

Presentation to



**OPINION REGARDING HYDRO QUÉBEC'S
THEORETICAL BORROWING COSTS
IN THE ABSENCE OF A GOVERNMENT GUARANTEE**

August 2000



Prepared by Brian Keegan
Ratings Advisory Group
Merrill Lynch & Co.

**OPINION REGARDING HYDRO QUÉBEC'S
THEORETICAL BORROWING COSTS
IN THE ABSENCE OF A GOVERNMENT GUARANTEE**

Table of Contents

Introduction.....	3
Background - Merrill Lynch Credentials	3
Summary of Opinion	3
Overview of Credit Rating Methodology for Power Corporation	4
1. Business Profile Analysis for Generation Activities	5
▪ <i>Regulation</i>	5
▪ <i>Markets</i>	6
▪ <i>Operations</i>	6
▪ <i>Competitiveness</i>	6
2. Business Profile Analysis for Transmission and Distribution Activities.....	7
▪ <i>Regulation</i>	7
▪ <i>Markets</i>	7
▪ <i>Operations</i>	7
▪ <i>Competitiveness</i>	7
3. Merrill Lynch Assessment of HQ's Business Profile.....	8
▪ <i>Quantitative Analysis</i>	10
▪ <i>Business Profiles vs. Group Benchmarks</i>	12
▪ <i>Hydro Quebec's Borrowing Cost Without the Guarantee</i>	14
Appendix	16

Introduction

As requested, Merrill Lynch is pleased to provide certain financial advisory services in the context of a tariff review with the Québec Energy Board.

In particular, you have asked us to opine on HQ's theoretical borrowing cost without the government guarantee.

Background – Merrill Lynch's Credentials

Merrill Lynch's Ratings Advisory Group has significant experience in advising clients on Rating Agency strategy and issuance of new securities. Moreover, our rating advisory experience for the global energy industry is unsurpassed. Some of our clients include: Enron Corp., TXU Corp., Repsol, Duke Energy Corp., Consolidated Edison Inc., Carolina Power & Light Co., Dominion Resources Inc., Edison International, Reliant Energy, Inc.

Unlike other rating advisory service providers, Merrill Lynch's Ratings Advisory Group is focused exclusively on ratings and strategic corporate, structural, and financial issues related to them. The Group consists of 21 professional analysts, mostly former rating agency employees, based in three regions, Pacific Rim (Tokyo, Melbourne, Hong Kong), Europe, Middle East and Africa (London), and the Americas (New York).

Summary of Merrill Lynch's Opinion

In order to determine HQ's borrowing cost without the government guarantee, we first need to ascertain what the Company's credit rating would be without this guarantee. It is our opinion that HQ would have a low investment grade rating of approximately BBB (Standard & Poor's)/ Baa3 (Moody's)/ B++(low)(CBRS)/ BBB(low)(DBRS). Under this light, the presence of the government guarantee overrides other considerations such as the specific business lines supporting the credit.

By comparing HQ's trading levels in the Canadian or US markets with levels shown in Moody's Bond Indices "Average Yield of Utility Bonds rated Baa" and CBRS "Canadian Bond Yield Averages for B++ Utilities", we have determined that HQ's long term borrowing cost without the said guarantee would be at least 50 basis points more than what it would otherwise pay with the guarantee. Additionally we doubt that HQ without the government guarantee would have had the access to the Canadian capital markets it enjoyed over the years.

Overview of Credit Rating Methodology for Power Companies

Although each rating agency has developed its own set of analytical issues and ratios for power companies, the rating methodologies used by the International and Canadian agencies all converge towards the same components and criteria. For purpose of this analysis, Merrill Lynch has predominantly used the Standard & Poor's ratings process as it is more transparent than the process employed by Moody's, DBRS and CBRS.

The rating agencies incorporate two basic components when evaluating credit risk. These components are:

- (i) a qualitative analysis of the company's business ("business profile"), and
- (ii) a quantitative analysis of its financial performance both past and perspective.

