Annual Report 2004

growing strong

Hydro Québec

growing strong

On April 14, 1944, Hydro-Québec boldly and resolutely took its first steps. Since then, our company has been through several surges in its development — times of change and maturation marked by challenges that forged a sense of commitment in men and women determined to build on the heritage left to them by their predecessors. Today, 60 years later, we're still as energetic and driven.

Hydro-Québec is a major producer, transmission provider and distributor of electricity. It conducts research and promotional activities in the areas of energy and energy transformation and conservation, as well as all other energy-related fields. The Québec government is its sole shareholder.

The company has separated its core operations into six divisions. It now competes freely with other power producers, while its transmission and distribution activities remain regulated.

On the cover: Eastmain-1. The site of the future generating station, seen from the tailrace. The tailrace will channel the turbine discharge back into the Eastmain River.

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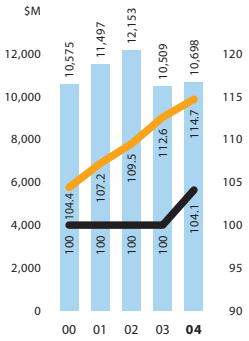
Financial Highlights

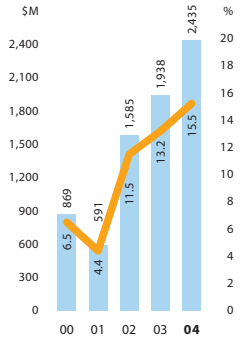
$M	2004	2003	Change (%)
Operations and dividends			
Revenue	**10,698**	10,509	2
Net income	**2,435**	1,938	26
Dividends declared	**1,350**	965	40
Balance sheet			
Total assets	**58,036**	57,731	1
Long-term debt, including current portion	**34,469**	35,980	(4)
Shareholder's equity	**16,220**	15,128	7
Cash flows			
Operating activities	**4,000**	3,795	5
Investing activities	**(2,130)**	(2,313)	(8)
Financing activities	**(1,957)**	(1,581)	24
Cash and cash equivalents at end of year	**94**	192	(51)
%			
Ratios			
Return on equity	**15.5**	13.2	2.3
Average cost of debt	**7.3**	8.0	(0.7)
Return on revenue	**22.8**	18.4	4.4
Capitalization	**32.8**	29.9	2.9
Self-financing	**74.2**	53.1	21.1

Sales, Average Rate Increase Index and Consumer Price Index



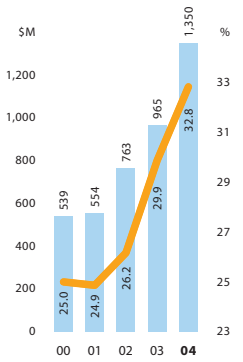
Sales totaled $10.7 billion, up 1.8% over 2003. Revenue generated by rate adjustments effective in 2004—the first in more than five years—slightly exceeded the decline in sales outside Québec resulting from efforts to replenish energy reserves.

Net Income* and Return on Equity*



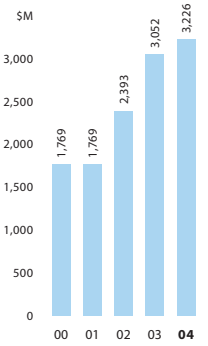
Net income rose to $2.4 billion, up $497 million over 2003. This increase can be attributed to lower financial expenses and a gain on the disposal of our interest in Noverco.

Dividends Declared and Capitalization*



Dividends declared amounted to $1,350 million, or 55.4% of net income. This will be the eighth consecutive payment to our shareholder and the largest in our history, bringing the total amount paid to the Québec government since 1998 to almost $5.3 billion.

Investments in Fixed and Intangible Assets

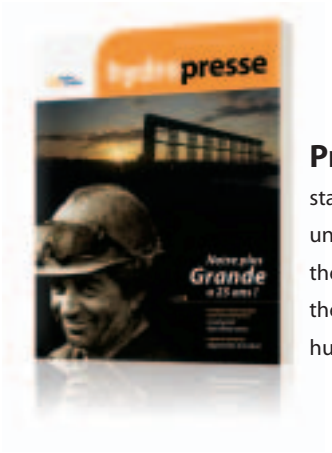


Cash from operations totaled $4.0 billion. Combined with revenue from the sale of our interest in Noverco ($900 million) and our investment in Meiya Power Company ($110 million), it financed the repayment of close to $1 billion in debt, the $965-million payout of dividends declared in 2003, and $3.2 billion in investments, one of the largest capital outlays in the past 10 years.

* *Data for 2000 to 2003 have been restated further to the retroactive effect of the accounting standards governing foreign currency translation and asset retirement obligations. The reported data are presented under Supplementary Information—Five-Year Review.*

46,000 men and women at work

In 2004, our energy flowed from the daily efforts of 46,000 people. In addition to our 22,000 employees, thousands of other people were active on construction sites and in other enterprises throughout the province, helping to build Québec's energy future.



Pride. On October 29, La Grande-2, now known as Robert-Bourassa generating station, was the site of an emotion-filled ceremony as the world's largest underground powerhouse celebrated 25 years of operation. Robert-Bourassa was the first of the eight La Grande generating stations to be commissioned. Building the "project of the century" in the James Bay region required the mobilization of human and material resources that overwhelm the imagination to this day.

Partnership. On April 19, we signed a historic agreement with the Crees: the *Agreement Concerning a New Relationship between Hydro-Québec/SEBJ and the Crees of Eeyou Istchee*. This opened the way to new relations founded on mutual respect, good faith and partnership.

Development. On April 29, the ground was broken at the site of a new hydropower project on the Péribonka River in the Saguenay–Lac-St-Jean region. The 385-MW underground generating station will come on stream in 2008. Until then, some 530 workers will be busy at the jobsite each year, with the peak workforce reaching almost 1,200 in 2006. The potential economic spinoffs for the region are estimated at $345 million.

Determination. On October 21, we filed our Energy Efficiency Plan 2005–2010 with the Régie de l'énergie. The plan calls for $1 billion in incentives to encourage customers to use energy wisely, and targets 3 TWh in savings.

Innovation.

At the Paris Auto Show from September 23 to October 10, our subsidiary TM4 was in the spotlight. The Cleanova II, a plug-in hybrid manufactured by the Société de Véhicules Électriques, and the Quark, made by Peugeot, both feature its drivetrain systems.

Growth. On July 29, we commissioned the first of three generating units at Rocher-de-Grand-Mère on the Saint-Maurice River. The new station has increased our generating capacity by 230 MW.

Accessibility.

On September 14, Platts, a McGraw-Hill company, deemed our website—especially the Customer Services pages—the best in the world, after conducting a two-year survey of 170 public utility websites without their knowledge.

Solidarity. On September 9, we sent line crews to Florida, accompanied by mechanics, clerks, managers and an occupational safety expert. For 27 days, our 122 employees helped their American counterparts rebuild the power grids damaged by hurricanes Frances and Ivan.

Supply.

On October 4, we announced the eight bids accepted for the supply of 990 MW of wind power. Six were from Cartier Wind Energy and the other two from Northland Power/ Northland Power Income Fund. The power will be delivered from December 2006 to 2012.

Reliability.

In January, the province of Québec experienced a cold spell of Siberian intensity that drove electricity consumption up dramatically. At 5:30 p.m. on January 15, the load reached an unprecedented 36,268 MW. The grid was severely tested but showed its mettle. Throughout the days of bitter cold, the public responded to our call by cutting power consumption at critical times.

Exciting results

Hydro-Québec ended the year 2004 with net income of $2,435 million, compared with $1,938 million in 2003. This $497-million increase is mainly attributable to a reduction of $395 million, or 14.9% , in our financial expenses as well as a gain of $265 million stemming from the sale of our stake in Noverco.

Revenue totaled $10,698 million, up $189 million from last year. The rate adjustments approved by the Régie de l'énergie (Energy Board) offset the decline in exports. We cut back our short-term sales outside Québec during the first six months of the year and increased our purchases of electricity in order to replenish our energy reserves, which had been affected by low runoff in recent years. However, a slackening of domestic industrial demand, due to plant closings and a labor dispute in an electricity-intensive sector, as well as the improvement in our energy reserves, allowed a cautious return to export sales in the second half of the year.

Beyond the immediate year-end results, we may observe that the efforts expended in the last decade to make Hydro-Québec a leading-edge player in an open and competitive market have paid off. Our divisions have met sizable challenges at a time when expenses have been frozen. Hydro-Québec Distribution, which operated at a loss up to now, posted income of $287 million as a result of the rate adjustments and improved efficiency. We thank all our employees for their contribution to our success. Their receptiveness to change, their great motivation to help us achieve our objectives and their ability to innovate have sustained Hydro-Québec's growth and enabled the company to fulfill its business mission, to the benefit of all Quebecers.

Major projects

The past year confirmed the resumption of major hydroelectric development projects. Rocher-de-Grand-Mère generating station went into operation, while work proceeded on Eastmain-1, Péribonka, Toulnustouc and Mercier. In 2004, our projects under construction had a total value of some $5 billion and generated economic spinoffs in excess of $800 million in various regions of the province. They will add more than 8 TWh to our annual energy output by 2008. Two other projects are awaiting approval: the Eastmain-1-A powerhouse and Rupert diversion project, which includes the construction of Sarcelle powerhouse, and the Chute-Allard and Rapides-des-Cœurs development project on the Saint-Maurice River. We also continued studies for a complex of four generating stations to be built on the Romaine River.

An economic lever

With the launch of these construction projects, Hydro-Québec is once again acting as an economic lever, a role it played in the 1970s and 1980s. Considering all the jobs created by our activities, including contractors, construction site workers, equipment and machinery manufacturers, suppliers of raw materials and goods of all kinds, consulting engineering firms, construction companies and service enterprises,

The efforts expended in the last decade to make Hydro-Québec a leading-edge player in an open and competitive market have paid off.

nearly 46,000 people get up every day to go to work for Hydro-Québec, directly or indirectly. We have every reason to be proud of these positive spinoffs.

These accomplishments are made possible by an unprecedented desire by all the players involved—the Québec and Canadian governments, regional authorities and Aboriginal communities—to pool their efforts in response to the forecast growth in Quebecers' energy needs. Through the agreements they have reached, rapid progress is being made on these projects, which benefit us all.

Of particular interest in this regard are two new partnering agreements that were signed, one with the Crees of Eeyou Istchee and the other with the Municipality of Baie-James. These are in addition to several other agreements already reached with the band council of the Montagnais of Lac-Saint-Jean, the Fjord-du-Saguenay and Maria-Chapdelaine regional county municipalities, the band councils of the Montagnais of Betsiamites and of Essipit, and a number of regional county municipalities along the North Shore and in the Saguenay region.

Ensuring the future

We must continue developing Québec's hydropower potential to provide adequate leeway so that we can meet demand on the domestic market and take advantage of business opportunities on export markets. Annual growth in Québec demand is projected to average 1.2%, or about 2 TWh, over the coming decade. This forecast, which is slightly lower than last year's, takes into account a decline in industrial demand and the energy savings accruing from the implementation of our Energy Efficiency Plan, among other factors.

Demand growth will mean that in 2005 our domestic sales are likely to exceed the level set aside as the heritage pool. To continue assuring Quebecers of a reliable power supply at all times, we developed an Electricity Supply Plan covering the years 2005–2014 and filed it with the Régie de l'énergie. With a view to sustainable development, our calls for tenders during the year mainly targeted producers of renewable energy.

André Bourbeau
Chairman of the Board of Directors

André Caillé
President and Chief Executive Officer

The contracts Hydro-Québec Distribution signed with Bowater Canadian Forest Products and Kruger for the supply of 39.4 MW from biomass were approved by the Régie de l'énergie. In addition, we accepted the bids of Cartier Wind Energy and Northland Power/Northland Power Income Fund for the supply of 990 MW of wind power generated in the Matane RCM and the Gaspé–Magdalen Islands region. The related contracts were signed in February 2005.

The average cost of these new supplies is less than 8¢/kWh. While this reflects market conditions, it far exceeds the cost of 2.79¢/kWh set for the heritage pool of 165 TWh of electricity.

At the same time, to reduce the impact of the rate adjustments and safeguard our resources, we tabled our Energy Efficiency Plan 2005–2010 with the Régie. This plan targets a minimum of 3 TWh in energy savings by 2010 and covers all our customer categories.

An efficient organization

Our net exports declined by 36% in 2004 as a result of our decision to limit sales outside Québec during the first six months of the year. The temporary decline in industrial demand meant that Hydro-Québec Production was able to resume some sales on these markets in the second half. Once the hydroelectric developments currently under construction are commissioned, the division should have reasonable room to maneuver by 2012, which would allow it to keep up its exports. In a free market, exports have so far proven highly profitable for Québec.

Hydro-Québec TransÉnergie continued to develop the assets it owns outside the province. An agreement signed with representatives of the states of New York and Connecticut enabled the division to resume service on the Cross Sound Cable underwater line, which links southwestern Connecticut and Long Island, N.Y. The division continued expanding its operations in South America and Australia. In Québec, new steps were taken to protect the system at peak periods, and improvements were made to increase its transmission capacity.

Hydro-Québec Équipement, for its part, had a busy year, with activities totaling $1,984 million, a $392-million increase stemming largely from the major hydroelectric development projects on the Eastmain, Toulnustouc and Péribonka rivers. The division carried out $594 million worth of rehabilitation and refitting work on Hydro-Québec Production and Hydro-Québec TransÉnergie facilities in order to extend their useful life and increase output at certain generating stations. It continued to improve its procedures with a view to reducing project time and cost. Thanks to their innovative approach, the engineers came up with original solutions to problems related to the features of each specific site.

Over the year, Hydro-Québec Technologie et développement industriel supported the other divisions by carrying out innovation projects to help them meet their business objectives. New partnerships were formed and the synergy among activities was heightened.

With the support of the corporate units, each division in the company fully integrated its strategic planning, human resources management and technological development. Each also met its responsibilities in terms of sustainable development, in accordance with the commitments made by Hydro-Québec regarding environmental protection, sound management of resources and respect for the communities in which it operates.

A modern company

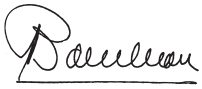
As a result of the changes it has made in recent years, Hydro-Québec has become a modern company, thoroughly adapted to the new, deregulated North American power industry. Its profitability has grown year by year, confirming the soundness of its business strategies.

With the Régie's approval, Hydro-Québec Distribution and Hydro-Québec TransÉnergie, whose activities are regulated, have acquired the means of achieving and maintaining a reasonable level of profitability. They are therefore able to carry out the projects needed to ensure a reliable power supply for Québec customers and offer them service that measures up to their expectations. The other divisions, which are subject to the laws of the marketplace, are maintaining their efforts to generate benefits for Québec society as a whole and to tap the full potential of renewable energy resources, in a way that is respectful of the environment. These resources represent a priceless economic legacy and an enormous contribution to the quality of life of all Quebecers.

To carry out this task, the company can rely on a Board of Directors whose members have a wide range of talents and skills. We are grateful for their firm commitment and their expert contributions, which ensure a sound, transparent decision-making process in keeping with high standards of corporate ethics and governance.

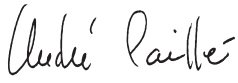
We wish to thank outgoing Board members Daniel Boulard, Alain Forand, Serge Racine and Louise Roy for their invaluable efforts. We welcome Norman E. Hébert Jr., Jacques Leblanc, Michel Plessis-Bélair and Marie-France Poulin, who will give us the benefit of their expertise in the coming years.

As we conclude this year of many accomplishments, it gives us great satisfaction to report on results that we can all be proud of. Together, we have made a tremendous effort to ensure that Hydro-Québec once again becomes the driving force behind the economic and social development of Québec and its regions. We can look forward to the future with the utmost confidence.



André Bourbeau

Chairman of the Board of Directors



André Caillé

President and Chief Executive Officer

growth

An expanding fleet

We have an impressive generating fleet: 52 hydropower stations, 5 thermal generating stations, 1 wind farm, over 560 dams and 25 large reservoirs. With the commissioning of Rocher-de-Grand-Mère, we acquired another 230 MW of installed capacity. Other facilities will add to this, and we are fine-tuning our operations in order to make maximum use of our generating assets. We're producing energy for today and planning for tomorrow.

Our generating fleet is growing

The past year confirmed a return to major hydroelectric development projects. With the commissioning of Rocher-de-Grand-Mère, the step-up of construction at the Eastmain-1 and Toulnustouc sites, and the groundbreaking at Péribonka and Mercier, preparations for Québec's energy future are well under way.

Tapping a collective resource

Hydro-Québec Production generates electricity and sells it on wholesale markets both inside and outside Québec.

We supply Hydro-Québec Distribution with a heritage pool of up to 165 TWh of electricity per year, at a fixed price of 2.79¢/kWh. Above this volume, we compete freely in selling our output on domestic and external markets, in response to calls for tenders or on short-term markets. Because of the flexibility of our fleet of generating stations, which use water to produce 96% of their output, we are able to import electricity when prices are low and export it when prices are higher. We also conduct profitable arbitrage and purchase/resale transactions on markets outside Québec.

To meet our contractual commitments in Québec and outside the province, we manage our reservoirs in such a way as to maintain sufficient means and energy reserve at all times to offset a potential runoff deficit of 64 TWh over two consecutive years. We also keep enough capacity reserve—approximately 10% of demand under our contracts—to comply with the industry's current reliability criteria.

Thierry Vandal
President,
Hydro-Québec
Production and
Hydro-Québec
Pétrole et gaz

Demand growth on all our markets has prompted us to continue developing Québec's cost-effective hydroelectric potential.

Fixed assets as at December 31, 2004	$25.8 billion
Revenue in 2004	$6.0 billion
Net income in 2004	$1,664 million
Customers in 2004 (% of revenue)	
Hydro-Québec Distribution and other internal customers	77%
Other wholesale markets	22%
International market	1%
Regulatory regime	Heritage pool electricity (maximum volume of 165 TWh per year) at a fixed rate for Hydro-Québec Distribution Above that volume and outside Québec: free competition

Sales volume in 2004: 166.8 TWh

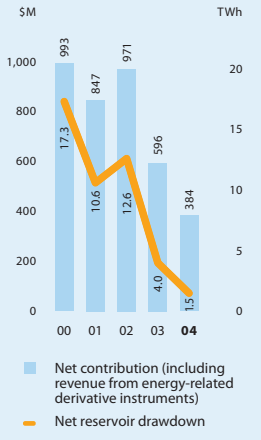
We recorded net income of $1,664 million, down from $1,751 million in 2003. This decrease of approximately 5% is largely attributable to a 36% reduction in our net exports. We decided to cut back our volume of exports in the first six months in order to replenish our energy reserves after several years of low runoff and higher-than-projected growth in domestic electricity demand.

Our sales to Hydro-Québec Distribution totaled 165.3 TWh, versus 166.7 TWh in 2003. This 0.8% decrease is due to a slackening in industrial demand during the second half of the year. It should be noted that the maximum volume of heritage pool electricity was not reached in 2004 or 2003, since the sales to the Distributor included items that are not part of the heritage pool, such as the volume for dual energy.

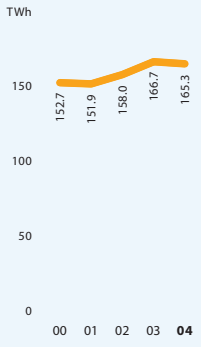
Electricity purchases made in the first sixth months and lower sales to Hydro-Québec Distribution in the second half allowed us to resume short-term sales on external markets. Altogether, net electricity exports and the related financial transactions generated $384 million, for net reservoir drawdown of 1.5 TWh, compared with $596 million and 4.0 TWh in 2003. Unit revenue on markets outside Québec consequently grew by 72% in 2004—clear evidence of the outstanding performance of our energy trading floor.

The impact of the decline in net exports on our net income was offset by the corresponding reduction in transmission charges paid to Hydro-Québec TransÉnergie, the increase in unit revenue and the decrease in financial expenses.

Net Electricity Exports



Electricity Sales to Hydro-Québec Distribution



The average cost of a kilowatthour in 2004 was 1.9¢, which corresponds to the sum of the Generator's production and supply costs divided by the net sales volume.

Developing Québec's hydroelectric potential

Demand growth on all our markets has prompted us to continue developing Québec's cost-effective hydroelectric potential. This development must also allow us to establish greater operating flexibility so that we can better manage the risks related to annual variations in runoff and take advantage of business opportunities on short-term markets.

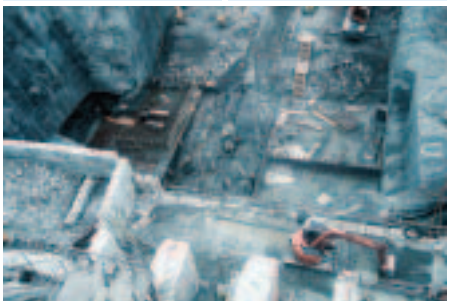
The hydropower development begun in recent years proceeded at a steady pace in 2004.

- Rocher-de-Grand-Mère generating station was completed in 2004 and went into operation in December. This $520-million project was launched in spring 2000. The new facility has an installed capacity of 230 MW and annual output of 1.2 TWh—80 MW and 0.2 TWh more than the existing Grand-Mère generating station. The latter facility will be operated selectively, primarily during spring and fall floods.
- In April 2004, the Québec and Canadian governments simultaneously authorized the construction of a hydroelectric facility on the Péribonka River. This development includes a 385-MW powerhouse that will produce 2.2 TWh per year, and related structures. Commissioning is slated for 2008. The $1.2-billion project comes under agreements signed in 2003 with the Montagnais band council of Lac-Saint-Jean (Manitukapatakan Agreement) and the Fjord-du-Saguenay and Maria-Chapdelaine regional county municipalities.
- Construction continued on three other generating stations: Toulnustouc (526 MW, nearly $1 billion), scheduled for commissioning in 2005; Eastmain-1 (480 MW, $2.1 billion), scheduled for commissioning in 2007; and Mercier (51 MW, about $140 million), scheduled for commissioning in 2006.
- The Bureau d'audiences publiques sur l'environnement (BAPE) held hearings on the project to develop the Chute-Allard and Rapides-des-Cœurs project on the Saint-Maurice River between Gouin reservoir and Blanc reservoir. These two generating stations would have a total installed capacity of 138 MW and annual output of nearly 0.9 TWh, and will cost an estimated $700 million. We plan to complete the permitting process and begin construction in spring 2005, with a view to commissioning in 2008.
- The environmental impact statement for the Eastmain-1-A powerhouse and Rupert diversion project, which includes construction of Sarcelle powerhouse, was filed with the Provincial Administrator of the *James Bay and Northern Québec Agreement* and with the federal Review Panel in December 2004. The two generating stations would have a combined installed capacity of 888 MW, and the project would add 8.5 TWh to our annual output as a result of the turbining of the water diverted from the Rupert River at Robert-Bourassa, La Grande-2-A and La Grande-1. If construction gets under way as scheduled in summer 2006, the powerhouses will be commissioned in stages between the end of 2009 and the end of 2012. The estimated cost of the project is $4 billion.
- The Québec government gave the go-ahead for draft-design studies for a hydroelectric complex consisting of four generating stations to be built on the Romaine River, with a total installed capacity of 1,500 MW. According to preliminary estimates, the project will cost $5.6 billion.

Rocher-de-Grand-Mère generating station, built beside the existing Grand-Mère plant (left) and commissioned in 2004.

Work is progressing at the Toulnustouc jobsite in the North Shore region.

Mercier jobsite in the Outaouais region. The powerhouse will be built right into the dam.



At year-end, we had about $4.4 billion in hydroelectric developments under construction for an installed capacity of nearly 1,500 MW and annual output of nearly 8 TWh.

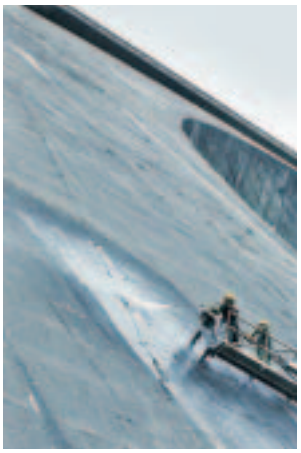
All our projects comply with the conditions we have set for development: they must be profitable, environmentally acceptable and favorably received by local communities. Two new partnering agreements were reached in this regard. The *Agreement concerning a New Relationship between Hydro-Québec/SEBJ and the Crees of Eeyou Istchee,* signed April 19, 2004, put an end to close to 20 years of litigation between the Crees and Hydro-Québec. It will facilitate participation by the James Bay Crees in hydroelectric development projects by various means, including partnership, employment and contracts. On January 28, 2005, Hydro-Québec and the Municipality of Baie-James signed an agreement in connection with the Eastmain-1-A powerhouse and Rupert diversion project. The municipality will receive a total of $310 million over 50 years from the date the necessary approvals are obtained.

Managing one of the world's largest hydroelectric generating fleets

We are a world leader in hydroelectric generation. We devote all the efforts required to ensure optimum development and maintenance of our generating assets, valued at $26 billion. Our generating facilities, which comprise 52 hydroelectric generating stations, 5 thermal generating stations (1 of them nuclear) and 1 wind farm, have a total installed capacity of 34 GW. Our hydroelectric developments also include 25 large reservoirs with a storage capacity of 172 TWh, and over 560 dams and control structures, more than 200 of which are classified as "large dams" according to the criteria of the Centre d'expertise hydrique du Québec.

We operate our facilities and reservoirs in such a way as to ensure maximum capacity and energy at the right time, while minimizing energy losses. In addition, various measures implemented over the years have enabled us to improve the efficiency of units at a number of generating stations and reduce energy-capable spillages. We also conduct an annual diagnosis of the condition of our dams and control structures in order to identify those that need special monitoring.

Signing of the agreement between Hydro-Québec and the Municipality of Baie-James. Seated, from left to right: Thierry Vandal, President, Hydro-Québec Production, and Gérald Lemoyne, Mayor. Standing: Sam Hamad, then Minister of Natural Resources, Wildlife and Parks, and Jean Charest, Premier of Québec.



Daniel-Johnson dam in the North Shore region. All dams are inspected on a yearly basis.

Major refurbishment and rehabilitation continued in 2004, notably at Beauharnois, La Tuque, Rapides-des-Quinze, Rapide-2, Rapide-7, Bersimis-1, Outardes-3, Outardes-4 and Rivière-des-Prairies generating stations. Work was also done on the Coteau and Île-Juillet control structures. Over the year, we allocated $375 million to refurbishing our facilities in order to ensure their long-term operability.

- Refitting continued at Outardes-3 and Outardes-4. This work will gradually add some 310 MW in capacity by 2008.
- The BAPE public hearings on the project to modify the radioactive waste storage facilities at Gentilly-2 nuclear power plant and to refurbish the plant concluded in December. Draft-design studies for the plant's rehabilitation are proceeding.
- On July 23, 2004, the operations quality management system at Gentilly-2 was certified ISO 9001. According to the firm that conducted the audit, it is the world's first nuclear generating station to obtain such certification.
- The Canadian Nuclear Safety Commission renewed the operating permit for the Gentilly-2 waste management facility. The permit is valid until December 31, 2009.
- The environmental management system in the Generating Facilities Operation Department maintained its ISO 14001 registration. For the third year in a row, the audit found no instance of non-compliance.
- Application of the measures prescribed by the *Dam Safety Act* continued, as did the establishment and review of emergency measures plans and impounded water management plans.

