Hydro Québec

September 26, 2008

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Subject: Comment letter on the discussion paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*

Dear Sir/Madam,

Hydro-Québec is a major producer, transmission provider and distributor of electricity in North America, and the Québec government is its sole shareholder. It offers all its employees a contributory defined benefit pension plan, as well as other post-retirement and post-employment benefits. These plans are currently recognized in the Corporation's financial statements in accordance with Canadian GAAP. Effective January 1, 2011, Hydro-Québec, like most Canadian publicly accountable enterprises, will adopt the International Financial Reporting Standards (IFRS).

I thank you on behalf of Hydro-Québec for providing us with the opportunity to respond in regard to your discussion paper *Preliminary Views on Amendments to IAS 19 Employee Benefits.* You will find enclosed our comments on the questions concerning recognition and presentation of defined benefit promises.

Should you wish further clarification of our opinion, please do not hesitate to contact us.

Yours sincerely,

Lise Croteau

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

GENERAL COMMENTS

Regarding the scope of the project, and the recognition and presentation of post-employment defined benefit promises

In general, we agree with the principle of eliminating deferred recognition, except for past service cost arising from plan amendments. Presentation of the financial position of post-employment defined benefit promises (plans) directly on the balance sheet will make it easier to understand financial disclosures concerning defined benefit plans. We believe that the SoRIE method (OCI) should be the only method allowed. See proposal in 4(B).

We do not, however, agree with the current treatment in IAS 19, nor with the one proposed in this discussion paper for recognizing past service cost arising from plan amendments. We think that this cost should be recognized in profit or loss for the period in which the economic benefits will occur.

We are also convinced that the best measurement of the return on assets in the cost of a post-employment defined benefit promise is the expected long-term return, determined in accordance with the investment policy of the pension fund.

Lastly, we consider that the very long-term nature of this type of promise absolutely must be taken into account in determining the cost in the income statement. Thus, in our opinion, the three approaches proposed for presenting cost do not allow the cost of post-employment defined benefit promises, which are very long-term obligations, to be properly reflected. This is particularly the case for a fair value approach, which may entail significant volatility. We think that such an approach could even prompt a number of sponsors to close their defined benefit plan, which is certainly not a desirable outcome, especially in Canada where this type of plan has been in decline in recent years. We therefore propose, in 4(B), an alternative to the preliminary approaches presented in this discussion paper, i.e., maintaining the SoRIE/OCI method of recognizing gains and losses and the cost of past service in OCI.

CALL FOR COMMENTS

SCOPE OF THE PROJECT

1. GIVEN THE OBJECTIVE OF THE IASB PROJECT TO ADDRESS SPECIFIC ISSUES IN A LIMITED TIME FRAME, ARE THERE ADDITIONAL ISSUES WHICH YOU THINK SHOULD BE ADDRESSED BY THE BOARD AS PART OF THIS PROJECT? IF SO, WHY DO YOU REGARD THESE ISSUES AS A MATTER OF PRIORITY?

YES, there are.

We believe that the Board should review the relevance of using a market rate for the valuation of defined benefit plan obligations. The current market crisis demonstrates the volatility of the credit risk associated with high quality corporate bonds (AA corporate bonds). We think that the original intention of standard-setters in using the market rate was not to reflect such impacts in the valuation of the defined benefit plan obligations. It is therefore our opinion that the substantial volatility carried over from the use of market rates is a problem that must be addressed within this project.

RECOGNITION AND PRESENTATION OF DEFINED BENEFIT PROMISES

CHAPTER 2 DESCRIBES THE BOARD'S DELIBERATIONS ON THE RECOGNITION OF DEFINED BENEFIT PROMISES (PARAGRAPHS PV2-PV3-PV4).

2. ARE THERE FACTORS THAT THE BOARD HAS NOT CONSIDERED IN ARRIVING AT ITS PRELIMINARY VIEWS? IF SO, WHAT ARE THOSE FACTORS? DO THOSE FACTORS PROVIDE SUFFICIENT REASON FOR THE BOARD TO RECONSIDER ITS PRELIMINARY VIEWS? IF SO, WHY?

YES, there are.