In short, a utilities business profile is used to determine which financial profile and capital structure is most appropriate for a given rating category. For example, a utility with a strong business profile would be permitted to have weaker financial protection measures (high debt leverage and/or thin fixed-charge coverage measures) than one with a weaker business profile, yet it could still achieve the same rating if the latter has very strong financial measures (low leverage and/or robust coverage measures). In determining a business profile, the rating agencies generally analyze key qualitative attributes such as:

- regulation
- markets
- operations
- competitiveness
- management.

Business profiles are ranked on a "1" to "10" scale by S&P's, with "1" being the strongest. It should be noted that business profile rankings address only the stand-alone creditworthiness of the utility, before factoring in credit enhancements or credit constraints attributable to ownership and/or guarantees (as described under "utility types" in the next paragraph).

S&P's, when accessing a utilities' business profile, places a utility into one of four categories or 'types' that they have identified. These types are determined through the analysis of the influence of government ownership, the degree of financial stability derived from the structure of the industry, and the relative competitiveness of the system.

- Type I utilities receives overwhelming governmental and regulatory support, such as a government guaranteeing debt obligations or directly facilitating a utility's access to capital markets. Type I utilities are usually at-least partly owned by the government. For Type I utilities the ultimate rating determination rest heavily on the credit quality of the entity providing the explicit support. Until recently, most of the provincial utilities in Canada were Type I utilities.

- Type II utilities generally enjoy a high degree of protection from competition and financial variability by the government or regulator. For Type II utilities, the business profile factors of regulation and markets are weighted more heavily than other criteria such as competitiveness and management because of the supportive regulatory safety net. Municipally-owned utilities have traditionally been Type II utilities.
- Type III utilities usually have certain franchise monopoly characteristics and their financial success may hinge on their ability to control cost and provide high quality service, in addition to a rate-setting mechanism. Business profile factor weighting for utilities in this category are more evenly distributed across all five criteria. As an example, many of the U.S. vertically integrated utilities are Type III utilities.
- Type IV utilities are essentially unregulated as to revenue or return. For Type IV utilities, an assessment of operations, competitiveness, operations and markets are assigned greater weights than regulation. Unregulated generators in Argentina and Chile are an example of Type IV utilities.

The weighting or analytical emphasis that each business profile factor (regulation, markets, operations, competitiveness and management) receives will be strongly influenced by the type of utility.

1. Business Profile Analysis for Generation Activities

Generation is the riskiest segment of the electric utility industry due to complex operating risks and the increasingly competitive nature of the business. With its unique storage capabilities, advantageous geographic location and predominantly hydro-based generating capabilities, Hydro-Québec is in a good position to mitigate some of those business risks. Key considerations for business attributes relating to Hydro-Québec are as follows:

Regulation

- Status of restructuring in the Province of Québec, e.g. Bill 116 and impact of vested contracts on HQ's financial situation, role of the Régie with respect to regulation of transmission and distribution activities, etc.
- Nature of regulatory scheme such as electricity price establishment for vested contracts and open market, period of the vesting contract, future consideration for a power exchange, etc.
- Uncertainty concerning evolving rules for regional transmission organizations ("RTOs"), independent system operators, and for-profit transcos, including independence and equal access

Markets

- HQ's customer mix and diversity (wholesale and retail)
- Generating capacity vs. domestic market demand
- U.S. exports
- Québec economic growth prospects

Operations

- Composition of HQ's generation portfolio (i.e. baseload, intermediate, peaking)
- Level of physical and financial hedging sophistication
- If significant, impact of power purchase agreements (buy side) on operations, including PPA rates vs. market rates
- Nature of supply contracts (sell side), such as HQ's power purchase agreements with Vermont and other U.S. states
- Technology of plants in operation
- Asset concentration within portfolio of generating units
- Construction risk for new projects
- Possibility of detrimental environmental legislation
- Diversity of fuel sources and types, availability and level of reservoirs
- Marketing prowess
- Access to U.S. transmission

