

BP-16 Rates Workshop

Financial Reserves August 13, 2014



Financial Reserves

Agenda

- A. Review July 16th meeting materials
- B. Discuss possible methods for reserve targets
- C. Discuss possible reserve policies
- D. Discuss the current situation and where to go

(Appendix: BPA Financial Reserves Workshop handout – July 16, 2014)

Financial Disclosure

- This information was made publicly available by BPA on July 10, 2014, and contains information not reported in agency financial statements.

Review July 16th Meeting Materials

- BPA issues more 3rd party debt than in the past (estimated \$7 Billion over next 10 years). The interest rate BPA receives is a function of market conditions and BPA's credit rating.
- The difference in interest rates for a one-category credit rating difference is greater today (.63%) than before the financial crisis (.17%).
- Agency Reserves for Risk have declined since 2008.
- The amount of BPA Reserves for Risk, and any BPA plans to increase or decrease future Reserves for Risk levels, are material factors in BPA's credit rating. Plans to decrease Agency reserve levels for rate relief, as was done in the Transmission part of the BP-14 rate case, were viewed negatively in light of Agency reserves levels that were considered to be low.
- BPA has no policy on Reserves for Risk levels other than the 95% TPP standard.
- TPP standard defines a floor level of Reserves for Risk for Power and Transmission (roughly speaking, \$0 and \$200M respectively, at the levels of risk reflected in our BP-14 models and relying on \$430M of the Treasury Facility for Power TPP).
- Compared to their total revenue and to their financial risk, reserves attributed to Power are low, and reserves attributed to Transmission are high.

Review July 16th Meeting Materials

- BPA proposed these objectives for a policy framework and received no customer comments either for or against them:
 1. Assure adequate cash flow for liquidity.
 2. Support a strong credit rating.
 3. Take an Agency view, while remaining sensitive to business line-specific issues.
Any policy would be compatible with the Treasury Payment Probability standard

- Customers Comments General Themes:
 - Conduct meetings to discuss BPA's overall credit rating and all financial metrics, not just liquidity.
 - Reserve levels should meet business line requirements (95% TPP) without regard to credit rating considerations.
 - Reserves are disproportionate relative to each business line's financial risk and alternatives such as a TPP band, e.g., 95%-96% would provide a floor and ceiling level of reserves.
 - There should be mechanisms in Transmission rates to return "over-recovered costs".

Initial Responses to Comments (Further Discussions will Follow)

- Managing BPA's credit rating holistically is desirable.
 - BPA's credit rating is assessed as if BPA were a unified agency. This rating affects the interest rate Transmission customers pay for Lease Financed projects and the interest rate Power customers pay for Energy Northwest borrowings, and therefore matters to both groups of stakeholders.

- Managing reserve levels only on the basis of business line requirements precludes managing the impact of reserves levels on BPA's credit rating. BPA staff believe BPA has a fiduciary responsibility to support its credit rating to keep interest costs for non-Federal borrowing low.

Benefits of a Reserves Policy

- Having a policy, including reserves targets, will be viewed positively by rating agencies.
- If the policy results in increasing levels of Agency reserves, there would be another plus in the rating agencies' views.
- Having explicit targets for Agency and business line levels of reserves for risk would provide a solid foundation for questions about whether reserves are sufficient, more than sufficient, or not sufficient, especially in rate cases.
- Would help clarify reserve amounts each business line should carry to support BPA's credit rating.
- A policy should provide clear and regionally vetted guidance for what to do when reserves are significantly above or below target levels.

Some Possible Reserve Target Methods

1. Status Quo – let TPP determine the minimum level of reserves.

- Pros:
 - The methodology is familiar.
 - Explicitly incorporates business-line financial risks.
- Cons:
 - Does not lead to financial reserves as high as those of peer entities with double-A ratings.
 - Is mute on the question of how high is high enough.
 - TPP as currently implemented provides guidance only for business line reserves levels, not Agency levels.

2. Days Cash on Hand – determine a desired number of days cash on hand, and derive targets for Agency and business line reserves levels.

- Pros:
 - Assuming the desired number of days cash on hand is commensurate with BPA's peers, the method will support a strong credit rating.
 - Sensitive to the different sizes of the business lines' revenue.
 - Days cash is a metric the rating agencies routinely examine.
- Cons:
 - Blind to business line-specific financial risk.

Some Possible Reserve Target Methods (*continued*)

3. TPP without the Treasury Facility—calculate the minimum reserves to meet 95% TPP without the availability of the TF. Would require no change for Transmission Services (TS) (TF not currently used in TS TPP*) but would result in a target of roughly \$510 M for Power (based on BP-14 final rate case models).
- Pros:
 - Captures business line-specific financial risk.
 - Cons:
 - Would result in an Agency target of ~\$710 million which equates to ~131 days cash which is below the average for A-rated, let alone AA-rated industry peers (see appendix slide “Days Cash Comparables”).
 - If implemented quickly, would increase Power rates significantly; if implemented slowly, would not support BPA’s credit rating very soon.
 - Is mute on the question of how high is high enough.
 - TPP as currently implemented provides guidance only for business line reserves levels, not Agency levels.

* While the TF is not used in TS TPP calculations, the TF is available to meet unanticipated TS cash needs.