Earning worldwide recognition for our competence

On the international scene, we make the most of our expertise through asset management and technical service contracts. Our foreign assets are concentrated in Latin America, specifically in Costa Rica and Panama, where we have an interest in the company that owns the Fortuna hydroelectric facility, the country's largest generating station. We are providing technical services under contract in Poland, in the field of water management, and in Latin America (Venezuela, Panama), Asia (China, Vietnam) and Africa.

In 2004, we sold our investment in Meiya Power Company of China, for a gain of $6.8 million. We also sold our 30% stake in Hunan C.C. Power, which operates the 20-MW Qingshan hydroelectric generating station in the Chinese province of Hunan.

La Tuque generating station on the Saint-Maurice River. Refitting work is under way to increase the station's installed capacity.

Outardes-3 generating station, located in the North Shore region, is undergoing major refurbishing.

Hydro-Québec Pétrole et gaz

In 2004, we sold our 50.38% interest in Noverco, along with $285 million worth of subordinate debt instruments of that company, to the Caisse de dépôt et placement du Québec for $900 million. This interest, which we acquired in 1997 at a cost of $482 million, no longer fit in with our strategic objectives. The sale yielded a gain of $265 million.

We continued our Québec exploration initiative begun in 2002. This work is generally carried out in partnership with companies that have the necessary financial capacity and expertise. We hold 10 permits for oil and gas exploration in the Gaspé Peninsula, as well as a 25% to 50% share in 24 exploration permits on Anticosti Island. Altogether, these permits cover an area of more than 650,000 hectares. We also have an option guaranteeing us a minimum share of 18.75% in the drilling permits for one of the largest undrilled geological structures in Canada: Old Harry, in the Gulf of St. Lawrence. These permits are held by Corridor Resources.

A 1,430-m exploration well was completed on the Miguasha 1 site, near Nouvelle, on the Gaspé Peninsula. The drilling was carried out by Hydro-Québec together with its partners Gastem and Questerre Energy Corporation. According to the test results, this well does not have commercial potential and has therefore been abandoned. However, the data collected indicated that it was worth completing the drilling at Miguasha Ouest, which was halted at a depth of 1,245 m in September 2004.

Reentry of the Chaloupe well on Anticosti Island, in partnership with Corridor Resources, was also abandoned in 2004. While the results are inconclusive, the Trenton formation remains a promising zone. Further drilling nearby is under consideration.

During the year, Hydro-Québec acquired the Soquip Énergie geoscientific database. This database, which is one of the most extensive on Eastern Canada, provides access to more than 66,000 km of seismic data.

Since inception, Hydro-Québec Pétrole et gaz has invested nearly $20 million in oil and gas exploration in Québec.

reliability

A stronger, more secure grid

With 32,487 km of lines and 506 substations, our transmission grid grows more complex and sophisticated every day. And every day we invest to make it more robust and reliable. For example, we have developed new ways of dealing with the winter peak. Our customers can count on us.

Strengthening our connections

Hydro-Québec TransÉnergie operates the most extensive transmission system in North America. In 2004, we increased capacity and continued strengthening the system to maintain reliability. A leader in transmission system design, operation and maintenance, we are also very active abroad, in particular in the United States, South America and Australia.

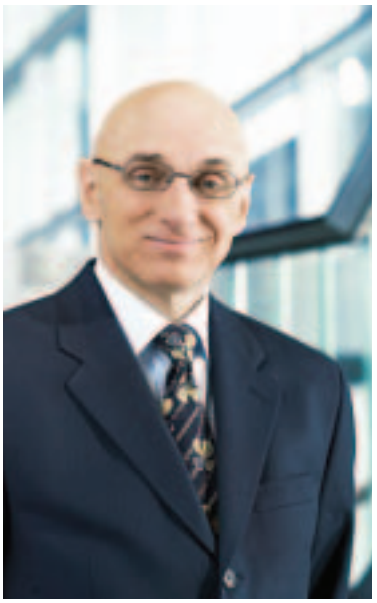
Complying with the requirements of North American regulators

The Hydro-Québec TransÉnergie transmission system comprises 32,487 km of lines, 18 interconnections allowing power interchange with the systems in Newfoundland and Labrador, New Brunswick, Ontario and the U.S. Northeast, and 506 substations.

In compliance with North American regulatory provisions, we offer non-discriminatory access to our transmission system to all customers on the wholesale market in northeastern North America. We also make our interconnections available to customers both inside and outside Québec. The capacity available on our system is posted on the OASIS (Open Access Same-Time Information System) website.

Fixed assets as at December 31, 2004	$17.3 billion
Revenue in 2004	$2.8 billion
Net income in 2004	$365 million
Customers in 2004 (% of revenue)	
Hydro-Québec Distribution	82%
North American wholesale markets	4%
International market	8%
Other	6%
Regulatory regime	Cost-based

Yves Filion
President,
Hydro-Québec
TransÉnergie



We regularly take action to increase system robustness and reliability.

Adapting to change

We initiated several projects in 2004 to accommodate the growing native load and the need to bring new output onto the grid.

- The Régie de l'énergie approved the project to connect Eastmain-1 to the transmission system.
- We undertook work to integrate the feed-in from companies that have contracts to supply Hydro-Québec Distribution, such as TransCanada Energy, which is building a cogeneration plant in Bécancour.
- Work got under way on a 14-km, 69-kV line to connect Mercier generating station to the grid.
- Construction proceeded on a 55-km, 315-kV line linking the future Toulnustouc generating station to Micoua substation. The line will be commissioned in spring 2005.
- We continued work on the project to erect a single-circuit 69-kV line between Nemiscau and Waskaganish substations. The Cree village of Waskaganish will be supplied by this 208-km line starting in 2006.
- Cedars Rapids Transmission Co. (CRT), a subsidiary of Hydro-Québec, commissioned the transmission line between Les Cèdres substation, in Québec, and Cornwall, Ontario. This 72-km line is operated at 120 kV. The CRT system is connected to the Cornwall Electric grid in Ontario and the Niagara Mohawk grid in New York.
- The last 120-kV lines on the Montérégie loop started operation, bringing this project to a conclusion.

New transmission equipment is being installed at Micoua substation.

Continually improving system capacity and reliability

Hydro-Québec TransÉnergie has all the attributes of a Regional Transmission Organization, or RTO, as defined by the Federal Energy Regulatory Commission (FERC). In fact, we're working with the Northeast Power Coordinating Council (NPCC) and the North American Electric Reliability Council (NERC) to conduct a study of reliability standards applying to North American transmission systems.

We regularly take action to increase system robustness and reliability. These measures are intended to ensure system availability and provide customers with services tailored to their needs. In 2004, we continued our review of operability criteria in order to improve our practices and optimize our investment decisions.

- The Régie de l'énergie authorized Hydro-Québec TransÉnergie to invest a total of $397 million in the construction or acquisition of buildings and other transmission assets costing less than $25 million each. These investments were allocated to maintaining assets, improving quality, satisfying legal and regulatory requirements, and meeting growing customer needs.
- New equipment designed to protect the system during peak periods went into operation.
- Several projects were undertaken to increase transformer capacity at satellite substations and source substations that supply the native load.
- We added capacitor banks to three substations on the Montréal loop to increase reactive power by 1,188 Mvar, thereby enhancing the system's transmission capacity.
- The Régie authorized the installation of de-icing equipment at Lévis substation. One of the goals of this project is to increase security on the 735-kV line section that supplies the greater Québec City area.
- We simulated line breaks in various situations in order to determine the most suitable means of preventing towers from cascading.
- The quality of the transmission system enabled it to perform satisfactorily during the winter 2004–2005 peak, which reached 34,956 MW on December 20, 2004.

Thanks to the efforts invested in recent years to strengthen the transmission system, along with milder weather conditions, the average number of hours of service interruption per customer was 0.45 at the end of 2004.

Work was done to increase capacity at Boucherville substation, part of the Montréal loop.

Live-line de-icing work.

Major efforts are being deployed to enhance system robustness.

Maintaining an active presence abroad

We maintain a presence abroad through Hydro-Québec International, and are responsible for managing its transmission operations. TransÉnergie HQ and its subsidiaries market services and technologies related to transmission system management. We also carry out transmission facility design, construction and acquisition projects, and manage and develop our portfolio of investments in this field.

In 2004, we launched a study that will help us reposition the marketing of our transmission know-how, products and services. This analysis took into account the needs of Québec engineering firms active on the international scene.

United States

An agreement between the Long Island Power Authority, the Connecticut Department of Environmental Protection, the Connecticut Department of Public Utility Control, Northeast Utilities and Cross Sound Cable allowed us to resume service on the Cross Sound Cable, our underwater line linking southwestern Connecticut and Long Island, N.Y.

Australia

We filed a revised application with the Australian Competition and Consumer Commission to bring our DirectLink interconnection under regulatory control and thereby enhance its value.

South America

A line in the HQI Transelec Chile S.A. (Transelec) system was converted to 500 kV and put into service. This was the Chilean power transmission industry's largest construction project in the last 20 years. The system makes use of several Hydro-Québec technologies.

Hydro-Québec TransÉnergie continues to operate Transelec and the TransMantaro consortium so as to create optimum value from these assets.

The Transelec system in Chile uses several technologies developed by Hydro-Québec.

3 TWh

Combined efforts to save energy

We believe in energy conservation. Our Energy Efficiency Plan has an ambitious target: 3 TWh in savings. In partnership with researchers, contractors, manufacturers and retailers, we're implementing original solutions to meet the needs of all customer categories. Together, we can make a difference.

Serving the people of Québec

Hydro-Québec Distribution ensures a secure power supply for Quebecers and a reliable distribution system. It also offers its customers a wide range of quality products and services adapted to their needs. To meet the demand, we have access to the heritage pool that Hydro-Québec Production is obliged to supply. Beyond this pool, we award supply contracts to various power suppliers by means of calls for tenders.

Every three years, we draw up an Electricity Supply Plan for the next 10 years based on the native load forecast. According to the 2005–2014 plan we filed with the Régie de l'énergie on November 1, 2004, our electricity needs will exceed the heritage pool as of 2005.

Our choice of energy supply sources is partially based on a non-monetary criterion related to sustainable development. As well, to conserve resources, we promote responsible power consumption by offering all our customers energy efficiency programs.

We make every effort to maintain or improve service quality, in our ongoing concern to respond to customers' expectations promptly and diligently.

In line with the commitment we made in the *Strategic Plan 2004–2008,* our operating expenses have remained stable, despite substantial growth in our customer base. We are striving to maintain the best possible balance between quality and cost of service in order to limit rate increases.

Fixed assets as at December 31, 2004	$8.2 billion
Revenue in 2004	$9.1 billion
Net income in 2004	$287 million
Customers in 2004 (% of revenue)	
Markets subject to the Rates Bylaw	93%
Special contracts	5%
Other	2%
Regulatory regime	Cost-based

Ensuring security of supply

According to the Electricity Supply Plan 2005–2014, increase in demand will average 1.2% (2 TWh) per year over the period covered. This forecast factors in moderate growth in industrial demand as well as the energy savings that should accrue from the energy efficiency programs we have implemented.

To fulfill our mission of supplying power to the Québec market, we have access to a heritage pool of 165 TWh of electricity, which Hydro-Québec Production is required to supply at a fixed price of 2.79¢/kWh. To meet demand beyond that volume, we award supply contracts based not just on price, but also on a non-monetary criterion linked to sustainable development. Except for very short-term supplies, these contracts must be approved by the Régie de l'énergie.

- In 2004, we issued three short-term calls for tenders to meet the 2005 domestic demand. After the first call, issued in April, we awarded five contracts for the supply of up to 250 MW between January 1 and December 31, at an average price of US5.7¢/kWh. The other two, issued in October, led to 36 contracts being awarded for the supply of up to 350 MW between January 1 and September 30, at an average price of 6.4¢/kWh.
- The Régie approved two 20-year contracts with Bowater Canadian Forest Products (20.4 MW) and Kruger (19 MW) for the supply of power produced by biomass cogeneration plants at an average price of 6.7¢/kWh. Deliveries from Bowater will begin in July 2006, and those from Kruger in March 2007.
- We accepted the bids from Cartier Wind Energy and Northland Power/Northland Power Income Fund for the supply of 990 MW of wind power over a 20-year term. The wind farms, as well as the nacelle assembly and rotor blade and tower manufacturing plants, will be located in the Matane RCM and the Gaspé–Magdalen Islands region, as ordered by the Québec government. The regional spinoffs should amount to $1.9 billion. The contracts were signed in February 2005 and are subject to Régie approval. The average price under these contracts is 7.8¢/kWh.

André Boulanger
President,
Hydro-Québec
Distribution

We make every effort to maintain or improve service quality, in an ongoing concern to provide our customers with services suited to their needs.

Our top priority: Satisfying our customers

Hydro-Québec Distribution offers services tailored to meet its customers' priority expectations. In addition, as part of our commitment to sustainable development, we have established significant energy efficiency programs to help our customers practise responsible energy consumption, with the encouragement of various incentives.

In 2004, we filed a new comprehensive Energy Efficiency Plan with the Régie de l'énergie, targeting a minimum of 3 TWh in energy savings by 2010. The plan calls for investments of more than $1 billion and comprises a number of programs designed for our different customer categories. To ensure its success, we have formed partnerships with many key players in this field, including the provincial Agence de l'efficacité énergétique, the Office of Energy Efficiency (Natural Resources Canada), the Corporation des maîtres électriciens du Québec, the provincial home builders' association, and manufacturers and retailers of energy-saving products.

Residential, commercial and business customers

- The residential customer satisfaction index was 7.3 out of 10, down slightly from 7.4 in 2003. This decline is explained in part by the energy security issue and the rate increases.
- The satisfaction index for commercial customers fell back to 7.3 out of 10, compared with 7.4 last year, while for business customers it was 7.2, versus 7.3 in 2003.
- By working closely with consumer associations and other organizations, we were able to develop services that are better adapted to the needs of low-income customers who are having trouble paying their bills. We also conducted a survey of these customers to find ways to improve the support we give them, and we held talks with the Québec government to explore avenues for alleviating the problem. Meanwhile, we continued to offer flexible payment arrangements to low-income customers. In 2004, close to 18,000 were taking advantage of such arrangements, for a total of about $20 million.
- In February, we introduced a variety of energy efficiency tools and programs for residential customers. These include the Energy Wise Home Diagnostic and promotions applicable to the purchase and installation of electronic thermostats as well as the purchase of pool filter timers. The results achieved by the end of 2004—312,375 diagnostics completed, 93,088 thermostats installed in new buildings and 25,412 timers distributed—far exceed our targets.

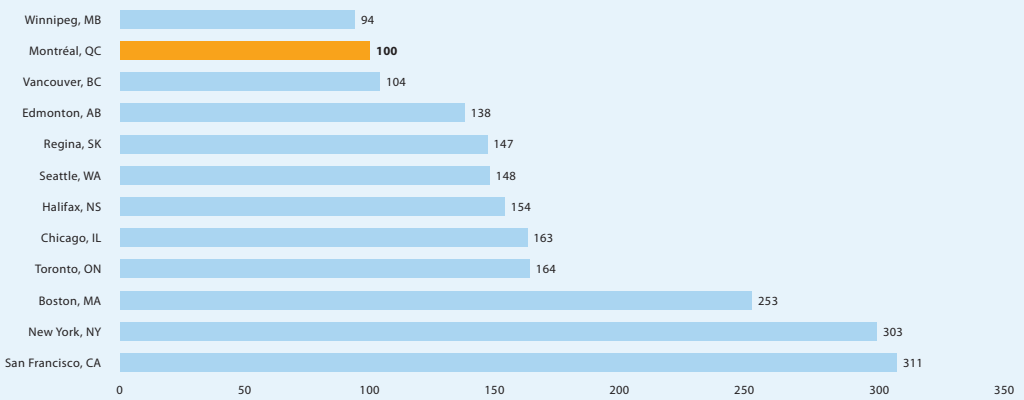
The logo identifying Hydro-Québec's energy efficiency programs was launched in February as part of a far-reaching campaign.

Wind farms will be built in eastern Québec.

The higher the turbine, the stronger the wind and the greater the output.

- We kept up our support for government energy efficiency programs for residential customers, including the Novoclimat program and the Program for Low-Income Households, both offered by the Agence de l'efficacité énergétique (AEE), and the EnerGuide for Houses program, offered by the Office of Energy Efficiency in partnership with the AEE.
- Other energy-saving tools and programs were instituted for commercial and business customers: the Energy Wise Diagnostic for Small Service Companies; the Empower Program for Building Optimization, aimed at commercial, institutional and industrial customers; the Empower Program for Industrial Systems, designed to optimize industrial customers' operations; and the Traffic Light Optimization Program, intended for municipalities and other levels of government. At year-end, 67 initiatives had been approved, representing energy savings of more than 30 GWh, and nearly 3,000 energy-saving traffic lights had been installed. These results surpass our objectives.
- The Customer Information System (CIS) project made considerable progress in 2004. We will be able to move on to phase one of its implementation in spring 2005, as planned. This project to optimize our business and administrative processes in tandem with the modernization of our information systems will enable us to better meet our customers' current and future expectations.

Comparative Index of Electricity Prices at April 1, 2004
Residential Customers[a]



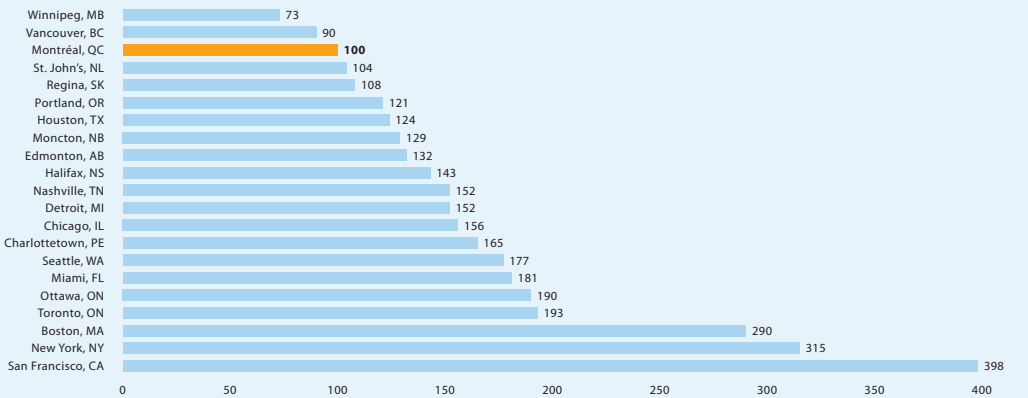
a) Monthly bill (before taxes) for a consumption of 1,000 kWh.

Large-power customers (5 MW or more)

Hydro-Québec Distribution pays particular attention to the needs of large-power customers. Their consumption represents more than 40% of electricity sales in Québec and their operations have a major regional impact. By working in partnership with these customers, we contribute to the province's economic growth. Customers with a billing demand of 5 MW or more each enjoy the services of a designated commercial officer who facilitates their relations with the various Hydro-Québec departments, advises them on the best energy choices available and looks for profitable technical solutions with them.

- In 2004, our industrial development initiatives with our partners resulted in private-sector capital projects worth $419 million. These projects will create or maintain close to 3,900 direct jobs.
- Large-power customer satisfaction held steady at 9.0 out of 10.
- We conducted 201 quality partnership sessions with a view to improving our products and services based on customers' priority needs.
- The Régie de l'énergie approved the renewal of the interruptible power program until November 30, 2006. This option benefits all Quebecers by helping us manage the winter peak.
- We launched two energy efficiency programs for large-power customers: the Industrial Initiatives Program, which covers projects submitted by customers with the aim of reducing specific electricity consumption, and the Industrial Analysis and Demonstration Program. Altogether, 130 projects were under way at December 31, representing investments of $29 million and energy savings of 182 GWh, the equivalent of the energy consumed by 7,300 electrically heated homes.
- A public recognition program was developed for major customers that take part in Hydro-Québec energy efficiency initiatives.

Comparative Index of Electricity Prices at April 1, 2004
Large-Power Customers[a]



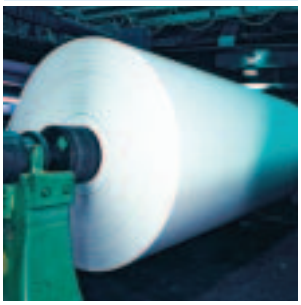
a) Monthly bill (before taxes) for 50 MW of power, at 120 kV, and a consumption of 30,600 MWh.

Building a stronger distribution system year by year

Hydro-Québec Distribution invests considerable efforts in delivering high-quality services, with particular emphasis on service continuity and access to information. One of our top priorities is to improve overall system performance in order to reduce the number and length of service interruptions. We also work closely with municipalities on such issues as providing information to authorities in the event of major power failures, vegetation management and undergrounding of distribution grids.

- Thanks to the efforts deployed since 1999 to improve overall system performance, the adjusted average number of hours of service interruption per customer per year remained stable at around 2.
- In 2004, the unadjusted average number of hours of service interruption per customer stood at 2.11, against 3.22 in 2003—the best performance we have ever posted. This 34% improvement is mainly due to the fact that few exceptional weather events occurred.
- The rate of new hookups on schedule was 92%, despite the increase in the number of new accounts.
- The customer satisfaction index for information received in the event of power failures fell slightly to 7.2 out of 10, against 7.3 in 2003.
- The search for ways to reduce undergrounding costs in residential neighborhoods continued. It included pilot projects featuring the installation of joint-use enclosures in the Laurentides and Montmorency service territories.
- A major undergrounding project is in progress in the historic Ursulines district in Trois-Rivières, at a cost of $3.5 million.
- An underground cable guide, titled *Guide en matière de distribution souterraine,* was published on the initiative of the Union des municipalités du Québec and Hydro-Québec, in collaboration with the Fédération Québécoise des Municipalités, Bell Canada, Vidéotron, Cogeco and Telus. This guide proposes avenues of cooperation and practices to facilitate undergrounding projects.
- Rollout of the geographic information system known as Dcartes began with the Richelieu territory, and will be extended to all territories in 2005. This software package allows all distribution grid and customer system assets to be shown on a continuous map base, optimizing infrastructure planning, design and analysis.

We have set up various energy efficiency programs for large-power customers wishing to reduce their power consumption.



System undergrounding will enhance the beauty of the historic Ursulines district in Trois-Rivières.

We are turning to new solutions, such as this joint-use enclosure.

Service Quality

%	2004	2003		Change
Rate of new hookups on schedule	**92**	93	↘	1
Rate of meter reading	**95**	96	↘	1
Rate of call response in 20 seconds or less	**67**	68	↘	1
Rate of inquiries resolved on the first call				
Residential customers	**81**	82	↘	1
Business and commercial customers	**66**	67	↘	1
Rate of customers notified in advance of scheduled outages				
Overall	**86**	78	↗	8
Customers significantly affected by outages	**83**	68	↗	15
Hours				
Average hours of distribution service interruption per customer —unadjusted (excluding Hydro-Québec TransÉnergie)	**2.11**	3.22	↘	1.11
Average hours of distribution service interruption per customer —adjusted[a] (excluding Hydro-Québec TransÉnergie)	**1.97**	2.10	↘	0.13

a) Not including exceptional weather events.

Improving distribution system reliability and performance is an ongoing objective.

The underground distribution system continues to expand.

Applying the decisions of the Régie de l'énergie

Most of Hydro-Québec Distribution's operations are regulated. By law, the Régie de l'énergie sets electricity rates and other conditions, after analyzing the division's rate applications.

- The Régie approved across-the-board rate increases of 3.0% and 1.41%, which came into force on January 1 and April 1, 2004, respectively. Before these increases, rates had been frozen for more than five years.
- In view of the increase in our supply costs, as well as that expected in our financial expenses starting in 2005, we filed an application with the Régie for a 2.7% rate adjustment for 2005–2006. In February 2005, the Régie authorized an adjustment on the order of 1.2%, effective April 1, 2005.
- The Régie approved the phaseout of the dual-energy rate (Rate BT), effective April 1, 2006. The customers concerned may receive financial assistance for adapting their heating systems and switching to a different rate, or for converting to other energy sources.
- We filed tariff conditions and terms of service intended to encourage small residential and commercial consumers to set up their own generation facilities using renewables.

Our neighbors can count on us

- At the request of Florida Power and Light and the Southern Company, Hydro-Québec Distribution dispatched 122 employees to Florida for 27 days to help rebuild the companies' power systems, which were severely damaged by hurricanes Frances and Ivan.
- After hurricane Jeanne hit Haiti, we sent an emergency aid mission to Gonaïves at the request of the Québec government. This mission, which cost nearly $3 million in 2004, restored the power supply to essential services and reinforced the city's distribution system.

In the aftermath of hurricanes Frances and Ivan, 122 Hydro-Québec employees were dispatched to Florida to help repair the power grids.

Emergency aid mission in Gonaïves, Haiti.

$2 billion
CAT

Construction: Full steam ahead

We had $2 billion in projects under way throughout the province in 2004: new facilities, plant overhauls, impact assessments and draft-design studies. This meant jobs not only for thousands of construction workers but also for people involved in planning, engineering and manufacturing. Our projects contribute to the Québec economy and benefit all of society.

Unique know-how

Hydro-Québec Équipement and Société d'énergie de la Baie James carry out engineering and construction for hydroelectric developments in Québec. Hydro-Québec Équipement is also in charge of transmission line and substation projects all over the province. Our teams of builders provide high-value-added services in engineering, environment and project management. Their expertise is recognized worldwide and makes a direct contribution to Hydro-Québec's performance. We can offer optimal solutions to reduce the construction costs and lead times of the projects entrusted to us and, consequently, deliver highly efficient facilities to our customers, at competitive prices.

At all times, we are concerned with our projects' impacts on the natural and human environment. We maintain harmonious relations with Aboriginal and local populations, and include as many of their workers as possible on our teams. We form partnerships with the communities concerned, in order to have a structuring effect on the local economy, promote the development of expertise in the community and optimize the regional spinoffs of our activities.

Volume of activity as at December 31, 2004	$1,984 million
Main customers in 2004 (% of volume)	
Hydro-Québec Production	77%
Hydro-Québec TransÉnergie	22%
Other	1%

No challenge too big

With the return to major projects, Hydro-Québec Équipement and Société d'énergie de la Baie James had the opportunity to put their sense of organization and innovative spirit to the test. From desk studies to turnkey delivery of hydroelectric generating stations, transmission lines and substations, we are able to meet significant technical and logistical challenges. By adapting our operations to fit customers' needs, we provide services right in line with their business objectives.