A. Entities should not divide the return on assets into an expected return and other changes in the fair value of assets (gains and losses). PV3

   We completely disagree with this principle. We believe that the cost of a post-employment defined benefit promise should include an expected long-term return, determined in accordance with the investment policy of the pension fund. The other changes in the fair value of assets (gains or losses) are attributable to current market fluctuations which should not affect the expected long-term return recognized in the cost for the fiscal year since defined benefit promises are very long-term obligations.

In our opinion, gains and losses on assets should be recognized in the statement of comprehensive income, as proposed in Approach 3 of this discussion paper.

B. <u>The treatment of past service cost arising from defined benefit plan amendments. PV4</u>

We believe that the Board should have considered an approach allowing the total past service cost to be recognized in the statement of comprehensive income in the year of the plan amendment, as well as an ongoing reclassification of subsequent years to the income statement, over a period corresponding to the life of the future economic benefit. This approach is comparable to the cash flow hedging treatment recommended in IAS 39.

Recognition in expenses in the same period as the plan amendment is not consistent with the objective when improvements to defined benefit promises are granted to employees. An agreement between the employer and its employees entailing an increase in pension benefits generally results from negotiation affecting several aspects of compensation (total compensation). In granting pension plan improvements, the employer's objective is to increase compensation over the employment period of active employees, and not to recognize past service. In exchange, the employer therefore expects to achieve future economic benefits.

Application of the provision concerning past service cost in IAS 19 and the proposal included in this discussion paper will significantly enhance compensation in the accounting period of the agreement (especially in Canada where rights are vested immediately) and correspondingly reduce it for subsequent fiscal years, therefore having an effect exactly opposite to the employer's objective of stable compensation over time.

We therefore propose that the total past service cost be accounted for in the statement of comprehensive income in the year of the plan amendment, to be then amortized on a straight-line basis in the income statement over the period in which the economic benefits will be achieved. With this approach, the total past service cost can be presented in the obligation on the entity's balance sheet for the year of the plan amendment (no off-balance-sheet unrecognized amount) and recognition of the costs in profit or loss, on a basis consistent with the life of future economic benefits.

We are of the opinion that the period in which such costs should be recognized is the expected average remaining service life (EARSL) of active employees, in the case of permanent improvements, or the period corresponding to the term of the collective agreement for improvements granted on a temporary basis. This period constitutes the most consistent cost recognition basis and best reflects the period in which the entity expects to realize economic benefits.

Even if there is still no set IFRS policy on the reclassification of amounts from the statement of comprehensive income to the income statement, this concept is applied if the basis of recognition in income is suitable and consistent, as is the case in IAS 39 for gains and losses arising from cash flow hedging. This question should therefore be considered by the Board within the context of the IAS 19 improvement project, bearing in mind that it would, in our opinion, constitute a superior conceptual approach for the treatment of past service cost.

CHAPTER 3 SETS OUT ALTERNATIVE APPROACHES FOR THE PRESENTATION OF COMPONENTS OF THE DEFINED BENEFIT COST AND ANALYSES THE RELATIVE MERITS OF EACH APPROACH (PARAGRAPH PV5).

3. (A) WHICH APPROACH TO THE PRESENTATION OF CHANGES IN DEFINED BENFIT COSTS PROVIDES THE MOST USEFUL INFORMATION TO USERS OF FINANCIAL STATEMENTS? WHY?

We are surprised that the SoRIE method was not retained by the Board. In our opinion, none of the approaches proposed in the Discussion Paper provides more useful information to users of financial statements. See our answer in 3(C). We therefore propose an alternative approach in 4(B), i.e., maintaining the SoRIE method and recognizing the cost of past service in OCI.

Nevertheless, we think that Approach 3, which includes an expected long-term return determined in compliance with IAS 19, is the one that comes closest to the SoRIE method.

We think that the measurement of the expected long-term return of a post-employment defined benefit promise is management's best estimate of the expected long-term return, determined in compliance with the investment policy of its pension fund.

This approach is also the one which is most consistent with the treatment prescribed by other standards (IAS 16, IAS 38 and IAS 39) regarding the gains and losses arising from a change in fair value. Gains and losses on assets are recognized in the statement of comprehensive income.