Some Possible Reserve Target Methods (*continued 2*)

4. Single Financial Loss + Working Capital Requirements—create a single plausible scenario (a “very bad case”, not “worst case”) that results in significant annual financial loss. This could be done by business line or at the Agency level. The target would be set at the minimum amount of reserves to operate the business (necessary working capital) plus a buffer against the described severe financial loss scenario.
- Pros:
 - Captures a component of business line-specific financial risk.
 - A discrete loss scenario would be easy to grasp.
 - Cons:
 - Scenario development may be an ongoing point of contention.
 - Is mute on the question of how high is high enough.

Some Possible Reserve Target Methods (*continued 3*)

5. Stochastic Modeling (Monte Carlo Modeling)—build a model that simulates monthly cash flows for both business lines and the Agency to understand how high reserves should be to have a very, very low probability of being depleted.

- Pros:
 - Explicitly captures business line-specific financial risk.
 - Assures adequate cash flow for liquidity on a monthly basis.
 - Best way to ensure adequate cash flow for liquidity.
 - Highly consistent with BPA’s general approach to uncertainty as reflected in TPP calculations and estimating potential net secondary revenue.
 - Work is under way to create this capability.
- Cons:
 - This capability is a year or two away.
 - Does not answer the question of how high is high enough, though it could be adapted to do so by setting upper and lower probability limits for running out of cash in a year.
 - The model and its data would be complex; less transparent than some other possible methods.
 - Resulting reserves targets might be lower than those prescribed by the rating agencies’ days cash calculations.

Connections to the CRAC and DDC

- Power rates have included CRAC and DDC provisions for many years; Transmission rates have included neither.
- The CRAC and DDC were adopted at the same time, before the financial impact of BPA's credit rating was as important as it is today.
- Incorporating credit rating issues into the CRAC and DDC should involve:
 - Considering the adequacy of business line reserves for credit rating when setting the CRAC threshold.
 - Considering the adequacy of Agency reserves for credit rating support when determining policies about what actions would or could be taken when reserves are above the DDC threshold.

Possible Reserve Policy Characteristics

- Describe what should be done under plausible future circumstances
 1. Agency reserves are too low: which business line needs to generate incremental reserves, how, and how fast?
 2. Agency reserves are just adequate but reserves attributed to one business line are higher than otherwise called for—what actions are permissible or required?
 3. When reserves attributed to a business line, and Agency reserves, are significantly above their targets:
 - How should ‘available’ reserves be used?
 - Best long-term investment, for example, pay off high-interest debt, or offset new borrowing to extend borrowing authority.
 - Biggest near-term benefit, for instance, reduce current rates.
 - Reconsider this each time the situation arises.
 - Other ideas?

Why We Might Want to Fix the Current Situation

Two main considerations:

1. Agency Reserve Levels

- Agency reserves have been declining, and are now commensurate with A-rated peers, below BPA's desired rating of AA.
- Past practice of using reserves for TS rate relief puts negative pressure BPA's credit rating.
- Significant financial implications of a downgrade:
 - BPA issues more 3rd party debt than in the past (estimated \$7 Billion over next 10 years). The interest rate BPA receives is a function of market conditions and BPA's credit rating.
 - The difference in interest rates between higher and lower credit ratings is greater than before the financial crisis (.63% between AA and A today vs. .17% before the financial crisis).

2. Business line reserve levels relative to their financial risk

- Compared to their total revenue and to their financial risk, reserves attributed to Power are low, and reserves attributed to Transmission are high.
- At the end of FY 2013, cash attributed to TS was about 400 days; cash attributed to PS was about 50 days.

Possible Solutions

- If new reserve targets are adopted, how might BPA transition towards them?
 1. Do nothing; hope that good targets are achieved over time.
 2. PNRR: generate additional reserves over a defined number of rate periods to get to the target.
 3. Adopt revised CRAC and DDC mechanisms for both P and T that take into account agency reserves targets.
 4. [Other] _____

BPA Staff Suggestions for Discussion

1. For now, use days' cash to set the Agency target for reserves.
 - Plan to use Monte Carlo modeling for target setting when we have that capability.
2. Use the bottom end of the range for AA-rated entities – 150 days. This would be about \$687M* for the Agency (compared to \$641M, or 140* days, at the end of FY 2013).
3. Do not adopt plans expected to reduce Agency reserves when Agency reserves are below the target level.
4. Explore ways to move towards an agency reserves position more evenly balanced between the two business lines.

* Numbers are approximate

BPA is Seeking Feedback

- BPA would like stakeholder feedback to shape the development of a financial reserves policy. BPA seeks comments on any of the points in this presentation, specifically:
 1. Favored methodology for developing reserves targets.
 2. Suggested target levels for Power, Transmission and the Agency. A rationale for the preference would be helpful, also.
 3. Parties' positions on key policy framework questions from this presentation.
 4. Recommendations for achieving business line and Agency reserve targets, and when BPA should implement this approach.
 5. Any or all aspects of the BPA Staff discussion suggestions on the previous slide.

