaint was originally filed by the Port of Seattle in the United States District Court for the Western District of Washington against numerous companies, including Avista Corp., Avista Energy, Inc. and Avista Power, LLC (collectively the Avista defendants), seeking compensatory and treble damages for alleged violations of the Sherman Act and the Racketeer Influenced and Corrupt Organization Act by transmitting, via wire communications, false information intended to increase the price of power, knowing that others would rely upon such information. The complaint alleged that the defendants and others knowingly devised and attempted to devise a scheme to defraud and to obtain money and property from electricity customers throughout the Western Electricity Coordinating Council (WECC), by means of false and fraudulent pretenses, representations and promises. The alleged purpose of the scheme was to artificially increase the price that the defendants received for their electricity and ancillary services, to receive payments for services they did not provide and to manipulate the price of electricity throughout the WECC. This case was transferred to the United States District Court for the Southern District of California to consolidate it with other pending actions. In May 2004, the United States District Court for the Southern District of California granted motions to dismiss filed by the Avista defendants, as well as other defendants, with respect to this complaint. The Court dismissed the complaint because it determined that it was without jurisdiction to hear the plaintiff's claims, based on, among other things, the exclusive jurisdiction of the FERC and the filed-rate doctrine. In May 2004, the Port of Seattle filed an appeal with the United States Court of Appeals for the Ninth Circuit. In October 2005, the Ninth Circuit denied the plaintiffs' joint motion for summary disposition of the Port of Seattle's appeal. The Port of Seattle's appeal to the Ninth Circuit has been briefed and oral argument is scheduled for March 7, 2006. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its

financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Wah Chang Complaint

In May 2004, Wah Chang, a division of TDY Industries, Inc. (a subsidiary of Allegheny Technologies, Inc.), filed a complaint in the United States District Court for the District of Oregon against numerous companies, including Avista Corp., Avista Energy and Avista Power. The complaint seeks compensatory and treble damages for alleged violations of the Sherman Act, the Racketeer Influenced and Corrupt Organization Act, as well as violations of Oregon state law. According to the complaint, from September 1997 to September 2002, the plaintiff purchased electricity from PacifiCorp pursuant to a contract that was indexed to the spot wholesale market price of electricity. The plaintiff alleges that the defendants, acting in concert among themselves and/or with Enron Corporation and certain affiliates thereof (collectively, Enron) and others, engaged in a scheme to defraud electricity customers by transmitting false market information in interstate commerce in order to artificially increase the price of electricity provided by them, to receive payment for services not provided by them and to otherwise manipulate the market price of electricity, and by executing wash trades and other forms of market manipulation techniques and sham transactions. The plaintiff also alleges that the defendants, acting in concert among themselves and/or with Enron and others, engaged in numerous practices involving the generation, purchase, sale, exchange, scheduling and/or transmission of electricity with the purpose and effect of causing a shortage (or the appearance of a shortage) in the generation of electricity and congestion (or the appearance of congestion) in the transmission of electricity, with the ultimate purpose and effect of artificially and illegally fixing and raising the price of electricity in California and throughout the Pacific Northwest. As a result of the defendants' alleged conduct, the plaintiff allegedly suffered damages of not less than \$30 million through the payment of higher electricity prices. In September 2004, this case was transferred to the United States District Court for the Southern District of California for consolidation with other pending actions. In February 2005, the Court granted the defendants' motion to dismiss the complaint because it determined that it was without jurisdiction to hear the plaintiff's complaint, based on, among other things, the exclusive jurisdiction of the FERC and the filed-rate doctrine. In March 2005, Wah Chang filed an appeal with the United States Court of Appeals for the Ninth Circuit. The appeal of Wah Chang is still pending before the Ninth Circuit and awaits oral argument. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

City of Tacoma Complaint

In June 2004, the City of Tacoma, Department of Public Utilities, Light Division, a Washington municipal corporation (Tacoma Power), filed a complaint in the United States District Court for the Western District of Washington against over fifty companies, including Avista Corp., Avista Energy and Avista Power. According to the complaint, Tacoma Power distributes electricity to customers in Tacoma, and Pierce County, Washington, generates electricity at several facilities in western Washington and purchases power under supply contracts and in the Northwest spot market. Tacoma Power's complaint seeks compensatory and treble damages from alleged violations of the Sherman Act. Tacoma Power alleges that the defendants, acting in concert, engaged in a pattern of activities that had the purpose and effect of creating the impressions that the demand for power was higher, the supply of power was lower, or both, than was in fact the case. This allegedly resulted in an artificial increase of the prices paid for power sold in California and elsewhere in the western United States during the period from May 2000 through the end of 2001. Due to the alleged unlawful conduct of the defendants, Tacoma Power allegedly paid an amount estimated to be \$175.0 million in excess of what it would have paid in the absence of such alleged conduct. In September 2004, this case was transferred to the United States District Court for the Southern District of California for consolidation with other pending actions. In February 2005, the Court granted the defendants' motion to dismiss this complaint for similar reasons to those expressed by the Court in the Wah Chang complaint described above. In March 2005, Tacoma Power filed an appeal with the United States Court of Appeals for the Ninth Circuit. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

State of Montana Proceedings

In June 2003, the Attorney General of the State of Montana (Montana AG) filed a complaint in the Montana District Court on behalf of the people of Montana and the Flathead Electric Cooperative, Inc. against numerous companies, including Avista Corp. The complaint alleges that the companies illegally manipulated western electric and natural gas markets in 2000 and 2001. This case was subsequently moved to the United States District Court for the District of Montana; however, it has since been remanded back to the Montana District Court.

The Montana AG also petitioned the Montana Public Service Commission (MPSC) to fine public utilities \$1,000 a day for each day it finds they engaged in alleged "deceptive, fraudulent, anticompetitive or abusive practices" and order refunds when consumers were forced to pay more than just and reasonable rates. In February 2004, the MPSC issued an order initiating investigation of the Montana retail electricity market for the purpose of determining whether there is evidence of unlawful manipulation of that market. The Montana AG has requested specific information from Avista Energy and Avista Corp. regarding their transactions within the State of Montana during the period from January 1, 2000 through December 31, 2001.

Because the resolution of these proceedings remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that these proceedings will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Montana Public School Trust Fund Lawsuit

In October 2003, a lawsuit was filed by Richard Dolan and Denise Hayman in the United States District Court for the District of Montana against all private owners of hydroelectric dams in Montana, including Avista Corp. The lawsuit alleges that the hydroelectric facilities are located on state-owned riverbeds and the owners have never paid compensation to the state's public school trust fund. The lawsuit requests lease payments dating back to the construction of the respective dams and also requests damages for trespassing and unjust enrichment. An Amended Complaint adding Great Falls Elementary School District No. 1 and Great Falls High School District No. 1A was filed in January 2004. In February 2004, the Company filed its motion to dismiss this lawsuit; PacifiCorp and PPL Montana, as the other named defendants also filed a motion to dismiss, or joined therein. In May 2004, the Montana AG filed a complaint on behalf of the state to join in this lawsuit to allegedly protect and preserve state lands/school trust lands from use without compensation. In July 2004, the defendants (including Avista Corp.) filed a motion to dismiss the Montana AG's complaint. In September 2004, the United States District Court granted the motion to dismiss filed with respect to plaintiffs Richard Dolan, Denise Hayman and the school districts. However, the motion to dismiss the Montana AG's complaint was denied, citing, among other things, that the FERC does not have exclusive jurisdiction over this matter. Subsequently, in response to the motions of the defendants, the federal magistrate judge in January 2005 filed recommendations that the Court's previous decision be vacated based on lack of jurisdiction of the Court. In September 2005, the U.S. District Court issued an order vacating its prior decision, except as to matters of standing and jurisdiction. In November 2004, the defendants (including Avista Corp.) filed a petition for declaratory relief in Montana State Court requesting the resolution of the controversy that the plaintiffs raised in federal court and the Montana AG filed an answer, counterclaim and motion for summary judgment. The defendants have filed responses to the Montana AG's motion for summary judgment. In June 2005, Avista Corp. moved for leave to amend its complaint to, inter alia, add two causes of action relating to breach of contract and negligent misrepresentation arising out of its Clark Fork Settlement Agreement that was entered into in 1999 with the State of Montana relating to the relicensing of Avista Corp.'s Noxon Rapids Hydroelectric Generating Project. The Montana State Court heard the motion for summary judgment of the Montana AG and took the matter under advisement. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, the Company intends to seek recovery of any amounts paid through the rate making process.

