Hydro Québec

September 30, 2010

Mr. Russell G. Golden, Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Via Email to director@fasb.org

Re: File Reference No. 1810-100

Dear Mr. Golden,

We appreciate the opportunity to comment on the proposed Accounting Standards Update, *"Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities" ("the proposal").* We welcome the efforts deployed by the FASB and the IASB to reduce the complexity related to accounting for financial instruments. However, we are not convinced that the proposal advanced will actually make it possible to achieve the objectives presented, especially with regard to the model for classifying financial instruments, the complex rules surrounding impairment of financial assets, additional disclosures in the financial statements, and the restrictions imposed on the voluntary dedesignation of hedging relationships.

You rely on a model based on fair value measurement, which you consider to be the most relevant type of measurement, while you require additional amortized cost disclosures on the face of the balance sheet and by way of notes, which seems somewhat inconsistent to us. If you consider fair value to be the most relevant measurement, then only fair value disclosures should be made. If so many additional disclosures are required for the reader, there is reason to question whether fair value is still the most relevant measurement.

We were expecting a proposal in line with IFRS 9 and the recent exposure drafts published by the IASB. In the context of a global economy, we believe that the requirements concerning financial instrument measurement, disclosure and presentation ought to promote comparability of financial reports between entities. In our opinion, convergence between U.S. and international standards is essential in an area as important as financial instruments. We therefore encourage you to continue your efforts to issue a joint proposal with the IASB.

The following pages provide a brief picture of Hydro-Québec, along with our comments on specific points in the proposal.

Yours very truly,

Lise Croteau

Lise Croteau, FCA
Vice President – Accounting and Control
Hydro-Québec

Hydro-Québec is a Crown corporation whose mission under its governing statute is to supply power and to pursue endeavors in energy-related research and promotion, energy conversion and conservation, and any field connected with or related to power or energy. In Québec, electricity transmission and distribution activities are regulated by the Régie de l'énergie (energy board). Hydro-Québec's operations are supported by property, plant and equipment recorded at cost ($58 billion).

The capital structure of Hydro-Québec is on the order of 55% based on bonded debt ($38 billion), of which 4% is payable in foreign currencies and nearly 10% is in the form of floating-rate bonds. This represents a significant exposure to foreign exchange and interest rate risks, which explains why the enterprise has adopted a sophisticated management strategy for these risks.

Hydro-Québec hedges future revenue streams denominated in US dollars using debt totaling nearly $2 billion, so as to manage a significant portion of its foreign exchange risk exposure. Hydro-Québec also enters into swap contracts that serve as a hedge for both the principal and interest repayments on debt. Some swaps also modify the long-term exposure to interest rate risk.

Several other types of derivative instruments are also used to manage short-term and long-term foreign exchange and interest rate risk exposures. In addition, specific risks are managed through derivative instruments, i.e., raw material price risks and market risks resulting from fluctuations in energy prices.

COMMENTS ON THE FASB EXPOSURE DRAFT "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities"

CLASSIFICATION

We do not agree with having a measurement model whose basic premise is fair value. Your a priori simple model becomes complicated thereafter in order to meet criteria to permit changes in fair value to be recognized in other comprehensive income and which, through other exceptions, allow certain financial instruments to be reported at amortized cost.

The proposal strikes us as more complex than IFRS 9 which itself presents a simplified model that classifies financial instruments into two single categories: at amortized cost or at fair value. We think that amortized cost is the most relevant measurement in cases where the object is to collect or pay contractual cash flows and the business strategy is not to manage financial assets or financial liabilities based on the return on fair value. In this context, we have trouble understanding the basis of the category "Recognizing a Change in Fair Value in Other Comprehensive Income." Financial instruments are measured at fair value on the balance sheet, while income is affected based on amortized cost. In our opinion, this category makes subsequent accounting for financial instruments more complex, and makes reading financial reports more arduous.

However, we do agree that fair value is the most relevant measurement for a derivative instrument or a financial instrument not held with a view to the collection or payment of contractual cash flows. In such cases, changes in fair value should be recognized in net income, unless the derivative instrument is designated in a hedging relationship.

Furthermore, according to your criteria, and as you illustrate in IG73, a perpetual instrument would be measured at fair value with subsequent changes recognized in net income. However, such an instrument does not seem to us to be any more restrictive than our other financial liabilities recognized at amortized cost and used to finance our assets recognized at cost. Measurement at amortized cost would, in our opinion, better represent the perpetual character of this type of instrument and would more fairly present income.