Looking Ahead

- Please submit comments and suggestions by Wednesday, August 27, 2014, to <http://www.bpa.gov/applications/publiccomments/OpenCommentListing.aspx> under 2014 Financial Reserves Workshop.
- BPA will use stakeholder feedback and BPA's own internal analysis to develop a draft position.
- BPA would like to propose a reserves level policy or draft policy in time for consideration in the BP-16 rate case.
- Questions?
- Comments?

Appendix

BPA Financial Reserves

- Meeting Date: July 16th, 2014
- Time: 9am – 12pm
- Location: BPA Rates Hearing Room, 1201 Lloyd Blvd, Suite 200, Portland, OR
- Phone Bridge: 866-901-8645, passcode 5491871

Financial Disclosure

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Current Policies Regarding Reserves

- BPA's TPP standard is the only major policy in place with respect to reserves levels.
- The Treasury Payment Probability (TPP) standard was set in the 10-Year Financial Policy adopted in the 1993 rate case:
 - “BPA will set rates in each 2-year rate period to maintain a level of reserves sufficient to assure a 95 percent probability of meeting its U.S. Treasury payments in full and on time.”
- Reserves are a key factor for determining TPP, thus, the TPP policy defines a floor level of reserves, but there may be other reasons for higher levels of reserves that are not reflected in any policies.
- BPA has incorporated the consideration of reserve levels separately for the rates established by each business line.

Other Reserves Policy Concerns

- A reserves target and policy looking over a longer horizon are common among peer entities. BPA-supported Non-Federal Debt often competes for investors with these entities' debt.
- Since the Financial Crisis (2007), rating agencies have been increasingly emphasizing entities' financial positions and metrics, and in particular, cash positions (financial reserves positions).
- The security for BPA's Non-Federal Debt is BPA commitments for payment and related financial support. All BPA revenues are available to pay all of BPA costs; therefore, the rating agencies rate BPA as a whole and do not separately rate Power Services and Transmission Services.
- It is in BPAs' and customers' interest to review BPA's reserves practices in response to developments of the last few years, and perhaps to develop a policy on acceptable and desirable levels of reserves.

What Are BPA's Financial Reserves?

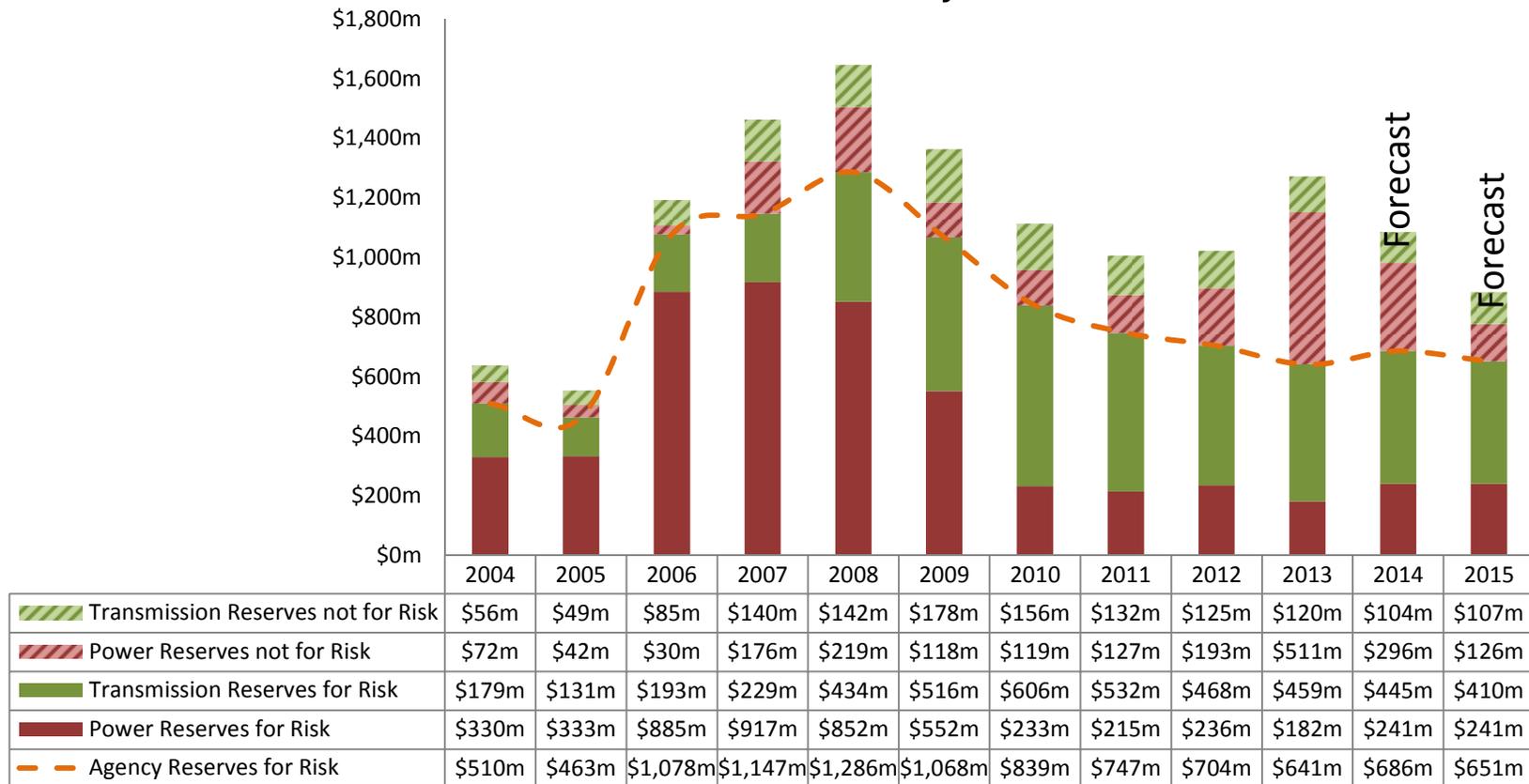
- Financial Reserves Defined
 - 2006 and earlier:
 - Cash in the BPA Fund plus deferred borrowing (deferred borrowing: cash used for capital spending but not yet borrowed for - BPA authorized from the U.S. Treasury; convertible to cash very quickly);
 - 2007 and later:
 - Cash and market-based special investments (U.S. Treasury investments) in the BPA Fund plus deferred borrowing.