Competitiveness

- Relative costs of production, both total and variable
- Threat from new, low-cost entrants for new production
- Alternatives to electricity, such as natural gas, technological innovations, and remote site applications, including fuel cells and microturbines
- Plant's importance to transmission and voltage support

2. Business Profile Analysis for Transmission and Distribution Activities

When evaluating electric transmission and distribution companies, S&P's is most concerned about the predictability and sustainability of financial performance. The regulatory environment is by far the most important consideration affecting the business profile of T&D companies. In Québec, it is expected that the Régie will study and analyze in the near future the cost of service for the Québec transmission network in order to establish transmission and transit rates. Distribution cost of service and rates would likely follow thereafter. Key considerations for business attributes relating to Hydro-Québec are as follows:

Regulation

- Status of restructuring in the Province and the nature of the Régie rate-making structure in the near future, e.g. performance-based vs. cost-of-service
- Authorized return on equity by the Régie
- Consistency of rate treatment over the years (expected)
- Evolving rules for regional transmission organizations, independent system operators, and for-profit transcos
- Incentives to maintain existing delivery assets and invest in new assets

Markets

- Québec economic and demographic characteristics, including size and growth rates, customer mix, industrial concentrations, and cyclical volatility
- HQ's location and interconnections with NEPOOL, NYPP and Ontario

Operations

- T&D operations are typically low risk
- HQ's cost, reliability, and quality of service (usually measured against various benchmarks)
- Capacity utilization
- Projected capital improvements and asset condition
- Nature of diversified business operations, if any
- Transmission constraints

Competitiveness

- Alternative fuel sources, such as gas and self-generation
- Location of new generation
- Potential for bypass
- Rate structure

3. **Merrill Lynch Assessment of HQ's Business Profile**

As mentioned previously, Standard & Poor's assigns an actual business profile assessment to each rated entity, and business profiles are expressed on a scale of 1 (low risk) to 10 (high risk). In the case of HQ, the proforma business profile assessment would be at least a '4' but quite possibly a '3'. Our view reflects the Company's solid competitive position as a low-cost power supplier to residential and industrial consumers in the Province of Québec and an exporter of power to the Northeastern US. We have taken into account that HQ's transmission and distribution functions will remain regulated, and that HQ will continue to enjoy access to low-cost power. The other rating agencies also employ a similar business position scale, but these have not been made available to the public.

Absent the Provincial guarantee, HQ would likely be classified as a Type II utility. Although the regulatory environment for transmission and distribution of electricity in the province of Québec is still unproven, HQ benefits from good relations with other regulatory bodies such as FERC, NPCC, NEB, etc. Moreover, Bill 116 establishes the legal environment for a sound commercial development of HQ's generation activities.

HQ's very favorable business position risk attributes, again absent the provincial guarantee, somewhat reduce concerns over the Company's very poor credit metrics and support the low-investment grade rating. Qualitative factors positively influencing on Hydro-Québec credit rating include:

- low-cost hydro-based generation with considerable hydroelectric storage capacity
- regionally-focused investment strategy to expand customer service across broader energy market and well positioned to benefit from trend in energy convergence
- open access to U.S. electricity markets
- expected stability of cash-flows and projected cash flow surpluses available for potential debt reduction

Low cost hydro-based generation with considerable hydroelectric storage capacity

HQ's low power costs achieved through primarily hydroelectric generating facilities creates strategic advantages. HQ operates one of the largest systems in North America for the generation, transmission, and distribution of electric power. Generating capacity is almost entirely hydro based, the most cost efficient form of energy generation, and contributes to one of the lowest cost structures in Canada. Hydro-Québec has almost unlimited water storage capacity, which provides for strategic energy trading. This allows HQ to buy low cost power during off peak periods and sell self-generated power at higher rates during peak demand periods to maximize the export revenues. In addition, the storage capacity greatly simplifies its own peak shaving needs, since hydro generation is simple to turn on and off.

