



March 9, 2011

International Accounting Standards Board (IASB)
1st Floor, 30 Cannon Street
London,
United Kingdom

Via Email to the IFRS Foundation website (www.ifrs.org)

Subject: Comments on the Exposure Draft, "Hedge Accounting"

We appreciate the opportunity to comment on the exposure draft, "Hedge Accounting."

We agree with the main objective of favoring a financial statement presentation that reflects companies' financial risk management and, by the same token, the context in which they use hedge accounting. We give credit to this initiative, which aims to bring hedge accounting for risk management closer to the economic reality of entities wishing to manage their risk exposure.

We welcome some of the new rules that add greater ease and flexibility, as for example the designation of hedged items and hedging items.

We disagree, however, with the proposals that would prohibit the voluntary discontinuation of a hedging relationship, and which would require rebalancing of a hedging relationship when it no longer meets the objective of the hedge effectiveness assessment. In our opinion, the current rules under IAS 39 do not present any problems and have the latitude required for companies to apply their financial risk management strategies.

Furthermore, this exposure draft also presents amendments to disclosures and the presentation of financial position. In this regard, we believe that some requirements make financial statement preparation and presentation even more complex and consequently, do not add the reader's understanding of the financial statements.

Finally, we have noted some discrepancies between recent IASB exposure drafts and the FASB exposure draft "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities." We encourage you to pursue your efforts to issue a joint proposal.

Yours truly,

A handwritten signature in cursive script, appearing to read "Lise Croteau", is written over a horizontal line.

Lise Croteau, FCA
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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 EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We agree with the objective of hedge accounting, which is to present in the financial statements the effect of an entity's financial risk management activities, and the context in which it chooses to use hedge accounting. Accordingly, this objective recognizes the economic nature of hedging transactions, which result from strategies implemented to manage an entity's exposure to certain risks. The standards adopted in recent years have sometimes led entities to change their procedures and adapt their management strategies to meet accounting requirements. We commend the new principles-based approach, allowing hedge accounting to be better adapted to economic realities.

Furthermore, we believe that a more precise definition of "management risk" should be provided for the enhanced comparability of financial statements. Among other things, we propose that the definition be limited to the management of financial risks relating to financial instruments covered by IFRS 9.

Lastly, we emphasize that hedge accounting must remain optional. Entities could also decide to manage some risks without necessarily using hedge accounting.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We are in favor of these proposals, which provide more flexibility by allowing companies to designate non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss as hedging items. We suggest, however, that this possibility be limited to financial instruments to which IFRS 9 applies.

In addition, it is clear that the idea is to limit eligibility to financial instruments already measured at fair value for qualifying as hedging items. We fail to understand the conceptual basis for not allowing any non-derivative financial instrument to be designated even if such instrument is not measured at fair value through profit or loss. This would not preclude imposing a specific limit, as for example for investments in equity instruments designated at fair value through other comprehensive income.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We strongly support the proposal that a synthetic instrument that is a combination of another exposure and a derivative or group of derivatives may be designated as a hedged item. Before IAS 39 was issued, and CICA Handbook Section 3855 was issued in Canada, this situation was allowed and often used in financial risk management activities. Once again, we commend the effort made to bring hedge accounting principles closer to the economic reality of financial risk management.

In our opinion, it would also be useful to make some clarifications and perhaps to provide examples of accounting for these items. In fact, it is not clear if such a situation would modify the measurement of a derivative instrument designated as a hedged item. Would a derivative instrument designated as a hedged item needs to be recognized at fair value or at amortized cost?

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We are very much in favor of this proposal. While providing the possibility of hedging a component of a separately identifiable and measurable risk, this amendment eliminates an inconsistency in the current standards that we had criticized in previous discussions. In some cases, it also allows companies' financial risk management to be simplified and hedge accounting to be applied. This proposal is another example of bridging the gap between the economic reality of an entity exposed to several specific risks and the use of hedging instruments to manage some of these separately identifiable and measurable risks.

Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

We agree with the proposal to allow the designation of a layer of the nominal amount of an item as the hedged item.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We are generally in favor of the proposed effectiveness requirements. We definitely agree that hedge effectiveness should be one of the requirements to be met by a hedging relationship in order to qualify for hedge accounting. We also support the elimination of retrospective tests and of the 80-125 per cent 'bright line' for testing. The last proposal allows for more flexibility and, therefore, avoids the disqualification of relationships that only slightly exceed the 'bright line' even if they adequately meet the objectives of the entity's risk management activities.

