ACCOUNTING POLICIES,
ACCOUNTING METHODS AND PRACTICES
AUTHORIZED BY THE RÉGIE DE L'ÉNERGIE

The consolidated financial statements of Hydro-Quebec are drawn up in compliance with the Generally Accepted Accounting Principles of Canada as established by the Canadian Institute of Chartered Accountants, and take into account certain methods and practices authorized by the Régie de l'énergie.

The main policies used by the Distributor as the basis for this file are the policies in use by the Distributor on December 31, 2005, where applicable, as described in the supplementary note to the consolidated financial statement included in the 2005 annual report.

This document is comprised of three sections:

? **Section 1:** list of policies, methods and practices previously approved by the Régie, and the number of the relevant decision.

- Table 1: Authorized accounting policies
- Table 2: Accounting methods and practices authorized by the Régie de l'énergie.

? **Section 2:** additions and modifications to policies already accepted for approbation

- Annex: previously approved policies affected by the application of new norms presented in Section 2.

? **Section 3:** modification of accounting presentation.

1. ACCOUNTING POLICIES, METHODS AND PRACTICES AUTHORIZED BY THE RÉGIE DE L'ÉNERGIE

Table 1: Accounting policies

Accounting policies	Decision	Annex
Capital assets	D-2003-93	
Intangible assets	D-2004-47	
Abandoned or delayed major projects	D-2003-93	
Deferred development costs	D-2003-93	
Materials, fuel and supplies	D-2003-93	
Long-term debt	D-2003-93	Section 1.1
Currency conversion and derivative instruments – currency swaps	D-2003-93	Section 1.2
Derivative Instruments – interest rate swaps	D-2003-93	Section 1.3
Retirement of long-term assets and abandonment of activities	D-2005-34	
Obligations associated with the retirement of capital assets	D-2005-34	
Long-term depreciation of assets	D-2005-34	
Hedging relationships	D-2005-34	Section 1.4

Table 2: Accounting methods and practices authorized by the Régie de l’énergie

<table>
<tr><th>Other accounting methods and practices authorized by the Régie de l’énergie (Note 1)</th><th>Decisions</th><th>References</th></tr>
<tr><td>Government compensation related to the 1998 Ice Storm</td><td>D-2003-93</td><td>S/O</td></tr>
<tr><td>Deferred costs – commercial programs and Global Energy Efficiency Plan</td><td>D-2006-56
D-2003-93
D-2002-288
D2002-25</td><td rowspan="5">HQD-4, Document 5</td></tr>
<tr><td>Deferred costs – Interruptible electricity option</td><td>D-2006-34
D-2004-213
D-2003-224</td></tr>
<tr><td>Deferred costs – Transfer of costs of electricity supply and of transmission service</td><td>D-2006-34
D-2003-93</td></tr>
<tr><td>Deferred costs – BT rate</td><td>D-2006-34
D-2004-170</td></tr>
<tr><td>Deferred costs – Pass-on of post-heritage supply costs</td><td>D-2005-132
D-2005-34</td></tr>
</table>

Note 1: The account for deferred costs relative to personnel reduction and renewal measures, approved by the Régie in decision D-2003-93, has been removed from the list because it will be completely amortized at the end of 2006.

2. ADDITIONS AND MODIFICATIONS TO ACCOUNTING POLICIES

Financial Instruments and Hedging Relationships after January 1, 2007

As of January 1, 2007, the Distributor will adopt new accounting norms for financial instruments. These will modify certain existing accounting norms already accepted by the Régie:

- Long-term debt
- Currency conversion and derivative instruments – currency swaps
- Derivative instruments – interest rate swaps
- Hedging Relationships

Descriptions of these norms are presented for reference purposes in sections 1.1 to 1.4 respectively of the annex.

These new norms are covered by three new chapters of the *CICA Manual*:

Chapter 3855, Financial Instruments – Accounting and Evaluation

This chapter establishes the policies for accounting and evaluating financial assets, financial liabilities and non-financial derivatives. It also covers recording of gains and losses on financial instruments.

Chapter 3865, Hedges

This chapter reiterates the recommendations of AcG-13 regarding the application of hedge accounting and gives specifics on the application of hedge accounting.