Finally, in the context in which you recommend measurement at fair value for all financial instruments, paragraph 30 is essential in our opinion, since it will prevent a mismatch when most of the entity's assets are recorded at cost.

That being said, we reiterate that the complexity of the model would be reduced if all financial liabilities were classified a priori in an amortized cost category, unless the business strategy is to manage them on the basis of return on fair value.

INITIAL MEASUREMENT

The approach FASB has chosen for initial measurement strikes us as unnecessarily complex. We believe it would be much simpler to use fair value as the basic premise, barring exceptions. We do not see the utility of making a distinction between financial instruments measured at amortized cost and financial instruments measured at fair value with changes recognized in other comprehensive income. We think it would be enough to provide for exceptions.

Besides, the criteria in paragraphs 28 to 30 to qualify for the "amortized cost" category limit the type of financial instruments to "standard" contracts, such that no difference is anticipated between fair value and the transaction price. Moreover, the requirement imposed on entities to assess whether there is a difference between fair value and the transaction price increases the complexity of the initial measurement. In this regard, we prefer the IASB's proposal, which considers fair value generally equivalent to the transaction price, apart from specific exceptions.

IMPAIRMENT

The impairment model you propose is based on the economic environment that exists when a financial asset is evaluated for impairment. We think that entities should be able to use prospective data when relevant. We do not support the IASB's proposed approach, which requires an entity to consider all potential future scenarios when estimating future cash flows. Incorporating all potential future economic environments when estimating losses in value would be extremely complex, costly and tedious for preparers to apply. Consequently, we prefer a model that allows an entity to use its best estimate when determining the expected collectibility of future cash flows from a financial asset. In so doing, the entity can consider past events, present conditions and currently available information of a prospective nature. We think it is essential to strike the right balance and allow the entity to make the most of the information available to it without having to make predictions about the future economic environment.

Furthermore, because circumstances vary from one entity to another, we support the proposal that do not prescribe a specific method to determine the historical loss rate for a pool of financial assets.

HEDGING

Eligible hedging relationships

In paragraph 111a, you inform us that the current provisions of Topic 815 dealing with items and risks eligible for hedge accounting would continue to apply. In this regard, we think it would be opportune to make use of the current discussions and review some of the provisions of Topic 815 that seem more problematic to us.

Concerning cash flow hedging of a nonfinancial instrument, among other things, we think it would be opportune to permit hedging of the risk associated with a determinable component of a nonfinancial instrument.

Dedesignation

We support all efforts to simplify the application of hedge accounting. However, we strongly disagree with the proposal to no longer permit voluntary dedesignation of hedging relationships. We do not understand why voluntary dedesignation would be a problem when hedge accounting is itself optional. Furthermore, this restriction unfortunately does not take into account the many operational realities involved in managing financial risks. Dedesignation is also very advantageous and must be permitted since financial requirements and financial risks may change over a very long period, and market prices may fluctuate widely in certain years.

Moreover, we think that to overcome this obstacle, entities will be obliged to carry out a larger number of transactions to adjust risk hedging. In fact, they will have to dispose of their derivative instruments or acquire derivative instruments with reverse positions. For one thing, long-term derivative instruments cannot always be disposed of quickly on the market, and for another, these additional transactions will generate additional costs. Consequently, this measure complicates management of hedging relationships and goes against this exposure draft's expressed objective of simplification.

Furthermore, we consider that the proposed changes are not sufficiently clear concerning the rules that would allow a hedging relationship to be changed without it being discontinued. In particular, changes in the hedged risk or the hedged proportion of a hedged item are not addressed. Thus, could a hedged risk be changed by adding a derivative to an existing hedging relationship?[1] Also, could the proportion of the item hedged be changed by partially reversing a position?

Effectiveness

We endorse the proposal to reduce the requirements for evaluating effectiveness and the level required to maintain hedging relationships. In our view, maintaining a hedging relationship when it is considered "reasonably effective" rather than "highly effective" could in fact reduce the number of hedges discontinued because they no longer meet the criteria for the application of hedge accounting. This would bring the accounting for certain transactions closer to the economic strategy at the base of the transaction. Indeed, it is unfortunate that a hedging relationship is discontinued when it does not meet the criterion of being highly effective when in fact management considers the transaction to be still meeting its hedging objective because it is reasonably effective. Clearly, we can expect that entities will not want to maintain hedging relationships that do not meet this last criterion since ineffectiveness will, in any case, be recognized in income, inducing a certain volatility.