Regionally-focused investment strategy to expand customer service across broader energy market and well positioned to benefit from trend in energy convergence

With its indirect investment in Gaz Métropolitain, HQ is in a good position to benefit from the trend towards energy convergence. HQ reorganized its legal structure several years ago to manage its growing number of business initiatives. The primary subsidiaries through which it engages in activities outside its mandated role as primary electricity provider to the province of Québec are described thereafter. Pursuing a moderate to conservative risk profile, HQ has expanded its initiatives outside North America in the past year from asset ownership to predominately fee-based endeavors.

Hydro-Québec International engages in the development of energy-related projects in international markets, including the exports of technological knowledge. HQ's international presence includes Asia, Latin America, and Africa.

Société d'énergie de la Baie James provides engineering, construction, and rehabilitation services for hydroelectric and thermal projects around the globe.

Hydro-Québec Capitech, formerly known as Nouveler, invests as a partner in energy technology companies and their related products. It also manages HQ's non-strategic investments and provides management services for strategic subsidiaries.

Noverco, in which HQ has a 41% ownership interest, is a holding company that controls Gaz Métropolitain and other companies involved primarily in the transmission and distribution of natural gas.

HQ has also transferred its transmission grid in 1997 to a separate division, TransEnergie, which is managed independently from its electricity generation assets, making the provincial grid accessible to all energy suppliers on equal terms. This move was essential to gaining a US power marketing license.

Open access to U.S. electricity markets

HQ obtained a FERC power marketing license in 1997, which has enhanced its access to U.S. markets. In return, the Utility had to grant U.S. utilities reciprocal (wholesale) access within the province. However, HQ did not give up very much, since:

- it will be difficult for U.S. electric utilities to compete against its low cost hydro based energy, particularly when one considers that electricity rates in the U.S. Northeast at average US 9¢-US 11¢ per kWh
- the relatively low Canadian dollar gives HQ a competitive advantage over U.S. electric utilities
- only about 4% of electricity in the province is distributed by third parties who can potentially buy from energy marketers.

In 1999, HQ sold 24.7 TWh of electricity to customers outside of Québec, an increase of 32.8% compared to 1998. A large number of these wholesale contracts will expire in 2001-2002, but the potential loss of revenues will be somewhat offset by increasing retail demand within Québec and additional short-term and spot wholesale sales.

Expected stability of cash-flows and projected cash flow surpluses available for potential debt reduction

Arising from its new “business-first” vision, Hydro-Québec is focusing its strategies on growth, the development of new markets and the commercialization of research and development activities, while preserving low and stable rates for Québec customers. These strategies have recently yielded sustained growth in revenues and improvement in profitability and cash flows. This positive cash-flow trend is expected to continue in the near future and beyond as HQ develop further its businesses.

HQ has been able to annually refinance about \$2 billion in maturing debt at progressively lower coupons, thereby reducing interest expenses and improving profitability. Earnings should continue to benefit from this trend over the medium term given HQ debt maturity.

Quantitative Analysis

Credit rating agencies measure financial strength by a utility’s ability to generate consistent cash flow to service its debt, finance its operations, and fund its investments. The focus is typically on a utility’s financial results for the last five years and on pro forma, five-year projections. The four measures used are:

- profitability
- capital structure
- cash flow
- financial flexibility

Hydro-Québec has weak credit metrics that are somewhat offset by the Company’s very favorable business position risk attributes. The weak credit metrics can be summarized as follows:

- low profitability and return on equity over the past decade
- highly leveraged capital structure and low debt service coverage ratios relative to investor-owned utilities
- domestic rate frozen until 2002 (and maybe beyond) and earnings sensitive to water levels
- competition in the North American energy market (natural gas, etc.) and international operations

Low profitability and return on equity over the past decade

HQ has experienced very low profitability over the past decade due to consistently high debt levels, with interest costs currently equal to about 39% of total revenues, down from a peak of 48% in 1991. By comparison, interest costs of the private sector utilities, which have considerably stronger balance sheets, ranged between 10-15% of revenues over the same period.