<u>Chapter 1530, Comprehensive Income</u>

This chapter introduces new rules concerning certain gains and losses which are temporarily accumulated outside net income to be re-classified when appropriate. The comprehensive income and the elements it comprises must be presented in a financial statement of the same prominence as other statements included in a complete financial statement.

Effects of implementation of the new norms

i) Accounting of derivative instruments and application of hedge accounting

As of January 1, 2007, all derivative instruments will be evaluated and presented at fair value in the balance sheet. Gains and losses relative to fluctuations in fair value will be recorded in the results, except if the elements are designated as elements constituting a hedge relationship. In this case, the new norms permit the application of special accounting rules which allow gains, losses, products and expenses which compensate each other effectively to be recorded in the results in the same period or periods. The effect of these special rules is essentially to preserve the objective of hedge accounting as practiced under existing norms. Therefore, the application of the new norms will ultimately have minimal impact in terms of the cost of the regulatory debt.

There are two types of hedging relationships:

1. <u>Fair value hedge</u>

This type of hedge generally applies to situations where the Transmission Provider converts a fixed-rate debt to a floating-rate debt through a swap.

In the case of a fair value hedge, the fluctuations in fair value of a derivative (where the swap receiver's rate is fixed and the payer's rate floating) are recognized in the results. Simultaneously, the fluctuations in fair value of the hedged item (the debt) attributable to hedged risk must be recorded as adjustments of the carrying value of the hedged item and recorded in the results.

Analysis of the accounting of this type of hedging relationship shows that the effect of recording a derivative at its fair value is compensated by the effect of having to record an adjustment to the hedged item, except when the relationship is ineffective. Ineffectiveness exists when the fluctuations in value of the hedging instrument and the hedged item do not cancel each other out completely.

The presence of ineffectiveness is not systematic. Many existing relationships, as well as most of the new relationships, are considered perfectly effective. Furthermore, if there is inefficiency, the effect remains secondary because otherwise accounting norms would not permit hedge accounting.

The new norms do not modify the criteria which must be met to benefit from hedge accounting. But any imperfection in the hedge relationship must be recognized and reported on an on-going basis rather than deferred. Compared to existing policies, there is therefore a temporal difference in the recognition of imperfections in hedge relationships. However, this difference obviously works out to zero over the duration of the relationship.

2. <u>Cash flow hedge</u>

This type of hedge applies, for example, when a company transforms a floating Canadian debt into a fixed-rate debt or when it converts a fixed- or floating-rate foreign currency debt into a fixed-rate debt in Canadian dollars.

In the case of a cash flow hedge, the fluctuations in fair value of the derivative which constitute an effective hedge are reported in the comprehensive income statement while, if necessary, the ineffective portion of these variations must be recognized in the results. The recording of the effective element in the comprehensive income statement allows the deferral of recognition of gains and losses in the results, in order to recognize them when appropriate. In this way, gains and losses deferred to the comprehensive income statement are re-classified for recognition in statements for the period or periods when the hedged item affects the results.

Here is an illustration of the application of the new standards for the accounting of derivative instruments.

Table 1

Accounting of derivative financial instruments

	Before			After			
	Balance Sheet	**Results**		**Balance Sheet**	**Comprehensive Income**	**Results**	
See Example 1	***Currency swap Fixed US-Var CAD: Fair Value Hedging Relationship***						
DEBT	At cost +re-evaluation at current exchange rate	Fluctuation in exchange rate	-fixed-rate coupon $US	Re-evaluation at fair value[1]		Fluctuation in fair value	-fixed-rate coupon $US
SWAP	At cost = 0 +re-evaluation at current exchange rate	Fluctuation in exchange rate	+ fixed-rate coupon $US – floating-rate coupon $CAD	Re-evaluation at fair value		Fluctuation in fair value	+ fixed-rate coupon $US – floating-rate coupon $CAD
NET	Perfect compensation	Perfect compensation	– floating-rate coupon $CAD	Perfect compensation if no ineffectiveness		Perfect compensation if no ineffectiveness	– floating-rate coupon $CAD
See Example 2	***Interest rate swap Floating CAD-Fixed CAD: Cash Flow Hedging Relationship***						
DEBT	At cost		-floating-rate coupon $CAD	At cost			-fixed-rate coupon $US
SWAP	At cost = 0		+ floating-rate coupon $CAD –fixed-rate coupon $CAD	Re-evaluation at fair value		Fluctuation in fair value	+ floating-rate coupon $CAD – fixed-rate coupon $CAD
					Effective portion of the fluctuation in fair value of the swap	Reclassification of the fluctuation in fair value in the comprehensive income statement[2]	
NET			– fixed-rate coupon $CAD	Perfect compensation if no ineffectiveness		Perfect compensation if no ineffectiveness	– fixed-rate coupon $CAD