Colstrip Generating Project Complaint

In May 2003, various parties (all of which are residents or businesses of Colstrip, Montana) filed a consolidated complaint against the owners of the Colstrip Generating Project (Colstrip) in Montana District Court. Avista Corp. owns a 15 percent interest in Units 3 & 4 of Colstrip. The plaintiffs allege damages to buildings as a result of rising ground water, as well as damages from contaminated waters leaking from the lakes and ponds of Colstrip. The plaintiffs are seeking punitive damages, an order by the court to remove the lakes and ponds and the forfeiture of all profits earned from the generation of Colstrip. The owners of Colstrip have undertaken certain groundwater investigation and remediation measures to address groundwater contamination. These measures include improvements to the lakes and ponds of Colstrip. The Company intends to continue to work with the other owners

of Colstrip in defense of this complaint. Because the resolution of this lawsuit remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this lawsuit will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Environmental Protection Agency Administrative Compliance Order

In December 2003, PPL Montana, LLC, as operator of Colstrip, received an Administrative Compliance Order (ACO) from the Environmental Protection Agency (EPA) pursuant to the Clean Air Act (CAA). In January 2006, the EPA issued a draft settlement agreement related to the ACO. The ACO alleges that Colstrip Units 3 & 4 have been in violation of the CAA permit at Colstrip since 1980. The permit required the Colstrip project operator to submit for review and approval by the EPA an analysis and proposal for reducing emissions of nitrogen oxides to address visibility concerns if, and when, EPA promulgates Best Available Retrofit Technology requirements for nitrogen oxide emissions. The EPA is asserting that regulations it promulgated in 1980 triggered this requirement. Avista Utilities and the other owners of Colstrip believe that the ACO is unfounded. The owners of Colstrip are discussing the proposed settlement agreement with the EPA, the Department of Environmental Quality (Montana DEQ) and the Northern Cheyenne Tribe. The draft settlement agreement would resolve the potential liability related to this issue. Because the resolution of this issue remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, the Company intends to seek recovery of any amounts paid through the rate making process.

Colstrip Royalty Claim

The Western Energy Company (WECO) supplies coal to the owners of Colstrip Units 3 & 4 under a Coal Supply Agreement and a Transportation Agreement. The Minerals Management Service (MMS) of the United States Department of the Interior issued an order to WECO to pay additional royalties concerning coal delivered to Colstrip Units 3 & 4 via the conveyor belt (approximately 4.46 miles long). The owners of Colstrip Units 3 & 4 take delivery of the coal at the western end (beginning) of the conveyor belt. The order asserts that additional royalties are owed MMS as a result of WECO not paying royalties in connection with revenue received by WECO from the owners of Colstrip Units 3 & 4 under the Transportation Agreement during the period October 1, 1991 through December 31, 2001. WECO's appeal to the MMS was substantially denied in March 2005; WECO has now appealed the order to the Board of Land Appeals of the U.S. Department of the Interior. The entire appeal process could take several years to resolve. The owners of Colstrip Units 3 & 4 are monitoring the appeal process between WECO and MMS.

WECO has indicated to the owners of Colstrip Units 3 & 4 that if WECO is unsuccessful in the appeal process, WECO will seek reimbursement of any royalty payments by passing these costs through the Coal Supply Agreement. The owners of Colstrip Units 3 & 4 advised WECO that their position would be that these claims are not allowable costs per the Coal Supply Agreement nor the Transportation Agreement in the event the owners of Colstrip Units 3 & 4 were invoiced for these claims. Because the resolution of this issue remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this issue will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Hamilton Street Bridge Site

A portion of the Hamilton Street Bridge Site in Spokane, Washington (including a former coal gasification plant site that operated for approximately 60 years until 1948) was acquired by the Company through a merger in 1958. The Company no longer owns the property. In January 1999, the Company received notice from the State of Washington's Department of Ecology (DOE) that it had been designated as a potentially liable party (PLP) with respect to any hazardous substances located on this site, stemming from the Company's past ownership of the former gas plant site. The Company responded to the DOE acknowledging its listing as a PLP, but requested that additional parties also be listed as PLPs. In the spring of 1999, the DOE named two other parties as additional PLPs.

The DOE, the Company and another PLP, Burlington Northern & Santa Fe Railway Co. (BNSF), signed an Agreed Order in March 2000 that provided for the completion of a remedial investigation and a feasibility study. After receiving input from the Company and the other PLPs, the final Cleanup Action Plan (CAP) was issued by the DOE in August 2001 and the Consent Decree to implement the CAP was finalized in September 2002. The third PLP did not sign the Consent Decree. In September 2004, a Site Preparation Agreement was reached with the third PLP with

respect to the logistics of the CAP. The third PLP then completed the site preparation. The selected contractor then completed construction/installation of the work under the CAP by the end of the third quarter of 2005. The Company and BNSF filed the final Cleanup Action Report with the DOE during the fourth quarter of 2005. The Cleanup Action Plan does call for periodic ground water sampling and reporting for a period of five years.

Spokane River

In March 2001, the DOE informed Avista Development, a subsidiary of Avista Capital, of a health advisory concerning PCBs found in fish caught in a portion of the Spokane River. In June 2001, Avista Development received official notice that it had been designated as a PLP with respect to contaminated sites on the Spokane River. The DOE discovered PCBs in fish and sediments in the Spokane River in the 1970s and 1980s. In the 1990s, the DOE performed subsequent sampling of the river and identified potential sources of the PCBs, including the Spokane Industrial Park (SIP) and a number of other entities in the area. The SIP, renamed Pentzer Development Corporation (Pentzer Development) in 1990, operated a wastewater treatment plant at the site until it was closed in December 1993. The SIP's treatment plant discharged to the Spokane River under the terms of a National Pollutant Discharge Elimination System permit issued by the DOE. Pentzer Development sold the property in 1996 and merged with Avista Development in 1998. The DOE has named at least three other PLPs in this matter.

As directed by Avista Development and one other PLP, Kaiser Aluminum & Chemical Corporation (Kaiser), the field-work for the remedial investigation began in April 2003 and was completed by the end of 2003. The other PLPs have not been participating in the process. The Cleanup Action Plan (CAP), remedial investigation and feasibility study were finalized in August 2005. The Company expects that work under the CAP will be completed in 2006.