Highly leveraged capital structure and low debt service coverage ratios relative to investor-owned utilities

With debt levels of about 74% (better than the 85% average typical of government-owned utilities), Hydro-Québec has a weak balance sheet, particularly in comparison to the approximate 60% average typical of investor-owned utilities. This has resulted in consistently weak interest coverage ratios.

Domestic rate frozen until 2002 (and maybe beyond) and earnings sensitive to water levels

HQ has had to maintain very competitive electricity rates in the province in order to retain market share in the province of Québec energy market. Given the hydro-based nature of generating capacity, HQ's earnings are sensitive to water levels. HQ must manage reservoir levels to ensure that earnings are not adversely affected by abnormally low water levels.

Competition in the North American energy market (natural gas, etc.) and international operations

Natural gas, which can be used to generate electricity or as an alternative form of energy, remains a competitive threat that continues to pressure electricity rates in the province. More recently, the development of Sable Island gas reserves, and the construction of the Maritimes and Northeast Pipeline and the Portland Natural Gas Transmission System have extended this competition threat into export markets in the U.S. northeast.

Hence, in summary, HQ percentage of debt in the capital structure is quite high and cash flow-to-interest coverage is very weak. Moreover, the absolute level of cash flow is very small relative to the amount of debt in the capital structure. Debt leverage greater than 60% is viewed to be aggressive for the Baa3/BBB- rating category. This high level of debt is not expected to be aggressively reduced in the near term since internally generated cash flows fund about 61 % of HQ's expected capital expenditure and long-term debt maturities for the period 2000 to 2004.

S&P's provide the following approximate benchmarks for electric utilities:

	FFO Interest Coverage (x)		Financial Ratio Medians FFO to Total Debt (%)		Total Debt to Capital (%)	
	A	BBB	A	BBB	A	BBB
	Generators	7.1	4.7	48	35	39
T & D Cos	3.5	2.6	23	17	55	62
Integrated Cos	5.1	3.8	35	25	43	50
Hydro-Québec	1.9		7.4		74.1	

HQ's business profile combined with the above financial ratios points us towards a low end of a BBB/Baa rating if the utility was on a stand-alone basis without a provincial guarantee. At a low BBB level, most U.S. integrated companies comparable to Hydro-Québec have debt levels near 60%. In general, the riskier power generation can carry less debt than the stable transmission/distribution.

Quantitative Analysis – Business Profiles vs. Group Benchmarks

The group benchmarks presented in the following tables relate to an electric utility with a business profile of '3' for a given credit rating of "A" or "BBB". As mentioned before, Hydro-Québec is well below all quantitative benchmarks but compensate by a lower overall risk profile.

FFO Interest Coverage (x)		
Business Position	A	BBB
1	2.6 – 1.9x	1.9 – 0.9x
2	3.3 – 2.5	2.5 – 1.5
3	3.9 – 3.1	3.1 – 2.1
4	4.5 – 3.8	3.8 – 2.7
5	4.8 – 4.0	4.0 – 3.0
6	5.7 – 4.5	4.5 – 3.1
7	7.0 – 5.1	5.1 – 3.3
8	8.3 – 5.9	5.9 – 3.5
9	9.5 – 7.1	7.1 – 4.3
10	11.3 – 8.6	8.6 – 5.3

Total Debt/Total Capital (%)		
Business Position	A	BBB
1	55.0 – 60.5%	60.5 – 67.5%
2	51.0 – 56.5	56.5 – 63.5
3	47.5 – 53.0	53.0 – 61.0
4	43.0 – 49.5	49.5 – 57.0
5	41.5 – 47.0	47.0 – 55.0
6	39.5 – 46.0	46.0 – 53.5
7	39.5 – 45.0	45.0 – 52.5
8	35.0 – 43.0	43.0 – 51.5
9	30.0 – 39.0	39.0 – 47.5
10	24.0 – 33.0	33.0 – 40.5