We do not, however, completely agree with what is proposed to replace the elimination of the 'bright line.' The requirement to ensure that the expected hedge effectiveness is minimized causes us problem. This approach seems to be rather subjective, and it is our understanding that it would require entities to conduct demonstrations in cases where the instrument acquired cannot ensure that ineffectiveness has been minimized but takes into account the entity's risk management policies, market conditions and transaction costs.

Furthermore, considering that, on the one hand, the choice of the hedging instrument and the degree of effectiveness sought are up to management, in connection with risk management, and that, on the other hand, hedge accounting applies only to the effective portion of a hedging instrument, we find it hard to understand why it is important to emphasize that ineffectiveness be minimized. In our view, generic demonstrations proving the correlation between historic and forecast data would suffice. Therefore, effectiveness has become an eligibility criterion for hedge accounting while an assessment focuses on expected hedge ineffectiveness.

In addition, since the exposure draft proposes to eliminate quantitative effectiveness tests, it would be appropriate, in our opinion, to present a few instructions on how to quantify the ineffectiveness that must be properly measured and accounted for.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

We disagree with the requirement to rebalance a hedging relationship, which originally met the objective in terms of effectiveness. We believe that since hedge accounting is optional, rebalancing should also be optional. If failure to rebalance a hedging relationship results in higher ineffectiveness, that is still, in our opinion, a legitimate choice for the entity.

We believe, moreover, that the exposure draft proposals concerning rebalancing of a hedging relationship will add to the complexity of monitoring these relationships whereas a designation and redesignation are a much simpler practice for computer systems and recognition. In addition, rebalancing will necessarily result in a larger number of transactions. It is therefore not always easy and economically justifiable to proceed in this way as it may result in extra cost for companies.

Also see the answer to Question 8.

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We strongly disagree with the exposure draft proposal not to allow entities a free choice to discontinue hedge accounting prospectively for a hedging relationship. We cannot understand the problem with voluntarily revoking the designation of a hedging relationship when hedge accounting itself is optional. The current rules, which allow a designation to be revoked voluntarily, do not pose any problem provided there is adequate documentation and prospective application, and they do not allow results to be manipulated in any way.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Furthermore, in the context where discontinuation of a hedging relationship is described in the exposure draft, it becomes very subjective, in our opinion. It is clear, however, that an entity that discontinues hedge accounting does so because its risk management strategy has changed.

A designation should also be allowed to be revoked voluntarily in order to reduce the complexity of follow-up by the systems. At the very least, as mentioned above, it could be permitted if it was immediately followed by a redesignation. For entities with a significant number of hedges, hedge accounting is required to be automated. Hence, the management rules to be implemented for a relationship "rebalanced" along the way can become very complex and cumbersome to manage.

We are of the opinion that this restriction fails to take into account the numerous operating realities of actively managing financial risk. For example, in the context of long-term foreign currency risk management where the hedge may be highly effective on an annual basis, it becomes necessary and useful to revoke the designation in the short term in order to redesignate it on a monthly basis or quite simply to continue the existing economic hedging relationship in order to facilitate follow-up. Revoking a designation is advantageous and must be permitted because financial risks and needs may change over a very long period, and market prices may fluctuate sharply in some years.

In summary, we believe that it would be much more advisable for current rules on the subject in IAS 39 to be retained in IFRS 9.

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

In theory, for a fair value hedge, we agree with certain arguments to present the gain or loss on the hedging item and the hedged item in other comprehensive income. In this way, treatment of fair value hedges would be aligned with the current model for cash flow hedges, and the effects of hedges would be grouped together in other comprehensive income.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

From a practical standpoint, however, this treatment seems to increase the complexity, which is not consistent with the objective of this exposure draft. In accordance with current standards, the fair value hedge adds few accounting mechanisms that differ from the normal rules for recognition, except for the adjustment for the hedged item. Accordingly, the ineffectiveness of such a hedging relationship is accounted for normally in profit or loss and disclosed in a note. We are therefore not convinced of the added value of this new proposal. Accounting is made more complex by first recognizing gains or losses on the hedged item and the hedging item in comprehensive income, and then returning the ineffective portion to profit and loss. Moreover, there will be no effect on comprehensive income. Therefore, what seems to be valid in theory at first glance does not provide any added value, in our opinion, because the addition of several steps increases complexity of the accounting process to arrive at the same result in the financial statements.