The Company has entered into a settlement with the DOE and Kaiser relating to the remediation of the site. Under the agreement, the Company will perform the selected remedial action. Kaiser, which is presently operating under Chapter 11 bankruptcy protection, has paid the Company approximately 50 percent of the current estimate of the total costs, which was approved by the Kaiser bankruptcy judge and will be used by the Company to fund the costs of the remediation. During 2004, the Company accrued its share of the total estimated costs, which was not material to the Company's consolidated financial condition or results of operations. Because of uncertainties with respect to, among other things, any future cost sharing agreement with the non-participating PLPs and unforeseen site conditions, the Company's estimate of its liability could change in future periods. Based on information currently known to the Company's management, the Company does not believe that such a change would be material to its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimate of the liability. Such a change, should it occur, could be significant.

Harbor Oil Inc. Site

Avista Corp. used Harbor Oil Inc. (Harbor Oil) for the recycling of waste oil and non-PCB transformer oil in the late 1980s and early 1990s. In June 2005, EPA Region 10 provided notification to Avista Corp., as a customer of Harbor Oil, that the EPA had determined that hazardous substances were released at the Harbor Oil site in Portland, Oregon and that Avista Corp. may be liable for investigation and cleanup of the site under the Comprehensive Environmental Response, Compensation, and Liability Act, commonly referred to as the federal "Superfund" law. Harbor Oil's primary business was the collection and blending of used oil for sale as fuel to ships at sea. The initial indication from the EPA is that the site may be contaminated with PCBs, petroleum hydrocarbons, chlorinated solvents and heavy metals.

Thirteen other companies received a similar notice, including current and former owners of the site, the Bonneville Power Administration, Portland General Electric Corporation, Northwestern Energy and Unocal Oil. Several meetings have been held with the EPA and the Potentially Responsible Parties (PRPs) to ask questions of the EPA regarding the Harbor Oil site and discuss the process used by the EPA in selecting PRPs.

Based on the review of its records related to Harbor Oil, the Company does not believe it is a major contributor to this potential environmental contamination based on the relative volume of waste oil delivered to the Harbor Oil site. However, there is currently not enough information to allow the Company to assess the probability or amount of a liability, if any, being incurred. As such, it is currently not possible to make an estimate of any liability at this time.

Northeast Combustion Turbine Site

In August 2005, a diesel fuel spill occurred at the Company's Northeast Combustion Turbine generating facility (Northeast CT) located in Spokane, Washington. The Northeast CT site had fuel storage facilities that were leased to Co-op Supply, Inc., an affiliate of Cenex Cooperative (Co-op). The fuel spill occurred when Co-op made a

delivery of diesel to a tank that was already nearly full and the extra fuel overflowed into a containment area. It is estimated that approximately 26,000 gallons of fuel escaped the containment area and leaked into the soil below it. An investigation, supervised by the DOE, determined the fuel was, for the most part, uniformly present in the soil to a depth of 30-35 feet. Groundwater below the site is at a depth of 170 feet. Remediation efforts included the removal of contaminated soil and the related fuel storage facilities. Options to dispose of the contaminated soil are currently being evaluated and are expected to be completed by the middle of 2006. During the fourth quarter of 2005, the Company filed a complaint against Co-op and an engineering firm to recover a substantial portion of the cleanup costs. The Company has accrued the estimated cleanup costs during 2005, which was not material to the Company's consolidated financial condition or results of operations. It is possible that a change could occur in the Company's estimate of the liability. Such a change, should it occur, is not expected to be significant.

Lake Coeur d'Alene

In July 1998, the United States District Court for the District of Idaho issued its finding that the Coeur d'Alene Tribe of Idaho (Tribe) owns, among other things, portions of the bed and banks of Lake Coeur d'Alene (Lake) lying within the current boundaries of the Coeur d'Alene Reservation. This action had been brought by the United States on behalf of the Tribe against the state of Idaho. The Company was not a party to this action. The United States District Court decision was affirmed by the United States Court of Appeals for the Ninth Circuit. The United States Supreme Court affirmed this decision in June 2001. This will result in, among other things, the Company being liable to the Tribe for compensation for the use of reservation lands under Section 10(e) of the Federal Power Act.

The Company's Post Falls Hydroelectric Generating Station (Post Falls), a facility constructed in 1906 with a present capability of 18 MW, utilizes a dam on the Spokane River downstream of the Lake which controls the water level in the Lake for portions of the year (including portions of the lakebed owned by the Tribe). The Company has other hydroelectric facilities on the Spokane River downstream of Post Falls, but these facilities do not affect the water level in the Lake. The Company and the Tribe are engaged in discussions with respect to past and future compensation (which may include interest) for use of the portions of the bed and banks of the Lake, which are owned by the Tribe. If the parties cannot agree on the amount of compensation, the matter could result in litigation. The Company cannot predict the amount of compensation that it will ultimately pay or the terms of such payment. However, the Company intends to seek recovery of any amounts paid through the rate making process.

Spokane River Relicensing

The Company owns and operates six hydroelectric plants on the Spokane River, and five of these (Long Lake, Nine Mile, Upper Falls, Monroe Street and Post Falls) are under one FERC license and are referred to, collectively, as the Spokane River Project. The sixth, Little Falls, is operated under separate Congressional authority and is not licensed by the FERC. The license for the Spokane River Project expires on August 1, 2007; the Company filed a Notice of Intent to Relicense in July 2002. The formal consultation process involving planning and information gathering with stakeholder groups has been underway since that time. The Company filed its license application with the FERC in July 2005. The Company has requested the FERC to consider a license for Post Falls that is separate from the other four hydroelectric plants. This is due to the fact that Post Falls presents more complex issues that may take longer to resolve than those dealing with the rest of the Spokane River Project. If granted, new licenses would have a term of 30 to 50 years. In the license application, the Company has proposed a number of measures intended to address the impact of the Spokane River Project and enhance resources associated with the Spokane River. Currently, certain environmental measures in the Company's license application have estimated costs of \$3.2 million per year. For certain items, costs cannot be reasonably estimated at this time. The total annual operating and capitalized costs associated with the relicensing of the Spokane River Project will become better known and estimable as the process continues through July 2007. The Company intends to seek recovery of relicensing costs through the rate making process.

Clark Fork Settlement Agreement

Dissolved atmospheric gas levels exceed state of Idaho and federal water quality standards downstream of the Cabinet Gorge Hydroelectric Generating Project (Cabinet Gorge) during periods when excess river flows must be diverted over the spillway. Under the terms of the Clark Fork Settlement Agreement, the Company developed an abatement and mitigation strategy with the other signatories to the agreement and completed the Gas Supersaturation Control Program (GSCP). The Idaho Department of Environmental Quality and the U.S. Fish and Wildlife Service approved the GSCP in February 2004 and the FERC issued an order approving the GSCP in January 2005. The GSCP provides for the opening and modification of one and, potentially, both of the two existing diversion tunnels built when Cabinet Gorge was originally constructed. Streamflows would be diverted to the tunnels when these flows are in excess of turbine capacity. The Company has undertaken physical and computer modeling studies to confirm the feasibility and likely effectiveness of its tunnel solution. The results of these studies will also help the

Company to refine its estimated costs for completion of the tunnels. The cost of modifying the first tunnel is currently preliminarily estimated to be \$38 million (including AFUDC and inflation) and will be incurred between 2004 and 2010 (\$1.7 million incurred through December 31, 2005), with the majority of these costs being incurred in 2007 through 2009. The second tunnel would be modified only after evaluation of the performance of the first tunnel and such modifications would commence no later than 10 years following the completion of the first tunnel. It is currently preliminarily estimated that the costs to modify the second tunnel would be \$26 million (including AFUDC and inflation). As part of the GSCP, the Company provides \$0.5 million annually as mitigation for aquatic resources that might be adversely affected by high dissolved gas levels. Mitigation funds will continue until the modification of the second tunnel commences or if the second tunnel is not modified to an agreed upon point in time commensurate with the biological effects of high dissolved gas levels. The Company intends to seek recovery of the costs for the modification of Cabinet Gorge and the mitigation payments through the rate making process.