[1] : Adjustment due to the application of hedge accounting and corresponding to the fair value of the portion attributable to hedged risk only.

Example 1: Fair value hedge

Hedged item:	Fixed-rate debt 5,5 %, $100M US issued January 1, 2006
Hedging item:	SWAP received $100M US at fixed-rate 5,5 % disbursed $100M CAD at floating rate (first fixing at 7,2 per cent) transaction date January 1, 2006
Hedged risk:	Fluctuation in fair value of the debt associated with the risk of the interest rate swap and the exchange rate
Date of designation:	January 1, 2006
Exchange rate:	Historic rate: 1,00 January 31 rate: 1,07
Note: The hedging relationship is assumed to be perfectly effective.	

		Before		After	
		Balance Sheet	Results	Balance sheet	Results
2006-01-01	Issuance of debt ($100M US * 1,00)	100	-	(100)	-
	Cost of derivative	-	-	-	-
2006-01-31	Conversion of debt at current exchange rate $100M US * (1,07-1,00)	(7)	7	(7)	7
	Conversion of swap at current exchange rate	7	(7)	7	(7)
	Re-evaluation of the derivative at fair value (excluding conversion)	-	-	(5)	5
	Re-evaluation of the derivative at fair value[3] (excluding conversion)	-	-	5	(5)
	Coupon for debt interest	(0,5)	0,5	(0,5)	0,5
	Interest coupon for: Swap- received Swap – disbursed	0,5 (0.6)	(0,5) 0,6	0,5 (0,6)	(0,5) 0,6
Total	**Debt** **Interest**	**(100)** **(0,6)**	**0,6**	**(100)** **(0,6)**	**0,6**

[2] : Reclassification due to the application of hedge accounting and corresponding to the effective portion of the fluctuation in fair value of the swap.
[3] Adjustment necessary due to application of hedge accounting and corresponding to the fair value of the portion attributable to hedged risk only.

Example 2: Cash flow hedge

Hedged item:	Floating-rate debt $100M US issued January 1, 2006 (first fixing at 6 %)
Hedging item:	Swap received $100M at floating-rate (first fixing at 6 %) disbursed $100M at fixed rate 7,2 % transaction date January 1, 2006
Hedged risk:	Variability in cash flow associated with risk of interest rate swap
Date of designation:	January 1, 2006
Note: The hedging relationship is assumed to be perfectly effective.	

		Before		After		
		Balance Sheet	**Results**	**Balance Sheet**	**CI**	**Results**
2006-01-01	Issuance of debt	100		(100)		
	Cost of derivative	-	-	-	-	-
2006-01-31	Re-evaluation of swap at fair value	-	-	(2)		2
	Re-classification of fair value of swap for comprehensive income.[4]				2	(2)
	Coupon for interest on debt	(0,5)	0,5	(0,5)		0,5
	Interest coupon for: Swap- receipt Swap – disbursed	0,5 (0,6)	(0,5) 0,6	0,5 (0,6)		(0,5) 0,6
2006-02-06	Re-evaluation of swap at fair value	-	-	2		(2)
	Re-classification of fair value of swap for comprehensive income.				(2)	2
	Coupon for interest on debt	(0,5)	0,5	(0,5)		0,5
	Interest coupon for: Swap- receipt Swap – disbursed	0,5 (0,6)	(0,5) 0,6	0,5 (0,6)		(0,5) 0,6
Total	**Debt** **Interest**	**(100)** **(1,2)**	**1,2**	**(100)** **(1,2)**		**1,2**

***CI=Comprehensive Income**

[4] Re-classification due to application of hedge accounting and corresponding to the effective portion of the variation in fair value of the swap.