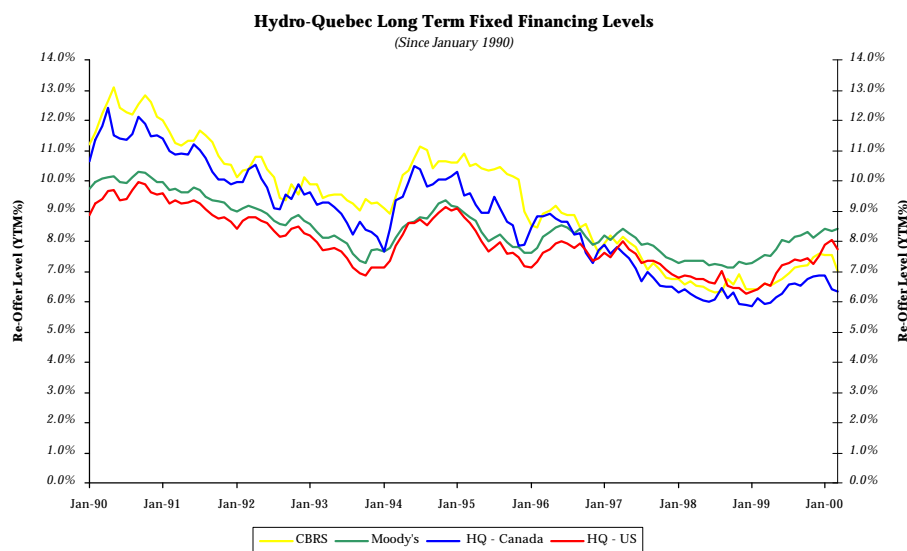
FFO/Total Debt (%)		
Business Position	A	BBB
1	16.5 - 12.5%	12.5 – 7.0%
2	21.0 – 16.0	16.0 – 10.5
3	26.0 – 20.0	20.0 – 14.0
4	30.5 – 24.5	24.5 – 17.5
5	33.0 – 27.0	27.0 – 20.5
6	39.0 – 31.0	31.0 – 22.0
7	47.0 – 36.5	36.5 – 24.5
8	55.0 – 42.5	42.5 – 27.5
9	64.5 – 49.5	49.5 – 32.0
10	78.0 – 60.5	60.5 – 39.0

Hydro Québec's Borrowing Cost Without the Guarantee

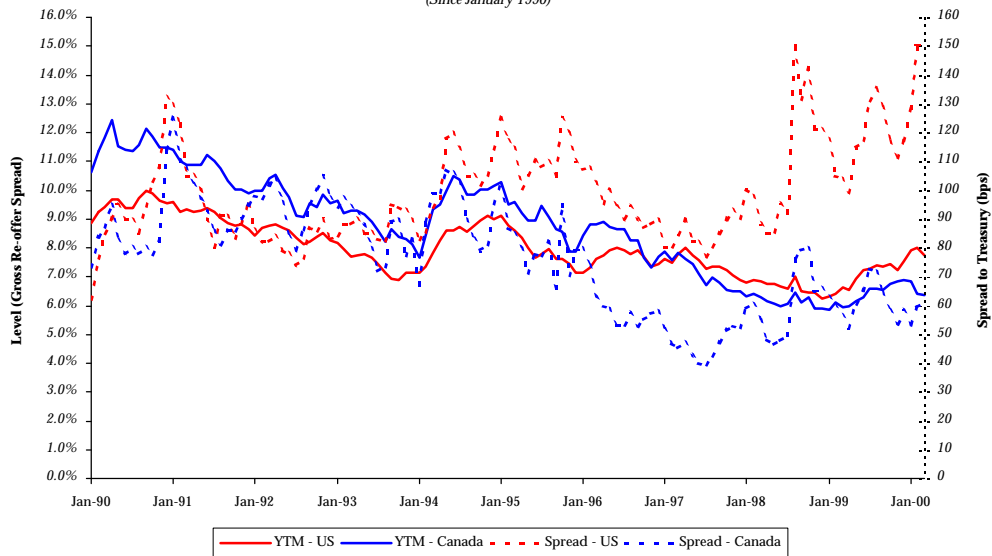
In order to opine on Hydro-Québec's theoretical borrowing cost without the government guarantee, Merrill Lynch has analyzed Hydro-Québec bond trading levels in the secondary market for a period of 10 years, i.e. from January 1990 to January 2000 and compared these trading levels to levels shown in Moody's Bond Indices "Average Yield of Utility Bonds rated Baa" and CBRS's "Canadian Bond Yield Averages for B++ Utilities".