The U.S Fish and Wildlife Service has listed bull trout as threatened under the Endangered Species Act. The Clark Fork Settlement Agreement describes programs intended to restore bull trout populations in the project area. Using the concept of adaptive management and working closely with the U.S. Fish and Wildlife Service, the Company is evaluating the feasibility of fish passage at Cabinet Gorge and Noxon Rapids. The results of these studies will help the Company and other parties determine the best use of funds toward continuing fish passage efforts or other bull trout population enhancement measures.

Emergis Technologies, Inc. Complaint

On January 20, 2006, Emergis Technologies, Inc. (Emergis) filed a complaint against the Company alleging that certain electronic invoicing and payment system processes employed by Avista Utilities infringe upon a patent owned and held by Emergis. The complaint was filed in the United States District Court for the Eastern District of Washington and seeks unspecified compensatory and treble damages from alleged infringement of Emergis' patent. The Company is in the process of assessing the validity of the complaint with respect to its electronic utility billing and payment processing system. Because the resolution of this complaint remains uncertain, legal counsel cannot express an opinion on the extent, if any, of the Company's liability. However, based on information currently known to the Company's management, the Company does not expect that this complaint will have a material adverse effect on its financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

Other Contingencies

In the normal course of business, the Company has various other legal claims and contingent matters outstanding. The Company believes that any ultimate liability arising from these actions will not have a material adverse impact on the Company's financial condition, results of operations or cash flows. It is possible that a change could occur in the Company's estimates of the probability or amount of a liability being incurred. Such a change, should it occur, could be significant.

The Company routinely assesses, based on in-depth studies, expert analyses and legal reviews, its contingencies, obligations and commitments for remediation of contaminated sites, including assessments of ranges and probabilities of recoveries from other responsible parties who have and have not agreed to a settlement and recoveries from insurance carriers. The Company's policy is to accrue and charge to current expense identified exposures related to environmental remediation sites based on estimates of investigation, cleanup and monitoring costs to be incurred.

The Company has potential liabilities under the Federal Endangered Species Act for species of fish that have either already been added to the endangered species list, been listed as "threatened" or been petitioned for listing. Thus far, measures adopted and implemented have had minimal impact on the Company.

Under the federal licenses for its hydroelectric projects, the Company is obligated to protect its property rights, including water rights. The State of Montana is examining the status of all water right claims within state boundaries. Claims within the Clark Fork River basin could potentially adversely affect the energy production of the Company's Cabinet Gorge and Noxon Rapids hydroelectric facilities. The Company is participating in this extensive adjudication process, which is unlikely to be concluded in the foreseeable future.

The Company must be in compliance with requirements under the Clean Air Act and Clean Air Act Amendments at with respect to its thermal generating plants. The Company continues to monitor legislative developments at both the state and national level with respect to the potential for further restrictions on sulfur dioxide, nitrogen oxide,

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carbon dioxide (including cap and trade emission reduction programs), as well as other greenhouse gas and mercury emissions. In particular, the EPA has finalized mercury emission regulations that will affect coal-fired generation plants, including Colstrip. The new EPA regulations establish an emission trading program to take effect beginning in January 2010, with a second phase to take effect in 2018. In addition, the Montana DEQ is planning to propose rules for the control of mercury emissions from coal-fired plants that would be more restrictive than EPA regulations. The proposed rules will be presented to the Montana Board of Environmental Review on March 23, 2006. Compliance with these new and proposed requirements and possible additional legislation or regulations could result in increases in capital expenditures and operating expenses for expanded emission controls at the Company's thermal generating facilities. The amount of these costs and the impact of the restrictions on the operation of the facilities cannot be estimated at this time.

As of December 31, 2005, the Company's collective bargaining agreement with the International Brotherhood of Electrical Workers represented approximately 50 percent of all of Avista Utilities' employees. The agreement with the local union in Washington and Idaho representing the majority (approximately 90 percent) of the bargaining unit employees expires in March 2007. Two local agreements in Oregon, which cover approximately 50 employees, expire in April 2010. Another local agreement in Oregon is up for negotiations in 2007.

NOTE 27. INFORMATION SERVICES CONTRACTS

The Company has information services contracts that expire between 2006 and 2012. Total payments under these contracts were \$12.8 million, \$12.8 million and \$12.0 million in 2005, 2004 and 2003, respectively. The majority of these costs are included in other operating expenses in the Consolidated Statements of Income. Minimum contractual obligations under the Company's information services contracts are approximately \$11.1 million, \$11.4 million, \$11.8 million, \$12.1 million, \$12.5 million, \$12.9 million and \$13.2 million from 2006 through 2012. The most significant of these contracts provides for increases due to changes in the cost of living index and further provides flexibility in the annual obligation from year-to-year subject to a three-year true-up cycle.

NOTE 28. DISPOSITION OF SOUTH LAKE TAHOE PROPERTIES

In April 2005, Avista Corp. completed the sale of its South Lake Tahoe, California natural gas properties to Southwest Gas Corporation as part of Avista Utilities' strategy to focus on its business in the northwestern United States. This was the Company's only regulated utility operation in California. The cash proceeds received during 2005 were approximately \$16.6 million. The total pre-tax gain for 2005 was \$4.1 million related to the Company's disposition of its South Lake Tahoe natural gas properties.

Total revenues for 2004 from the South Lake Tahoe region were approximately \$20.3 million (or 6 percent of total natural gas revenues) and approximately 22.1 million therms (or 4 percent of total therms) were delivered to South Lake Tahoe customers.

The Company classified the assets of its South Lake Tahoe natural gas properties as assets held for sale on the Consolidated Balance Sheets as of December 31, 2004. These assets consisted primarily of net utility property, accounts receivable and deferred natural gas costs.

NOTE 29. INFORMATION BY BUSINESS SEGMENTS

The business segment presentation reflects the basis currently used by the Company's management to analyze performance and determine the allocation of resources. Avista Utilities' business is managed based on the total regulated utility operation. The Energy Marketing and Resource Management business segment primarily consists of electricity and natural gas marketing, trading and resource management including optimization of energy assets owned by other entities and derivative commodity instruments such as futures, options, swaps and other contractual arrangements. Avista Advantage is a provider of facility information and cost management services for multi-site customers throughout North America. The Other business segment includes other investments and operations of various subsidiaries as well as certain other operations of Avista Capital.