How Has BPA Used Financial Reserves?

- BPA has for many years relied on reserves for liquidity (the availability of cash on hand to meet current obligations)
 - Reserves are BPA's primary tool for mitigating financial risk. BPA establishes rates for cost recovery, so that expected net cash flow is zero unless PNRR is required or reserves are used to finance capital or reduce rates. However, because BPA establishes rates prospectively, actual costs and revenues can vary from rate case forecasts. In some rate periods, reserves can increase and in some rate periods reserves can decrease.
 - Within each year, BPA needs reserves for liquidity in situations when; disbursements outpace receipts, receipts are lower than anticipated, or disbursements are higher than anticipated.
- Since 2006, BPA has also used reserves
 - As a source of funding transmission capital projects (\$15 million per year from FY 2006 through present). This use reduces future interest expense by avoiding capital projects borrowing.
 - To eliminate or moderate Transmission rate increases for the 2010-2011, 2012-13 and 2014-15 rate periods. This use provides an immediate, one-time rate effect.

Levels of Financial Reserves over Time

BPA Historical and Projected Reserves for Risk



- Agency reserves for risk have declined from 2008
- Power Services reserves for risk have decreased
- Declining reserves for risk have been identified by certain bond ratings agencies as a credit strength issue
- It may be appropriate for Transmission Services and Power Services to have differing levels of reserves for risk given the differing levels of financial uncertainty they carry

Recent Developments in TPP & Liquidity

- 2007 rate case: BPA and Treasury agreed to establish a \$300 million line of credit (the Treasury Facility) that BPA can access to pay certain FCRPS operating expenses. Amounts drawn can have a term up to one year and can be extended one year. BPA concluded that for TPP purposes, the Treasury Facility is equivalent to reserves. Use of the Treasury Facility counts against BPA's statutory borrowing authority cap and BPA in effect reserves the amount of the Treasury Facility for liquidity.
- 2007 Supplemental rate case (covering rates for 2009): the Treasury Facility was increased to \$750 million; that remains the limit.
- Availability of the Treasury Facility has reduced the need for reserves to support TPP in Power rate cases.
- Market prices for electricity have been trending downwards, reducing the magnitude of the financial risk BPA faces from the natural variability of its supply of hydro power.
- Power TPP has been above 95% since the 2007 supplemental rate case.
- Because of the changed risk profile for Power Services, BPA believes that the downward deviations in reserves attributed to Power have not needed counteraction by increases in PNRR (Planned Net Revenue for Risk).
- Transmission TPP has been above 99% since 2002.