Next, the exposure draft does not provide any instructions about reclassifying gain or loss for a currency or interest hedge in profit or loss. For instance, for a fixed-rate debt in foreign currency hedged by a foreign exchange swap, fixed-rate receipts and floating-rate disbursements,¹ is the foreign exchange effect on the debt and the swap kept in comprehensive income or must it be reclassified to profit or loss? What happens with the effect of interest? If the proposals regarding accounting for fair value hedges are retained, we encourage you to add examples to support these proposals.

Lastly, why are there different instructions in paragraph 3 of the exposure draft for fair value hedges of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities? This item does not appear sufficiently clear to us for understanding its scope and allows for the possibility of two types of fair value hedge treatments, which is not advisable in light of the objectives of the exposure draft.

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

We disagree with the proposal to present the gain or loss on the hedged item as a separate line item in the statement of financial position. We believe that such a disclosure could make this financial statement long and cumbersome, particularly in cases where several different line items of the statement of financial position are subject to a fair value hedge. In recent years, accounting standards have evolved so that only items that meet the definition of assets and liabilities can be presented as assets and liabilities. We therefore find it hard to understand why this type of adjustment must this time be presented on the balance sheet itself.

¹ Hedged item: Fixed U.S. debt.

Hedging item: Swap of fixed-rate USD receipts and floating-rate CAD disbursements

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

We suggest that a disclosure be allowed for the hedged line item, which will allow the users of the financial statements to be quite adequately informed, without making the statement of financial position long and cumbersome.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

We agree with the general principle proposed for the treatment of an option contract's time value when an entity chooses to separate the intrinsic value and time value of such a contract, and designates as the hedging instrument only the change in the intrinsic value. This treatment, which provides for the deferral of the time value to comprehensive income as a cost of hedging seems appropriate to us. The current treatment under IAS 39 provides for charging the time value to profit or loss, which can give rise to significant volatility in profit or loss.

We were wondering, however, about the difficulty of distinguishing between a transaction related hedged item and a time period related hedged item. Subjectivity must be avoided at all costs as it may affect the comparability of financial statements and make them even more complex. More specific examples could help those preparing financial statements to improve treatment of this item.

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree entirely with the flexibility added to the criteria for eligibility of groups of items as a hedged item. This is further proof of bringing hedge accounting closer to risk management.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Initially, the proposal to authorize the designation of a net position for the hedge of a group of items as a hedged item may seem attractive. However, isn't an entity doubly disadvantaged by proceeding in this way? First, the designation of a gross position as the hedged item could be more advantageous, particularly to hedge forecast transactions. As a result, we believe there would be greater leeway and the risk of such a hedging relationship being disqualified would be limited. Second, the effect of the hedges, given their purpose, is presented separately from gains and losses on hedged items instead of being presented at the hedged rate. In short, designating a net or gross position as a hedged item should be the entity's decision based on its objectives and strategies.

Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

We understand the IASB's concern to ensure that entities' disclosures in financial statements concerning their hedging activities are useful and transparent. We are of the opinion that a significant amount of disclosure is already required under IFRS 7 concerning companies' exposure to financial risks and the strategies used to reduce such risks. It is therefore important to thoroughly review all the disclosures to be issued in order to avoid information overload on the part of readers. Disclosures must be useful and transparent, but also relevant. For example, we agree that the reader should be informed of the origin of various risks and how the entity manages each of them. Disclosure, however, of the extent of risk exposure managed by the entity appears

COMMENTS ON THE EXPOSURE DRAFT, "HEDGE ACCOUNTING"

somewhat irrelevant to us. In addition, such data could be difficult to verify by the auditors.

Furthermore, we do not understand the utility or relevance of certain amounts regarding existing hedging relationships as opposed to those for hedging relationships whose designation has been revoked. Such disclosures do not seem essential to us, and would add, in our view, to the reader's difficulty in finding his or her way through the plethora of information already provided under IFRS 7 and this exposure draft.

Finally, for any additional information required, the proposals in the Exposure draft should clearly indicate the nature of the risks concerned by such new requirements. We believe that only undue financial risks or those related to financial instruments covered by IFRS 7 should be considered.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

At the present time, we are closely monitoring the work of the IASB, which still has a few outstanding drafts concerning financial instruments and should be issuing IFRS 9 on financial instruments in its entirety by the end of 2011. Only after acquainting ourselves with the final standard will we therefore know all the changes to be made to our processes and systems. Hence, it will only be at that time that we will be able to properly determine if the implementation period is sufficient.