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The following table presents information for each of the Company's business segments (dollars in thousands):

| | Avista Utilities | Energy Marketing And Resource Management | Avista Advantage | Other | Intersegment Eliminations (1) | Total |
|---|---------------------|--|---------------------|----------|----------------------------------|-------------|
| For the year ended December 31, 2005: | | | | | | |
| Operating revenues..... | \$1,161,317 | \$167,439 | \$31,748 | \$18,532 | \$ (19,429) | \$1,359,607 |
| Resource costs..... | 669,596 | 165,423 | - | - | (19,429) | 815,590 |
| Gross margin..... | 491,721 | 2,016 | - | - | - | 493,737 |
| Other operating expenses..... | 181,478 | 18,795 | 22,738 | 18,120 | - | 241,131 |
| Depreciation and amortization..... | 80,914 | 1,488 | 2,037 | 2,472 | - | 86,911 |
| Income (loss) from operations..... | 165,378 | (18,267) | 6,973 | (2,060) | - | 152,024 |
| Interest expense (2)..... | 91,847 | 395 | 912 | 1,694 | (2,134) | 92,714 |
| Income taxes..... | 29,967 | (4,981) | 2,147 | (1,272) | - | 25,861 |
| Net income (loss)..... | 52,479 | (8,621) | 3,922 | (2,612) | - | 45,168 |
| Capital expenditures..... | 213,652 | 1,573 | 1,106 | 1,365 | - | 217,696 |
| For the year ended December 31, 2004: | | | | | | |
| Operating revenues..... | 972,574 | 275,646 | 23,444 | 17,127 | (137,211) | 1,151,580 |
| Resource costs..... | 519,002 | 236,804 | - | - | (137,211) | 618,595 |
| Gross margin..... | 453,572 | 38,842 | - | - | - | 492,414 |
| Other operating expenses..... | 180,418 | 25,797 | 19,800 | 21,781 | - | 247,796 |
| Depreciation and amortization..... | 72,787 | 1,364 | 1,902 | 2,372 | - | 78,425 |
| Income (loss) from operations..... | 134,073 | 11,681 | 1,742 | (7,026) | - | 140,470 |
| Interest expense (2)..... | 92,068 | 528 | 874 | 1,008 | (1,431) | 93,047 |
| Income taxes..... | 18,383 | 5,421 | 334 | (2,546) | - | 21,592 |
| Net income (loss) before cumulative effect of accounting change..... | 32,467 | 9,733 | 577 | (7,163) | - | 35,614 |
| Net income (loss)..... | 32,467 | 9,733 | 577 | (7,623) | - | 35,154 |
| Capital expenditures..... | 115,346 | 1,455 | 840 | 831 | - | 118,472 |
| For the year ended December 31, 2003: | | | | | | |
| Operating revenues..... | 928,211 | 307,141 | 19,839 | 13,581 | (145,387) | 1,123,385 |
| Resource costs..... | 483,097 | 246,952 | - | - | (145,387) | 584,662 |
| Gross margin..... | 445,114 | 60,189 | - | - | - | 505,303 |
| Other operating expenses..... | 165,478 | 28,852 | 18,518 | 15,570 | - | 228,418 |
| Depreciation and amortization..... | 72,068 | 1,259 | 2,652 | 1,832 | - | 77,811 |
| Income (loss) from operations..... | 146,777 | 30,078 | (1,331) | (3,821) | - | 171,703 |
| Interest expense (2)..... | 91,908 | 1,009 | 742 | 1,025 | (1,699) | 92,985 |
| Income taxes..... | 26,884 | 11,457 | (718) | (2,283) | - | 35,340 |
| Income (loss) from continuing operations..... | 36,241 | 20,672 | (1,334) | (4,936) | - | 50,643 |
| Capital expenditures..... | 102,271 | 2,013 | 459 | 916 | - | 105,659 |
| Total Assets: | | | | | | |
| Total assets as of December 31, 2005 | 2,838,154 | 2,012,354 | 46,094 | 51,892 | - | 4,948,494 |
| Total assets as of December 31, 2004 | 2,608,155 | 1,002,843 | 47,318 | 53,305 | - | 3,711,621 |

- (1) Intersegment eliminations reported as operating revenues and resource costs represent the transactions between Avista Utilities and Avista Energy for energy commodities and services, primarily natural gas purchased by Avista Utilities under the Agency Agreement. Intersegment eliminations reported as interest expense represent intercompany interest.

- (2) Including interest expense to affiliated trusts.

NOTE 30. SELECTED QUARTERLY FINANCIAL DATA (Unaudited)

The Company's energy operations are significantly affected by weather conditions. Consequently, there can be large variances in revenues, expenses and net income between quarters based on seasonal factors such as, but limited to, temperatures and streamflow conditions. A summary of quarterly operations (in thousands, except per share amounts) for 2005 and 2004 follows:

| | Three Months Ended | | | |
|---|--------------------|----------------|-----------------|----------------|
| | March 31 | June 30 | September 30 | December 31 |
| 2005 | | | | |
| Operating revenues | \$362,664 | \$272,832 | \$265,679 | \$458,432 |
| Operating expenses | <u>324,481</u> | <u>226,822</u> | <u>261,752</u> | <u>398,621</u> |
| Gain on sale of utility properties | - | <u>3,209</u> | <u>884</u> | - |
| Income from operations | <u>38,183</u> | <u>49,219</u> | <u>4,811</u> | <u>59,811</u> |
| Net income (loss) | \$10,189 | \$18,604 | \$(9,037) | \$25,412 |
| Outstanding common stock: | | | | |
| Weighted average | 48,478 | 48,508 | 48,538 | 48,568 |
| End of period | 48,501 | 48,532 | 48,561 | 48,593 |
| Total earnings (loss) per common share, diluted | \$0.21 | \$0.38 | \$(0.20) | \$0.52 |
| Dividends paid per common share | \$0.135 | \$0.135 | \$0.135 | \$0.14 |
| Trading price range per common share: | | | | |
| High | \$18.37 | \$18.66 | \$20.20 | \$19.55 |
| Low | \$16.62 | \$16.31 | \$17.90 | \$16.76 |
| 2004 | | | | |
| Operating revenues | \$343,732 | \$225,888 | \$241,552 | \$340,408 |
| Operating expenses | <u>300,525</u> | <u>189,301</u> | <u>237,007</u> | <u>284,277</u> |
| Income from operations | <u>43,207</u> | <u>36,587</u> | <u>4,545</u> | <u>56,131</u> |
| Net income (loss) before cumulative effect | | | | |
| of accounting change | 12,684 | 10,132 | (9,782) | 22,580 |
| Cumulative effect of accounting change | <u>(460)</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Net income (loss) | \$12,224 | \$10,132 | \$(9,782) | \$22,580 |
| Outstanding common stock: | | | | |
| Weighted average | 48,352 | 48,384 | 48,416 | 48,446 |
| End of period | 48,375 | 48,411 | 48,440 | 48,472 |
| Earnings (loss) per common share, diluted: | | | | |
| Earnings (loss) before cumulative effect | | | | |
| of accounting change | \$0.26 | \$0.21 | \$(0.20) | \$0.46 |
| Cumulative effect of accounting change | <u>(0.01)</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Total earnings (loss) per common share, diluted | <u>\$0.25</u> | <u>\$0.21</u> | <u>\$(0.20)</u> | <u>\$0.46</u> |
| Dividends paid per common share | \$0.125 | \$0.13 | \$0.13 | \$0.13 |
| Trading price range per common share: | | | | |
| High | \$18.92 | \$19.17 | \$18.56 | \$18.55 |
| Low | \$17.55 | \$15.51 | \$16.95 | \$16.95 |

NOTE 31: SUBSEQUENT EVENT

In February 2006, the Board of Directors of Avista Corp. made the decision to ask shareholders to approve a change in the Company's organization, which would result in the formation of a holding company. The proposed holding company would become the parent to the regulated utility Avista Corp. (Avista Utilities) and Avista Capital, which is the parent to the Company's non-utility subsidiaries.

The proposal for the formation of a holding company will be described for shareholders in Avista Corp.'s Proxy Statement-Prospectus to be distributed to shareholders in connection with the annual meeting of shareholders to be held on May 11, 2006. Avista Corp. has filed for regulatory approval from the FERC and the utility regulators in Washington, Idaho, Oregon and Montana, conditioned on approval by shareholders. If shareholders approve the proposal, and if state and federal regulatory approvals are received, the holding company organization could be implemented by the end of 2006.