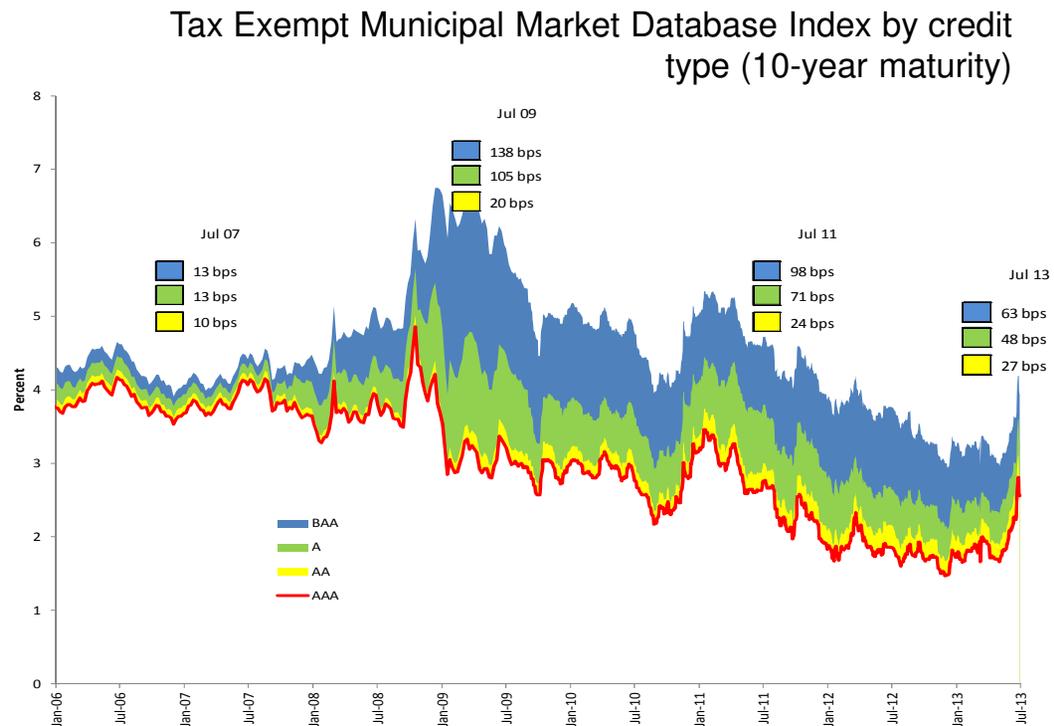
The Rating Agency Perspective

Rating agencies consider many factors, but do not reveal their relative weights:

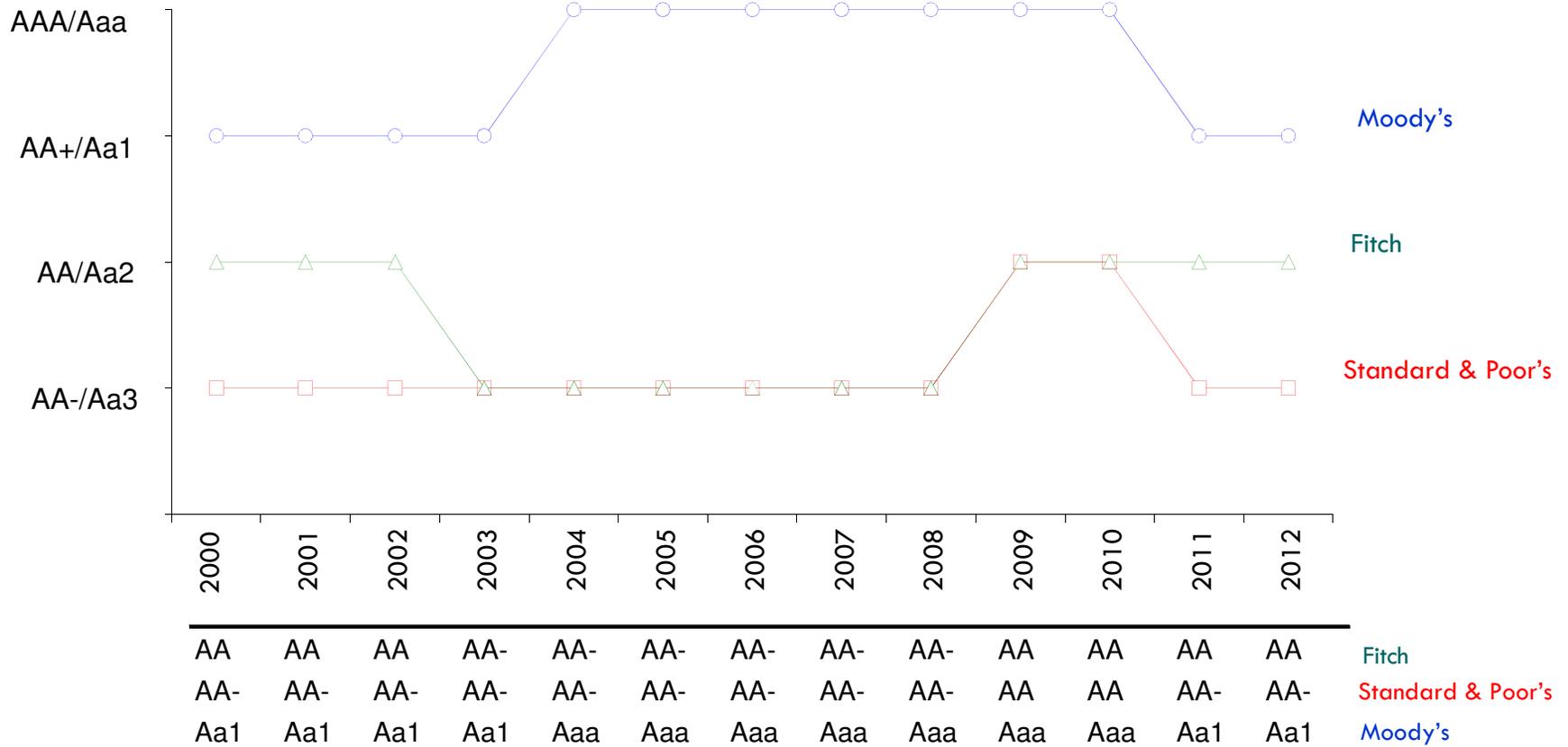
- Management's commitment to financial integrity;
- Days' cash on hand (a metric used in rating all entities): the number of days' worth of operating expenses that could be covered by an entity's cash on hand (financial reserves). BPA's total reserves available for risk do not provide the number of days' cash that the rating agencies are typically provided by other credits;
- The Treasury Facility is a credit positive but is not considered cash on hand.
- Reserves Available for Risk (reserves not accrued or derived to meet specific costs): the rating agencies understand that some of BPA's reserves are not available for risk and in effect are held for specific costs or uses.
- BPA's total reserves for risk have been declining since 2008;
- Use of reserves to reduce short-term rates in light of "low" reserve levels is viewed negatively.