In 2004, we undertook a number of facility design and construction projects for Hydro-Québec Production and Hydro-Québec TransÉnergie. Our volume of activity totaled $1,984 million, broken down as follows: $1,251 million in hydroelectric developments, $97 million in transmission facilities, $594 million in rehabilitation and refitting, and $42 million in other projects. We also worked on several draft designs that will enable Hydro-Québec Production to meet growing demand.

Projects for Hydro-Québec Production

- The 230-MW Rocher-de-Grand-Mère hydroelectric generating station was commissioned in December 2004. The project cost $520 million, with regional spinoffs in excess of $150 million. At the peak, there were more than 700 workers on the site, 71% of them from the surrounding regions. Building this station posed a considerable challenge, as it entailed carrying out major construction work in a limited, urban space, while protecting the jobsite from flooding by the Saint-Maurice River. Site restoration is in progress, as are heritage preservation efforts and work to bring Grand-Mère generating station into compliance with the *Dam Safety Act*. The latter facility will be operated selectively, in particular during spring and fall floods.
- Construction of Toulnustouc hydroelectric generating station, begun in 2001, is nearly finished, and most of the environmental mitigation measures have been applied. This 526-MW facility is scheduled for commissioning in 2005 and will cost nearly $1 billion. Thanks to partnership agreements with the Betsiamites Band Council and the Manicouagan RCM, regional economic spinoffs amounted to more than $300 million by the end of 2004. Since the start of the project, the weekly labor force on the site has averaged 770 workers, more than 60% of them from the region. The community of Betsiamites has supplied over 10% of the workforce.
- Eastmain-1 hydroelectric generating station is more than half complete. Originally slated for 2008, commissioning could be moved up to spring 2007. This $2.1-billion facility will add 480 MW to our total installed generating capacity. In 2004, the weekly workforce on the site averaged 1,870 workers, more than 14% of them Cree. Contracts and purchases from local companies totaled more than $60 million in 2004. By project end, Cree companies will have been offered contracts worth $300 million, in accordance with the *Nadoshtin Agreement*.
- Construction of the 51-MW Mercier generating station, scheduled for commissioning in early 2006, got under way. This project on the Gatineau River calls for an investment of $145 million and will generate estimated spinoffs of $10.6 million in the Laurentians and the Outaouais region.
- We broke ground on the Péribonka development in spring 2004. This $1.2-billion project will add 385 MW to our installed capacity. On average, more than 530 people were working on the site every week, 82% of them from the Saguenay–Lac-Saint-Jean region. The region also received over half the contracts awarded.

Richard Cacchione
President,
Hydro-Québec
Équipement
President and Chief
Executive Officer,
Société d'énergie
de la Baie James

We form partnerships with the communities concerned, in order to have a structuring effect on the local economy, promote the development of expertise in the community and optimize the regional spinoffs of our activities.

- The project to build the Chute-Allard and Rapides-des-Cœurs hydroelectric developments, with a total installed capacity of 138 MW, successfully completed the public hearing stage. This project is expected to cost nearly $700 million.
- The environmental impact statement for the Eastmain-1-A powerhouse and Rupert diversion project, which now includes Sarcelle powerhouse, was filed with the competent authorities. The two powerhouses will have an installed capacity of 888 MW. The estimated cost of this project is close to $4 billion.
- We began draft-design studies for a complex of four generating stations to be built on the Romaine River, with a combined installed capacity of approximately 1,500 MW.
- Refurbishment totaling $260 million was carried out at a number of generating stations, including Beauharnois, Bersimis-1, Rapides-des-Quinze, Rapide-2 and Rapide-7. In addition, refitting continued at Outardes-3, Outardes-4 and La Tuque. These efforts will add about 420 MW to our installed capacity by 2008.

Main Generating Projects

Generating station	Installed capacity (MW)	Total investment	Number of employees at the 2004 peak	Cumulative regional economic spinoffs as at December 31, 2004	Commissioning
Rocher-de-Grand-Mère	230	$520 million	700	$150 million	2004
Toulnustouc	526	$1.0 billion	1,381	$300 million	2005
Eastmain-1	480	$2.1 billion	2,660	$250 million	2007
Mercier	51	$145 million	186	$7 million	2006
Péribonka	385	$1.2 billion	651	$100 million	2008

At the Eastmain-1 jobsite, John Paul Murdoch, legal advisor for the Grand Council of the Crees, Johnny Saganash, Cree counsellor, and Denis Groleau, jobsite manager. More than 500 Crees worked on the jobsite in 2004.

Toulnustouc generating station in the North Shore region, scheduled for commissioning in 2005.

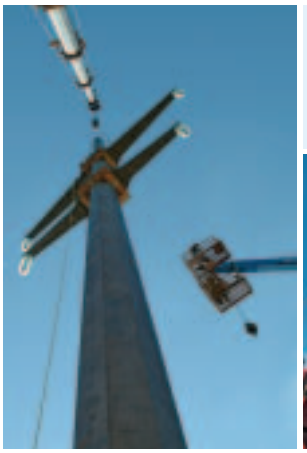
Eastmain-1 generating station is being built in the James Bay region. Commissioning is slated for 2007.

Projects for Hydro-Québec TransÉnergie

- In a Québec first, a section of the 120-kV Lafontaine–Paquin line was rebuilt on high-performance-concrete structures. The $10.4-million project was completed on time and within budget.
- We built two 120-kV lines—Acton–Montérégie and Saint-Dominique–Montérégie—to complete the Montérégie loop project, which was initiated following the ice storm of 1998.
- We began work to bring the generating stations currently under construction onto the transmission grid: a $129-million project involving a switchyard and a 315-kV line linking Toulnustouc generating station to Micoua substation, and a $115-million project for a 315-kV line between Eastmain-1 and Nemiscau substation.
- The right-of-way was cleared for the 208-km, 69-kV Nemiscau–Waskaganish line, which will connect the village of Waskaganish to the grid. The cost of this project, which also includes construction of a substation at Waskaganish, is estimated at $64 million. Commissioning is scheduled for 2006.
- The addition or replacement of power transformers in about 30 substations got under way. This work will strengthen the substations and increase system capacity. It will continue until 2008.
- We finished the refurbishing and modernization started in 2000 at Central substation. At a cost of $55 million, the work increased supply capacity at this hundred-year-old facility to meet increasing demand in a fast-growing neighborhood of Montréal.
- We made alterations to Copper Mountain substation and to a transmission line in order to bring output from Mont-Copper and Mont-Miller wind farms, on the Gaspé Peninsula, onto the grid. The project cost $6.8 million.
- We obtained government approval and undertook engineering and procurement for the installation of de-icing equipment at Lévis substation. This $191-million project, to be completed by 2007, is aimed at reinforcing strategic lines in order to secure the power supply to the Québec City, Chaudière-Appalaches, Lower St. Lawrence and Eastern Township regions.
- Installation of a variable-frequency transformer (VFT) at Langlois substation, in the Montérégie region, was completed. The world's first converter unit of its kind, the VFT applies an innovative technology that optimizes interchanges across asynchronous system boundaries.

Mercier generating station, under construction in the Outaouais region, should be up and running in 2006.

High-performance concrete tower—a new technology being deployed in the transmission system.



Assembling a tower for the line that will link Toulnustouc generating station to Micoua substation.

Péribonka generating station will be situated at the confluence of the Manouane and Péribonka rivers.

innovation

Challenges in technology

Enhancing the energy performance of our customers, our systems and our generating facilities. We work to improve the overall efficiency of the Québec power system, and our technology breakthroughs are designed to conserve energy. Our latest invention is a heating system, designed for businesses and institutions, that collects heat during low-consumption periods and delivers it during peak demand.

Meeting the technological challenges of the energy industry

Hydro-Québec Technologie et développement industriel spearheads the company's technological innovation and is Québec's leading innovator in the energy sector.

Our mission is to provide integrated management of all aspects of innovation: research and technology commercialization, industrial development and capital venturing. Our goal is to generate value from technological challenges, in cooperation with an extensive network of partners.

We focus on Hydro-Québec's core businesses, contributing to the achievement of its short- and medium-term objectives and to its long-term viability. In line with the company's commitment to serve its customers better through innovation, our teams work to optimize the overall performance of Québec's power system, and they support initiatives designed to enhance Quebecers' energy efficiency.

Innovation projects and technical support	
Amount appropriated in 2004	$87 million
Customers in 2004 (% of appropriation)	
Hydro-Québec Production	19%
Hydro-Québec TransÉnergie	25%
Hydro-Québec Distribution	26%
Other internal customers	15%
Outside customers	15%
Regulatory regime	Cost-based for projects for Hydro-Québec TransÉnergie and Hydro-Québec Distribution
Industrial development – Hydro-Québec IndusTech	
Investments as at December 31, 2004	$324 million
Regulatory regime	Free competition
Venture capital – Hydro-Québec CapiTech	
Investments as at December 31, 2004	$196 million
Regulatory regime	Free competition

Supporting the other divisions while preparing for the future

The innovation projects undertaken by Hydro-Québec Technologie et développement industriel and the technical support it provides reflect the company's priorities and business objectives: improving plant output, reducing expenses, postponing capital outlays, contributing to the Energy Efficiency Plan, etc. Each division determines technological innovation avenues based on its specific priorities and objectives, then makes the necessary funds available. Conducted in close collaboration between our laboratories in Varennes and Shawinigan, our commercialization experts, other divisions and Hydro-Québec partners, our projects must meet strict gating criteria to progress through their various stages to completion.

TECHNOLOGICAL INNOVATION AVENUES
as at December 31, 2004

Generation (21 projects)	Develop new concepts for generating facilities
	Extend the service life of dams and control structures
	Improve the performance and long-term operability of generating facilities
	Increase the profitability and acceptability of generating facilities
Transmission (47 projects)	Increase service life by 10% and reduce maintenance costs by 10% for certain equipment
	Reduce the cost of new lines and substations by 10%
	Increase transmission capacity in certain corridors by 33%
	Optimize transmission system management
	Reduce the impact of extreme weather conditions by 50%
Distribution (30 projects)	Increase the quality of electricity service
	Reduce the cost of the underground grid by 50%
	Reduce the net discounted cost of the overhead system by 10%
Energy use (12 projects)	Promote energy efficiency and encourage residential, commercial and institutional customers to optimize their consumption
	Promote effective use of electricity to reduce the energy intensity (specific energy consumption) of Québec industry
	Contribute to sustainable development

- The spinoffs generated in 2004 by our innovation projects are estimated at $113 million.
- The project portfolio puts our know-how to work in six areas: chemistry and materials; power system analysis and control; electrical equipment; energy use; mechanical, metallurgical and civil engineering; and automation and measurement systems.

Élie Saheb
President,
Hydro-Québec
Technologie et
développement
industriel

Our innovation projects reflect the company's priorities and business objectives.

We also put together a strategic innovation portfolio of long-term projects arising from the company's technological roadmap. This roadmap, which is reviewed periodically, enables us to focus some of our efforts on issues and emerging technologies that may transform the energy market.

- In 2004, our strategic innovation projects had two main thrusts: power system management (impacts of climate change, real-time transmission grid management, etc.) and advancements in infrastructure and equipment (such as superconductor technologies).
- With regard to climate change, we continued our work with the Ouranos Consortium. We simulated temperatures in Québec for the next 30 years and incorporated the results into the load forecasting model used by Hydro-Québec Distribution. The company's experts also collaborated on a report published by the consortium in 2004, *Adapting to Climate Change*.

Encouraging partnership

Hydro-Québec has a vast network of partners in Québec, Canada and abroad: university and private research centres, small and medium-sized businesses, multinationals and investors. Pooling such complementary expertise encourages the emergence of innovative ideas and enhances projects, while diluting the risks inherent in research and development.

- Twenty-nine companies are currently working with us on 27 projects.
- Under a partnership agreement with the AREVA Group, Hydro-Québec will share detection technology know-how and R&D costs with a view to designing defence mechanisms that will protect the transmission system during extreme weather conditions.
- The company has signed an agreement with Siemens Canada to conduct joint R&D projects and to develop, industrialize and market new power transmission technologies.
- Under the auspices of the CANDU Owners Group, we began a project to develop tools that will measure the integrity of reactor feeder pipes in nuclear power plants. One of these tools, the "Cracking Crawler" bracelet, detects microcracks in aging feeder pipes. Having proven its worth at Gentilly-2, the Cracking Crawler is now in use at several other CANDU plants in Canada and elsewhere.

The active search for partners is conducted in parallel with careful management of intellectual property. To create maximum value from the technologies developed by Hydro-Québec, we negotiate manufacturing and marketing licences with companies that are able to give us access to world markets. At the moment, 65 licences are held by 55 companies.

Hydro-Québec is active in the Ouranos Consortium, which focuses on climate change.

LineROVer, a robot for inspecting transmission lines, designed at Hydro-Québec's research institute.

Testing the protection relays being developed under a partnership agreement with AREVA.

Industrializing and marketing the technologies of the future

When a technology derived from Hydro-Québec research shows significant growth potential, we work in partnership with the private sector, through Hydro-Québec IndusTech, to get it ready for industrial production and commercial sale. In 2004, we injected $52 million of share capital into this subsidiary, which holds two start-up companies, AVESTOR and TM4. Our cumulative investments in these companies total $289 million, with $259 million in AVESTOR and $30 million in TM4.

AVESTOR

AVESTOR is a joint venture of Hydro-Québec IndusTech and Kerr-McGee Stored Power. In 2004, AVESTOR refocused on the telecommunications market. It is currently working on the production and marketing of a line of lithium-metal-polymer (LMP) batteries that can power telecommunications system relays in the event of a power failure. Since this market has short-term growth potential, AVESTOR plans to dedicate its production line to it. As at December 31, 2004, the company had 240 employees and a total capitalization of $518 million.

TM4

TM4 is a subsidiary of Hydro-Québec IndusTech. It develops and markets custom high-density and high-efficiency electrodynamic solutions for the transportation and distributed power generation markets.

- The Quark drivetrain system, designed, developed and produced by TM4, was exhibited for the first time in the Peugeot booth at the 2004 Paris Auto Show.
- The Cleanova II, with a hybrid drivetrain also designed, developed and produced by TM4, was presented at the 2004 Paris Auto Show by Société de Véhicules Électriques, a joint venture of the Dassault and Heuliez groups.

Making strategic investments

Through Hydro-Québec CapiTech, Hydro-Québec's venture capital subsidiary, we make strategic investments in technology companies whose activities are related to the company's core businesses. This gives Hydro-Québec access to industry innovations, enabling it to identify technologies, products and services that may have a major impact on its own operations. The investment portfolio plays an important role in gathering the technological and commercial intelligence that underlies our innovation strategy. For example, we maintain close ties with our financial and strategic partners in the international energy-related venture-capital community.

- As at December 31, 2004, our cumulative direct investments were $163 million (including $8 million reinvested in 2004), or 83% of our total venture-capital portfolio. Our direct investment portfolio involves 30 companies (16 in Québec, 4 elsewhere in Canada and 10 foreign) in the following fields: facility performance and long-term operability; distributed power generation and storage; and enabling and information technology. In 2004, we sold our shares of Azure Dynamics and STAS for a total of over $6 million, generating a gain on disposal of nearly $3 million.
- As at December 31, 2004, our cumulative indirect investments totaled $35 million (including $7 million reinvested in 2004), or 17% of our total venture-capital portfolio. Our portfolio of indirect investments comprises four international energy funds: Nth Power Technologies Fund I, Nth Power Technologies Fund II, EnerTech Capital Partners II and SAM Private Equity Energy Fund.
- Hydro-Québec CapiTech did not make any new direct or indirect investments in 2004.

vision

Corporate citizenship

Environmental protection, social involvement, economic efficiency, job creation … We are intensely aware of our role in society. Wherever we are present, our decisions are scrutinized, debated and publicized. We make a meaningful contribution to economic, social and cultural development in the communities where we operate. We know how to run a power system, but we're also a good corporate citizen.

Acting responsibly

Hydro-Québec adopted the principles of sustainable development in 1989. This concept was defined in the Brundtland Report (*Our Common Future,* 1987, World Commission on Environment and Development) as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs." As stated in the Johannesburg Declaration in 2002, economic development, environmental protection and social development must progress together. This principle imbues our values, our policies, the codes of ethics that guide our managers' and employees' actions, and our daily practices and management.

Our results are measured periodically so that we can continuously improve our work methods. Since 1995, we have published an annual report on our environmental performance. Our *Sustainability Report 2004* is based on the internationally recognized Global Reporting Initiative Guidelines.

Promoting sustainable energy choices

Hydro-Québec is one of the largest producers of renewable energy in North America and the world. About 96% of our electricity is generated by water power, and we intend to continue developing Québec's hydropower potential. Thanks to hydroelectricity, our performance is excellent, particularly with regard to emissions of greenhouse gases (GHGs) and atmospheric pollutants. Our hydropower development projects must meet three interrelated conditions: environmental acceptability, positive acceptance by host communities, and profitability under market conditions.

We support sustainable development by promoting hydroelectricity, sharing our expertise and working with such international organizations as the World Energy Council, the International Hydropower Association (IHA) and the International Energy Agency. We collaborated with the IHA on the publication of sustainable development guidelines and development of a protocol for applying them to hydroelectric projects and development. We also participate in major events like the International Conference on Renewable Energy and the United Nations Symposium on Hydropower and Sustainable Development. The contribution hydroelectricity (including large hydro) makes to energy sustainability on our planet is now acknowledged.

Research shows that reservoirs generate very low levels of GHG emissions.

After collection, a large proportion of treated hazardous waste is recovered in some way.

Conservation and enhancement of the Mont-Wright old-growth forest — one of many projects funded by the Fondation Hydro-Québec pour l'environnement.

Preserving the environment

All Hydro-Québec divisions and corporate units respect the environment in their operations and continuously improve their performance in this regard. We promote responsible use of resources and preservation of biodiversity, and we take steps to mitigate or compensate for the environmental impacts of our projects and operations. The environmental studies that we have compiled over the years for all of our projects have provided us with an exceptional understanding of the biophysical and human environments in which we operate. These studies are completed in conjunction with the communities concerned: information sessions and discussion forums begin when the project starts so that we can inform the public, hear people's concerns and take them into account throughout the project.

- Two new ISO 14001 certificates have been obtained. As a result, of all our employees whose activities include a significant environmental component, 98% were governed by a registered environmental management system in 2004 (81% in 2003).
- The environmental impact statement for the Eastmain-1-A powerhouse and Rupert diversion project, which now includes the construction of Sarcelle powerhouse, was filed with the competent authorities.
- In 2004, 93% of the energy generated or purchased by Hydro-Québec came from renewable sources. This proportion may increase significantly in the coming years because of agreements with producers of biomass (39.4 MW) and wind power (990 MW).
- Hydro-Québec contributed to the publication of *Greenhouse Gas Emissions – Fluxes and Processes,* an exhaustive report on ten years of research into GHG emissions from reservoirs and natural bodies of water. The researchers concluded that hydroelectricity is a renewable energy that contributes very little to GHG emissions. Several universities and companies around the world collaborated on this publication.
- At the request of the Régie de l'énergie, Hydro-Québec Distribution added a non-monetary requirement, based on five sustainable development indicators, to be considered when awarding long-term supply contracts.
- Hydro-Québec Distribution submitted a proposal to the Régie designed to encourage small residential and commercial consumers to produce their own electricity from renewable sources.
- A total of 12,379 tonnes of residual hazardous materials were recovered throughout Québec. Over 87% of the RHMs treated in 2004 were recovered in some way.
- The Fondation Hydro-Québec pour l'environnement funded 16 new projects in 10 regions of Québec, for a total of over $740,000.
- Hydro-Québec supported a number of environmental organizations, including the Fédération québécoise pour le saumon atlantique, the Québec Wildlife Foundation, the Association québécoise de vérification environnementale, the Fondation Marie-Victorin pour la nature et les sciences, the Quebec Environment Foundation and Les Amis des Jardins de Métis.

Developing our human resources

Hydro-Québec implements various health and safety, recruitment, training and motivation programs and measures to provide a stimulating, respectful work environment for its employees.

- The work-related accident frequency rate dropped to 3.34 per 200,000 hours worked in 2004, down from 3.49 in 2003.
- We filled 1,150 permanent positions in order to ensure continuity and reduce job insecurity.
- Internships were granted to 176 university students, including 24 in the field of environment.
- The overall employee motivation index rose to 6.70 out of 10, an increase of 0.12 over 2003.
- Job satisfaction at Hydro-Québec reached 8.29 out of 10, an improvement of 0.09 over 2003.

Contributing to society

For many years, Hydro-Québec has helped hundreds of organizations that endeavor to improve social conditions in communities throughout Québec. We also encourage our employees to do volunteer work. Over 260 employees took advantage of a program that enables them to obtain up to $1,000 in funding for the community organizations they support; our 2004 contributions on behalf of these employees totaled $200,000.

Community health and social assistance

- As in past years, Hydro-Québec's employees and retirees made a major contribution to the United Way/Centraide; this year's donation was over $2.5 million. Hydro-Québec matched the amount, as always, bringing the total contribution to over $5 million. This amount is distributed throughout Québec.
- Some sixty donations supported research and development in regional hospitals, including the hospitals in Chicoutimi and Granby, and major institutions like the Montréal Heart Institute, Sainte-Justine Hospital in Montréal, and the Québec City university hospital.
- Donations were made to over 125 foundations and organizations that help people who are ill or having difficulty: they include the Maison Victor-Gadbois, Portage, the Québec Mental Illness Foundation, the Society of Saint Vincent de Paul and the Fondation Père de la Sablonnière.
- We worked with the YWCA Foundation on the Québec Women of Distinction awards.

Hydro-Québec provides a safe working environment for its personnel. The accident frequency rate dropped again in 2004.

Employee satisfaction is key to the company's success.

Our contribution to the United Way/Centraide topped $5 million in 2004!

Education and youth

- Hydro-Québec donated $3.5 million to Québec universities, including $1.65 million to 15 research chairs in various fields.
- The company contributed financially to the creation of the Laboratoire de didactique des sciences at the Université du Québec à Montréal, set up in conjunction with the Montréal Science Centre.
- We awarded 15 scholarships to electrical engineering students enrolled in the Institute of Electrical Power Engineering.
- We renewed our partnership with the Conseil de développement du loisir scientifique to organize Expo-Science fairs for the purpose of stimulating young people's interest in careers in science and technology; we also continued to sponsor the Québec delegation to the International Youth Scientific Exhibition.
- We worked with organizations that are preparing our future leaders, such as Jeunes Entreprises du Québec, and supported such initiatives as the Commerce Games, the Engineering Games and the Québec Engineering Competition.
- Our presentation entitled *Eau bleue = Énergie verte* (Blue water = Green energy) was given to 2,700 students in various elementary and secondary schools to raise awareness about the environmental advantages of hydropower.

Culture

- Hydro-Québec sponsored a number of major public events, including the Québec City Summer Festival, Épopée de la Manic, International FestiBlues of Montréal, the Petite-Vallée song festival, Festival international de Lanaudière and Drummondville's Mondial des Cultures.
- We supported numerous theatre groups in remote areas, including Théâtre les gens d'en bas, Atelier de théâtre l'Eau-vive, Les Têtes Heureuses, Théâtre du Tandem and Théâtre La Manivelle.
- We gave funding to all the symphony orchestras in Québec, as well as to other ensembles like the McGill Chamber Orchestra, Les Violons du Roy and the I Musici chamber orchestra of Montréal.
- For the fifth consecutive year, we were the main sponsor of the Centaur Theatre Company and the Saidye Bronfman Centre for the Arts. We also sponsored the Théâtre du Trident, the Théâtre d'Aujourd'hui and many other theatres.
- We supported a number of multicultural events, including the Arab cultural festival, the 11th Montréal Italian week and the multicultural component of the Francofolies festival.

Sports

- Hydro-Québec renewed its sponsorship of the Défi sportif challenge for athletes with disabilities and collaborated on the Québec Special Olympics.
- We awarded 22 scholarships of $3,000 each to young amateur athletes through the Québec Foundation for Athletic Excellence and continued our association with the Québec Games.

Working with communities and organizations

Partnerships with such organizations as the provincial farm producers' union and associations of municipalities make it easier to find mutually satisfactory solutions to land-use issues. We also work with socio-economic organizations like the Association des professionnels en développement économique du Québec and the Urban Development Institute of Québec. In 2004, we signed some 40 new agreements with such organizations. In addition, we continued to encourage Aboriginal community participation in our studies and projects.

- Through the Integrated Enhancement Program, we granted $1.7 million to support community initiatives where major transmission projects are located.
- On April 19, 2004, Hydro-Québec, Société d'énergie de la Baie James and the Grand Council of the Crees signed an agreement that provides for such economic and social measures as the creation of partnerships, recruitment of Cree workers and awarding of contracts to Cree businesses. More than 500 Crees worked on the Eastmain-1 construction site in 2004.
- On January 28, 2005, Hydro-Québec signed a partnership agreement with the Municipality of Baie-James regarding the Eastmain-1-A powerhouse and Rupert diversion project. Under this agreement, the company will pay $310 million over 50 years to the Jamesian community, beginning on the date the project approvals are received.
- Five young Aboriginals received Hydro-Québec awards for excellence. Four college students received $1,000 each and one university student received $2,000 and an invitation to do a 16-week internship in finance.
- Like the other 90-odd signatories of the *Policy Statement by the Montréal Community Regarding Sustainable Development,* Hydro-Québec is helping to develop Montréal's first sustainable development strategic plan.
- Hydro-Québec again sponsored the Grands Prix du tourisme québécois awards and the Ordre national du mérite agricole.

$3,000 scholarships were granted to 22 young amateur athletes.

More than 500 Crees were employed on the Eastmain-1 jobsite in 2004.

Playing an active role on the world scene

Hydro-Québec's international activities support the company's commercial operations, raise its profile and that of Québec, and provide energy-related technical assistance to developing countries.

In 2004, we participated in 35 international cooperation initiatives in over a dozen countries, mostly French-speaking nations with which we have close ties. The projects mainly involved training or technical knowledge transfer. A number of these initiatives were carried out in conjunction with Francophonie institutions (Institut de l'énergie et de l'environnement de la Francophonie in Burkina Faso, Senghor University in Egypt, etc.), international institutions (World Bank and specialized agencies of the UN) or Québec universities (École des hautes études commerciales).

To enhance its visibility and to showcase Québec know-how, Hydro-Québec participated in a variety of events here and elsewhere, such as the Conference of Montréal and HydroVision 2004. The company received an award for the best presentation at a technical conference in Argentina; the conference was organized by the Comisión de Integración Energética Regional.

In addition, to further our international relations and at the request of our business units, we received numerous delegations that were interested in developing ties with Hydro-Québec.

- We joined the United Nations Global Compact, whose members agree to comply with ten main principles regarding human rights, labor relations, environmental protection and anticorruption. We were among the first companies in Canada to sign the Compact.
- We signed a cooperation agreement with the Brazilian national electric utility, Eletrobrás, to exchange information in several fields and explore contract possibilities.
- On October 7 and 8, 2004, the 17th Centre Jacques Cartier Discussions were held in Montréal. Hydro-Québec organized and, in conjunction with Électricité de France, hosted a conference entitled *Sustainable Development, a Challenge for Energy and Transportation.*
- At Hydro-Québec's invitation, a delegation of Chilean parliamentarians and government officials well-versed in energy issues held a seminar on the economy of Chile during the Conference of Montréal in June.