Table 1 above illustrates clearly that the changes imposed by the new norms on financial instruments will have little impact on the cost of the regulatory debt. First, in the absence of ineffectiveness in the hedge relationships, there will be no impact because the net effect on the results is the same as under the current policies. Second, if a relationship is not perfectly effective, the impact in terms of the current policies will essentially be the recognition of the ineffectiveness in the period in which it occurs, which as indicated above, represents a secondary impact which will ultimately sum to zero over the duration of the hedge relationship.

On the other hand, because the accounting of derivative instruments at fair value will lead to the recording of a compensatory element and give rise to significant modifications to the balance sheet and the presentation of financial information, the formula for the cost of the regulatory debt will need to be reviewed in order to ensure it continues to correspond to the fundamental definition.

However, the adaptation of the definition of the cost of the regulatory debt should not be addressed before the projection of the regulatory debt cost for the next rate application (test year 2008) for the following reasons:

- As previously indicated, once the definition of the regulatory debt is adapted to the changes ensuing from the application of the new norms on accounting of financial instruments, the Distributor believes the changes will have little impact on the cost of the regulatory debt. The impact, if any, will be in temporal in terms of the recognition of certain minor effects in the results. As a result, the projected cost of the 2007 regulatory debt as a function of the current accounting policies is adequate and coherent with the fact that the real figures used in the reference year 2006 are a function of the existing policies. On the other hand, for the next rate application (test year 2008) the real figures will reflect the effect of the new norms, which will require an adjustment of the definition of the cost of the regulatory debt and the model used to project it.

- Before the end of the year 2006, the Distributor intends to acquire the software tools necessary to ensure that accounting practices comply with the new norms. Once the new accounting procedures are in place, the company will be able to make the necessary modifications to the definition of the cost of the regulatory debt to reflect the new norms. Then, when presenting the projected cost of the debt for the next rate application (test year 2008,) the Distributor will propose modifications to the definition of the cost of the regulatory debt and will be able to confirm the marginal impact of the new norms, in the context of the proposed adjustments.

ii) Long-term Debt

Beginning January 1, 2007, the long-term debt will be recorded at cost after amortization using the effective rate method. Therefore, the discounts, premiums and issuing expenses currently recorded under the line-item Deferred Costs Related to the Long-term Debt, or Deferred Discounts and other Credits Related to the Long-term Debt and amortized using a straight-line method for the duration of the loan, will be recorded in the balance of the long-term debt. The impact will be limited to the timing of the recognition of discounts and issuing expenses, which will have a zero sum effect over the life of the items.

The Distributor will not be in a position to precisely evaluate these effects before the installation of software to implement the new norms. Therefore, the projected cost of the regulatory debt for 2007 is based on the norms currently in force. The new method will be integrated in time for the evaluation of the cost of the debt for the next rate application (test year 2008.)The company will then identify the impact of this change in procedure on the base year and the projected year.

iii) Hedging of sales in American dollars

Currently, in cases where the Distributor hedges the debt with sales in American dollars, only the principal of the debt is designated. Beginning January 1, 2007, the Distributor will also have to designate the interest on the debt. Therefore, in view of the re-classification explained in section 3.A, the exchange gains and losses on the interest of these debts will henceforth be presented under the line-item Products while interest will be recorded at historic rates under the line-item Financial Costs. The impact of this element will be identified along with the others for the next rate application.

3. MODIFICATION OF ACCOUNTING PRESENTATION

A. Re-classification of the effect of hedged sales in American dollars

The company records the effect of hedges to compensate the hedged elements with one significant exception, which is the presentation as financial costs of foreign exchange gains and losses associated with debts and swaps designated as hedges of sales in American dollars.

More precisely, the Distributor holds debts and swaps in American dollars of which the fluctuations due to the exchange rate compensate the company for the inverse effect on its sales in American dollars. These debts and swaps are, from an economic and accounting point of view, in a hedge relationship with the sales.