Credit Rating and Cost of Borrowing Over Time

- The value of a higher credit rating in terms of cost of borrowing is greater than before the recession. BPA-supported Non-Federal Debt continues to be issued, leading to frequent ratings of BPA’s creditworthiness.
- Prior to the financial crisis, the average spread between “AA” and “A” rated 20 year tax-exempt municipal debt was .17%. Now it is .63%, even though yields are now lower.



BPA's Credit Rating



AA	AA	AA	AA-	AA-	AA-	AA-	AA-	AA-	AA	AA	AA	AA	Fitch
AA-	AA	AA	AA-	AA-	Standard & Poor's								
Aa1	Aa1	Aa1	Aa1	Aaa	Aa1	Aa1	Moody's						

How Much Does BPA's Credit Rating Matter?

- BPA has direct and indirect responsibility for paying debt service on \$14.6 billion of principal outstanding.
- \$6.8 billion of such debt has been issued by third parties in the municipal bond market and carry BPA's underlying credit rating (Non-Federal Debt).
- BPA forecasts that in the next 10 years, starting in 2015, ~\$7.0 billion of Non-Federal Debt will be issued, carrying BPA's underlying credit rating. Of this, \$2.3 billion will be attributed to Transmission and \$4.7 billion will attributed to Power.
- A 50 basis point^{1/} interest rate increase (+0.50%) today would result in ~\$377 million^{2/} PV increase in interest costs on the ~\$7.0 billion Non-Federal Debt forecast to be issued over the next 10 years. This equates to an average annual interest expense increase of ~\$25 million per year over the 20 year life of the debt.
- *Supporting BPA's credit rating with additional financial metrics (reserves, debt ratio, & coverage ratio) may be worth the investment and an advantage for both Power and Transmission.*

Comparison of Debt Outstanding to Credit Rating for U.S. Public Power Utilities with Generation Ownership Exposure		
# of Entities	Avg. Debt Outstanding	Average Credit Rating
4	3.3B	Aa1
10	1.4B	Aa2
12	1.3B	Aa3
38	0.3B	A1
35	0.2B	A2
23	0.8B	A3
2	0.3B	Ba1

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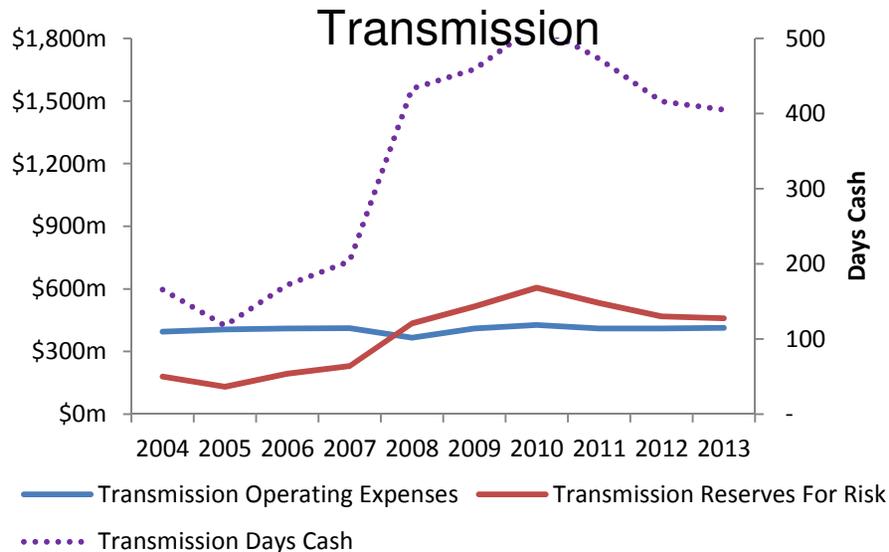
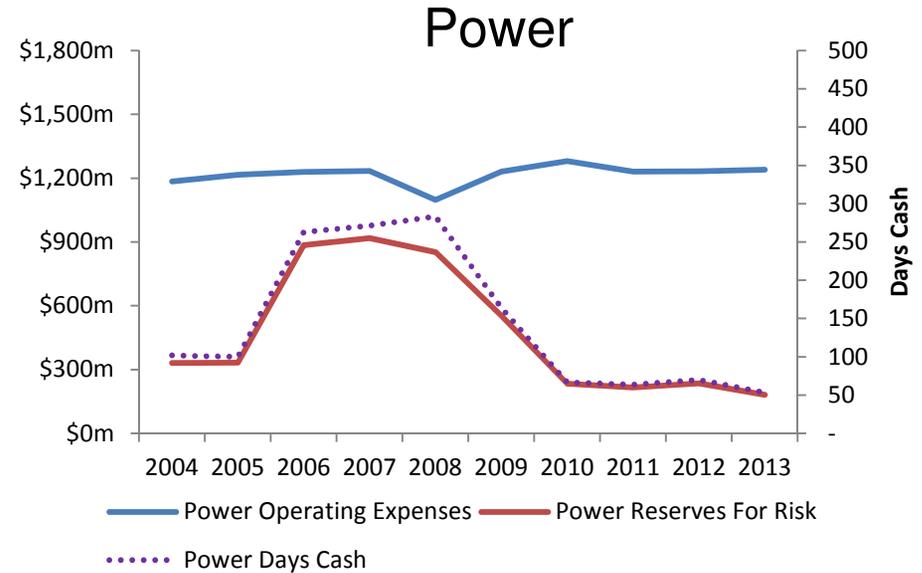
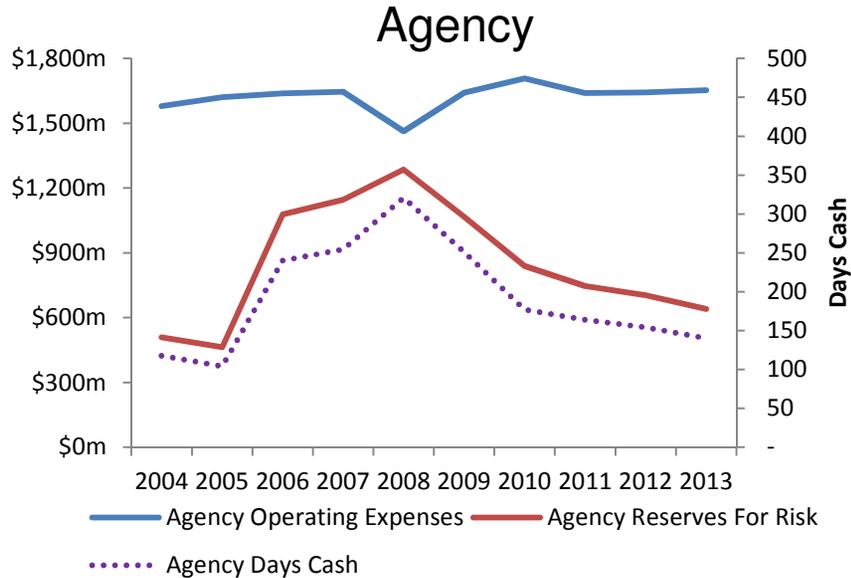
- The table above shows the average debt outstanding for all U.S. Public Power Utilities with Generation Ownership Exposure grouped by credit rating.
- On average, utilities with more debt have a higher credit rating likely because of their reliability on debt, size of their economic base and their increased focus on maintaining credit ratings.