Exchanging ideas at the Institut de l'énergie et de l'environnement de la Francophonie, in Burkina Faso.

Prize awarded by the Comisión de Integración Energética Regional for the best presentation at a symposium held in Argentina.

Contributing to public wealth

Hydro-Québec makes a substantial contribution to Québec's economic development through its operations, capital investment, procurement of goods and services, electricity purchases from private producers and the activities of its technology subsidiaries. For example, procurement of goods and services from Québec companies reached nearly $2.25 billion in 2004 and supported an estimated 15,000 direct jobs across the province.

- Procurement of goods and services within Québec and from outside Québec totaled $2,394 million: $965 million for the purchase of goods, $27 million for rentals, $1,008 million for specialized services and other work and $394 million for professional services. Compared to 2003, procurement of goods and services grew by over 4%, mainly because of the increase in the number of projects carried out by Hydro-Québec Équipement.
- We procured nearly 94% of our goods and services from suppliers in Québec. Goods and services procured from Aboriginal organizations, contractors or independent workers exceeded $220 million, compared to $185 million in 2003.
- We established partnerships to ensure that our projects and operations would run smoothly. Economic spinoff committees were created to assist with awarding contracts and hiring local and regional workers.
- In accordance with the policy "Our Acquisitions of Goods and Services," we reviewed our major strategic contracts so as to be able to meet our needs in coming years and guarantee our supply of goods and services. This exercise enabled us to consolidate our positions with existing suppliers and qualify new ones.
- To increase our efficiency and reduce procurement costs, we worked with our suppliers to identify cost-effective optimization measures covering the entire service life of specific products.
- To maintain quality, we certified suppliers of professional services and updated the list of qualified suppliers for certain business sectors, such as the environment, architecture, building engineering and geomatics.
- We deployed a system to enable our suppliers to send their invoices by e-mail or by electronic data interchange. Digital invoicing accelerates processing and generates savings for all concerned.
- We continued to treat our suppliers fairly and confidentially. The number of complaints and claims this year dropped from 20 to 14.

HYDRO-QUÉBEC PROCUREMENT BY ADMINISTRATIVE REGION[a] ($'000)

	Services[b]	Goods[c]	Total
Abitibi-Témiscamingue (08)	18,975	9,401	28,376
Bas-Saint-Laurent (01)	14,240	1,858	16,098
Capitale-Nationale (03)	170,720	49,175	219,895
Centre-du-Québec (17)	50,255	21,720	71,975
Chaudière-Appalaches (12)	65,030	23,251	88,281
Côte-Nord (09)	81,244	14,576	95,820
Estrie (05)	9,593	6,864	16,457
Gaspésie–Îles-de-la-Madeleine (11)	4,349	744	5,093
Lanaudière (14)	21,019	49,133	70,152
Laurentides (15)	45,818	13,337	59,155
Laval (13)	61,828	26,578	88,406
Mauricie (04)	121,030	29,121	150,151
Montérégie (16)	104,369	196,234	300,603
Montréal (06)	457,775	406,130	863,905
Nord-du-Québec (10)	11,434	2,507	13,941
Outaouais (07)	4,518	15,348	19,866
Saguenay–Lac-Saint-Jean (02)	108,185	29,722	137,907
Total	**1,350,382**	**895,699**	**2,246,081**

a) Amounts billed by suppliers located in the administrative region.

b) Specialized services, professional services and other work.

c) Purchases and rentals.

growing strong

Management's Discussion and Analysis

This Management's Discussion and Analysis should be read in conjunction with the Consolidated Financial Statements of Hydro-Québec and the notes thereto. The financial information presented hereinafter and the tabular amounts are expressed in Canadian dollars, unless otherwise indicated.

The Consolidated Financial Statements take into account certain accounting practices that are specific to regulated enterprises. These practices mainly relate to the capitalization of net costs associated with disposals of fixed and intangible assets; the government reimbursement for the 1998 ice storm; deferred charges for incentive payments to customers affected by the rescission of dual-energy Rate BT, amortized as of April 1, 2006; deferred charges related to the Energy Efficiency Plan 2003–2006 and their amortization; and the capitalization of financial expenses to fixed assets under construction, including return on shareholder's equity authorized by the Régie de l'énergie. In addition, the method of establishing the cost of debt accepted by the Régie takes into account the impact of long-term derivative instruments used in the context of integrated risk management.

Hydro-Québec would like to point out that this analysis, and especially the Outlook section, contains statements based on estimates and assumptions concerning future results and the course of events. Given the risks and uncertainties inherent in any forward-looking statements, Hydro-Québec's actual future results could differ materially from those anticipated. It should also be noted that certain financial and operating data for previous years have been reclassified to respect the presentation adopted in 2004. Finally, the information contained herein takes into account any significant event that occurred before March 16, 2005.

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Overview

Net income totaled $2.4 billion, up $497 million from 2003, mainly because of a substantial reduction in financial expenses and a gain on the sale of our interest in Noverco. These items largely offset the drop in operating income.

Financial expenses were $2.3 billion, down $395 million (14.9%) from 2003. This reduction can be credited to two factors: the impact of the appreciation of the Canadian dollar on the repayment of U.S. dollar–denominated debt and swaps, and the foreign exchange gain recognized following the write-down of the natural hedge between debts and sales in U.S. dollars.

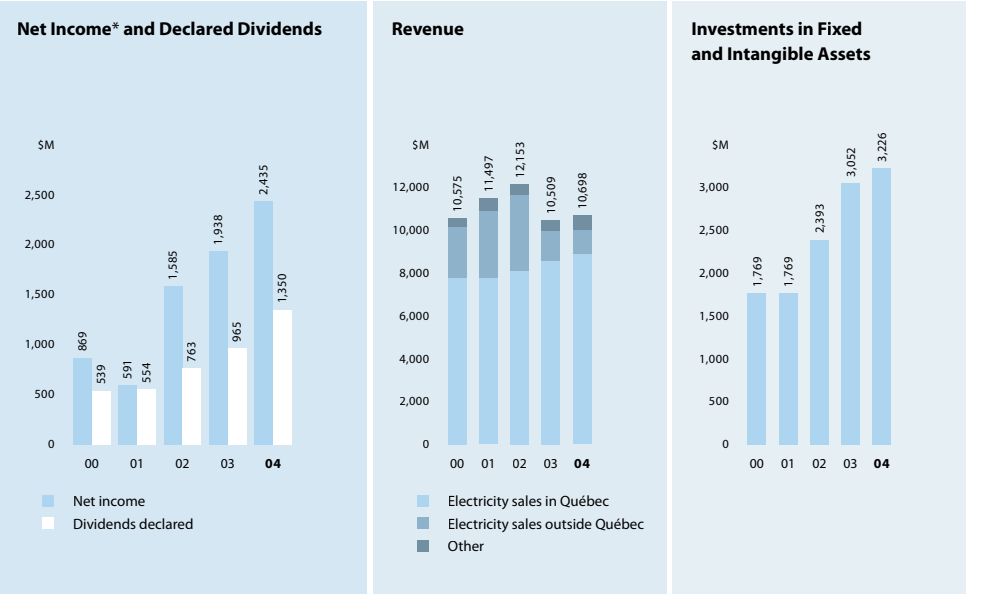
Operating income was $4.4 billion, down $144 million (3.2%). Mitigated by the rate adjustments that took effect in 2004 after a freeze lasting more than five years, the drop in operating income was the result of a reduction in electricity sales transactions outside Québec, combined with an increase in operating expenses—chiefly the recognized pension plan cost—and in depreciation and amortization.

Revenue totaled $10.7 billion, or $189 million (1.8%) more than in 2003. The rate adjustments in 2004 more than made up for the reduction in electricity sales transactions outside Québec. This reduction was the result of prudent management of energy reserves in the first half of the year, the Corporation having elected to limit exports and increase electricity and fuel purchases in order to replenish reserves. In the second half of the year, a drop in industrial demand in Québec enabled us to resume our transactions on external markets.

Return on equity was 15.5%, as against 13.2% in 2003, while the **return on revenue** was up 4.4% to total 22.8%, a sign of solid financial performance.

Cash from operations amounted to $4.0 billion, slightly more than in 2003. Coupled with the revenue from the disposal of our interest in Noverco ($900 million) and our investment in Meiya Power Company ($110 million, of which $104 million has been received), these funds enabled us to repay almost $1 billion of long-term debt, pay the $965 million in dividends declared in 2003 and finance our **investments**, which totaled $3.2 billion in 2004, versus $3.1 billion in 2003. The investments made in 2004, among the largest capital outlays in the past 10 years, reflected the Corporation's renewed activity in major projects, which began in 2003 and related mainly to the Generation and Transmission segments.

Dividends declared were $1,350 million, as compared to $965 million in 2003. This eighth consecutive payment—the largest to date—will bring the total amount paid to our shareholder since 1998 to almost $5.3 billion.



* *Data for 2000 to 2003 have been restated further to the retroactive effect of the accounting standards governing foreign currency translation and asset retirement obligations. The reported data are presented under Supplementary Information—Five-Year Review.*

Consolidated Results

In this Management's Discussion and Analysis, "Hydro-Québec" refers to the group formed by the government corporation Hydro-Québec (the "Corporation") and enterprises in which it has an ownership interest.

Our analysis focuses on Hydro-Québec's consolidated results and its financial position, as well as on integrated business risk management. We then present the operating results, investing activities and risk management for each segment, followed by our outlook for 2005.

Operating Results

Net income totaled $2,435 million, up $497 million (25.6%) from 2003. This increase is chiefly attributable to active debt management—an approach introduced several years earlier—and favorable capital market conditions, which enabled us to reduce financial expenses by $395 million. Added to this was the sale of our interest in Noverco, which generated a $265-million gain on disposal. These factors largely offset the $144-million (3.2%) reduction in operating income and had a beneficial effect on all our financial ratios.

Revenue grew $189 million (1.8%) to stand at $10,698 million. Electricity sales on the Québec market amounted to $8,922 million, an increase of $344 million (4.0%) over 2003. This increase consisted mainly of an additional $321 million of revenue generated by the application of rate adjustments after a freeze of more than five years. The volume of electricity sales in Québec decreased by 1.2 TWh, primarily as a result of a 2.9-TWh drop in industrial sales following plant closures and a strike at the Bécancour aluminum smelter, which reduced our industrial sales by $80 million compared to 2003. Some 1.7 TWh of growth in sales volume in other customer categories partially compensated for this reduction and generated additional revenue of $103 million over 2003.

Electricity sales on markets outside Québec fell by $261 million (19.4%) to stand at $1,084 million, chiefly because of efforts to replenish energy reserves during the first half of the year. However, a drop in industrial demand enabled us to take advantage of business opportunities on external markets in the second half. As a result, sales outside Québec reached 14.4 TWh in 2004, compared to 15.8 TWh in 2003.

	2004	2003
OPERATIONS AND DIVIDENDS ($M)		
Revenue	**10,698**	10,509
Net income	**2,435**	1,938
Dividends declared	**1,350**	965
BALANCE SHEET ($M)		
Total assets	**58,036**	57,731
Fixed assets	**51,589**	50,904
Long-term debt, including current portion	**34,469**	35,980
Shareholder's equity	**16,220**	15,128
RATIOS		
Return on equity (%)	**15.5**	13.2
Average cost of debt (%)	**7.3**	8.0
Return on revenue (%)	**22.8**	18.4
Capitalization (%)	**32.8**	29.9
Self-financing (%)	**74.2**	53.1
Interest coverage	**1.72**	1.65

Total expenditure was $6,296 million, or $333 million (5.6%) more than in 2003. This rise was chiefly owing to increases of $94 million (4.3%) in operating expenses and $111 million (6.1%) in depreciation and amortization. However, had it not been for the termination in 2004 of the application of a credit against the recognized cost of the pension plan—a credit that amounted to $73 million in 2003—the rise in operating expenses would have been below the inherent growth in the payroll because of cost rationalization initiatives. In line with our commitments, we kept operating expenses, excluding subsidiaries and holdings, at the budgeted 2003 level, and we intend to do the same in 2005. The increase in depreciation and amortization expense can be explained by the commissioning of a number of facilities, including Sainte-Marguerite-3 generating station.

Financial expenses totaled $2,261 million, compared to $2,656 million in 2003, a decrease of $395 million (14.9%). For a second consecutive year, the Canadian dollar's appreciation against the U.S. dollar served as leverage in managing the debt. The average value of the Canadian dollar in fact rose from US$0.714 in 2003 to US$0.768 in 2004. This 7.6% appreciation had an impact of $231 million on the repayment of U.S. dollar–denominated debt and swaps and accounted for more than half of the reduction in our financial expenses. The remainder was mainly due to a foreign exchange gain recognized following the write-down of the natural hedge between debts and sales in U.S. dollars.

Discontinued operations contributed $303 million to net income, as against $52 million in 2003, because of the $265-million gain realized on the disposal of our interest in Noverco.

Financial Position

Operating Activities

Operating activities generated $4,000 million in 2004, versus $3,795 million in 2003. These funds were used mainly to finance the renewed capital program initiated in 2003, to repay a portion of the debt and to pay the dividends declared in 2003. The self-financing ratio increased from 53.1% in 2003 to 74.2% in 2004.

Investing Activities

In 2003, Hydro-Québec embarked on a series of major investments in fixed and intangible assets. These investments totaled $3.2 billion in 2004, compared to $3.1 billion in 2003, an increase of $174 million (5.7%). More than $1.8 billion went to projects to develop generating facilities, including the ongoing construction of Eastmain-1, Toulnustouc and Mercier, completion of Rocher-de-Grand-Mère and commencement of work on Péribonka. On completion, these five projects will add more than 1,500 MW of installed capacity to our fleet and generate more than 8 TWh of electricity annually. Rehabilitation work continued at Beauharnois, Outardes-3 and Outardes-4, and other generating stations. Draft-design studies began for the Romaine complex, and the impact assessment was completed for the Eastmain-1-A powerhouse and Rupert diversion project, which now includes Sarcelle powerhouse. The Chute-Allard and Rapides-des-Cœurs development project passed the public hearing stage and we expect to receive government approvals in 2005.

Hydro-Québec TransÉnergie invested $733 million, including $595 million in the transmission system in order to respond to growing demand, maintain or improve the quality of its assets and bring the future Toulnustouc and Eastmain-1 generating stations onto the power grid. The division also invested $138 million in South America through Hydro-Québec International. Hydro-Québec Distribution made a $607-million investment to meet increased residential demand, refurbish equipment at the end of its useful life and enhance service quality. It also continued development of the Customer Information System (CIS), a project launched in 2003 in order to modernize the division's information systems and improve its business and administrative practices.

It should be mentioned that Hydro-Québec Équipement and Société d'énergie de la Baie James carry out most of the engineering and construction projects of Hydro-Québec Production and Hydro-Québec TransÉnergie.

Financing Activities

Hydro-Québec's borrowing, including cash inflows and outflows related to credit risk management and other financing arrangements, amounted to $1,557 million in 2004, compared to $2,767 million in 2003. The Corporation initially anticipated borrowing $2.5 billion in 2004, but the sale of assets brought in more than $1.0 billion and reduced financial requirements for the year by a corresponding amount. More specifically, Hydro-Québec received $900 million for the sale of its interest in Noverco, and $110 million ($104 million of which has been received) for the sale of its investment in the China-based Meiya Power Company.

Most of the funds borrowed in 2004 were raised through the reopening, on January 16, February 6 and December 3, 2004, of the bond issue launched in 1999 and maturing in February 2035. The three reopenings raised an additional $1,704 million at an average rate of 5.58%.

Another $180 million was raised through two issues of variable-interest notes maturing in 2007.

Transactions performed under agreements signed by Hydro-Québec to mitigate counterparty risk led to cash outflows of $438 million.

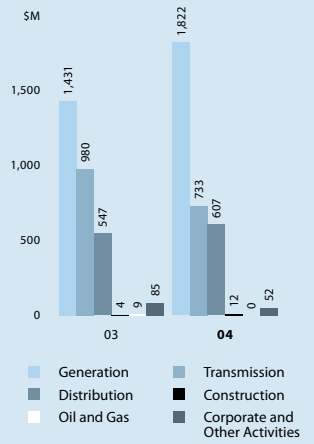
Financial Risks

The financial risks associated with the volatility of interest rates, exchange rates and the price of aluminum are subject to active integrated management. The objective is to limit the impact of unfavorable fluctuations in these factors on the Corporation's results according to criteria determined each year based on risk tolerance.

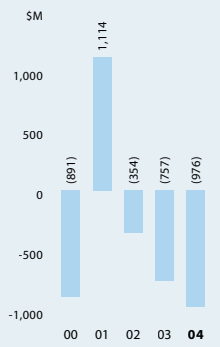
$M	2000	2001	2002	2003	**2004**
Issues	2,116	4,688[a]	2,170	2,767	**1,557**
Redemptions	(3,007)	(3,574)	(2,524)	(3,524)	**(2,533)**

a) Includes a $1.6-billion borrowing for the acquisition of Transelec in October 2000.

Investments in Fixed and Intangible Assets by Segment



Net Issue (Net Repayment) of Long-Term Debt



PREAUTHORIZED FUNDING SOURCES

The Corporation has access to the following preauthorized funding sources:

Type of financing	Authorized volume	Market	Outstanding at December 31, 2004
Credit	US$350M or C$350M		–
	C$40M		–
	US$110M		–
Standby credit[a]	US$1,500M		–
Commercial paper[a]	US$2,250M or equivalent in C$	United States or Canada	C$44M
Medium-term notes[a]	US$3,000M or equivalent in other currency	United States	US$829M
	US$4,000M or equivalent in other currency	Euromarket	US$1,334M
	C$12,000M	Canada	C$8,296M

a) Guaranteed by the Government of Québec.

CREDIT RATINGS

Hydro-Québec's credit ratings are presented in the table below:

	2004	2003
U.S. agencies		
Moody's	**A1 positive**	A1 positive
Fitch Ratings	**AA– stable**	AA– stable
Standard & Poor's	**A+ stable**	A+ stable
Canadian agency		
DBRS	**A positive**	A positive

Dividends and Capitalization Rate

Dividends of $1,350 million, or 55.4% of net income, were declared for 2004, since the Corporation had met all the necessary conditions. In fact, Hydro-Québec's year-end capitalization rate was 34.6%. After payment of dividends to the shareholder, our capitalization rate will be 32.8%, up from 29.9% in 2003 as a result of our solid financial performance in 2004.

The dividends declared in 2004 will constitute the eighth consecutive payment to our shareholder and bring the total amount paid since 1998 to almost $5.3 billion.

Integrated Business Risk Management

Like any major corporation, Hydro-Québec has to manage a very diverse portfolio of risks inherent in its activities. This portfolio includes financial risks, risks relating to runoff, weather conditions and management of the power grid, economic and environmental risks and risks relating to regulation, to name only the principal ones.

For several years now, risk monitoring has been integrated into our business processes—including strategic and operational planning—as well as project management and management of the subsidiaries. To make risk management a consistent and systematic part of all our activities, we rely on training, consulting services and standardized practices which promote a common understanding of this concept within the framework of a comprehensive risk management policy.

In addition, we continue to enhance the mechanisms for communication, reporting and integration of risks by strengthening connections between business units, corporate units and the Corporation's Management.

Finally, we have initiated a project aimed at changing our governance processes to align ourselves as closely as possible with the model defined by the U.S. *Sarbanes-Oxley Act*, which applies to publicly traded companies.

Segmented Information

In 1997, the Corporation created the Hydro-Québec TransÉnergie division to comply with the trade rules of the North American wholesale market. It then further segregated its operations, creating other divisions to benefit from electricity market restructuring.

Its operating activities are divided into the same segments as in 2003: Generation, Transmission, Distribution, Construction, and Oil and Gas, as well as Corporate and Other Activities. However, some changes were made to the organizational structure in 2004:

- Management of Hydro-Québec's corporate telecommunications, formerly the responsibility of Hydro-Québec TransÉnergie, was taken over by the Shared Services Centre, which is part of the Corporate and Other Activities segment.
- Since the disposal of Hydro-Québec's interest in Noverco on June 30, 2004, Hydro-Québec Pétrole et gaz has not been active in the pipeline transmission of oil, natural gas and liquid natural gas, nor in gas distribution. The division is focusing its efforts on the company's oil and gas exploration activities and investments.

Segment Highlights

Since debt and financial expenses are managed for the Corporation as a whole and allocated among the various operating segments, income before financial expenses for each segment is presented below. In 2004, as in 2003, the reduction in financial expenses improved each segment's results.

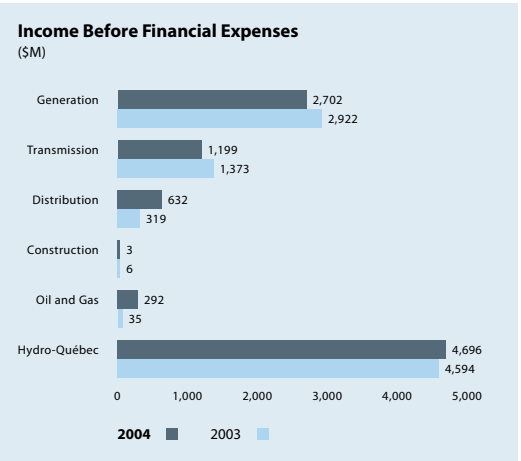
The **Generation** segment recorded income before financial expenses of $2,702 million, versus $2,922 million in 2003. The main reasons for the decrease are reduced net electricity exports—a result of efforts to replenish energy reserves in the first half of the year—and the increase in the depreciation and amortization expense.

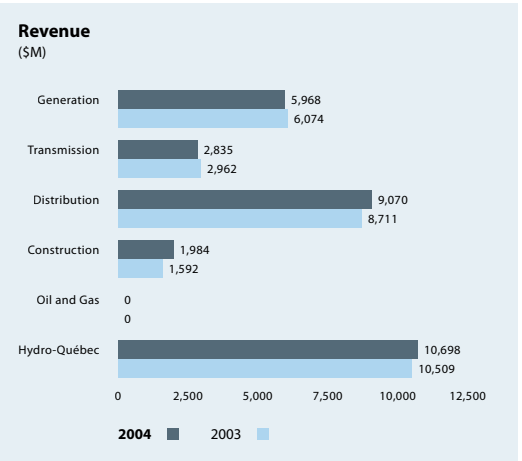
The **Transmission** segment recorded income before financial expenses of $1,199 million, versus $1,373 million in 2003. This result is mainly attributable to a decline in demand for long-term point-to-point transmission service because of the Producer's reduced electricity exports.

The **Distribution** segment recorded income before financial expenses of $632 million, compared to $319 million in 2003. This improvement is essentially due to rate adjustments that took effect in 2004 after a freeze of more than five years.

The **Construction** segment's volume of activity totaled $1,984 million, compared to $1,592 million in 2003. This increase stems from the renewed construction program, initiated in 2003 by Hydro-Québec Production and Hydro-Québec TransÉnergie.

The **Oil and Gas** segment recorded income before financial expenses of $292 million, as against $35 million in 2003. The sale of Hydro-Québec's interest in Noverco accounted for this result.





Generation

Hydro-Québec Production provides Hydro-Québec Distribution with a maximum of 165 TWh of heritage pool electricity annually, at a fixed price of 2.79¢/kWh. Output in excess of this volume is sold on regional markets in the northeastern part of the continent, including Québec, at market prices.

The division operates 58 generating stations. Its capital projects serve a twofold objective: to ensure the long-term operability of existing facilities and to develop Québec's hydroelectric potential.

Operating Results

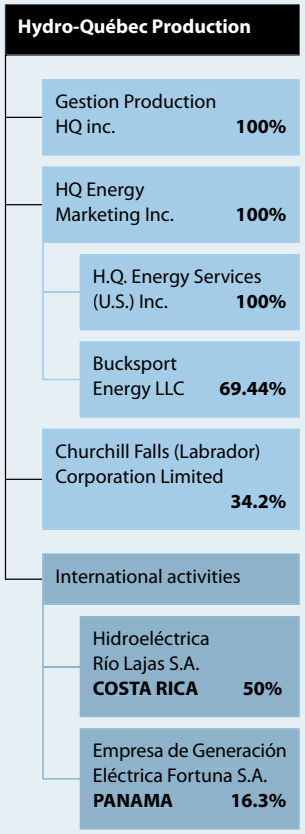
Hydro-Québec Production recorded net income of $1,664 million in 2004, compared to $1,751 million in 2003, a decrease of $87 million (5.0%) due to a reduction in short-term electricity sales transactions on markets outside Québec and an increase in electricity purchases in the first half of the year, both aimed at replenishing energy reserves. In the second half, the division offset the decline in demand from the Distributor by resuming short-term sales transactions. Financial expenses were $1,038 million, down by $133 million.

Electricity Sales to Hydro-Québec Distribution

Electricity sales to Hydro-Québec Distribution totaled 165.3 TWh, versus 166.7 TWh in 2003. However, the maximum volume of heritage pool electricity was not reached in either 2004 or 2003, given that sales to the Distributor include elements that are excluded from the heritage pool, such as the volume for dual energy. The 1.4-TWh (0.8%) decline from 2003 occurred primarily during the last few months of the year, as a result of plant closures and a labor dispute in the smelting and refining sector. Nevertheless, revenue generated by sales to the Distributor rose by $44 million to total $4,557 million, chiefly because of the increase in the price of electricity for the dual-energy market.

Electricity Sales Outside Québec

Electricity sales outside Québec totaled 14.4 TWh, for sales of $1,084 million. The $261-million decline in sales compared to 2003 is mainly attributable to lower short-term sales volume in the first half because of efforts to replenish energy reserves. The decrease in sales to Hydro-Québec Distribution in the second half allowed a gradual resumption of short-term sales on markets outside Québec. In terms of net reservoir drawdown, sales outside Québec (including revenue from energy-related derivative instruments) generated $384 million for 1.5 TWh of drawdown in 2004, compared to $596 million for 4.0 TWh in 2003. The remaining sales, 12.9 TWh in 2004 (11.8 TWh in 2003), chiefly reflect energy trading on U.S. markets. As a result of optimization measures, the net reservoir drawdown, combined with trading transactions, generated a very significant contribution of 25¢/kWh in 2004, compared to 15¢/kWh in 2003.



International Electricity Sales

International sales carried out through corporations in which Hydro-Québec International (HQI) has an ownership interest amounted to $35 million, versus $37 million in 2003, even though HQI withdrew from two Chinese companies during 2004. HQI sold its investments in Meiya Power Company and Hunan C.C. Power Ltd. for total gains on disposal of approximately $7 million.