(B) IN ASSESSING THE USEFULNESS OF INFORMATION TO USERS, WHAT IMPORTANCE DO YOU ATTACH TO EACH OF THE FOLLOWING FACTORS, AND WHY:

(i) presentation of some components of defined benefit cost in other comprehensive income; and

Presentation of some cost components in the statement of comprehensive income is fundamental in recognizing defined benefit promises. Given the long-term nature, in particular, of the commitments relating to these promises, the significant volatility arising from the use of market rates to value the obligation, the significant short-term changes in the fair value of the assets, and the impact of revised estimates that are not related to events in the current fiscal year, we believe that some cost components must be recognized in the statement of comprehensive income (actuarial gains and losses and past service cost).

In addition, presenting some cost components in the statement of comprehensive income is entirely consistent with what is prescribed by other standards regarding the treatment of certain gains and losses arising from changes in fair value, including IAS 16, IAS 38 and IAS 39.

(ii) disaggregation of information about fair value of assets?

As previously mentioned, in our opinion, the best measurement of return on the assets of a defined benefit plan is the expected long-term return, determined in compliance with the investment policy of the pension fund. Consequently, we believe that it is very important for this value to be presented separately from the current changes in the fair value of the plan assets (gains and losses).

Changes in the fair value of assets are attributable to current market fluctuations and should not affect the expected long-term return recognized in the cost for the fiscal year. We are of the opinion that these changes in the fair value of assets must be charged to the statement of comprehensive income, as proposed in Approach 3 of the present discussion paper.

(C) WHAT WOULD BE THE DIFFICULTIES IN APPLYING EACH OF THE PRESENTATION APPROACHES?

APPROACH 1 – FAIR VALUE (all changes in the value of the obligation and assets are presented in the income statement)

We are of the opinion that fair value is not a good yardstick of the cost of post-employment defined benefit promises. These promises arise from very long-term plans or commitments. Thus, cost based on long-term assumptions should not be affected by one-time market fluctuations.

We do not understand how a fair value approach can be considered for recognizing the cost of defined benefit promises in an income statement since this is not the case for the recognition of financial instruments (IAS 39) and asset revaluations (IAS 16 and IAS 38). Gains and losses arising from the change in fair value are charged to the statement of comprehensive income. This approach therefore appears to us to be inconsistent with several other standards.

In our opinion, it does not provide the best information for users of financial statements since it combines information having a different predictive value.

We are convinced that a fair value approach would lead to unacceptable volatility in cost on the financial statements of defined benefit plan sponsors, and could trigger the closing of a significant number of plans.

APPROACH 2 – (COST OF SERVICE + GAINS AND LOSSES OTHER THAN ON THE DISCOUNT RATE IN THE INCOME STATEMENT)

We think that this approach does not allow the right balance to be reflected in the cost of a defined benefit promise in entities' profit or loss. In our opinion, the cost of a post-employment defined benefit promise must include both the current service cost and the financing cost of the obligation, as well as the return on assets. The financing cost and the return on assets are incurred because the payment of benefits is deferred over time. We therefore believe that these elements form an integral part of the cost of a defined benefit promise, and that they should not be presented separately from the current service cost.

We are concerned because this approach could lead to certain behavior regarding reviews of assumptions. Given the large extent to which a change in assumption can affect the results for the year in which the change occurs, we think that some sponsors could decide to postpone a review until a subsequent fiscal year.

We also believe that since there is no requirement to perform an actuarial valuation on an annual basis, this approach would mean that the gains and loss experience would not necessarily be attributed to the right accounting period

APPROACH 3 – (ALL COSTS IN THE INCOME STATEMENT, EXCEPT FOR GAINS AND LOSSES ON ASSETS AND GAINS AND LOSSES ARISING FROM THE DISCOUNT RATE)

We have the same concerns as for Approach 2 regarding the review of assumptions and the treatment of gains and loss experience.

Expected long-term return prescribed by IAS 19 (para. 106)

In the event that the alternative proposed by us in 4(B) was not acceptable, we would opt for this approach. We think that the measurement of the expected long-term return of a post-employment defined benefit promise is management's best estimate of expected long-term return, determined in accordance with the investment policy of its pension fund.