^{1/} Possible impact of taxable and tax-exempt interest rate increase between AA and A credit post financial crisis. Estimate based on municipal market data from 12/7/2007 to 2/7/2013.

^{2/} Assumes average 20 year maturity, discounted at BPA's weighted average cost of capital (4.7% as of 9/30/2013). At a 9% discount rate, PV is \$235m.

* Estimate is \$4.7 billion issued taxable (\$2.4B for P & \$2.3B for T) and \$2.3 billion tax-exempt (all P).

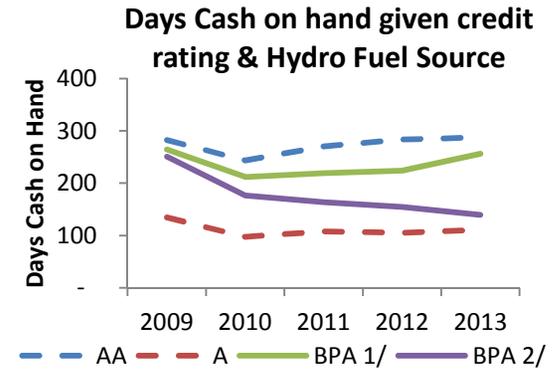
Historical Reserves Relative to Operating Expenses



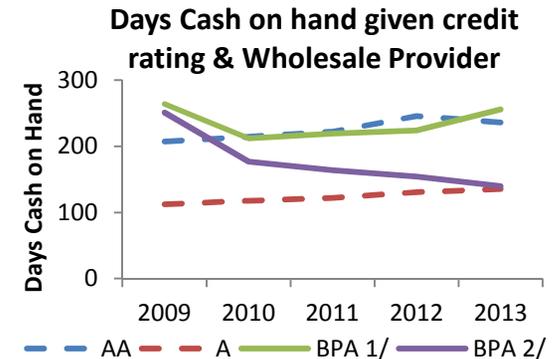
- Graphs show reserves for risk and approximate operating expenses for the Agency and by business line.
- This view does not reflect any values for revenue or expense uncertainty, which differ by business line.
- This view is a common liquidity measure used by the rating agencies.

Days Cash Comparables

Utility	Fuel Supply	Type	Rating	Days Cash On Hand				
				2009	2010	2011	2012	2013
Benton PUD	Hydro	Retail	A+	251	177	164	154	140
Boise Kuna Irr. Dist.	Hydro	Retail	A-	143	39	53	38	38
Bonneville Power Administration ^{1/}	Hydro	Wholesale	AA	264	212	219	224	256
Bonneville Power Administration ^{2/}	Hydro	Wholesale	AA	251	177	164	154	140
Chelan PUD	Hydro	Retail	AA+	521	499	494	564	496
Clark PUD	Hydro	Retail	A+	16	11	46	74	103
Cowlitz PUD	Hydro	Retail	A	95	66	77	110	144
Eugene Electric	Hydro	Retail	A+	161	103	103	109	105
Grant PUD	Hydro	Retail	AA	321	255	247	346	464
Grays Harbor PUD	Hydro	Retail	A	81	82	84	69	69
Hydro Quebec	Hydro	Retail	AA-	201	102	205	220	246
Klickitat PUD	Hydro	Retail	A-	205	180	183	165	165
New York Power Authority	Hydro	Wholesale	AA	155	187	206	232	195
Pend Oreille PUD	Hydro	Retail	A-	123	122	154	125	125
Snohomish PUD	Hydro	Retail	AA-	207	233	280	193	183
Tacoma Power	Hydro	Retail	AA-	341	283	348	335	318
Average				208	170	189	195	199