Electricity and Fuel Purchases

Electricity and fuel purchases amounted to $1,509 million in 2004, a $15-million increase compared to 2003. Purchases for markets outside Québec totaled $750 million, for a volume of 12.2 TWh, as against $701 million for a volume of 11.1 TWh in 2003. This $49-million rise resulted from efforts to replenish energy reserves during the first half of the year. Purchases for the Québec market were also up, by $40 million. However, these factors were partially offset by a decline in transmission system reservation expenses related to lower sales volumes outside Québec.

Operating Expenses

Operating expenses totaled $692 million in 2004, versus $686 million in 2003. The increase was chiefly due to a $21-million rise in pension expense following the termination in 2004 of the application of a credit against the recognized cost of the pension plan. If this item had been excluded, there would have been a $15-million reduction from the previous year. This result attests to productivity gains in operations and is in line with the division's commitment to freeze operating expenses, excluding subsidiaries and holdings, at the budgeted 2003 level.

Depreciation and Amortization

The depreciation and amortization expense was $728 million in 2004, up $59 million from 2003 as a result of the Sainte-Marguerite-3 commissioning and project write-offs including about $7 million for Suroît.

Investing Activities

In 2004, Hydro-Québec Production's investments in fixed and intangible assets affecting cash flow amounted to $1,822 million, of which $1,447 million was spent on hydroelectric projects to increase the total generating capacity. Most of this amount went toward continuing construction on Eastmain-1, Toulnustouc, Péribonka and Mercier, completing Rocher-de-Grand-Mère, continuing with the draft-design studies for the Eastmain-1-A powerhouse and Rupert River diversion project (which now includes Sarcelle powerhouse) and starting the draft-design studies for the Romaine complex.

In addition, the division invested $375 million in upgrading and improving its fleet. This work focused on modernizing power stations, maintaining or increasing their performance and extending their useful lives. The key projects for 2004 were the ongoing rehabilitation of Beauharnois, Outardes-3 and Outardes-4 generating stations.

Risk Management

Hydro-Québec Production manages its business risks in a context in which the principal uncertainties relate to natural runoff conditions. The division must ensure that there is sufficient supply to meet its heritage pool and contractual obligations, which means maintaining an energy reserve to cover any runoff deficits. The reserve must be sufficient to cover a deficit of 64 TWh over two consecutive years, and 98 TWh over four consecutive years.

Hydro-Québec Production's strategy is based primarily on multiyear management of energy reserves and on maintaining an adequate cushion between its generating capacity and its contractual commitments. This gives the division enough flexibility to compensate for runoff fluctuations, replenish its reserves or take advantage of business opportunities. The construction projects currently being studied or under way will give it an annual margin of approximately 20 TWh in 2012.

Transmission

Hydro-Québec TransÉnergie transmits power that meets customers' quality requirements at the lowest possible cost. Acting from a sustainable development perspective, the division ensures the reliability, long-term operability and optimal deployment of the power transmission system in Québec. It is also responsible for the transmission system's telecommunications network. On January 1, 2004, the division transferred its corporate telecommunication operations to Hydro-Québec's Shared Services Centre.

Hydro-Québec TransÉnergie's transmission operations in Québec fall under the exclusive jurisdiction of the Régie de l'énergie. In September 2004, the division filed the first phase of its 2005 rate application, aimed at increasing revenue from $2,609 million (the figure approved by the Régie in 2001) to $2,622 million, a $13-million rise. This increase will have no impact on Québec customers in 2005 since rates will not be reviewed until the second phase of the application, which will be filed early in 2005.

Considered a leader in the design, operation and maintenance of power transmission facilities, Hydro-Québec TransÉnergie manages and operates systems abroad, where it also carries out profitable infrastructure projects.

Operating Results

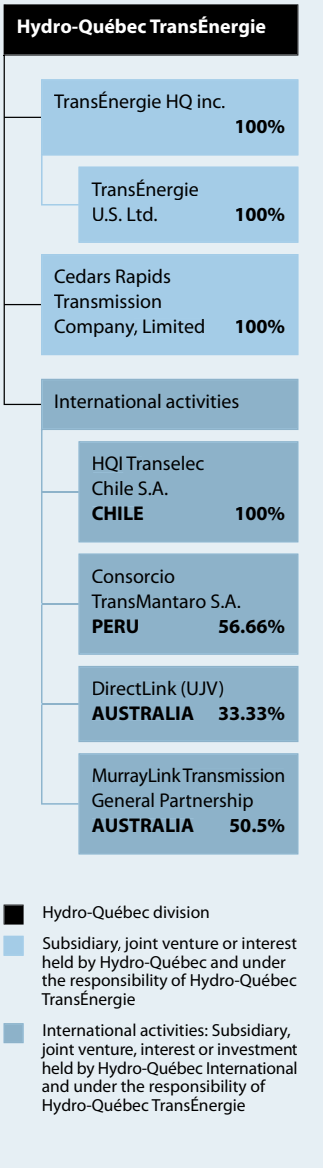
Net income was $365 million in 2004, down $30 million from 2003, mainly as a result of lower sales in regulated activities, an increase in depreciation and amortization expense and the discontinuance of hedge accounting for international operations following the adoption of the guideline on fair value accounting. These items were offset by a decrease in financial expenses for regulated and unregulated activities.

Sales amounted to $2,835 million, down $127 million from 2003. The decrease is due to a $111-million reduction in revenue from long-term reservations for point-to-point transmission service. Regulated activities accounted for 87.0% of sales, versus 86.2% in 2003.

Operating expenses totaled $712 million in 2004, as against $733 million in 2003, for a decrease of $21 million (2.9%). The division fulfilled its commitment to freeze operating expenses, excluding those for subsidiaries and holdings, at the budgeted 2003 level.

Depreciation and amortization expense stood at $668 million, up $44 million over 2003. The increase was chiefly due to the commissioning of large facilities at the end of 2003, the write-off of capital expenditures and development expenses related to projects in the United States, and the depreciation of transmission assets for the northern Chile system acquired in 2003.

Financial expenses were $834 million in 2004, down $144 million from 2003.



Investing Activities

In 2004, Hydro-Québec TransÉnergie's investments in fixed and intangible assets affecting cash flow amounted to $733 million: $540 million for regulated activities, $55 million for unregulated activities and $138 million for international activities.

Regulated Activities

More than two-thirds of the investments made in 2004 were to ensure the long-term operability of the system and maintain or improve the quality of the division's assets. These investments included $27 million for the construction of the Montérégie loop, $15 million of which was spent on bringing the Montérégie substation onto the 120-kV grid. The commissioning of this substation in November 2004 marked the end of this project, which the division launched after the 1998 ice storm in order to enhance system reliability in southern Québec, including Montréal; the total cost was $428 million.

Growth in demand dictated close to 30% of the amount invested in transmission system development in 2004. The division almost doubled its investments compared to 2003 in order to increase system capacity, in line with the rise in Hydro-Québec Distribution's native load, as well as to integrate power from new facilities. In this regard, the connection projects for Toulnustouc and Eastmain-1 generating stations cost $78 million in 2004. The Toulnustouc project involves building a 315-kV single-circuit line extending approximately 55 km between the new generating station and Micoua substation, which will need to be modified as a result, as will Bergeronnes and Jacques-Cartier substations. This project represents a total investment of $81 million, including $65 million in 2004. The line is scheduled to be commissioned in 2005. Connecting the future Eastmain-1 powerhouse, a project launched in 2004, will bring 480 MW onto the grid, as well as the eventual output from Eastmain-1-A and Sarcelle powerhouses. The work, slated for completion in 2006, cost $13 million in 2004.

In August 2004, the Régie de l'énergie approved the installation of de-icing equipment at Lévis substation. The purpose of this $191-million project, of which $5 million was invested in 2004, is to enhance the security of the power supply at three 735-kV source substations in the Québec City area (Laurentides, Jacques-Cartier and Lévis). The equipment should be commissioned in fall 2006.

The division rolled out a variable-frequency transformer (VFT) at Langlois substation during the year. This new interconnection technology uses a 100-MW converter to optimize interchanges between asynchronous networks.

Unregulated Activities

More than 80% of the investments made in 2004 were earmarked for maintaining assets and responding to the growth in demand for transmission system telecommunication services.

International Activities

HQI Transelec Chile S.A., the leading power transmission provider in Chile, inaugurated a new 500-kV transmission system in September 2004. This $163-million project—the biggest in 20 years in the Chilean power transmission sector—was self-funded from Transelec's equity.

Risk Management

Hydro-Québec TransÉnergie practises integrated risk management in the course of its day-to-day operations, according to priorities that are updated periodically.

The division must connect new energy sources (wind, private production, etc.) to its system without compromising service reliability. It must also comply with the increasingly strict reliability standards imposed by North American authorities since the major blackout in summer 2003. At the same time, the division is implementing the necessary measures to help its personnel adapt to technological and organizational changes.

Distribution

Hydro-Québec Distribution provides Quebecers with electricity, and its ongoing concern is for the security and reliability of the power supply as well as for offering a range of services tailored to its customers' needs. The Régie de l'énergie is the only competent authority for setting rates and conditions applicable to power distribution.

In February 2004, the Régie approved an across-the-board rate increase of 1.41%, taking effect on April 1, 2004; this increase followed closely on a first rate adjustment of 3% that took effect on January 1. Moreover, recognizing that the dual-energy Rate BT gives some customers an advantage and that the terms for its application are no longer in step with the market, in August 2004 the Régie approved the rescission of this rate effective April 1, 2006. Finally, Hydro-Québec Distribution filed its 2005–2006 rate application on September 30, 2004, proposing an adjustment that chiefly reflects the increased cost of supply and higher financial expenses. In February 2005, the Régie authorized an adjustment on the order of 1.2%, effective April 1, 2005.

To meet needs in excess of the annual heritage pool, Hydro-Québec Distribution essentially relies on calls for tenders. In 2004, the division signed two 20-year contracts for the purchase of electricity produced by biomass and accepted eight bids for the supply of wind power, also for a 20-year term. The Régie approved the biomass power supply contracts in June, and the wind power contracts, signed in February 2005, are now pending approval. With respect to the increase in short-term demand, the calls for tenders issued in 2004 led to the signing of contracts that will cover a significant portion of the excess requirements projected in 2005.

At the end of 2004, the supply portfolio reflected the strategies outlined in the Electricity Supply Plan 2002–2011. On November 1, 2004, Hydro-Québec Distribution submitted a second plan to the Régie, this time for the period from 2005 to 2014. The supply plan, which is revised every three years, presents the strategies developed to meet electricity needs.

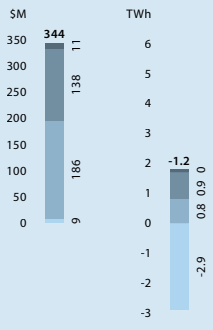
Hydro-Québec Distribution

- Hydro-Québec ValTech inc. **100%**
  - HydroSolution, Limited Partnership **100%**
- Centre d'innovation sur le transport d'énergie du Québec (CITEQ) inc. **50%**

Hydro-Québec division

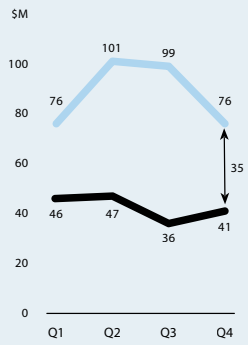
Subsidiary, joint venture or interest held by Hydro-Québec and under the responsibility of Hydro-Québec Distribution

Change in Electricity Sales by Category



Industrial
Residential and farm
General and institutional
Other

Cumulative Effect of Temperature in Comparison to the Norm



2004
2003
Normal temperature

Operating Results

Hydro-Québec Distribution had net income of $287 million in 2004, compared to a $133-million net loss in 2003. This improvement was driven by rate adjustments ($321 million) and a reduction in financial expenses ($107 million).

Regulated Activities

ELECTRICITY SALES IN QUÉBEC BY CATEGORY

	Sales Volume			Sales Revenue		
	2004	2004–2003 Change		**2004**	2004–2003 Change	
	TWh	TWh	%	$M	$M	%
Residential and farm	**58.0**	0.8	1.4	**3,690**	186	5.3
General and institutional	**33.2**	0.9	2.8	**2,234**	138	6.6
Industrial	**69.7**	(2.9)	(4.0)	**2,751**	9	0.3
Other	**5.0**	0.0	–	**247**	11	4.7
Total	**165.9**[a]	(1.2)	(0.7)	**8,922**	344	4.0

a) The maximum volume of heritage pool electricity was not reached in 2004 because the 165.9-TWh total includes sales at rates not included in the heritage pool, among other things.

Revenue from electricity sales rose by $344 million over 2003, in spite of a 1.2-TWh reduction in sales volume. The increase in revenue is chiefly attributable to the 2004 rate adjustments, while the decrease in volume is due to reduced demand in the industrial category.

FACTORS IN THE 2004–2003 CHANGE IN SALES BY CATEGORY

	Demand		Temperature			Leap Year	Rate Adjustments	Other
	TWh	$M	TWh	$M	TWh	$M	$M	$M
Residential and farm	1.0	62	(0.4)	(21)	0.2	12	137	(4)
General and institutional	1.2	66	(0.4)	(13)	0.1	6	86	(7)
Industrial	(3.1)	(78)	–	–	0.2	7	89	(9)
Other	0.0	4	0.0	(1)	0.0	1	9	(2)
Total	(0.9)	54	(0.8)	(35)	0.5	26	321	(22)

Although total demand fell by 0.9 TWh, revenue was up $54 million in 2004. While industrial demand decreased by 3.1 TWh, creating a $78-million shortfall, demand from the other customer categories increased by 2.2 TWh, generating $132 million in additional revenue. Plant closures and a labor dispute in the smelting and refining sector contributed to the drop in industrial consumption, while the strong economy, especially in housing starts, stimulated demand in the other categories.

A return to more normal temperatures translated into a 0.8-TWh ($35-million) reduction in demand in 2004, mainly in the residential and farm category, which is more sensitive to temperature fluctuations because of its heating requirements. The 1.2-TWh difference between 2004 and 2003 would have been greater had it not been for the fact that 2004 was a leap year, and the February 29 sales of 0.5 TWh ($26 million) partially offset the negative impact of the warmer weather.

Other factors in the change include the appreciation of the Canadian dollar, which resulted in a $31-million decline in revenue from sales in U.S. dollars.

Hydro-Québec Distribution's gross operating margin[a] expanded by $358 million over 2003, primarily because of the rate adjustments and, to a lesser degree, growth in demand from customers other than industrial.

Total expenditure, excluding electricity and fuel purchases, was $1,544 million, up $58 million (3.9%) over 2003 on account of the $38-million (4.0%) growth in operating expenses, primarily as a result of the $34-million increase in pension expense following the termination in 2004 of the application of a credit against the recognized cost of the pension plan. If this item had been excluded, operating expenses would have been stable compared to the previous year, despite the increase in the number of customers. This result is in line with the division's commitment to freeze operating expenses at the budgeted 2003 level.

a) The gross operating margin is equal to total electricity sales, including intersegment sales, less electricity and fuel purchases.

Unregulated Activities and International Activities

Hydro-Québec Distribution's unregulated activities are the responsibility of the subsidiary Hydro-Québec ValTech, while its international activities are carried on through Hydro-Québec International. Net income from these activities amounted to $3 million in 2004, unchanged from 2003.

Investing Activities

In 2004, Hydro-Québec Distribution's investments affecting cash flow totaled $607 million in the course of its day-to-day operations: specifically, $506 million in fixed assets and $101 million in intangible assets, chiefly in information technology development.

Of the overall amount, $600 million was spent on regulated activities, while $7 million went toward unregulated activities carried on through Hydro-Québec ValTech.

Regulated Activities

Investments in fixed assets amounted to $499 million, broken down as follows: $190 million to overhaul equipment at the end of its useful life and carry on with the rehabilitation of the Montréal underground grid; $235 million to handle growth in demand, including $186 million to supply new customers; $30 million to enhance service quality; and $44 million to meet government requirements (such as undergrounding programs) and third-party requests.

The $101 million invested in intangible assets went primarily toward quality improvement efforts, such as the CIS project ($75 million) and the Dcartes project ($17 million). The purpose of the CIS (Customer Information System) project, initiated in 2003 and slated for completion in 2007, is to improve business and administrative practices and modernize information systems. The Dcartes team is developing a computer program to optimize distribution system planning and design. Deployment is scheduled for 2005.

Hydro-Québec Distribution also invested $41 million in the Energy Efficiency Plan 2003–2006, filed with the Régie de l'énergie in November 2002. In October 2004, the division submitted a new plan covering the period from 2005 to 2010 and calling for investments on the order of $1 billion to reduce energy consumption by at least 3 TWh by 2010. Achievement of this target also hinges on the investment of $47 million by government partners and $641 million by participating customers. These customers may be able to save $1 billion over the life of the energy conservation measures they adopt.

Risk Management

The principal risk factors that will influence Hydro-Québec Distribution's management in the coming years are described below.

Domestic Demand in Excess of the Heritage Pool

Part of Hydro-Québec Distribution's mandate is to ensure security of supply for Québec customers. According to projections, the heritage pool electricity at its disposal will be used to its full extent starting in 2005. To meet demand beyond this volume, the division will be required to buy electricity at market prices.

Hydro-Québec Distribution's supply responsibility implies high exposure to risks due to changes in weather conditions, fluctuations in demand, market price volatility and uncertainties relating to long-term supply contracts. These uncertainties relate, among other things, to supplier equipment failures and fluctuations in certain price components, such as inflation, exchange rates and fuel prices. To mitigate these risks, the Distributor relies on a supply process that offers the necessary flexibility while promoting competition between potential suppliers. The process includes several measures, such as:

- Calls for tenders to award long-term supply contracts
- Conditions in calls for tenders that would allow the quantities to be changed up to the time the contracts are awarded, as well as options to postpone delivery start dates when appropriate under the circumstances
- Guarantees to protect against suppliers' failure to deliver
- Ongoing consideration of new energy management options, close monitoring of the Energy Efficiency Plan approved by the Régie, and deployment of a strategy for the rescission of Rate BT

In addition, as part of its 2005–2006 rate application, Hydro-Québec Distribution asked the Régie de l'énergie to approve the principle of transferring costs. This principle would enable it to recognize in its cost of service any increase in the cost of supply in excess of the heritage pool due to unforeseen changes in volume or price. In February 2005, the Régie authorized the division to create a deferred charges account for fiscal 2005 to cover all supply risks above a threshold equivalent to a standard deviation of ±1.9 TWh attributable to weather conditions.

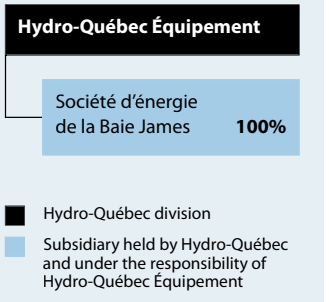
Unusual Events

The risk related to unusual events that could cause major service interruptions is also considered important. To reduce this risk, mitigate its effects and ensure service continuity for Québec customers, Hydro-Québec Distribution has introduced an internal emergency and backup plan. Harmonized with the corporate emergency plan, this plan guarantees appropriate communication with the competent public authorities. Mutual assistance agreements and ongoing exchange with several electricity providers in New Brunswick, Ontario and the United States also help minimize the potential impact of this risk.

Construction

Hydro-Québec Équipement carries out engineering and construction projects related to hydroelectric development throughout Québec, except in the territory governed by the *James Bay and Northern Québec Agreement*, where such work is handled by Société d'énergie de la Baie James (SEBJ). Hydro-Québec Équipement also builds power transmission lines and substations throughout Québec.

As engineering and environmental specialists, Hydro-Québec Équipement and SEBJ also undertook or continued surveys and draft-design studies with a value of more than $95 million in 2004. The purpose of these mandates included producing technical studies and reports to support major initiatives such as the Eastmain-1-A powerhouse and Rupert diversion project, which now includes Sarcelle powerhouse, and the Romaine complex.



Volume of Activity

In 2004, Hydro-Québec Équipement and SEBJ carried out work worth a total of $1,984 million, compared to $1,592 million in 2003, a 24.6% increase that reflects renewed capital spending by Hydro-Québec. Work done for Hydro-Québec Production totaled $1,524 million, versus $1,057 million in 2003, while work done for Hydro-Québec TransÉnergie amounted to $426 million, as against $484 million in 2003.

In all, the current projects of Hydro-Québec Équipement and SEBJ will add more than 600 MW to the Corporation's generating capacity in 2005, and more than 1,700 MW by 2008.

Hydro-Québec Équipement

In 2004, Hydro-Québec Équipement carried out activities worth $1,402 million, up $170 million (13.8%) from 2003. This sharp increase reflects continuing work on or completion of many projects in the Generation and Transmission segments, including power plant rehabilitation at Beauharnois, Outardes-3, Outardes-4, Grand-Mère, Rapide-2 and Rapide-7, construction of generating stations at Toulnustouc, Péribonka, Rocher-de-Grand-Mère and Mercier, and the connection of Toulnustouc, Eastmain-1 and Mercier generating stations to the Hydro-Québec system. The division also completed the Montérégie loop and began work under the PACT 1 program to increase transmission capacity.

Société d'énergie de la Baie James

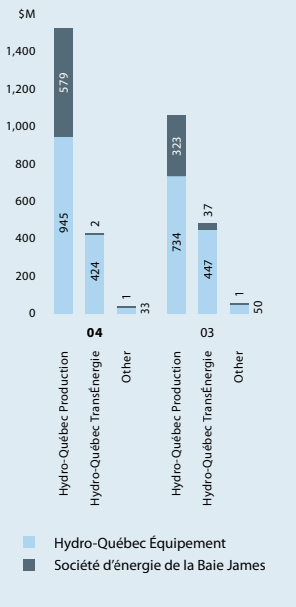
SEBJ's activities—mainly on behalf of Hydro-Québec Production—represented a total investment of $582 million in 2004, compared to $358 million in 2003. This strong increase is basically attributable to the ongoing construction of Eastmain-1 powerhouse. SEBJ also completed and filed the impact statement for the Eastmain-1-A/Rupert project.

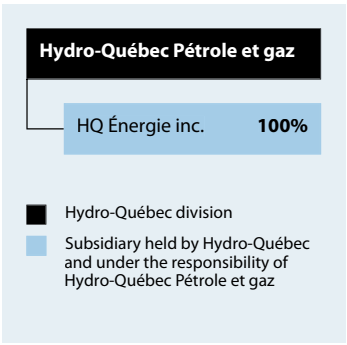
Risk Management

Rising electricity demand in the long term will have a strong impact on the Construction segment. Its volume of activity, currently on the increase, depends on the future of several major projects for which Hydro-Québec may have trouble obtaining the necessary approvals. This is why steps have been taken to speed up the authorization process. Promising breakthroughs in this regard have already been made in certain projects, including the Péribonka River development initiated in 2004.

Activities of the Construction Segment

Breakdown of the volume of activity





Oil and Gas

The mission of Hydro-Québec Pétrole et gaz is to tap Eastern Québec's oil and gas potential. The division also managed Hydro-Québec's interest in Noverco until it was sold on June 30, 2004, for $900 million.

In 2004, its oil and gas exploration activities were restricted to a few sites on the Gaspé Peninsula and Anticosti Island.

Operating Results

The net income of Hydro-Québec Pétrole et gaz totaled $292 million, versus $35 million in 2003. This increase is attributable to a gain of $265 million on the sale of Hydro-Québec's interest in Noverco.

Risk Management

The division's risk management strategy focuses mainly on exploration activities. Hydro-Québec Pétrole et gaz exercises tight control over the aggregate financial commitments associated with these activities.

Corporate and Other Activities

Corporate and Other Activities includes the division Hydro-Québec Technologie et développement industriel, shared services and all corporate activities.

Results

A net loss of $123 million was recorded in 2004, compared to a net loss of $110 million in 2003. The 2004 loss stems primarily from the activities of Hydro-Québec Technologie et développement industriel.

Hydro-Québec Technologie et développement industriel

The role of Hydro-Québec Technologie et développement industriel is to create value from Hydro-Québec technologies and ensure the integrated management of technological innovation. The division includes Hydro-Québec's research institute and two subsidiaries, Hydro-Québec IndusTech and Hydro-Québec CapiTech.

In 2004, the research institute implemented optimization measures that brought the cost of its technological and strategic innovation activities and its support and consulting services down to $87 million, from $99 million in 2003.

INSTITUT DE RECHERCHE D'HYDRO-QUÉBEC

Hydro-Québec's research institute provides technical support and carries out technological innovation projects to foster the operating divisions' solid performance and ensure the Corporation's long-term viability. It focuses on Hydro-Québec's core businesses: the generation, transmission and distribution of electricity.

HYDRO-QUÉBEC INDUSTECH

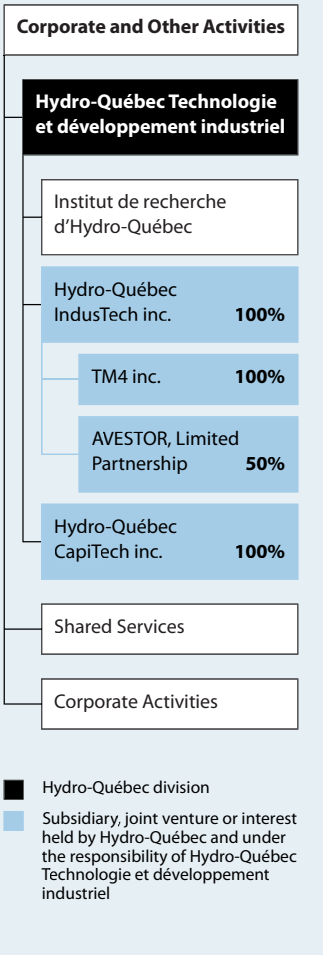
The mission of Hydro-Québec IndusTech is to work with the private sector to industrialize and market technologies resulting from Hydro-Québec's research activities and offering new avenues for growth. Its portfolio currently comprises interests in AVESTOR, TM4 and the PSEV project (Propulsion Systems for Electric Vehicles).

Hydro-Québec IndusTech posted a net loss of $51 million in 2004, compared to a net loss of $46 million in 2003. The 2004 loss is attributable to AVESTOR's continued fine-tuning of the manufacturing process for lithium-metal-polymer (LMP) batteries. The company plans to target the telecommunications market, for which it will provide a line of batteries designed to power backbone facilities in the event of blackouts.

HYDRO-QUÉBEC CAPITECH

The venture capital company Hydro-Québec CapiTech invests in energy businesses that market or are about to market promising technologies, thereby giving Hydro-Québec privileged access to outside innovations.

In 2004, Hydro-Québec CapiTech recorded a $37-million net loss following a revaluation of its investment portfolio and the consequent recognition of an other-than-temporary impairment in value of $35 million.



Shared Services Centre

The Shared Services Centre helps the Corporation carry out its mission and achieve its objectives by providing divisions and corporate units with a broad spectrum of services: procurement of goods and services, materials management, real estate management, transportation services, accounting services, document management, office automation, computer-based solutions, information technology operations, corporate telecommunications and a management systems competency centre. Its mandate is to provide its customers with quality services tailored to their needs at the lowest possible cost so that they can concentrate on their core businesses.