MANAGEMENT'S REPORTS TO AVISTA CORPORATION STOCKHOLDERS

Management's Statement of Responsibility

Management of Avista Corporation is responsible for the accuracy and completeness of the information in this annual report. The financial and operating information presented is derived from company records and other sources. This annual report includes amounts that are based on judgment and estimates where necessary. Disclosure controls and procedures in combination with the Company's internal control over financial reporting provide reasonable assurance that the annual report fairly and reasonably presents the Company's financial position and operating results.

Management's Report on Internal Control Over Financial Reporting

The Company's management, together with its consolidated subsidiaries, is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934). The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive officer and principal financial officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with accounting principals generally accepted in the United States of America.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principals generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the Company's financial statements.

Under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, the Company conducted an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2005 is effective.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 has been audited by Deloitte & Touche LLP, the independent registered public accounting firm who audits the Company's consolidated financial statements, as stated in their report on the following pages, which expresses unqualified opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting as of December 31, 2005.



Gary G. Ely
Chairman, President and
Chief Executive Officer



Malyn K. Malquist
Senior Vice President and
Chief Financial Officer

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Avista Corporation
Spokane, Washington

We have audited the accompanying consolidated balance sheets of Avista Corporation and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Avista Corporation and subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the consolidated financial statements ("Note 2"), during 2004, the Company was required to consolidate a partnership as well as several low-income housing project investments related to the adoption of Financial Accounting Standards Board ("FASB") Interpretation No. 46(R). Additionally, during 2003, as described in Note 1 to the consolidated financial statements ("Note 1"), the Company changed its method of accounting for energy trading activities related to the transition from Emerging Issues Task Force Issue No. 98-10 to Statement of Financial Accounting Standards ("SFAS") No. 133, and, as described in Note 2, was required to consolidate WP Funding LP, and deconsolidate the capital trusts related to the adoption of FASB Interpretation No. 46. Additionally, as described in Note 2, during 2003, the Company changed its classification of preferred stock to conform to the requirements of SFAS No. 150.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 6, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

Seattle, Washington
March 6, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Avista Corporation
Spokane, Washington

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Avista Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2005 of the Company, and our report dated March 6, 2006 expressed an unqualified opinion on those financial statements.

Deloitte & Touche LLP

Seattle, Washington
March 6, 2006

SELECTED FINANCIAL DATA

| | 2005 | 2004 | 2003 | 2002 | 2001 | 1995 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| FINANCIAL RESULTS | | | | | | |
| Operating revenues | \$1,359,607 | \$1,151,580 | \$1,123,385 | \$1,062,916 | \$1,511,751 | \$755,000 |
| Operating expenses | 1,211,676 | 1,011,110 | 951,682 | 905,774 | 1,327,685 | 565,160 |
| Gain on sale of utility properties | 4,093 | - | - | - | - | - |
| Income from operations | 152,024 | 140,470 | 171,703 | 157,142 | 184,066 | 189,840 |
| Interest expense | 92,714 | 93,047 | 92,985 | 104,866 | 105,819 | 59,020 |
| Income taxes | 25,861 | 21,592 | 35,340 | 34,849 | 40,585 | 52,410 |
| Income from continuing operations | 45,168 | 35,614 | 50,643 | 42,174 | 68,241 | 87,120 |
| Loss from discontinued operations | - | - | (4,949) | (6,719) | (56,085) | - |
| Net income before cumulative effect of accounting change | 45,168 | 35,614 | 45,694 | 35,455 | 12,156 | 87,120 |
| Cumulative effect of accounting change | - | (460) | (1,190) | (4,148) | - | - |
| Net income | 45,168 | 35,154 | 44,504 | 31,307 | 12,156 | 87,120 |
| Preferred stock dividend requirements (1) | - | - | (1,125) | (2,402) | (2,432) | (9,120) |
| Income available for common stock | \$45,168 | \$35,154 | \$43,379 | \$28,905 | \$9,724 | \$77,990 |
| Earnings per common share, diluted: | | | | | | |
| Earnings from continuing operations | \$0.92 | \$0.73 | \$1.02 | \$0.83 | \$1.38 | \$1.40 |
| Loss from discontinued operations | - | - | (0.10) | (0.14) | (1.18) | - |
| Earnings before cumulative effect of accounting change | 0.92 | 0.73 | 0.92 | 0.69 | 0.20 | 1.40 |
| Cumulative effect of accounting change | - | (0.01) | (0.03) | (0.09) | - | - |
| Total earnings per common share, diluted | \$0.92 | \$0.72 | \$0.89 | \$0.60 | \$0.20 | \$1.40 |
| Total earnings per common share, basic | \$0.93 | \$0.73 | \$0.90 | \$0.60 | \$0.21 | \$1.40 |
| COMMON STOCK STATISTICS | | | | | | |
| Dividends paid per common share | \$0.545 | \$0.52 | \$0.49 | \$0.48 | \$0.48 | \$1.20 |
| Book value per common share | \$15.87 | \$15.54 | \$15.54 | \$14.84 | \$15.12 | \$12.80 |
| Shares of common stock: | | | | | | |
| Outstanding at year-end | 48,593 | 48,472 | 48,344 | 48,044 | 47,633 | 55,900 |
| Average - basic | 48,523 | 48,400 | 48,232 | 47,823 | 47,417 | 55,100 |
| Average - diluted | 48,979 | 48,886 | 48,630 | 47,874 | 47,435 | 55,100 |
| Return on average common equity: | | | | | | |
| Total company | 5.9% | 4.7% | 5.9% | 4.0% | 1.3% | 11.2% |
| Utility only | 10.2% | 6.6% | 7.4% | 8.2% | 5.9% | 11.0% |
| Non-utility only | -3.0% | 1.0% | 3.2% | -1.7% | -3.4% | 12.1% |
| Common stock price: | | | | | | |
| High | \$20.20 | \$19.17 | \$18.70 | \$16.60 | \$23.97 | \$18.00 |
| Low | \$16.31 | \$15.51 | \$9.80 | \$8.75 | \$10.60 | \$13.50 |
| Year-end close | \$17.71 | \$17.67 | \$18.12 | \$11.56 | \$13.26 | \$17.50 |
| DEBT AND PREFERRED STOCK STATISTICS | | | | | | |
| Pretax interest coverage: | | | | | | |
| Including AFUDC/AFUCE | 1.84(x) | 1.60(x) | 1.78(x) | 1.59(x) | 1.32(x) | 3.37(x) |
| Excluding AFUDC/AFUCE | 1.80(x) | 1.56(x) | 1.76(x) | 1.57(x) | 1.29(x) | 3.34(x) |
| Embedded cost of long-term debt | 8.09% | 8.27% | 8.44% | 8.88% | 8.78% | 7.88% |
| Embedded cost of preferred stock | 7.39% | 7.39% | 7.35% | 7.42% | 7.39% | 7.37% |
| Credit Ratings (Standard & Poor's/Moody's) | | | | | | |
| Senior secured debt | BBB-/Baa3 | BBB-/Baa3 | BBB-/Baa3 | BBB-/Baa3 | BBB-/Baa3 | A-/A3 |
| Senior unsecured debt | BB+/Ba1 | BB+/Ba1 | BB+/Ba1 | BB+/Ba1 | BB+/Ba1 | BBB+/Baa3 |
| Preferred stock | BB-/Ba3 | BB-/Ba3 | BB-/Ba3 | BB-/Ba3 | BB-/Ba3 | BBB+/baa3 |
| FINANCIAL CONDITION | | | | | | |
| Total assets | \$4,948,494 | \$3,711,621 | \$3,640,075 | \$3,799,543 | \$4,210,704 | \$2,098,900 |
| Total net utility property | 2,126,417 | 1,956,063 | 1,914,001 | 1,749,114 | 1,739,123 | 1,357,410 |
| Utility property capital expenditures (excluding AFUDC) | 213,652 | 115,346 | 102,271 | 64,207 | 119,905 | 79,940 |
| Long-term debt | 989,990 | 901,556 | 925,012 | 902,635 | 1,175,715 | 738,280 |
| Long-term debt to affiliated trusts (2) | 113,403 | 113,403 | 113,403 | - | - | - |
| Preferred trust securities (2) | - | - | - | 100,000 | 100,000 | - |
| Preferred stock subject to mandatory redemption (1) | 26,250 | 28,000 | 29,750 | 33,250 | 35,000 | 135,000 |
| Common equity | \$771,128 | \$753,205 | \$751,252 | \$712,791 | \$720,063 | \$717,120 |