This approach also seems to us to be more consistent with other standards (IAS 16, IAS 38 and IAS 39) regarding the treatment of gains and losses arising from the change in fair value, since gains and losses are recognized in the statement of comprehensive income rather than in the income statement.

Return on assets based solely on fixed income (e.g.: dividends)

We completely agree with the arguments of the Board concerning the disadvantages of this method. We believe in fact that this method could create an incentive for some entities to invest in plan assets to achieve an accounting result, rather than for economic objectives.

This method does not provide management's best estimate of the expected long-term return on its plan. In our opinion, it does not provide adequate measurement of the cost, since it does not take into account the total expected return on plan assets. Returns other than on fixed income would never be recognized in the cost.

Return based on a rate of return of high quality corporate bonds "AA corporate bonds" as at the valuation date

As was the case in the previous approach (fixed income), we think that this approach does not adequately measure the cost since it does not take into account the total expected return on plan assets. We do not find this measurement of the return on assets meaningful, and we do not understand how it could be a better measurement than expected return.

In our opinion, this approach will lead to even more volatility in the results of entities. The use of a market rate to measure the long-term return on assets will lead to current market fluctuations, which must not, in our opinion, affect the expected long-term return.

4. (A) HOW COULD THE BOARD IMPROVE THE APPROACHES DISCUSSED IN THIS PAPER TO PROVIDE MORE USEFUL INFORMATION TO USERS OF FINANCIAL STATEMENTS?

See proposal in 4(B).

(B) PLEASE EXPLAIN ANY ALTERNATIVE APPROACH TO PRESENTATION THAT PROVIDES MORE USEFUL INFORMATION TO USERS OF FINANCIAL STATEMENTS. IN WHAT WAY DOES YOUR APPROACH PROVIDE MORE USEFUL INFORMATION TO USERS OF FINANCIAL STATEMENTS?

We propose instead maintaining the method by which gains and losses are recognized in the OCI (SoRIE method) and past service cost is recognized in OCI.

Income Statement	Statement of Comprehensive Income
• Current service cost	• Gains and losses on obligation[2]
• Interest on obligation	
• Expected return on assets[1]	• Gains and losses on assets[2]
• Past service cost (reclassified from statement of comprehensive income)	• Past service cost[3] (in the year of the amendment) • Less reclassifications, to the income statement, of past service cost in regard to EARSL

1. An expected return on plan assets, as prescribed in IAS 19 currently.
2. All gains and losses to be recognized in the period in which they occur, in comprehensive income, as allowed by IAS 19 currently.
3. Total amount of past service costs to be recognized in the period in which they occur, in the statement of comprehensive income, and reclassified to the income statement for the period in which the economic benefits occurred (see answer to Question 2).

In general, we consider that this approach has a number of advantages over IAS 19, moreover without jeopardizing the future of defined benefit plans. In our opinion, it ensures improved comparability since it does not allow any other choice in recognizing gains and losses. It also allows presentation of the financial position of the plans directly on the balance sheet for more transparency. If the promises which arise from these plans are very long-term obligations, this approach provides, in our opinion, an improved measurement of the service cost and financing cost of the plans in income.

1. Expected return

As previously mentioned, we believe that the best measurement of the return on defined benefit plan assets is the expected long-term return, determined in accordance with the investment policy of the pension fund. Other bases of return measurement are inadequate, in our opinion, for the reasons set out in 3(c).

2. All gains and losses required to be recognized in the statement of comprehensive income

We believe that all gains and losses should be recognized in the statement of comprehensive income, as is currently allowed under IAS 19. First, in order to avoid recognizing, in profit or loss, current market fluctuations, which we find to be inconsistent with the very long-term nature of defined benefit promises. Secondly, in order to take into account the fact that a review of the estimate of the obligation in a given period does not necessarily result in an event in that period and that attributing it to the profit or loss of the fiscal period under review does not constitute an appropriate measurement. Lastly, in order to avoid certain behavior regarding reviews of assumptions. We believe that the extent of the effects of a change in assumption on the profit or loss for a fiscal year, could cause some sponsors to postpone a review to a subsequent fiscal year.

3. Past service cost required to be recognized in the statement of comprehensive income

See answer to Question 2.