The Shared Services Centre's income totaled $732 million in 2004, versus $612 million in 2003. This $120-million increase is chiefly attributable to the reintegration of corporate telecommunication operations. By implementing various optimization measures in 2004, the Centre cut the cost of goods and services by 3.1% compared to budgeted costs, in spite of inflation and a slight increase in demand.

Corporate Activities

Corporate activities include financial services, human resources, corporate affairs, strategic planning coordination and cases or files to be submitted to the Régie de l'énergie.

The Finance Group manages debt, financial expenses and financial risks (such as interest rate and foreign exchange risks) for the Corporation as a whole and then allocates the financial expenses to the operating segments. As in 2003, the sharp decrease in financial expenses—by about $395 million in 2004—improved each segment's results. In addition, the Group provides corporate risk management support as well as tax and accounting expertise for all the Corporation's business segments. It is also responsible for producing and analyzing the consolidated financial statements, including segmented information, and for managing the pension plan, which has assets of close to $10 billion.

Investing Activities

Investments affecting cash flow totaled $52 million in 2004. The development and purchase of information systems accounted for most of this amount, while investments by Hydro-Québec IndusTech and Hydro-Québec CapiTech stood at $9 million.

Outlook

In 2005, we will continue to work toward the objectives set out in the *Strategic Plan 2004–2008*: increase generating capacity in Québec, maintain customer service quality and create value for the shareholder and Québec society. Expected net income for 2005—slightly more than $2 billion—promises to be higher than projected in the *Strategic Plan 2004–2008* ($1.8 billion). It will, however, be less than the 2004 net income, which was the result of non-recurring items such as the sale of our interest in Noverco and a foreign exchange gain recognized following the write-down of the natural hedge between debts and sales in U.S. dollars. The achievement of our financial objectives will depend on a number of factors: favorable interest and foreign exchange rates, adequate runoff, normal weather conditions, favorable conditions on markets outside Québec, and approval of the rate adjustment requested by the Distributor. In addition, we intend to maintain operating expenses (excluding those of subsidiaries and holdings and the recognized cost of the pension plan) at the budgeted 2003 level.

Hydro-Québec intends to invest nearly $4 billion in 2005. Based on debt maturities and cash from operations, we anticipate a borrowing program of just over $3 billion.

Hydro-Québec Production will continue to increase its generating capacity by developing Québec's hydroelectric potential. Work in progress will therefore continue at a steady pace in 2005: construction of Eastmain-1, Péribonka and Mercier generating stations and rehabilitation of Mercier dam; completion and commissioning of Toulnustouc generating station; rehabilitation of Beauharnois, Outardes-3, Outardes-4, Rapides-des-Quinze and La Tuque generating stations; draft-design studies for the Romaine complex; progress in the environmental assessment process for the Eastmain-1-A powerhouse and Rupert diversion project, which also includes Sarcelle powerhouse, and completion of the process to obtain government approvals for the Chute-Allard and Rapides-des-Cœurs developments.

For **Hydro-Québec TransÉnergie**, improving service quality as well as transmission system reliability and security will continue to be major concerns. Aside from investments to refurbish equipment, the division will continue projects such as the addition of line de-icing equipment at Lévis substation and bringing the output from new facilities onto the grid, including Toulnustouc, Eastmain-1 and the wind farms. It will also continue its international power transmission operations, predominantly in South America, where it already has a substantial presence.

Hydro-Québec Distribution will focus on providing a secure and reliable power supply to Quebecers, on delivering services adapted to its customers' priority expectations, and on promoting energy efficiency. The division will therefore continue to invest in a number of programs to extend, automate and reinforce the distribution grid, in particular to meet growth in demand and maintain its assets. In 2005, the CIS project will reach an important milestone with the delivery of the business customer component and the metering component for all customer categories except large-power customers. Furthermore, in 2005, the division will allocate more resources to the Energy Efficiency Plan than projected in the *Strategic Plan 2004–2008*. It is counting on this initiative to enhance the security of the power supply. As stated in the Electricity Supply Plan 2005–2014 submitted to the Régie de l'énergie in November 2004, stepped-up investment in this area—now budgeted at about $1 billion over an eight-year period (2003–2010)—will generate savings of 3 TWh by 2010.

In order to meet requirements in excess of the heritage pool in 2005, Hydro-Québec Distribution issued calls for about 3.5 TWh in fall 2004. Short-term calls for tenders will be made during the year to cover the end of 2005 and part of 2006.

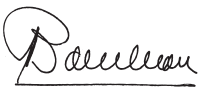
Management Report

Hydro-Québec's consolidated financial statements and all additional information contained in the Annual Report are the responsibility of Management and are approved by the Board of Directors. The financial statements have been prepared by Management in accordance with Canadian generally accepted accounting principles and in accordance with decisions handed down by the Régie de l'énergie with respect to the transmission and distribution of electricity and the distribution of natural gas in Québec. The financial statements include amounts determined based on Management's best estimates and judgment. Financial information presented elsewhere in the Annual Report is in accordance with the information provided in the financial statements.

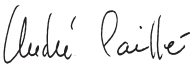
Management maintains an internal control system which includes communicating Hydro-Québec's code of ethics and a code of conduct to employees, primarily to ensure the proper management of resources and the orderly conduct of business. The objective of this system is to provide reasonable assurance that the financial information is pertinent and reliable and that the assets of Hydro-Québec are adequately recorded and safeguarded. An internal auditing process allows evaluation of the sufficiency and efficiency of control, as well as of Hydro-Québec's policies and procedures. Recommendations ensuing from this process are submitted to Management and the Audit Committee.

The Board of Directors is responsible for corporate governance. It assumes its responsibility for the consolidated financial statements principally through its Audit Committee, composed solely of independent directors, who do not hold full-time positions within the Corporation or in one of its subsidiaries. This committee's mandate is to ensure that the financial statements present fairly Hydro-Québec's financial position, the results of its operations and its cash flows. The Audit Committee meets regularly with Management, the General Auditor and the external auditors to discuss the results of their audits and their findings with respect to the integrity and the quality of the presentation of Hydro-Québec's financial information and the effectiveness of its internal control systems. The General Auditor and the external auditors have full and unrestricted access to the Audit Committee, with or without Management's presence.

The consolidated financial statements have been audited jointly by the external auditors, Samson Bélair/ Deloitte & Touche s.e.n.c.r.l. and PricewaterhouseCoopers LLP, who were appointed by the shareholder.



André Bourbeau
Chairman of the
Board of Directors



André Caillé
President and
Chief Executive Officer

Daniel Leclair
Executive Vice President,
Finance and Chief Financial Officer

Montréal, Québec
March 16, 2005

Auditors' Report

To the Minister of Finance of Québec:

We have audited the consolidated balance sheet of Hydro-Québec as at December 31, 2004, and the consolidated statements of operations, retained earnings and cash flows for the year then ended. These financial statements are the responsibility of Hydro-Québec's Management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by Management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Hydro-Québec as at December 31, 2004, and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles. In compliance with the requirements of the *Auditor General Act* (R.S.Q., c. V-5.01), we report that, in our opinion, after giving retroactive effect to the changes in accounting policies and except for the prospective application thereof, as explained in Note 2, these principles have been applied on a basis consistent with that of the preceding year.

Samson Bélair
Deloitte & Touche s.e.n.c.

Chartered Accountants

PricewaterhouseCoopers LLP

Chartered Accountants

Montréal, Québec
March 16, 2005

Consolidated Financial Statements

Consolidated Statement of Operations

For the year ended December 31 $M	Notes	2004	2003 (restated, Note 2)
Revenue		**10,698**	10,509
Expenditure			
Operations		**2,268**	2,174
Electricity and fuel purchased		**1,467**	1,383
Depreciation and amortization	3	**1,941**	1,830
Taxes	4	**620**	576
		6,296	5,963
Operating income		**4,402**	4,546
Financial expenses	5	**2,261**	2,656
Income from continuing operations before non-controlling interest		**2,141**	1,890
Non-controlling interest		**9**	4
Income from continuing operations		**2,132**	1,886
Discontinued operations	6	**303**	52
Net income		**2,435**	1,938

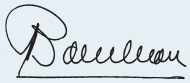
Consolidated Statement of Retained Earnings

For the year ended December 31 $M	Notes	2004	2003 (restated, Note 2)
Balance at beginning of year, as previously reported		**10,863**	9,897
Adjustment for retroactive application of change in accounting policy	2	**1**	(6)
Balance at beginning of year, as restated		**10,864**	9,891
Net income		**2,435**	1,938
		13,299	11,829
Dividends declared	20	**1,350**	965
Balance at end of year		**11,949**	10,864

Consolidated Balance Sheet

As at December 31 $M	Notes	2004	2003 (restated, Note 2)
ASSETS			
Fixed assets	7	**51,589**	50,904
Current assets			
Cash and cash equivalents		**94**	192
Investments		**72**	236
Accounts receivable		**1,954**	1,872
Swaps and sinking funds	9	**43**	101
Materials, fuel and supplies		**328**	426
		2,491	2,827
Other long-term assets			
Investments	8	**252**	794
Swaps and sinking funds	9	**1,671**	884
Trust for nuclear waste management	10	**28**	24
Goodwill	11	**79**	298
Intangible assets	12	**732**	711
Other assets	13	**1,194**	1,289
		3,956	4,000
		58,036	57,731
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt	14	**32,521**	34,351
Current liabilities			
Borrowings		**53**	77
Accounts payable and accrued liabilities		**1,832**	1,603
Dividends payable		**1,350**	965
Accrued interest		**974**	970
Current portion of long-term debt	14	**1,948**	1,629
		6,157	5,244
Asset retirement obligations	15	**264**	234
Other long-term liabilities	16	**2,357**	2,005
Perpetual debt	17	**391**	440
Non-controlling interest		**126**	329
Shareholder's equity	20		
Share capital		**4,374**	4,374
Retained earnings		**11,949**	10,864
Translation adjustment		**(103)**	(110)
		16,220	15,128
		58,036	57,731

Yvon Lamontagne
Chairman of the Audit Committee



André Bourbeau
Chairman of the Board of Directors

Consolidated Statement of Cash Flows

For the year ended December 31 $M	Notes	2004	2003 (restated, Note 2)
Operating activities			
Income from continuing operations		**2,132**	1,886
Depreciation and amortization of fixed and intangible assets		**1,845**	1,750
Amortization of deferred charges		**35**	76
Amortization of other deferred charges (credits) related to debt		**(225)**	118
Change in non-cash working capital items	21	**(3)**	(61)
Other		**216**	26
		4,000	3,795
Investing activities			
Fixed and intangible assets		**(3,226)**	(3,052)
Long-term investments		**107**	39
Disposal of investments, net of divested cash and cash equivalents		**894**	–
Net change in short-term investments		**159**	697
Other		**(64)**	3
		(2,130)	(2,313)
Financing activities			
Issue of long-term debt		**1,916**	2,300
Maturity of long-term debt and sinking fund redemption		**(1,802)**	(2,697)
Prepayment of long-term debt		**(738)**	(897)
Inflows (outflows) resulting from credit risk management		**(438)**	257
Net change in short-term borrowings		**(9)**	9
Dividends paid		**(965)**	(763)
Other		**79**	210
		(1,957)	(1,581)
Change in foreign exchange on cash and cash equivalents		**(3)**	(5)
Cash flows from continuing operations		**(90)**	(104)
Cash flows from discontinued operations	6	**(8)**	3
Net change in cash and cash equivalents		**(98)**	(101)
Cash and cash equivalents at beginning of year		**192**	293
Cash and cash equivalents at end of year		**94**	192
Additional disclosures with respect to cash flows	21		

Amounts shown in tables are in millions of Canadian dollars except where indicated otherwise.

Note 1 Significant Accounting Policies

Under the provisions of the *Hydro-Québec Act*, the government corporation Hydro-Québec (the "Corporation") is mandated 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. The Corporation is required, in particular, to supply heritage pool electricity in compliance with *An Act respecting the Régie de l'énergie*.

The consolidated financial statements include the accounts of the Corporation, its subsidiaries, all of which are wholly owned, and its joint ventures (collectively "Hydro-Québec").

Regulation

An Act respecting the Régie de l'énergie grants the Régie de l'énergie (the "Régie") exclusive authority to determine or modify the rates and conditions under which electricity is transmitted and distributed by the Corporation. Consequently, the Corporation's electricity transmission and distribution activities in Québec are said to be regulated. Moreover, this Act stipulates that rates are determined on a basis that allows for recovery of the cost of service plus a fair rate of return on the rate base.

The Corporation's electricity transmission operations are subject to decision D-2002-95, handed down by the Régie in April 2002. In this decision, the Régie established the cost of service and granted a rate of return of 9.72% on the rate base, assuming a capital structure with 30% shareholder's equity.

The Corporation's power distribution operations are regulated by a series of decisions issued by the Régie from May 2003 to March 2004 (D-2003-232, D-2004-47 and D-2004-57) regarding the recognition of regulatory principles and practices to be applied in determining rates. Across-the-board rate increases of 3% and 1.41%, effective as of January 1 and April 1, 2004, respectively, were granted in these decisions, following which the rate of return on the rate base granted by the Régie to the Distributor was set at 7.99%, assuming a capital structure with 35% shareholder's equity.

The consolidated financial statements take into account certain regulatory accounting practices authorized by the Régie and applied to the Corporation's regulated activities. These practices differ from those applied in unregulated enterprises and relate mainly to the capitalization of net costs associated with disposals of fixed and intangible assets; the government reimbursement for the 1998 ice storm; deferred charges for incentive payments to customers affected by the rescission of dual-energy Rate BT, amortized as of April 1, 2006; deferred charges related to the Energy Efficiency Plan 2003–2006 and their amortization; as well as the capitalization of financial expenses to fixed assets under construction, including return on shareholder's equity authorized by the Régie. In addition, the method of establishing the cost of the debt accepted by the Régie incorporates the impact of long-term derivative instruments used in the context of integrated risk management.

If rates were not regulated, the net costs associated with disposals of fixed assets, certain charges related to the Energy Efficiency Plan 2003–2006, and the deferred charges in connection with the rescission of dual-energy Rate BT would be included in Expenditure for the year in which they were incurred. The government reimbursement for the 1998 ice storm would be amortized over generally longer periods, and the capitalization of financial expenses would not include return on shareholder's equity.

Consolidation

Interests in joint ventures are accounted for using the proportionate consolidation method. Investments in companies over which Hydro-Québec can exercise a significant influence are accounted for on an equity basis, whereas venture capital investments are generally recorded at cost. Other long-term investments are also recorded at cost.

The operations and cash flows of Hydro-Québec International holdings are consolidated with a one-quarter lag. The financial position of these holdings disclosed in Hydro-Québec's consolidated balance sheet is as at September 30. If significant transactions or events occur during the fourth quarter, they are reflected in Hydro-Québec's financial statements for its fiscal year.

Use of estimates

The preparation of consolidated financial statements in accordance with Canadian generally accepted accounting principles requires that Management make estimates and assumptions that affect the amounts reported in the financial statements. Actual amounts could differ from those estimates.

Revenue

Revenue is recognized when electricity is delivered or services are rendered. Revenue from sales of electricity in Québec is recorded on the basis of cyclical billings and also includes revenue accrued in respect of electricity delivered but as yet unbilled.

Income taxes

The Corporation and most of its subsidiaries have not recorded any income taxes since they are government-owned and therefore exempt from paying taxes in Canada.

The incorporated subsidiaries and joint ventures subject to income tax use the liability method to account for income taxes.

Foreign currency translation

FOREIGN CURRENCY TRANSACTIONS

Revenue and expenditure resulting from foreign currency transactions are translated into the Canadian dollar equivalents at exchange rates in effect at the transaction date. Monetary assets and liabilities are translated into Canadian dollars at the closing exchange rates in effect at the balance sheet date, and non-monetary items are translated at exchange rates in effect at the transaction date.

The exchange gains or losses resulting from the translation of monetary items are included in the statement of operations, unless they relate to hedging items for anticipated future sales in U.S. dollars in accordance with Accounting Guideline 13 of the *Canadian Institute of Chartered Accountants (CICA) Handbook*, "Hedging Relationships" (AcG-13), in which case they are deferred to the year such sales are made.

FOREIGN OPERATIONS

The financial statements of the main foreign operations considered to be self-sustaining in terms of financial and operational management are translated according to the current rate method using the foreign currency as the measuring unit. Exchange gains or losses are presented as a Translation adjustment under Shareholder's equity. The financial statements of foreign operations considered to be integrated in terms of financial management and operations are translated according to the temporal method.

Fixed assets

Fixed assets are carried at cost, which comprises materials, labor, other costs directly contributing to construction activities and financial expenses capitalized during construction. Contributions from third parties are applied against the cost of the related fixed assets.

Financial expenses capitalized to fixed assets under construction are determined using the average cost of long-term debt of the Corporation at the end of the previous year. Financial expenses capitalized to fixed assets under construction related to regulated transmission and distribution activities take return on shareholder's equity into account. The portion that corresponds to return on shareholder's equity is included in Revenue in the consolidated statement of operations.

The costs of fixed assets under construction are transferred to fixed assets in service when construction is completed and the facilities are commissioned.

Note 1 Significant Accounting Policies (continued)

Fixed assets are depreciated over their useful lives, primarily using the sinking fund method, at a rate of 3%. Under the *Hydro-Québec Act*, the depreciation period is restricted to a maximum of 50 years. The depreciation periods for the main classes of fixed assets are as follows:

Hydraulic generation	45 to 50 years
Thermal generation, including nuclear	15 to 30 years
Transmission substations and lines	30 to 50 years
Distribution substations and lines	25 to 40 years

When unregulated fixed assets are disposed of, the cost of such assets and the cost of their dismantlement, net of accumulated depreciation and salvage value, are charged to operations for the year. Upon disposal of regulated fixed assets, these costs are charged to a separate account and depreciated over a maximum period of 10 years, using the sinking fund method, at a rate of 3%.

Impairment of long-lived assets

Hydro-Québec reviews the carrying value of its fixed assets whenever events or changes in circumstances indicate that expected undiscounted net cash flows could be less than the carrying amount of the fixed assets. If such is the case, an impairment loss is recognized which corresponds to the amount by which the carrying value exceeds fair value.

Cash and cash equivalents and short-term investments

Cash and cash equivalents comprise cash on hand and liquid short-term investments with a maturity of three months or less from the date of acquisition. Investments with a maturity of three to 12 months are disclosed separately under Current assets in the balance sheet.

Short-term investments are recorded at unamortized cost.

Employee future benefits

The Corporation offers all its employees a contributory defined-benefit pension plan based on final pay, as well as other post-retirement and post-employment benefits.

The cost of pension benefits and other post-retirement benefits provided in exchange for services rendered during the year is calculated using the projected benefit method prorated on years of service, and is based on best-estimate economic and demographic assumptions as determined by Management.

In order to establish its employee future benefit obligations, the Corporation has adopted the following policies:

- Past service costs arising from plan amendments and transitional balances relating to the Pension Plan and other post-retirement benefits as at January 1, 1999, are amortized over periods not exceeding employees' average remaining years of service, which totaled 13 years as at January 1, 2004 (13 years as at January 1, 2003), using the straight-line method.
- Amortization of actuarial gains or losses is recognized in Expenditure for the year if the unamortized net actuarial gain or loss at the beginning of the year exceeds 10% of the value of the accrued benefit obligations or 10% of the market-related value of the assets of the plan, whichever is greater. Amortization corresponds to the excess divided by employees' expected average remaining years of service.

- The expected return on Pension Plan assets is based on a market-related value determined by using a five-year moving average for equity securities held, and by valuing other asset classes at their fair value.
- The value of the benefit resulting from the difference between contributions actually paid by employees and their average contributions projected over the employees' expected average remaining years of service, for the year, is disclosed as a reduction of service cost, as contributions deemed paid. This amount is amortized using the method for amortizing actuarial gains and losses.

Goodwill and intangible assets

The excess of the cost of investments in subsidiaries and joint ventures over the share of the fair value of the net assets acquired is recorded as goodwill. Intangible assets are recorded at cost.

Goodwill and intangible assets with indefinite useful lives are not amortized. These assets are tested for impairment annually or more frequently if events indicate a potential impairment in value. The excess of the carrying amount over the fair value is recorded in the statement of operations for the year in which the impairment is determined.

Intangible assets with finite useful lives are amortized over their useful lives. The methods and amortization periods used for these assets are as follows:

Software, licences and patents	straight-line and sinking fund at 3%	3 to 15 years
Rights	sinking fund at 3%	40 years
Environmental studies	sinking fund at 3%	5 years

Sinking funds

Sinking funds are created through the purchase of the Corporation's debentures, Government of Canada bonds, or bonds issued or guaranteed by the Québec government. The Corporation's debentures are deducted from long-term debt, while the other securities are presented under Swaps and sinking funds.

Sinking fund securities are carried at unamortized cost, a method whereby the difference between the cost and the par value at maturity is amortized over the remaining term of the security.

Derivative instruments

As part of integrated risk management, Hydro-Québec uses various derivative instruments to mitigate foreign exchange and interest rate risk associated with long-term debt, the foreign exchange risk related to sales and the risk related to fluctuating energy and raw material prices.

Hedge accounting is applied to derivative instruments designated as being hedged that meet AcG-13 criteria.

- Currency swaps used to manage exchange risk related to long-term debt and sales in U.S. dollars are translated at the closing exchange rates in effect at the balance sheet date. Those representing debit balances are reported as Swaps and sinking funds, while those representing credit balances are presented as Long-term debt. Gains or losses on currency swaps related to payments on long-term debt are included in the statement of operations, while gains or losses on currency swaps related to sales in U.S. dollars are deferred to maturity and recognized as financial expenses for the year in which the sales are made, in accordance with the practice approved by the Régie.
- Interest rate exchanges that arise from currency swap agreements used to change long-term exposure to interest rate risk are off-balance sheet items. They are matched to interest expense on the borrowings to which they are related. The corresponding amounts payable or receivable are recorded as adjustments to accrued interest.

Note 1 Significant Accounting Policies (continued)

- Derivative instruments (forward contracts and swaps) used in the short term to manage financial risk over a period of no more than three years are recorded at cost. Realized gains or losses related to these instruments are deferred off-balance sheet and recognized in the statement of operations in the same period as the hedged item.
- Derivative instruments used to manage risks related to energy price fluctuations are accounted for at cost and the related gains or losses are deferred and charged to operations on a basis consistent with the recognition of the gains and losses of the underlying reverse risk position.

If a derivative instrument no longer satisfies hedging conditions, if it is sold or liquidated, or if Hydro-Québec terminates the designation of the hedging relationship, hedge accounting is no longer applied on a prospective basis. The fair value of the derivative instrument is then accounted for and deferred to be included in the statement of operations during the periods in which the hedged item affects operations. Should the hedged item cease to exist, the gains or losses deferred until then are immediately charged to operations.

When the conditions for hedge accounting cannot be applied, the realized and unrealized changes in fair value are recognized in the statement of operations in the period in which they occur.

The fair value of derivative instruments is based on the spot rates or the forward rates or prices in effect at market closing at the balance sheet date. In the absence of this information for a given instrument, Management uses the available forward rate or price for an equivalent instrument. Different valuation models recognized by financial markets are used to estimate the fair value of options.

Asset retirement obligations

The Corporation accounts for asset retirement obligations in the period in which these legal obligations are incurred when a reasonable estimate of their fair value can be made. The corresponding costs of asset retirement are added to the carrying amount of the related asset and are amortized over its useful life. In subsequent fiscal years, any change due to the passage of time is charged to operating expenses for the current year (accretion expense) and the corresponding amount is added to the carrying value of the liability. The changes resulting from revisions to the timing or the amount of the undiscounted cash flows are recognized as an increase or decrease in the carrying value of the liability associated with the asset retirement obligations, and the corresponding retirement adjustment is accounted for as part of the carrying amount of the related asset.

Estimated cash flows required to settle obligations are determined following studies taking into account various assumptions concerning the methods and timing to be adopted for the retirement of such assets. The Corporation periodically revises the valuation of these cash flows based on the various assumptions and estimates underlying the calculations, possible technological advances and changes in the standards and regulations governing the decommissioning of nuclear generating stations.

Reclassification

Some figures of the previous year have been reclassified in order to respect the presentation adopted in the current year.

Note 2 Changes in Accounting Policies

Recent changes

2003

DISCLOSURE OF GUARANTEES

On January 1, 2003, Hydro-Québec adopted the recommendations of Accounting Guideline 14 of the *CICA Handbook*, "Disclosure of Guarantees" (AcG-14). Under this Guideline, Hydro-Québec is required to disclose information on the guarantees that it has given, regardless of the probability that it will have to make payments under these guarantees. Note 23, "Commitments and Contingencies," describes the disclosures required for guarantees.

DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS

On May 1, 2003, Hydro-Québec adopted the new recommendations of Section 3475 of the *CICA Handbook*, "Disposal of Long-Lived Assets and Discontinued Operations." This section establishes standards for recognition, measurement, presentation and disclosure relating to disposals of long-lived assets. It also provides criteria for classifying assets held for sale and requires that these assets be presented at the lower of cost and fair value, less the cost of disposal. Finally, it provides criteria for classifying a disposal of assets as a discontinued operation and specifies the presentation and disclosure standards for discontinued operations and other disposals of long-lived assets. The adoption of these standards did not have any impact on the financial statements.

2004

HEDGING RELATIONSHIPS

On January 1, 2004, Hydro-Québec prospectively adopted the recommendations of AcG-13 of the *CICA Handbook*. The new Accounting Guideline establishes the conditions for applying hedge accounting. It deals specifically with the identification, designation, documentation and effectiveness of hedging relationships, as well as the discontinuance of hedge accounting. Hedge accounting is applied to derivative instruments used in risk management that conform to hedge accounting eligibility requirements, as described in Note 1. Changes in the fair value of derivative instruments that do not comply with these requirements are charged to operations.

As a result of the adoption of the new Guideline, hedging relationships that are no longer eligible for hedge accounting have been recorded in accordance with the transitional provisions. The difference between the carrying amount and the fair value of derivative instruments used in these hedging relationships has been deferred and will be recognized in the statement of operations for the same period as the gains, losses, revenue or expenditure initially related to the hedged item. Thus, for hedging relationships canceled as at January 1, 2004, the recognition in the balance sheet of derivative instruments at their fair value led to the recording of a deferred loss of approximately $65 million.

IMPAIRMENT OF LONG-LIVED ASSETS

On January 1, 2004, Hydro-Québec prospectively adopted the recommendations of Section 3063 of the *CICA Handbook*, "Impairment of Long-Lived Assets." This section establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets intended for use by Hydro-Québec, and further states that a long-lived asset must be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The test for recoverability is based on a comparison between the carrying amount of the asset and the expected undiscounted net cash flows which are directly associated with the asset and may result from its use and eventual disposal. If the expected undiscounted net cash flows are less than the carrying amount, an impairment loss is recognized corresponding to the amount by which the asset's carrying amount exceeds the fair value, which then becomes the new cost base of the asset. Fair value is based on discounted future cash flows if market prices are not available. The adoption of these standards did not have an impact on the 2004 financial statements.