We are also in favor of allowing qualitative rather than quantitative documentation, which we think will simplify the application of hedge accounting. However, entities must nonetheless produce quantitative analyses since ineffectiveness must be measured in all cases and recognized in net income. The same models are often used to calculate effectiveness and measure ineffectiveness.

Therefore, in our opinion, a safe way to reduce the load of quantitative analyses is to maintain the "shortcut method." This method excludes all quantitative analysis, both for assessing effectiveness and measuring ineffectiveness. We think that the criteria for applying this method are sufficiently restrictive to justify the exclusion of any quantitative analysis.

Reporting of the "underhedge"

We disagree with the proposal to report the underhedge related to measuring the ineffectiveness of cash flow hedges. We think that when the cumulative change in fair value of the hedging instrument is less than the cumulative change in the hedged item, no ineffectiveness should be recognized in the income related to the underhedge. Recognizing this ineffectiveness in net income would defer a nonexistent gain or loss related to the hedging instrument in accumulated OCI and recognize a nonexistent gain or loss related to the hedged item in net income.

[1] US variable-rate debt hedged by a first swap (US variable-rate receipt and CAD variable-rate disbursement) to which a second swap is added (CAD variable-rate receipt and CAD fixed-rate disbursement).

COMMENTS ON THE FASB EXPOSURE DRAFT "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities"

PRESENTATION AND DISCLOSURES

Balance sheet

We strongly dissent from presenting on the face of the balance sheet any information other than the recognized value. This information would needlessly weigh down the presentation of the entity's financial position.

Furthermore, as mentioned earlier, it is inconsistent to require so many cost disclosures, on the one hand, and on the other, to claim that fair value is the most relevant measurement. The proposed financial reporting requirements are inconsistent with your basis premise, which is to consider fair value appropriate for all types of financial instruments. Once again, this does not meet your objective of simplification.

Income

We do not agree with the requirement to present realized and unrealized gains separately within net income. First, we think it would be opportune for the proposal to contain a clear definition of the terms "realized" and "unrealized." According to our understanding, a realized gain would be a gain for which there is a cash inflow, contrary to an unrealized gain. Based on this definition, when a financial instrument is reported at fair value, we would recognize unrealized gains; but when a financial instrument is reported at cost, only the realized gains would be recognized in net income. In this context, since fair value is generally disclosed in a note, financial statement users are able to assess potentially unrealized gains and losses.

Moreover, according to paragraph 92, the exchange gains and losses resulting from translation of foreign debt recorded at amortized cost would be recognized in income, while they would be recognized in other comprehensive income for foreign debt recorded at fair value, with changes in fair value recognized in other comprehensive income. We see here another inconsistency related to this last category, which further complicates accounting for financial instruments.

COMMENTS ON THE FASB EXPOSURE DRAFT "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities"

Disclosures

For financial assets classified as "Financial Instruments for Which Qualifying Changes in Fair Value are Recognized in Other Comprehensive Income", additional disclosures are required to reconstitute amortized cost. In our opinion, these disclosures do not shed any relevant light on an entity's financial position, weigh down the financial reporting and consequently do not meet the objective of simplifying accounting for financial instruments.

EQUITY METHOD OF ACCOUNTING

We do not support the proposition made in paragraph 130 of the proposal. First, this should instead be dealt with in a separate draft. Second, we think that the use of equity accounting should be discussed jointly with the IASB. This proposal does not currently exist under the IFRS.

In our opinion, it is not necessary to add these supplementary criteria to the concept of significant influence to allow the use of equity accounting, mainly because the concept of significant influence does not require the investee's operations to be related to the investor's, and the concept of control does not require this either. However, if this were to be done, we suggest that these criteria be added to the standard in which significant influence is determined, and not to the one for financial instruments.

EFFECTIVE DATES AND TRANSITION

We encourage the FASB to continue its work in collaboration with the IASB with a view to harmonizing their respective standards on financial instruments. In this regard, the effective dates of your proposals should be coordinated with the provisions of IFRS 9.