We have limited our analysis over a 10 year period because Hydro-Québec's guarantor, the Province of Québec, was better rated in the early 1990's. Therefore, the spread differential between Hydro-Québec bonds (with the guarantee) and BBB utilities would be greater. Ten years is a sufficient period of time to encompass different economic cycles and market conditions.

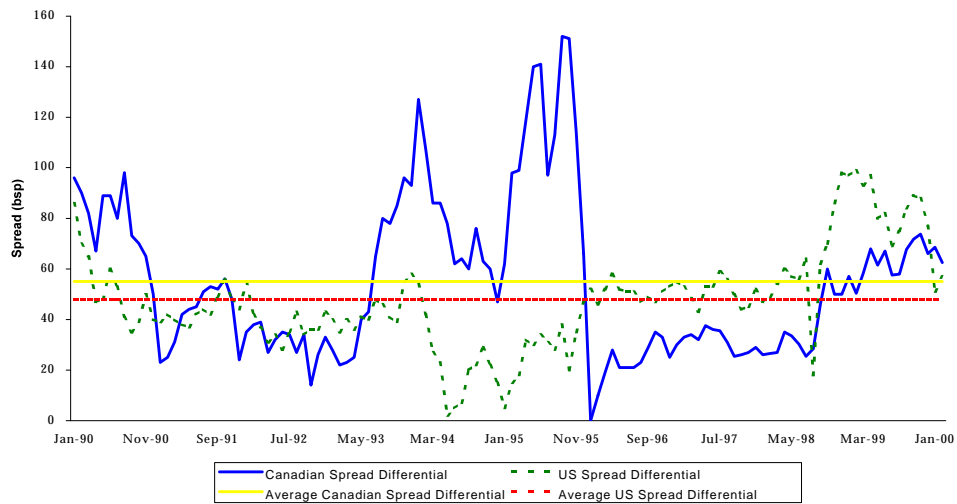
Merrill Lynch has found that from January 1990 to January 2000, Hydro-Québec's long-term borrowing cost in the Canadian or US markets with the guarantee from the Province of Québec (expressed as a spread over the corresponding government benchmark yield) was, on average for this period, of at least 50 bps less than what a Baa (Moody's)/B++ (CBRS) rated utility would have paid.



Hydro-Quebec Long Term Fixed Financing Levels
(Since January 1990)



Hydro-Quebec Long Term Fixed Financing Levels
(Since January 1990)



Although we have made a comparison of Hydro-Québec's long term borrowing cost in the Canadian market with what a B++ rated utility would have paid, it doesn't mean that a B++ issuer would have had the same access in terms of volume and frequency of issuance to Canadian capital markets that HQ enjoyed over the year. In fact, we express doubts that Hydro-Québec would have had the same access to Canadian capital markets with a B++ rating.

Appendix

Brian Keegan is the Global Head of Merrill Lynch's Ratings Advisory Group. Prior to joining the Ratings Advisory Group, Mr. Keegan managed a similar ratings advisory service for Toronto Dominion Securities (1990-1993). Mr. Keegan was a Senior Analyst at Moody's (1987-1990) following consumer non-durables. Mr. Keegan holds an MBA in Finance from New York University, a B.A. in Economics from the University of California at Los Angeles and an Associate Arts degree from the American University of Paris. Mr. Keegan is fluent in French and has conversational knowledge of Portuguese.