Note 2 Changes in Accounting Policies (continued)

ASSET RETIREMENT OBLIGATIONS

On January 1, 2004, Hydro-Québec adopted the recommendations of Section 3110 of the *CICA Handbook*, "Asset Retirement Obligations." This standard requires the recognition and measurement of liabilities for legal obligations associated with the retirement of an asset. The liability associated with an asset retirement obligation is measured initially at its fair value in the period in which the obligation is incurred, when a reasonable estimate of fair value can be made. A corresponding retirement cost is added to the carrying amount of the related asset and is amortized over its useful life. In subsequent periods, the liability is adjusted to reflect any changes due to the passage of time and to revisions made to the timing of the asset retirement or the amount of undiscounted cash flows relative to the original estimate. In accordance with the standard, Hydro-Québec applied these changes retroactively and the figures for the previous year have been restated.

The retroactive application of these recommendations resulted in a $1-million increase in retained earnings as at January 1, 2004. The restatement of the 2003 figures resulted in a $17-million rise in operating expenses, a $24-million decrease in amortization expense, a $29-million increase in fixed assets and a $28-million rise in asset retirement obligations.

The adoption of this new standard did not significantly affect the net income of 2004. Fixed assets and asset retirement obligations as at December 31, 2004, increased by $43 million and $59 million, respectively.

The following table presents the impact of the application of the new accounting standard:

	2004	2003
Reported net income	**2,435**	1,931
Adjustment	–	7
Restated net income	**2,435**	1,938

EMPLOYEE FUTURE BENEFITS

On June 30, 2004, Hydro-Québec adopted the recommendations of Section 3461 of the *CICA Handbook*, "Employee Future Benefits," concerning the disclosure of supplementary information intended to help the users of financial statements gain a better understanding of corporations' obligations with respect to employee future benefits.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION

On January 1, 2004, Hydro-Québec also adopted the recommendations of Sections 1100 and 1400 of the *CICA Handbook*, entitled respectively "Generally Accepted Accounting Principles" and "General Standards of Financial Statement Presentation." Section 1100 describes what constitutes Canadian generally accepted accounting principles (GAAP) and their sources. It also provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures, in cases where a matter is not dealt with explicitly in the primary sources of GAAP, thus establishing a new Canadian GAAP hierarchy. Section 1400 provides general instructions on financial statement presentation, and specifies what constitutes fair presentation in accordance with GAAP. The adoption of these standards did not have any impact on the financial statements.

Prospective changes in 2005

INVESTMENT COMPANIES

The CICA has issued Accounting Guideline 18, "Investment Companies." Under this Guideline, investment companies are required to account for their investments at fair value in certain cases where such investments would normally be consolidated or accounted for on an equity basis. Criteria are provided to determine whether a company should be classified as an investment company. Companies that do not meet these criteria will be required to consolidate or account for their investments using the equity method. The Guideline also provides guidance on circumstances where fair value must be used in the financial statements of the parent company or

entity exercising significant influence over the investment company. The provisions of the Guideline are effective for fiscal years beginning on or after July 1, 2004. The adoption of this Guideline could result in a reduction of approximately $5 million in investments and an equivalent increase in operating expenses.

CONSOLIDATION OF VARIABLE INTEREST ENTITIES

The CICA has published Accounting Guideline 15, "Consolidation of Variable Interest Entities." This Guideline provides the consolidation principles applicable to certain entities over which control is exercised other than by voting rights. Its purpose is to provide guidance to determine when an enterprise must include the assets, liabilities and results of the operations of such an entity in its consolidated financial statements. The provisions are effective for fiscal years or interim periods beginning on or after November 1, 2004. Hydro-Québec is currently assessing the impact of this Guideline on the financial statements.

Note 3 Depreciation and Amortization

	2004	2003 (restated, Note 2)
Depreciation of fixed assets	**1,739**	1,637
Amortization of intangible assets	**106**	113
Write-off of projects	**41**	30
Other	**55**	50
	1,941	1,830

Note 4 Taxes

	2004	2003
Capital tax	**324**	296
Tax on gross revenue as municipal real estate tax on certain immovables	**249**	235
Municipal, school and other taxes	**47**	45
	620	576

Note 5 Financial Expenses

	2004	2003
Interest		
Interest on debt securities	**2,520**	2,703
Amortization of borrowing discount and expenses	**42**	43
	2,562	2,746
Exchange loss (gain)	**(213)**	105
Loan guarantee fees	**165**	184
	(48)	289
Less		
Capitalized financial expenses	**236**	350
Net investment income	**17**	29
	253	379
	2,261	2,656

Note 6 Discontinued Operations

On June 30, 2004, Hydro-Québec sold its interest in Noverco Inc. to the Caisse de dépôt et placement du Québec for a cash consideration of $900 million, which generated a gain on disposal of $265 million. Hydro-Québec sold the 54 common shares it held in Noverco Inc., representing 41.2% of the outstanding shares, together with warrants on an additional portion of 9.2% of the shares and subordinated notes with a face value of $285 million. The Corporation had acquired its interest in Noverco in 1997 for $482 million, as an investment in the Oil and Gas segment.

The operating results and cash flows for 2004 and 2003 were presented as discontinued operations. Results and cash flows for these operations are as follows:

	2004	2003
Operations		
Revenue	**822**	936
Net income	**38**	52
Gain on disposal	**265**	–
Income from discontinued operations	**303**	52
Cash flows		
Operating activities	**134**	114
Investing activities	**(73)**	(133)
Financing activities	**(69)**	22
Cash flows from discontinued operations	**(8)**	3

The assets and liabilities of discontinued operations, as at the disposal date, were as follows:

	2004
Cash and cash equivalents	**6**
Other current assets	**155**
Long-term assets	**1,491**
Current liabilities	**137**
Long-term liabilities	**1,169**
Net assets of discontinued operations	**346**

Note 7 Fixed Assets

	In service	Accumulated depreciation	Under construction	2004 Total
Generation				
Hydraulic	27,674	6,763	3,237	**24,148**
Thermal, including nuclear	2,515	1,479	74	**1,110**
Other	806	325	21	**502**
	30,995	8,567	3,332	**25,760**
Transmission				
Substations and lines	21,225	5,539	541	**16,227**
Other	2,186	1,185	28	**1,029**
	23,411	6,724	569	**17,256**
Distribution				
Substations and lines	10,104	3,310	176	**6,970**
Other	2,047	1,036	184	**1,195**
	12,151	4,346	360	**8,165**
Construction	63	48	9	**24**
Oil and Gas	–	–	–	–
Other	1,096	744	32	**384**
	67,716	20,429	4,302	**51,589**

	In service	Accumulated depreciation	Under construction	2003 Total (restated, Note 2)
Generation				
Hydraulic	25,629	6,312	3,280	22,597
Thermal, including nuclear	2,485	1,380	60	1,165
Other	832	334	55	553
	28,946	8,026	3,395	24,315
Transmission				
Substations and lines	20,607	5,068	611	16,150
Other	2,330	1,280	49	1,099
	22,937	6,348	660	17,249
Distribution				
Substations and lines	9,761	3,069	214	6,906
Other	2,014	1,004	146	1,156
	11,775	4,073	360	8,062
Construction	60	47	2	15
Oil and Gas	1,360	469	10	901
Other	846	564	80	362
	65,924	19,527	4,507	50,904

Note 7 Fixed Assets (continued)

As at December 31, 2004, the Corporation had cumulative costs related to suspended draft-design studies amounting to $219 million ($307 million as at December 31, 2003). These costs, for which financial expenses are not capitalized, are presented as fixed assets under construction.

Since the Corporation anticipates carrying out some of these projects at a later date, it periodically reviews the cumulative costs of its draft-design studies.

During such reviews, Management must use estimates and make assumptions that have an impact on the amounts reported for draft-design studies at the balance sheet date. Such projects are assessed in terms of profitability based on prevailing market conditions at the time of their commissioning, compliance with sustainable development principles and how well they are received by local communities. A significant change in the assessment based on these criteria could result in a reduction of the balance for draft-design studies.

When a major project related to regulated fixed assets is discontinued, the costs determined to be non-recoverable are not recorded as operating expenses but are deferred and amortized over a period of three years using the straight-line method.

Note 8 Investments

	Notes	2004	2003
At cost			
Noverco Inc.	6		
Notes		–	142
Churchill Falls (Labrador) Corporation Limited	23		
Bonds[a]		**55**	56
Other[b]		**144**	189
		199	387
At equity			
Enbridge Inc.[c]	6	–	258
Churchill Falls (Labrador) Corporation Limited	23	**53**	48
Meiya Power Company Limited[d]		–	101
		53	407
		252	794

a) Bonds secured by a general mortgage bearing interest at 7.5%, due in 2010, par value of $60 million in 2004 (2003: $62 million).

b) Includes venture capital investments with a carrying value of $72 million and a fair value of $67 million as at December 31, 2004 ($101 million and $70 million as at December 31, 2003). The fair value of listed shares is based on the trading price at the balance sheet date; the fair value of unlisted shares is determined according to different valuation methods.

c) The interest was held by Noverco Inc., which was sold on June 30, 2004.

d) On July 2, 2004, Hydro-Québec sold its investment in Meiya Power for $110 million, generating a gain on disposal of $7 million.

Note 9 Swaps and Sinking Funds

	2004	2003
Swaps	**1,710**	981
Sinking funds	**4**	4
	1,714	985
Less		
Current portion	**43**	101
	1,671	884

Note 10 Trust for Nuclear Waste Management

On November 15, 2002, *An Act Respecting the Long-Term Management of Nuclear Fuel Waste* came into force. This legislation calls for nuclear energy companies that are owners of such waste in Canada to form a waste management organization as a separate legal entity and to set up a trust with a financial institution in order to finance the implementation of the nuclear fuel waste management proposal that will be adopted by the Government of Canada. In order to fulfill the financial responsibilities incumbent on nuclear fuel waste owners, the Corporation deposited an initial amount of $20 million in a trust within 10 days of the date the Act came into force. It will be required to deposit an additional $4 million per year in the same trust until the waste management organization determines the amount to be paid by each nuclear plant owner. The Corporation has been making the required payments since 2002. The sums are invested in short-term marketable securities, and interest accumulated on trust assets is returned to the trust.

Note 11 Goodwill

The changes in the carrying amount of goodwill per reportable segment are as follows:

				2004
	Generation	Transmission	Oil and Gas	Total
Balance at beginning of year	10	68	220	**298**
Changes in foreign exchange	–	1	–	**1**
Disposal of interest	–	–	(220)	**(220)**
Balance at end of year	10	69	–	**79**

				2003
	Generation	Transmission	Oil and Gas	Total
Balance at beginning of year	10	70	222	302
Changes in foreign exchange	–	(2)	–	(2)
Other	–	–	(2)	(2)
Balance at end of year	10	68	220	298

The Corporation performed annual impairment tests and no reduction in the value of goodwill was identified.

Note 12 Intangible Assets

	Cost	Accumulated amortization	2004 Net carrying value
Subject to amortization			
Software and licences	716	473	**243**
Rights	111	35	**76**
Environmental studies	121	102	**19**
Patents	37	20	**17**
	985	630	**355**
Not subject to amortization			
Servitudes			**377**
			732

	Cost	Accumulated amortization	2003 Net carrying value
Subject to amortization			
Software and licences	611	381	230
Rights	110	33	77
Environmental studies	118	95	23
Patents	38	15	23
	877	524	353
Not subject to amortization			
Servitudes			358
			711

The Corporation performed annual impairment tests and no reduction in the value of non-amortizable intangible assets was identified.

Note 13 Other Assets

	Note	2004	2003
Government reimbursement for the 1998 ice storm		**152**	166
Accrued benefit asset	22	**865**	844
Deferred charges		**177**	279
		1,194	1,289

Note 14 Long-Term Debt

Composition and maturities

Debentures, other long-term debt and swaps representing financial liabilities, translated into Canadian dollars at the closing exchange rates in effect at the balance sheet date, are summarized in the following table. These amounts are presented by year of maturity and include the sinking funds.

							2004	2003
	Debt of the Corporation							
Maturity	Canadian dollars	U.S. dollars	Other currencies	Sinking funds	Total	Subsidiaries and joint ventures	Total	Total
2004	–	–	–	–	–	–	**–**	1,629
2005	1,053	715	159	(19)	1,908	40	**1,948**	2,465
2006	1,328	1,569	299	(72)	3,124	75	**3,199**	3,331
2007	1,500	562	26	(325)	1,763	224	**1,987**	2,106
2008	186	31	1,288	–	1,505	12	**1,517**	1,704
2009	496	36	6	(4)	534	22	**556**	–
1 to 5 years	4,563	2,913	1,778	(420)	8,834	373	**9,207**	11,235
6 to 10 years	3,201	2,663	105	(208)	5,761	691	**6,452**	7,435
11 to 15 years	241	532	614	(43)	1,344	31	**1,375**	1,380
16 to 20 years	4,679	2,532	–	(106)	7,105	78	**7,183**	7,373
21 to 25 years	66	2,166	–	(167)	2,065	1	**2,066**	1,311
26 to 30 years	1,055	1,342	–	(11)	2,386	–	**2,386**	3,426
31 to 35 years	4,649	–	–	(87)	4,562	–	**4,562**	3,062
36 to 40 years	285	–	–	–	285	–	**285**	278
41 to 45 years	12	–	–	–	12	–	**12**	–
46 to 50 years	82	–	–	–	82	–	**82**	50
51 to 55 years	–	–	–	–	–	–	**–**	–
56 to 60 years	859	–	–	–	859	–	**859**	430
	19,692[a]	12,148	2,497	(1,042)[b]	33,295[c]	1,174	**34,469**	35,980
Less								
Current portion	1,053	715	159	(19)	1,908	40	**1,948**	1,629
	18,639	11,433	2,338	(1,023)	31,387	1,134	**32,521**	34,351

a) Includes $155 million and $341 million in zero-coupon bonds, reported at their discounted value at a semiannually computed interest rate of 10.95% and 10.67%, respectively. Their par value will reach $282 million and $1,729 million in 2010 and 2020, respectively. Other bonds, reported at their discounted value and amounting to $1,189 million, will reach a par value of $1,333 million at maturity.

b) The sinking funds include a special fund created for the majority of the significant discounted debt. This fund totaled $425 million as at December 31, 2004 ($152 million as at December 31, 2003).

c) Includes $31,349 million in bonds guaranteed by the Québec government ($32,812 million as at December 31, 2003).

Note 14 Long-Term Debt (continued)

Allocation of debt by currency at time of issue and impact of swaps and sinking funds

The following table summarizes long-term debt, including the current portion, in Canadian dollars and other currencies. Also shown are the effects of currency swaps and sinking funds allocated to repay debt, which are presented in the balance sheet under Swaps and sinking funds.

				2004	2003
		Long-term debt			
	In Canadian dollars and other currencies	At the closing exchange rates as at the balance sheet date[a]	Swaps and sinking funds	Total	Total
Debt of the Corporation					
Canadian dollars	19,076	19,076	(3)	**19,073**	19,081
U.S. dollars	8,866	11,722	(1,427)	**10,295**	11,574
Other currencies					
Euros	673	1,285	(178)	**1,107**	1,107
Yen	36,500	515	(38)	**477**	525
Pounds sterling	240	595	(61)	**534**	534
Swiss francs	97	102	(6)	**96**	96
		2,497	(283)	**2,214**	2,262
		33,295	(1,713)	**31,582**	32,917
Subsidiaries and joint ventures[b]		1,174	(1)	**1,173**	2,078
		34,469	(1,714)	**32,755**	34,995

a) Includes $1,460 million in financial liabilities composed of currency swaps ($923 million as at December 31, 2003) and $1,042 million in Hydro-Québec securities held in the sinking funds ($732 million as at December 31, 2003).

b) Long-term debt composed of $845 million in U.S. dollars and $328 million in Unidades de Fomento (indexed Chilean pesos) ($831 million in Canadian dollars, $925 million in U.S. dollars, $319 million in Unidades de Fomento and $3 million in Chinese renminbi as at December 31, 2003).

Allocation of debt by currency at time of issue and at time of repayment

The following table shows the allocation of debt, net of sinking funds, converted into Canadian dollars after taking swaps into account, according to the currency at time of issue and time of repayment.

	2004		2003	
	At time of issue	At time of repayment	At time of issue	At time of repayment
Debt of the Corporation				
Canadian dollars	**19,073**	**23,208**	19,081	20,439
U.S. dollars	**10,295**	**8,374**[a]	11,574	12,478
Other currencies	**2,214**	–	2,262	–
	31,582	**31,582**	32,917	32,917
Debt of subsidiaries and joint ventures				
Canadian dollars	–	–	831	831
U.S. dollars	**845**	**451**	925	672
Other currencies	**328**	**722**	322	575
	1,173	**1,173**	2,078	2,078
	32,755	**32,755**	34,995	34,995

a) Of this amount, 73.1% was used to hedge sales in U.S. dollars as at December 31, 2004 (94.1% as at December 31, 2003).

Interest rates

The Hydro-Québec interest rates presented in the following table take into account nominal interest rates on borrowings, the related discounts and expenses, and the effect of interest rate swaps.

				2004	2003
Maturity	Canadian dollars	U.S. dollars	Other currencies	Weighted average	Weighted average
1 to 5 years	5.43	9.89	4.59	**5.86**	5.24
6 to 10 years	8.62	7.31	8.20	**7.96**	7.37
11 to 15 years	6.01	8.43	9.70	**8.33**	7.81
16 to 20 years	10.61	9.18	9.20	**10.09**	10.01
21 to 25 years	6.00	8.55	–	**8.46**	8.45
26 to 30 years	6.70	8.65	–	**7.77**	8.30
31 to 35 years	5.99	–	–	**5.99**	6.15
36 to 40 years	6.41	–	–	**6.41**	6.41
41 to 45 years	–	–	–	–	–
46 to 50 years	6.44	–	–	**6.44**	6.44
51 to 55 years	–	–	–	**–**	–
56 to 60 years	6.62	–	–	**6.62**	6.62
Weighted average	7.71	8.52	7.30	**7.97**	7.94

The variable-rate portion of Hydro-Québec's debt amounted to 25.0%, or 25.9% after perpetual debt, as at December 31, 2004 (24.5%, or 25.4% after perpetual debt, as at December 31, 2003). For information purposes, a 1% change in the interest rate would change net income by $86 million (2003: $90 million), not including the impact of derivative instruments used to manage short-term financial risk (Note 18).

Fair value

As at December 31, 2004, the fair value of Hydro-Québec's debt amounted to $43,969 million ($45,594 million as at December 31, 2003). Net of sinking funds and after swaps, it totaled $42,449 million ($44,445 million as at December 31, 2003).

Fair value is obtained by discounting future cash flows, based on term and closing interest rates as at the balance sheet date for similar instruments available on financial markets. Changes in fair value reflect sensitivity to financial market interest rates. However, Management intends to retain these debt securities until maturity. Therefore, as at December 31, 2004, Hydro-Québec did not foresee any significant debt repayments that could result in the realization of this fair value.

Hydro-Québec has undrawn revolving standby credits totaling US$1,500 million and expiring in 2006 and 2009. Any borrowing under these lines of credit will bear interest at a rate based on the London Interbank Offered Rate (LIBOR).

Note 15 Asset Retirement Obligations

Liabilities arising from asset retirement obligations relate to the cost of dismantling Gentilly-2 nuclear generating station at the end of its useful life, the removal of irradiated nuclear fuel from its operation, the dismantling of oil tanks, the dismantling of certain thermal generating stations and the retirement of certain power transmission lines.

Hydro-Québec has also identified other asset retirement obligations for which no liability has been recorded. These relate to assets with an undetermined useful life, for which the Corporation does not have sufficient information to set a realistic obligation maturity schedule. A liability stemming from these asset retirement obligations will be accounted for in the period in which there is sufficient information to set such a schedule.

The aggregate carrying value of asset retirement obligations is as follows:

				2004
	Dismantling of nuclear generating station	Removal of irradiated fuel	Other assets	Total
Balance at beginning of year	140	72	22	**234**
Plus liabilities incurred	13	3	1	**17**
Plus accretion expense	9	7	1	**17**
Less liabilities settled	–	–	(4)	**(4)**
Balance at end of year	162	82	20	**264**

				2003
	Dismantling of nuclear generating station	Removal of irradiated fuel	Other assets	Total
Balance at beginning of year	131	64	21	216
Plus liabilities incurred	–	1	–	1
Plus accretion expense	9	7	1	17
Balance at end of year	140	72	22	234

The carrying value of asset retirement obligations is based on the following key assumptions:

	Dismantling of nuclear generating station	Removal of irradiated fuel	Other assets
Total undiscounted amount of estimated cash flows required to settle the obligations (in current dollars)	463[a]	519[a]	31
Expected timing of payment of the cash flows required to settle the obligations	Between 2012 and 2050[a]	Between 2012 and 2047[a]	Between 2004 and 2043
Credit-adjusted risk-free rate at which the estimated cash flows have been discounted (%)	6.4	6.4	6.4 and 7.0

a) When Gentilly-2 nuclear generating station was designed, the Corporation planned to operate it for 30 years, until 2013. The Corporation initiated a draft-design study to evaluate whether its useful life could be extended by 25 years through rehabilitation. If the rehabilitation is not carried out, Management could decide to decommission the nuclear generating station a few years earlier, depending on technical and economic factors. Pending the decision, the financial statements reflect end-of-life in 2011 for purposes of calculating the depreciation of the station and the related decommissioning costs. Consequently, once the decision is made, the estimated undiscounted cash flows and the expected timing of payment of the cash flows required to settle the obligations could change and thus, asset retirement obligations and decommissioning costs as well as the depreciation expense and accretion expense, as recorded in these financial statements, may vary significantly based on the end-of-life date retained and the increase inherent in the method used to calculate depreciation and amortization. As at December 31, 2004, the net carrying value of Gentilly-2 was $665 million. Based on the key assumptions established, asset retirement obligations relating to the dismantling of the nuclear generating station and the removal of irradiated fuel will total $911 million and $1,122 million, respectively, after factoring in a 2% inflation rate. However, the remaining portions of these obligations are scheduled to extend over periods of 46 years and 43 years, respectively.

Note 16 Other Long-Term Liabilities

	Note	2004	2003
Accounts payable		**255**	280
Accrued benefit liability	22	**452**	414
Deferred foreign exchange gain		**1,272**	1,138
Other deferred credits related to debt		**378**	173
		2,357	2,005

Note 17 Perpetual Debt

Perpetual notes in the amount of US$325 million (US$340 million as at December 31, 2003) bear interest at a rate established semiannually based on LIBOR. They are guaranteed by the Québec government and are redeemable only at the Corporation's option. In 2004, a portion amounting to US$15 million was purchased on secondary markets and then canceled. In 2003, the perpetual notes ceased to naturally hedge sales in U.S. dollars. However, various derivative instruments recorded at fair value are used to mitigate exchange risk.

As at December 31, 2004, the fair value of these notes was $370 million ($402 million as at December 31, 2003). As at December 31, 2004 and 2003, the LIBOR for perpetual notes was 2.1425% and 1.25%, respectively.

Note 18 Financial Instruments

Derivative instruments

Hydro-Québec concludes currency swaps in order to manage the foreign exchange risk associated with payments of principal on long-term debt, interest payments and sales in U.S. dollars. Some of these currency swaps allow for interest rate exchanges to change long-term exposure to interest rate risk. Interest rate swaps that do not allow for exchanges of principal are also used to manage this risk.

The valuation of these swaps, with terms through 2033, showed a positive fair value of $441 million (positive fair value of $427 million as at December 31, 2003).

The following table shows the notional amount of these swaps, expressed in Canadian dollars and other currencies.

	1 to 5 years	6 to 10 years	11 to 15 years	16 to 20 years	Over 20 years	2004 Total	2003 Total
Canadian dollars	(1,043)[a]	288	(38)	(300)	(3,043)	**(4,136)**	(1,185)
U.S. dollars	12	(106)	(271)	226	2,330	**2,191**	(565)
Other currencies							
Yen	34,500	1,000	1,000	–	–	**36,500**	39,500
Euros	612	–	61	–	–	**673**	673
Pounds sterling	–	40	200	–	–	**240**	240
Swiss francs	97	–	–	–	–	**97**	97
Unidades de Fomento (indexed Chilean pesos)	(4)	(7)	–	–	–	**(11)**	(7)

a) Figures in parentheses represent amounts to be paid.

Note 18 Financial Instruments (continued)

In managing short-term financial risks, Hydro-Québec assesses, on an ongoing basis, the overall impact of variations in exchange rates, interest rates and commodity prices. In order to manage this risk exposure, it holds options, forward contracts and swaps designed to hedge several positions. Although some of these instruments do not meet the conditions established by AcG-13, they help to mitigate financial risks.

Hydro-Québec also uses derivative instruments to manage market risks resulting from fluctuations in energy prices, and for negotiation purposes in order to act on business opportunities in markets outside Québec.

The fair value of these instruments is presented by specific risk in the following table. These derivative instruments mature through 2006.

	2004		2003	
	Recorded value	Fair value	Recorded value	Fair value
Exchange risk				
Forward exchange contracts and options				
Financial assets	**15**	**47**	1	12
Financial liabilities	**(296)**	**(375)**	(38)	(113)
	(281)	**(328)**	(37)	(101)
Interest rate risk				
Forward rate agreements, options and swaps				
Financial assets	**5**	**2**	–	11
Financial liabilities	**(10)**	**(15)**	–	(25)
	(5)	**(13)**	–	(14)
Risk of change in energy and commodity prices				
Forward contracts, options and swaps				
Financial assets	**12**	**12**	–	12
Financial liabilities	**(11)**	**(107)**	–	(52)
	1	**(95)**	–	(40)
	(285)	**436**	(37)	(155)

Other financial instruments

The carrying amount of investments, accounts receivable, the trust fund for nuclear fuel waste management, borrowings, and accounts payable and accrued liabilities approximates their fair value. As at December 31, 2004, the weighted average interest rate on short-term investments was 2.26% (2.72% as at December 31, 2003), whereas it was 3.16% (4.18% as at December 31, 2003) on borrowings.

Credit risk

Derivative instruments include an element of risk since a counterparty might not meet its obligations. However, this risk is moderate as Hydro-Québec generally deals with Canadian and international financial institutions with high credit ratings. Credit risk exposure is also reduced by applying a credit policy limiting credit risk concentration and a customer credit risk assessment program, as well as by adopting credit limits, where necessary. As at December 31, 2004, no counterparty had defaulted on its obligations toward Hydro-Québec regarding investments and derivatives.

Hydro-Québec is also exposed to a credit risk associated with trade receivables. However, this exposure is limited due to Hydro-Québec's large and diverse client base. Consequently, Management does not consider Hydro-Québec to be exposed to a major credit risk.