Utility	Fuel Supply	Type	Rating	Days Cash On Hand				
				2009	2010	2011	2012	2013
Bonneville Power Administration ^{1/}	Hydro	Wholesale	AA	264	212	219	224	256
Bonneville Power Administration ^{2/}	Hydro	Wholesale	AA	251	177	164	154	140
Connecticut Muni Coop	Gas	Wholesale	A+	57	48	81	111	73
Delaware Muni Coop	Gas	Wholesale	A-	8	11	5	57	57
Florida Muni Power Agency	Gas	Wholesale	A+	50	94	84	120	91
Grand River Dam Authority	Coal	Wholesale	A	179	152	201	138	151
Illinois Muni Electric Agency	Coal	Wholesale	A+	106	78	84	58	77
Indiana Muni Power Agency	Coal	Wholesale	A+	43	49	90	96	99
Lower Colorado River Authority	Coal	Wholesale	A	87	130	119	127	189
Massachusetts Muni Wholesale Electric Co.	Nuclear	Wholesale	A+	124	107	124	150	94
Minnesota Muni Power Agency	Gas	Wholesale	A	85	78	101	160	191
Muni Electric Authority of Georgia	Coal/Nuclear	Wholesale	A+	110	107	91	126	138
Muni Gas Authority of Nebraska	Coal	Wholesale	A	106	120	131	67	75
Muni Gas Authority of Georgia	Gas	Wholesale	A+	127	91	86	122	113
Nebraska Public Power District	Coal	Wholesale	A+	108	130	173	178	212
New York Power Authority	Hydro	Wholesale	AA	155	187	206	232	195
North Carolina Eastern Muni Power Agency	Nuclear/Coal	Wholesale	A-	151	166	218	275	251
North Carolina Muni Power Agency	Nuclear	Wholesale	A	272	307	263	248	220
Oklahoma Muni Power Agency	Coal/Gas	Wholesale	A	180	161	128	125	102
Piedmont Muni Power Agency	Nuclear	Wholesale	A-	250	263	224	177	193
Platte River Power Authority	Coal	Wholesale	AA	165	142	147	196	200
South Carolina Public Service Authority	Coal	Wholesale	A-	55	99	97	144	197
Texas Municipal Power Agency	Coal	Wholesale	A+	46	62	56	61	109
Western Minnesota Muni Power Agency	Coal	Wholesale	AA-	245	317	316	331	293
WPPI Energy	Coal	Wholesale	A+	103	95	81	70	76
Average				133	135	140	150	152



- Graphs show days cash relative to peers, given credit rating and fuel supply or wholesaler.
- BPA financial reserves relative to operating expenses continue to trend downward.

^{1/} Fitch calculation of Days Cash - includes reserves for risk and also reserves not for risk
^{2/} BPA calculation of Days Cash - includes only reserves for risk ("unrestricted")

Objectives of a Reserves Policy

- The importance to BPA of refining its practices regarding the level of reserves has grown in recent years. BPA has no policy on this topic other than as is implicitly imbedded in the TPP standard. Given the large amount of expected future incremental Non-Federal Debt issuances, bond ratings can have substantial annual financial impacts.
- BPA is not currently considering augmenting business line reserve levels by generating cash flow with higher rates in the BP-16 rate case.
- BPA is considering developing a policy for determining when reserves are minimally sufficient and when they may be considered robust enough to allow reserves to be used for purposes other than liquidity and risk (e.g., for capital financing, early debt retirement or rate relief).
- BPA is proposing these objectives for a policy framework:
 1. Assure adequate cash flow for liquidity
 2. Support a strong credit rating
 3. Take an Agency view, while remaining sensitive to business line-specific issues

* Any policy would be compatible with the Treasury Payment Probability standard

Looking Ahead

- BPA would like stakeholder feedback to shape the development of a financial reserves policy or [reserves practices]. BPA specifically seeks written suggestions:
 1. For changes to the draft Policy Objectives included above, with supporting explanations and rationales.
 2. For policy [and practices suggestions] that meet the previously described Policy Objectives
 - Please submit comments/suggestions by Wednesday July 30th, 2014 to <http://www.bpa.gov/applications/publiccomments/OpenCommentListing.aspx> under 2014 Financial Reserves Workshop
- BPA will use stakeholder feedback and BPA's own internal analysis to develop a draft position
- BPA would like to propose a reserves level policy or [interim reserves practices] in time for the BP-16 rate case. (By "practice" we mean a draft policy that has not had sufficient vetting to be adopted as a policy.)
- Questions/Comments?