(1) Preferred stock was reclassified from equity to liabilities in 2003 with the adoption of SFAS No. 150. Accordingly, preferred stock dividend requirements were reclassified to interest expense effective July 1, 2003. See Note 2 of the Consolidated Financial Statements. Balance as of December 31, 2005, 2004 and 2003 does not include current portion.

(2) Preferred trust securities was reclassified to Long-term debt to affiliated trusts in 2003 with the adoption of FASB Interpretation No. 46 and the deconsolidation of the capital trusts that have issued the preferred trust securities. See Note 2 of the Consolidated Financial Statements.

SELECTED FINANCIAL DATA

| VISTA UTILITIES | 2005 | 2004 | 2003 | 2002 | 2001 | 1995 |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Electric Operations | | | | | | |
| Electric operating revenues (millions of dollars): | | | | | | |
| Residential | \$211.9 | \$209.5 | \$204.8 | \$196.1 | \$158.8 | \$156.8 |
| Commercial | 203.5 | 201.8 | 201.3 | 194.7 | 155.4 | 140.2 |
| Industrial | 91.6 | 90.3 | 78.3 | 68.1 | 80.4 | 61.0 |
| Public street and highway lighting | 4.9 | 4.8 | 4.8 | 4.7 | 3.8 | 3.3 |
| Total retail revenues | <u>511.9</u> | <u>506.4</u> | <u>489.2</u> | <u>463.6</u> | <u>398.4</u> | <u>361.3</u> |
| Wholesale revenues | 151.4 | 62.4 | 73.4 | 64.1 | 480.9 | 109.2 |
| Revenues from sales of fuel | 41.8 | 64.0 | 71.5 | 40.9 | 19.0 | - |
| Other revenues | 18.0 | 19.3 | 16.8 | 15.5 | 23.9 | 16.5 |
| Total electric operating revenues | <u>\$723.1</u> | <u>\$652.1</u> | <u>\$650.9</u> | <u>\$584.1</u> | <u>\$922.2</u> | <u>\$487.0</u> |
| Electric energy sales (millions of kWhs): | | | | | | |
| Residential | 3,420 | 3,343 | 3,298 | 3,203 | 3,219 | 3,150 |
| Commercial | 2,994 | 2,919 | 2,919 | 2,837 | 2,882 | 2,592 |
| Industrial | 2,091 | 2,076 | 1,785 | 1,519 | 1,891 | 1,803 |
| Public street and highway lighting | 25 | 25 | 25 | 25 | 25 | 23 |
| Total retail energy sales | <u>8,530</u> | <u>8,363</u> | <u>8,027</u> | <u>7,584</u> | <u>8,017</u> | <u>7,568</u> |
| Wholesale energy sales | 2,508 | 1,472 | 2,075 | 2,215 | 6,262 | 3,910 |
| Total electric energy sales | <u>11,038</u> | <u>9,835</u> | <u>10,102</u> | <u>9,799</u> | <u>14,279</u> | <u>11,478</u> |
| Electric customers (average per year): | | | | | | |
| Residential | 294,036 | 288,422 | 283,497 | 279,735 | 276,845 | 253,364 |
| Commercial | 37,282 | 36,728 | 36,279 | 35,910 | 35,454 | 32,236 |
| Industrial | 1,408 | 1,416 | 1,414 | 1,420 | 1,434 | 1,107 |
| Public street and highway lighting | 421 | 418 | 422 | 413 | 402 | 349 |
| Total electric retail customers | <u>333,147</u> | <u>326,984</u> | <u>321,612</u> | <u>317,478</u> | <u>314,135</u> | <u>287,056</u> |
| Wholesale | 46 | 43 | 47 | 46 | 44 | 33 |
| Total electric customers | <u>333,193</u> | <u>327,027</u> | <u>321,659</u> | <u>317,524</u> | <u>314,179</u> | <u>287,089</u> |
| Electric customers (at year-end): | | | | | | |
| Residential | 298,961 | 292,150 | 287,141 | 282,269 | 279,129 | 255,545 |
| Commercial | 37,587 | 37,040 | 36,551 | 36,106 | 35,726 | 32,581 |
| Industrial | 1,393 | 1,416 | 1,426 | 1,409 | 1,424 | 953 |
| Public street and highway lighting | 428 | 408 | 436 | 426 | 415 | 347 |
| Total retail electric customers | <u>338,369</u> | <u>331,014</u> | <u>325,554</u> | <u>320,210</u> | <u>316,694</u> | <u>289,426</u> |
| Wholesale | 46 | 45 | 38 | 50 | 32 | 37 |
| Total electric customers | <u>338,415</u> | <u>331,059</u> | <u>325,592</u> | <u>320,260</u> | <u>316,726</u> | <u>289,463</u> |
| Revenue per residential kWh (cents) | 6.20 | 6.27 | 6.21 | 6.12 | 4.93 | 4.98 |
| Use per residential customer (kWh) | 11,630 | 11,591 | 11,633 | 11,450 | 11,629 | 12,434 |
| Revenue per commercial kWh (cents) | 6.80 | 6.91 | 6.90 | 6.86 | 5.39 | 5.41 |
| Use per commercial customer (kWh) | 80,314 | 79,465 | 80,472 | 78,995 | 81,288 | 80,393 |
| Electric energy resources (millions of kWhs): | | | | | | |
| Hydro generation (from Company facilities) | 3,611 | 3,789 | 3,540 | 4,010 | 2,564 | 4,038 |
| Thermal generation (from Company facilities) | 3,666 | 2,408 | 2,398 | 1,714 | 3,001 | 2,537 |
| Purchased power - long-term hydro contracts | 864 | 794 | 775 | 836 | 631 | 1,159 |
| Purchased power - wholesale | 3,519 | 3,422 | 3,909 | 3,828 | 8,624 | 4,113 |
| Power exchanges | 10 | 38 | 36 | 13 | (104) | 156 |
| Total power resources | <u>11,670</u> | <u>10,451</u> | <u>10,658</u> | <u>10,401</u> | <u>14,716</u> | <u>12,003</u> |
| Energy losses and company use | (632) | (616) | (556) | (602) | (437) | (525) |
| Total electric energy resources | <u>11,038</u> | <u>9,835</u> | <u>10,102</u> | <u>9,799</u> | <u>14,279</u> | <u>11,478</u> |