Historically, all foreign exchange gains and losses were recorded as Exchange Losses in the line-item Financial Costs, regardless of the hedged item. In a report submitted in March 2005, Hydro-Quebec's external auditors noted this state of affairs.

The Board of Directors decided to delay implementing change until more profound analyses could be conducted; on the one hand, of the accounting of all its financial instruments, including derivative instruments, and on the other hand, of the implications of this change for the matter of the regulatory approach to the risk of change in the presumed cost of the debt.

Following work completed in 2005, the Distributor adopted in 2006 a method under which the effect of the hedging of sales in American dollars with debts and swaps is re-classified under the Products line-item, therefore including the hedged item. This hedging effect is therefore no longer included in financial costs. In this way, the presentation is coherent with the economic objectives of the hedge and with the accounting standards for hedging applicable to this relationship. Further, the cost of the debt is largely protected against the volatility caused by exchange rate risk.

The impact of this re-classification in terms of statutory financial statements is a transfer to the Products of Hydro-Quebec of a gain of $130 M for 2006 and $200 M for 2007.

For the Distributor, this re-classification will be reflected only in terms of the cost of the debt, and will have no other impact on the regulatory results because the latter do not bear exchange rate risk in sales.

APPENDIX

ACCOUNTING POLICIES PREVIOUSLY APPROVED BY THE REGIE WHICH WILL BE AFFECTED BY THE NEW NORMS

The following paragraphs present for reference purposes the text initially approved before modification of the policies that will be affected by the new norms.

1.1 Long-term debt

Long-term debt is recorded at nominal value, except for zero-coupon or significantly discounted bonds, which are recorded at their discounted value. The discounts, premiums and issuance costs are deferred and amortized using the straight-line method for the duration of the loan. Significant discounts and premiums are amortized using the real interest method.

The accounting of the debt will be modified as of January 1, 2007 by the new norms on financial instruments (Chapters 3855, 3865 and 1530) described in Section 2.3.

1.2 Currency conversion and derivative instruments – foreign currency swaps

The products and expenses of operations conducted in foreign currencies are converted into Canadian dollars at the exchange rate effective during the operation. The monetary elements of assets and liabilities are converted at the closing rate on the date of the balance statement. The non-monetary elements are converted at the exchange rate effective during the operations.

Short-term foreign exchange gains or losses resulting from the conversion of monetary elements are included in results. Long-term foreign exchange gains or losses resulting from the conversion of monetary elements, **including currency swaps,** are also included in results, **unless they are related to liability elements hedging sales in American dollars, in which case they are deferred to the year the transaction is realized.**

The bolded information in the previous paragraph concerns financial instruments. The accounting and presentation of these instruments will be modified as of

January 1, 2007 by the new chapters 3855, 3865 and 1530 described in Section 2.3

1.3 Derivative instruments – interest rate swaps

Interest exchanges accounted as hedges and resulting from swaps used to modify long-term interest rate risk exposure, are recorded with the interest expense recorded for the loans with which they are associated.

The accounting and presentation of these instruments will be modified as of January 1, 2007 by the new chapters 3855, 3865 and 1530 described in Section 2.3

1.4 Hedging Relationships

The Distributor applies the recommendations of the CICA's Guideline 13 (AcG-13) entitled Hedging Relationships, which establishes the conditions under which hedge accounting can be applied. The guideline discusses the identification, designation, documentation and effectiveness of hedge accounting as well as the discontinuance of hedge accounting.

Derivative financial instruments which do not meet the hedge accounting admissibility criteria outlined in AcG-13 are recognized at fair value in the balance sheet and fluctuations in fair value are recognized in the results.

Hedging relationships which ceased to be admissible to hedge accounting have been recorded in compliance with transitional guidelines. The difference between the carrying value and fair value of derivative instruments which had been the object of hedge relationships was deferred and will be recognized in the income statement for the same period as the gains, losses, revenues and expenses related to the initial hedged item.

The impact of this orientation note on the cost of the regulatory debt was therefore not significant.

The new Chapter 3865 deals with hedging relationships and replaces AcG-13. The new norms concerning hedging relationships are described in Section 2.3.