SELECTED FINANCIAL DATA

| | 2005 | 2004 | 2003 | 2002 | 2001 | 1995 |
|--|----------------|----------------|----------------|----------------|----------------|----------------|
| Electric Operations (continued) | | | | | | |
| Total resources available at peak (MW): | | | | | | |
| Company owned: | | | | | | |
| Hydro | 980 | 965 | 955 | 955 | 956 | 971 |
| Thermal | 836 | 532 | 695 | 426 | 462 | 669 |
| Purchased power: | | | | | | |
| Long-term hydro contracts | 70 | 167 | 174 | 159 | 144 | 181 |
| Other | 670 | 888 | 733 | 673 | 1,991 | 1,034 |
| Total resources available at peak (winter) | <u>2,556</u> | <u>2,552</u> | <u>2,557</u> | <u>2,213</u> | <u>3,553</u> | <u>2,855</u> |
| Net system peak demand (winter) | 1,660 | 1,766 | 1,509 | 1,346 | 1,500 | 1,485 |
| Wholesale obligations | 282 | 454 | 417 | 297 | 1,734 | 1,060 |
| Total requirements (winter) | <u>1,942</u> | <u>2,220</u> | <u>1,926</u> | <u>1,643</u> | <u>3,234</u> | <u>2,545</u> |
| Reserve margin | 24% | 13% | 25% | 26% | 9% | 12% |
| Annual load factor | 56% | 62% | 65% | 62% | 65% | 62% |
| Average cost of production (cents per kWh) | 3.08 | 2.78 | 2.76 | 2.30 | 3.41 | 2.54 |
| Natural Gas Operations | | | | | | |
| Natural gas operating revenues (millions of dollars): | | | | | | |
| Residential | \$229.7 | \$194.5 | \$166.9 | \$184.0 | \$179.6 | \$84.3 |
| Commercial | 126.6 | 104.7 | 90.5 | 105.0 | 104.0 | 52.7 |
| Industrial | 11.9 | 9.4 | 7.5 | 7.1 | 11.2 | 7.5 |
| Total retail revenues | <u>368.2</u> | <u>308.6</u> | <u>264.9</u> | <u>296.1</u> | <u>294.8</u> | <u>144.5</u> |
| Wholesale revenues | 58.1 | 0.2 | 0.3 | 0.7 | 1.8 | 10.5 |
| Transportation revenues | 7.6 | 8.1 | 8.5 | 9.6 | 8.6 | 12.3 |
| Other revenues | 4.3 | 3.6 | 3.6 | 3.4 | 3.4 | 6.9 |
| Total natural gas operating revenues | <u>\$438.2</u> | <u>\$320.5</u> | <u>\$277.3</u> | <u>\$309.8</u> | <u>\$308.6</u> | <u>\$174.2</u> |
| Natural gas therms delivered (millions of therms): | | | | | | |
| Residential | 199.4 | 201.7 | 198.5 | 199.7 | 198.4 | 159.9 |
| Commercial | 123.0 | 122.8 | 122.1 | 126.2 | 126.9 | 120.8 |
| Industrial | 13.5 | 13.3 | 12.7 | 11.3 | 15.5 | 25.3 |
| Total retail | <u>335.9</u> | <u>337.8</u> | <u>333.3</u> | <u>337.2</u> | <u>340.8</u> | <u>306.0</u> |
| Wholesale | 72.9 | 0.3 | 0.7 | 2.3 | 4.8 | 104.8 |
| Transportation and other | 153.5 | 157.5 | 156.5 | 177.0 | 196.4 | 246.4 |
| Total natural gas therms delivered | <u>562.3</u> | <u>495.6</u> | <u>490.5</u> | <u>516.5</u> | <u>542.0</u> | <u>657.2</u> |
| Natural gas customers (average per year): | | | | | | |
| Residential | 265,294 | 268,571 | 261,063 | 254,700 | 249,650 | 192,252 |
| Commercial | 31,652 | 31,886 | 31,312 | 30,823 | 30,355 | 24,606 |
| Industrial | 307 | 311 | 310 | 315 | 328 | 312 |
| Total retail customers | <u>297,253</u> | <u>300,768</u> | <u>292,685</u> | <u>285,838</u> | <u>280,333</u> | <u>217,170</u> |
| Transportation and other | 105 | 82 | 85 | 89 | 88 | 80 |
| Total natural gas customers | <u>297,358</u> | <u>300,850</u> | <u>292,770</u> | <u>285,927</u> | <u>280,421</u> | <u>217,250</u> |
| Natural gas customers (at year-end): | | | | | | |
| Residential | 265,502 | 272,871 | 266,252 | 258,738 | 253,325 | 198,745 |
| Commercial | 31,476 | 31,675 | 31,732 | 31,141 | 30,697 | 25,102 |
| Industrial | 299 | 304 | 312 | 309 | 318 | 325 |
| Total retail customers | <u>297,277</u> | <u>304,850</u> | <u>298,296</u> | <u>290,188</u> | <u>284,340</u> | <u>224,172</u> |
| Transportation and other | 105 | 82 | 76 | 90 | 82 | 138 |
| Total natural gas customers | <u>297,382</u> | <u>304,932</u> | <u>298,372</u> | <u>290,278</u> | <u>284,422</u> | <u>224,310</u> |

SELECTED FINANCIAL DATA

| | 2005 | 2004 | 2003 | 2002 | 2001 | 1995 |
|---|-----------|-----------|-----------|-----------|-----------|---------|
| Natural Gas Operations (continued) | | | | | | |
| Revenue per residential therm (cents) | 115.19 | 96.42 | 84.11 | 92.13 | 90.51 | 52.75 |
| Use per residential customer (therms) | 752 | 751 | 760 | 784 | 795 | 832 |
| Revenue per commercial therm (cents) | 102.98 | 85.27 | 74.13 | 83.17 | 81.98 | 43.59 |
| Use per commercial customer (therms) | 3,885 | 3,853 | 3,900 | 4,095 | 4,180 | 4,911 |
| Heating degree days (at Spokane, Washington): | | | | | | |
| Actual | 6,538 | 6,314 | 6,351 | 6,818 | 6,800 | 6,363 |
| 30 year average | 6,820 | 6,820 | 6,820 | 6,842 | 6,842 | 6,842 |
| Actual as a percent of average | 96% | 93% | 93% | 100% | 99% | 93% |
| ENERGY MARKETING AND RESOURCE MANAGEMENT | | | | | | |
| Operating revenues (millions of dollars) | \$167.4 | \$275.6 | \$307.1 | \$222.6 | \$403.8 | \$ - |
| Resource costs (millions of dollars) | 165.4 | 236.8 | 246.9 | 168.4 | 269.5 | - |
| Gross margin (millions of dollars) | \$2.0 | \$38.8 | \$60.2 | \$54.2 | \$134.3 | \$ - |
| Gross Physical Realized Sales Volume | | | | | | |
| Electricity (thousands of MWs) | 28,377 | 32,629 | 41,579 | 40,426 | 47,927 | - |
| Natural gas (thousands of dekatherms) | 182,874 | 219,719 | 228,397 | 225,983 | 248,193 | - |
| Coal (thousands of tons) | - | - | - | - | - | - |
| Total assets (millions of dollars) | \$2,012.4 | \$1,002.8 | \$1,013.2 | \$1,349.6 | \$1,506.2 | \$ - |
| WISTA ADVANTAGE | | | | | | |
| Revenues (millions of dollars) | \$31.7 | \$23.4 | \$19.8 | \$16.9 | \$13.2 | \$ - |
| Total assets (millions of dollars) | \$46.1 | \$47.3 | \$45.6 | \$31.7 | \$20.3 | \$ - |
| POWER | | | | | | |
| Revenues (millions of dollars) | \$18.5 | \$17.1 | \$13.6 | \$14.6 | \$16.4 | \$93.8 |
| Total assets (millions of dollars) | \$51.9 | \$53.3 | \$48.3 | \$42.9 | \$86.5 | \$229.7 |

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