Note 19 Interests in Joint Ventures

The share of the principal joint venture items included in the consolidated financial statements is presented in the table below. In 2004, these joint ventures specifically included interests in various foreign joint ventures, primarily through Hydro-Québec International, which were essentially involved in the construction and operation of transmission systems and hydroelectric generating stations, and were mainly based in South and Central America and Australia. In 2003, the share also included an interest in Noverco Inc., which was disposed of on June 30, 2004. The Corporation held 41.2% of the outstanding common shares of Noverco Inc. and options on an additional 9.16%.

	2004	2003
Operations		
Revenue	**82**	82
Expenditure and financial expenses	**104**	107
Non-controlling interest	**2**	2
Discontinued operations	**38**	65
Net income	**14**	38
Balance sheet		
Current assets	**50**	198
Long-term assets	**484**	1,944
Current liabilities	**47**	263
Long-term liabilities	**153**	1,075
Non-controlling interest	**27**	230
Net assets	**307**	574
Cash flows		
Operating activities	**(20)**	54
Investing activities	**(17)**	(75)
Financing activities	**13**	(8)
Discontinued operations	**(1)**	26
Net change in cash and cash equivalents	**(25)**	(3)

Note 20 Shareholder's Equity

The authorized share capital comprises 50,000,000 shares with a par value of $100 each, and 43,741,090 shares were issued and paid-up.

Under the *Hydro-Québec Act*, any dividends to be paid by the Corporation are declared once a year by the Québec government, which also determines the terms and conditions of payment. For a given fiscal year, they cannot exceed the distributable surplus, equal to 75% of the year's operating income and net investment income, less interest on debt securities and amortization of borrowing discounts and expenses. This calculation is made on the basis of the consolidated financial statements.

However, in respect of a given fiscal year, no dividend may be declared in an amount that would have the effect of reducing the capitalization rate to less than 25% at the end of the year. The Québec government declares the dividends for a given year within 30 days after the Corporation has sent it the financial data relative to the distributable surplus. On expiry of the time prescribed, any portion of the distributable surplus that has not been subject to a dividend declaration may no longer be distributed to the shareholder as a dividend.

For 2004, the Québec government declared dividends of $1,350 million, which is less than the maximum permitted.

The dividends declared are deducted from the retained earnings of the year for which they were declared.

Note 21 Additional Disclosures with Respect to Cash Flows

	2004	2003
Change in non-cash working capital items		
Accounts receivable	**(177)**	34
Materials, fuel and supplies	**(9)**	10
Accounts payable and accrued liabilities	**173**	80
Accrued interest	**10**	(185)
	(3)	(61)
Investing activities not affecting cash		
Increase in fixed and intangible assets	**366**	96
Cash and cash equivalents paid during the year		
Interest paid	**2,264**	2,489

Note 22 Employee Future Benefits

The Corporation's pension plan (the "Pension Plan") is a funded plan that ensures pension benefits based on the number of years of service and average five best years of earnings. These benefits are indexed annually based on a rate which is the higher of the inflation rate, up to a maximum of 2%, and the inflation rate less 3%.

The Corporation also offers other post-retirement and post-employment benefits. Post-retirement benefits are provided by group life, medical and hospitalization plans, which are contributory plans with contributions adjusted annually. Post-employment benefits are under non-contributory salary insurance plans, which pay short- and long-term disability benefits. Most of these plans are not funded, with the exception of the long-term disability salary insurance plan, which is fully funded, and the supplementary group life insurance plan, which is partially funded.

The Corporation's employee benefit plans are defined benefit plans. Assets at their fair value and the accrued benefit obligations of these plans are valued by independent actuaries as at December 31 of each year. The most recent actuarial valuation for purposes of Pension Plan funding was made as at December 31, 2002, and the next valuation, as at December 31, 2003, should be filed in the first quarter of 2005.

The following tables present information concerning employee future benefits plans:

	2004 Pension Plan	2003 Pension Plan	2004 Other plans	2003 Other plans
Accrued benefit obligations				
Balance at beginning of year	**8,628**	7,937	**591**	564
Current service cost	**288**	244	**26**	24
Benefit payments and refunds	**(353)**	(329)	**(37)**	(34)
Interest on obligations	**568**	517	**39**	36
Actuarial losses	**1,125**	98	**69**	1
Adjustments for plan amendments	–	161	**–**	–
Balance at end of year	**10,256**	8,628	**688**	591
Plan assets at fair value				
Balance at beginning of year	**9,217**	8,326	**49**	46
Actual return on plan assets	**1,088**	1,246	**2**	1
Employee contributions	**38**	6	–	–
Contributions by the Corporation	**25**	1	**5**	7
Benefit payments and refunds	**(353)**	(329)	**(7)**	(5)
Administrative fees	**(33)**	(33)	**–**	–
Balance at end of year	**9,982**	9,217	**49**	49
Surplus (deficit) at end of year	**(274)**	589	**(639)**	(542)
Unamortized past service costs	**339**	391	**–**	–
Unamortized net loss (gain)	**2,169**	1,385	**65**	(7)
Unamortized transitional obligation (asset)	**(1,369)**	(1,521)	**122**	135
Accrued benefit asset (liability)	**865**	844	**(452)**	(414)

The Pension Plan accounting deficit as at December 31, 2004, was primarily because the actuarial valuation was based on lower interest rates and an anticipated long-term increase in the inflation rate.

Additional disclosures with respect to plan assets

As at December 31, assets of the Pension Plan at fair value consisted of:

%	2004	2003
Equities	**55**	54
Bonds and debentures	**31**	34
Real estate investments	**5**	4
Other	**9**	8
	100	100

Plan assets include securities issued by the Corporation and certain related companies. These securities are grouped under the following asset classes:

$M	2004 Pension Plan	2003 Pension Plan	2004 Other plans	2003 Other plans
Bonds and debentures	**656**	547	**32**	–
Equities	**–**	26	**–**	–
Short-term investments	**1**	–	**11**	41
	657	573	**43**	41

Note 22 Employee Future Benefits (continued)

Cash payments

Cash payments made by the Corporation for employee benefit plans comprise the contributions paid to funded plans and the benefits paid to employees and pensioners. The cash payments consisted of:

	2004	2003
Contributions by the Corporation		
Pension Plan	**25**	1
Other plans	**5**	7
Benefit payments – Other plans	**30**	29
Cash payments	**60**	37

The Corporation and its employees resumed their contributions to the Pension Plan on December 15, 2003. Contributions were resumed gradually at the rate of 1% of pensionable earnings for employees, and 1.8% of pensionable earnings for the Corporation in fiscal 2004. Subsequently, if the funding rate in the actuarial valuation report remains less than 110%, the employee and employer contribution rates will increase respectively by 1% and 1.8% annually to reach a maximum of 5.2% of pensionable earnings in both cases.

Elements of accrued benefit cost recognized in the year

	2004	2003	**2004**	2003
	Pension Plan	Pension Plan	Other plans	Other plans
Current service cost,[a] net of employee contributions	**227**	214	**26**	24
Administrative fees[b]	**33**	33	**–**	–
Interest on obligations	**568**	517	**39**	36
Actual return on plan assets	**(1,088)**	(1,246)	**(2)**	(1)
Actuarial losses	**1,125**	98	**69**	1
Adjustments for plan amendments	–	161	**–**	–
Cost (credit) before adjustments required to recognize the long-term nature of employee future benefits	**865**	(223)	**132**	60
Difference between actual and expected return on assets	**364**	503	–	–
Difference between actuarial losses (gains) on accrued benefit obligations and actuarial losses (gains) recognized	**(1,125)**	(98)	**(71)**	(2)
Difference between adjustments for plan amendments and amortization of past service costs	**52**	(121)	**–**	–
Amortization of transitional obligation (asset)	**(152)**	(152)	**14**	15
	(861)	132	**(57)**	13
Cost (credit) recognized in the year	**4**	(91)	**75**	73

a) For the long-term disability salary insurance plan, current service cost corresponds to the cost of new disability cases for the year.

b) Administrative fees chargeable to the Pension Plan are fully billed by the Corporation.

Significant actuarial assumptions

The following actuarial assumptions, used to determine the accrued benefit obligations and cost of plans, result from a weighted average.

%	**2004** Pension Plan	2003 Pension Plan	**2004** Other plans	2003 Other plans
Accrued benefit obligations				
Rate at end of year				
Discount rate	**6.03**	6.67	**6.03**	6.67
Salary escalation rate [a]	**3.87**	3.41	–	–
Accrued benefit cost recognized				
Rate at end of prior year				
Discount rate	**6.67**	6.58	**6.67**	6.58
Expected rate of return on plan assets	**6.86**	7.07	**3.53**	3.31
Salary escalation rate [a]	**3.41**	3.15	–	–

a) This rate takes salary increases into account as well as promotion opportunities while in service.

As at December 31, 2004, healthcare costs were based on an annual growth rate of 8.6% in 2005. Thereafter, based on the assumption used, this rate gradually decreases until it ultimately reaches 4.3% in 2015. A 1% change in this annual growth rate would have the following impact:

%	1% increase	1% decrease
Impact on current service cost and interest cost on accrued benefit obligations for the year	(3)	3
Impact on accrued benefit obligations at end of year	32	39

Note 23 Commitments and Contingencies

Electricity purchased

On May 12, 1969, the Corporation signed a contract with Churchill Falls (Labrador) Corporation Limited (CF(L)Co) whereby the Corporation undertook to purchase substantially all the output from Churchill Falls generating station, which has a rated capacity of 5,428 MW. Expiring in 2016, this contract will be automatically renewed for a further 25 years under agreed-upon terms and conditions. On June 18, 1999, the Corporation and CF(L)Co also entered into a contract to guarantee the availability of 682 MW of additional power until 2041 for the November 1 to March 31 winter period.

As at December 31, 2004, the Corporation was committed under 95 contracts to purchase electricity from other power producers, for an installed capacity of about 3,600 MW. It expects to purchase approximately 12.5 TWh of energy annually over the initial term of these contracts, which extend through 2033. The majority of these contracts include renewal clauses.

Guarantees

In the normal course of business, Hydro-Québec grants guarantees to third parties for indemnification purposes, mainly for energy purchase transactions. It also grants guarantees as part of its international operations and in the field of electrotechnology.

Under the agreement with CF(L)Co, the Corporation could be required to provide additional funding if CF(L)Co were unable to pay its expenses and service its debt. The agreement fails to specify the maximum amount that the Corporation could be required to pay.

At December 31, 2004, the potential maximum amount the Corporation could have to pay under letters of credit or guarantees totaled $441 million. Of this amount, $376 million relates to the purchase of energy, and a liability in the amount of $17 million has been recorded accordingly. Some guarantees expire between 2005 and 2019, while others do not have maturity dates.

In 2004, Hydro-Québec provided guarantees to the purchaser who acquired the interest in Noverco Inc. concerning all its representations in the sales agreement for a two-year period ending on June 30, 2006. It further guarantees additional tax liabilities until the expiry of a 60-day period after the date on which the tax authorities will no longer be authorized to assess tax.

Capital expenditures

The Corporation expects to invest approximately $3,700 million in fixed assets in 2005.

Agreements entered into with Aboriginal communities and regional county municipalities

Hydro-Québec has entered into various agreements related to capital projects with Aboriginal communities and regional county municipalities. The commitments under these agreements are recorded under fixed assets if they meet the definition of a liability.

Litigation

In the normal course of business, Hydro-Québec is party to claims and legal proceedings. Management is of the opinion that adequate provisions have been made for any disbursements that could result from these legal actions; it does not foresee any adverse effect of such contingent liabilities on Hydro-Québec's consolidated operating results or financial position.

Note 24 Segmented Information

Hydro-Québec has five operating segments, plus Corporate and Other Activities:

Generation: Hydro-Québec Production operates and develops the Corporation's generating facilities in Québec and a number of foreign facilities. This division also sells electricity on external markets and engages in energy trading activities. It provides Hydro-Québec Distribution with up to 165 TWh of heritage pool electricity annually at a fixed price of 2.79¢/kWh. In excess of this volume, it can participate in Hydro-Québec Distribution's calls for tenders in a context of free market competition.

Transmission: Hydro-Québec TransÉnergie develops and operates the Corporation's electric power transmission system and related telecommunications facilities in Québec. In addition, it manages and operates foreign transmission systems and carries out development projects abroad.

Distribution: Hydro-Québec Distribution operates and develops the Corporation's distribution system and is responsible for sales and service to Québec customers. It also ensures the security of the supply of electricity to the Québec market.

Construction: Hydro-Québec Équipement and Société d'énergie de la Baie James are involved in energy-related engineering services and construction projects in Québec.

Oil and Gas: Hydro-Québec Pétrole et gaz carries out activities intended to tap eastern Québec's oil and gas potential. Its exploration operations include seismic surveys and drilling wells with various partners in the Gulf of St. Lawrence, the St. Lawrence estuary and the Gaspé Peninsula.

Corporate and Other Activities: Corporate and Other Activities include corporate activities, mainly financial services, human resources, corporate affairs, the activities of the Shared Services Centre, notably procurement, computer services and corporate telecommunications, as well as the activities managed by Hydro-Québec Technologie et développement industriel, i.e., research, technical support, industrial development of Hydro-Québec technologies, and capital venturing.

The amounts presented for each segment are based on the financial information used to establish the consolidated financial statements. The accounting policies used to calculate these amounts are as described in Note 1.

Intersegment transactions related to electricity sales are recorded based on the supply and transmission rates provided for by the *Act respecting the Régie de l'énergie*. The Act sets a commodity rate for a maximum annual volume of heritage pool electricity of 165 TWh for the Québec market. This volume was not reached in 2004.

Information about the Distribution segment takes into account the decisions of the Régie (D-2004-47 dated February 26, 2004, and D-2004-170 dated August 16, 2004) concerning the dual-energy Rate BT, to be phased out by April 1, 2006. These decisions allow the segment to accumulate and defer the costs related to a portion of the deficit resulting from the Generation segment's supply cost of non–heritage pool electricity and the financial incentives paid to target customers for the period between January 1, 2004, and March 31, 2006. Deferred supply costs of $53 million in 2004 were eliminated in preparing the consolidated financial statements and are presented in the "Intersegment and Other" column of the table below.

The other intersegment products and services are valued at full cost.

Note 24 Segmented Information (continued)

The following tables contain information related to operations and assets by segment as well as geographical information:

Segments

								2004
	Generation	Transmission	Distribution	Construction	Oil and Gas	Corporate and Other Activities	Intersegment and Other	Total
Revenue								
– External customers	1,361	306	9,015	11	–	6	(1)	**10,698**
– Intersegment	4,607	2,529	55	1,973[a]	–	891	(10,055)	**–**
Depreciation and amortization	728	668	451	5	–	89	–	**1,941**
Financial expenses	1,038	834	345	–	–	43	1	**2,261**
Income (loss) from continuing operations	1,664	365	287	3	(11)	(123)	(53)	**2,132**
Discontinued operations	–	–	–	–	303	–	–	**303**
Net income (loss)	1,664	365	287	3	292	(123)	(53)	**2,435**
Capital expenditures (including intangibles)								
– Affecting cash	1,822	733	607	12	–	52	–	**3,226**
– Not affecting cash	350	10	6	–	–	–	–	**366**
Total assets	26,658	18,410	10,284	245	7	2,666	(234)	**58,036**

Segments

								2003
	Generation	Transmission	Distribution	Construction	Oil and Gas	Corporate and Other Activities	Intersegment and Other	Total
Revenue								
– External customers	1,511	321	8,667	11	–	(1)	–	10,509
– Intersegment	4,563	2,641	44	1,581[a]	–	786	(9,615)	–
Depreciation and amortization	669	624	437	5	10	85	–	1,830
Financial expenses	1,171	978	452	–	–	55	–	2,656
Income (loss) from continuing operations	1,751	395	(133)	6	(17)	(110)	(6)	1,886
Discontinued operations	–	–	–	–	52	–	–	52
Net income (loss)	1,751	395	(133)	6	35	(110)	(6)	1,938
Capital expenditures (including intangibles)								
– Affecting cash	1,431	980	547	4	9	85	(4)	3,052
– Not affecting cash	57	29	10	–	–	–	–	96
Total assets	25,247	18,479	9,931	244	1,820	2,191	(181)	57,731

a) Intersegment revenue generated by the Construction segment includes an amount of $1,973 million (2003: $1,571 million) that corresponds to capital expenditures for other segments.

Geographical information

	2004		2003	
	Revenue	Fixed assets and goodwill	Revenue	Fixed assets and goodwill
Québec	**9,060**	**49,390**	8,746	48,828
Canada, outside Québec	**127**	**22**	151	29
United States	**1,174**	**230**	1,315	372
Chile	**229**	**1,685**	206	1,599
Other countries	**108**	**341**	91	374
	10,698	**51,668**	10,509	51,202

Supplementary Information—Five-Year Review

Consolidated Financial Information

$M	**2004**	2003	2002	2001	2000
OPERATIONS					
Revenue	**10,698**	10,509	12,153	11,497	10,575
Expenditure					
Operations	**2,268**	2,174	2,134	2,050	2,050
Electricity and fuel purchased	**1,467**	1,383	3,026	2,782	1,872
Depreciation and amortization	**1,941**	1,830	1,921	1,764	1,818
Taxes	**620**	576	549	564	498
	6,296	5,963	7,630	7,160	6,238
Operating income	**4,402**	4,546	4,523	4,337	4,337
Financial expenses	**2,261**	2,656	2,973	3,768	3,481
Income from continuing operations before non-controlling interest	**2,141**	1,890	1,550	569	856
Non-controlling interest	**9**	4	3	2	2
Income from continuing operations	**2,132**	1,886	1,547	567	854
Discontinued operations	**303**	52	38	24	15
Restated net income*		1,938	1,585	591	869
Reported net income	**2,435**	1,931	1,526	1,108	1,078
SUMMARY OF BALANCE SHEET					
Reported total assets	**58,036**	57,703	59,098	59,861	59,038
Restated total assets*	–	57,731	59,130	58,696	58,915
Long-term debt	**32,521**	34,351	36,695	37,269	34,965
Reported shareholder's equity	**16,220**	15,127	14,215	14,834	14,280
Restated shareholder's equity*	–	15,128	14,208	13,473	13,451
ANNUAL INVESTMENTS AFFECTING CASH					
Fixed and intangible assets	**3,226**	3,052	2,393	1,769	1,769
Other	**(937)**	(42)	3	(11)	1,652
Total investments	**2,289**	3,010	2,396	1,758	3,421
FINANCIAL RATIOS					
Interest coverage[a]	**1.72**	1.65	1.56	1.42	1.36
Reported capitalization (%)[b]	**32.8**	29.9	26.2	26.8	26.2
Restated capitalization (%)[b, *]	–	29.9	26.2	24.9	25.0
Self-financing (%)[c]	**74.2**	53.1	70.7	50.4	46.4
Reported return on equity (%)[d]	**15.5**	13.2	11.0	7.6	7.7
Restated return on equity (%)[d, *]	–	13.2	11.5	4.4	6.5
Reported return on revenue (%)[e]	**22.8**	16.9	11.7	8.8	9.4
Restated return on revenue (%)[e, *]	–	18.4	13.0	5.1	8.2

* *The figures have been restated further to the retroactive effect of the accounting standards governing foreign currency translation and asset retirement obligations.*

a) Sum of operating income and net investment income divided by gross interest expense.

b) Shareholder's equity divided by the sum of shareholder's equity, long-term debt, perpetual debt, short-term borrowings and current portion of long-term debt, less swaps and sinking funds.

c) Cash from operations less dividends paid, divided by the sum of investments, long-term debt maturities and sinking fund redemptions.

d) Net income divided by average shareholder's equity.

e) Net income divided by revenue.

Note: Throughout the Supplementary Information section, certain financial and operating figures for previous years have been reclassified to reflect the presentation of the current year.

Operating Statistics

GWh	2004	2003	2002	2001	2000
Electricity sales					
In Québec					
Residential and farm	**58,002**	57,217	53,231	50,850	51,666
General and institutional	**33,137**	32,314	31,695	30,360	30,490
Industrial	**69,722**	72,546	68,535	66,343	65,950
Other	**5,026**	5,014	5,111	4,659	4,651
	165,887	167,091	158,572	152,212	152,757
Outside Québec					
Canada/U.S. (long-term)	**1,930**	2,047	2,219	3,691	6,428
Canada/U.S. (short-term)	**12,462**	13,739	51,980	38,698	30,479
	14,392	15,786	54,199	42,389	36,907
Other countries	**475**	484	482	425	416
Total electricity sales	**180,754**	183,361	213,253	195,026	190,080

$M					
Revenue from electricity sales					
In Québec					
Residential and farm	**3,690**	3,504	3,246	3,131	3,167
General and institutional	**2,234**	2,096	2,058	1,973	2,002
Industrial	**2,751**	2,742	2,577	2,482	2,405
Other	**247**	236	231	217	220
	8,922	8,578	8,112	7,803	7,794
Outside Québec					
Canada/U.S. (long-term)	**179**	207	233	288	346
Canada/U.S. (short-term)	**905**	1,138	3,233	2,794	2,003
	1,084	1,345	3,466	3,082	2,349
Other countries	**35**	37	41	38	31
Total revenue from electricity sales	**10,041**	9,960	11,619	10,923	10,174

At December 31					
Number of customer accounts in Québec					
Residential and farm	**3,399,776**	3,343,271	3,295,544	3,257,361	3,228,610
General and institutional	**282,748**	281,997	281,696	280,796	281,107
Industrial	**13,117**	13,383	13,509	13,215	13,081
Other	**5,634**	5,812	5,793	5,919	5,941
Total customer accounts	**3,701,275**	3,644,463	3,596,542	3,557,291	3,528,739

kWh/customer account					
Average annual consumption in Québec					
Residential and farm	**17,203**	17,237	16,247	15,680	16,058
General and institutional	**117,352**	114,651	112,695	108,061	108,604
Industrial	**5,262,038**	5,395,359	5,129,097	5,045,862	5,109,828
Other	**878,211**	864,110	872,780	785,666	779,911

Operating Statistics

MW	2004	2003	2002	2001	2000
Installed capacity[a]					
Hydroelectric	**31,622**	31,347	30,392	30,386	30,389
Thermal[b]	**2,268**	2,267	2,267	2,266	2,266
Wind	**2**	2	2	2	–
Total installed capacity	**33,892**	33,616	32,661	32,654	32,655
GWh					
Total requirements[c]	**193,025**	194,792	192,916	186,645	197,895
MW					
Peak power requirements[d]	**34,956**	36,268	34,989	30,080	30,412
km					
Lines (overhead and underground)					
Transmission	**32,487**	32,434	32,314	32,273	32,283
Distribution[e]	**107,423**	106,568	105,871	105,352	104,872
	139,910	139,002	138,185	137,625	137,155

a) In addition to the installed capacity of its own generating stations, Hydro-Québec has access to most of the output from Churchill Falls, which has a rated capacity of 5,428 MW, and to all of the output from the 141 turbines at four wind farms with a total installed capacity of 111 MW.

b) Includes Gentilly-2 nuclear generating station (rated 675 MW).

c) Total requirements include kilowatthours delivered within Québec and to neighboring systems.

d) Total power requirements at the annual domestic demand peak for the winter beginning in December, including interruptible power. The 2004–2005 winter peak for Québec occurred at 6 p.m. on December 20, 2004.

e) These figures include off-grid systems but exclude private systems, lines under construction and 44-kV lines (transmission).

Other Information

%	2004	2003	2002	2001	2000
Rate increases					
Average increase	**4.1**	–	–	–	–
Inflation rate	**1.9**	2.8	2.2	2.5	2.7
Number of employees[a]					
Permanent at December 31	**18,835**	18,317	18,025	17,679	17,277
Temporary (year's average)	**3,567**	3,596	3,632	3,545	3,399
Women (%)	**29.4**	28.9	28.5	28.3	28.6

a) Excludes employees of subsidiaries and joint ventures.

Supplementary Information

Consolidated Results by Quarter

$M	1st quarter	2nd quarter	3rd quarter	4th quarter	**2004** 12-month period
				(unaudited)	(audited)
Revenue	3,088	2,265	2,386	2,959	**10,698**
Expenditure					
Operations	543	531	531	663	**2,268**
Electricity and fuel purchased	417	433	313	304	**1,467**
Depreciation and amortization	454	459	472	556	**1,941**
Taxes	153	155	152	160	**620**
	1,567	1,578	1,468	1,683	**6,296**
Operating income	1,521	687	918	1,276	**4,402**
Financial expenses	439	594	601	627	**2,261**
Income from continuing operations before non-controlling interest	1,082	93	317	649	**2,141**
Non-controlling interest	2	2	3	2	**9**
Income from continuing operations	1,080	91	314	647	**2,132**
Discontinued operations	20	284	–	(1)	**303**
Net income	1,100	375	314	646	**2,435**

$M	1st quarter	2nd quarter	3rd quarter	4th quarter	2003 12-month period
				(unaudited)	(audited)
Revenue	3,350	2,324	2,234	2,601	10,509
Expenditure					
Operations	469	514	577	614	2,174
Electricity and fuel purchased	465	305	278	335	1,383
Depreciation and amortization	460	454	498	418	1,830
Taxes	148	145	145	138	576
	1,542	1,418	1,498	1,505	5,963
Operating income	1,808	906	736	1,096	4,546
Financial expenses	814	607	605	630	2,656
Income from continuing operations before non-controlling interest	994	299	131	466	1,890
Non-controlling interest	1	2	–	1	4
Income from continuing operations	993	297	131	465	1,886
Discontinued operations	13	24	14	1	52
Net income	1,006	321	145	466	1,938

Corporate Management

André Caillé
President and Chief Executive Officer

Marie-José Nadeau
Executive Vice President, Corporate Affairs and Secretary General

Daniel Leclair
Executive Vice President, Finance and Chief Financial Officer

Maurice Charlebois
Executive Vice President, Human Resources and Shared Services

Board of Directors

André Bourbeau[a, b, c, d, e, f, g, h, i, j]
Chairman of the Board of Directors,
Hydro-Québec

André Caillé[a, b, c, d, e, f, g, h, i, j]
President and Chief Executive Officer,
Hydro-Québec

Michel Boivin
Deputy Minister of Natural Resources
and Wildlife, Gouvernement du Québec

Joseph Benarrosh[d, f]
President, JJDS Capital inc.

Gaston Blackburn[c, g]
President, G. Blackburn Inc.

Andrée Corriveau[d, j]
President and Chief Executive Officer,
International Finance Centre – Montréal

Bernard Gaudreault[b, k]
Director, Hydro-Québec

Norman E. Hébert Jr.[b, i, k]
President and Chief Executive Officer,
Groupe Park Avenue

Régis Labeaume[h, j]
President and Chief Executive Officer,
Fondation de l'entrepreneurship

Louis Lagassé[a, e, f, h, i]
Chairman, Media5 Corporation

Yvon Lamontagne[a, e, k]
Chairman of the Board, SCOR Canada
Reinsurance Company (Toronto)

Paul Larocque[c, g]
President, Infrastructures Transport
Mayor, Bois-des-Filion

Jacques Leblanc[g, k]
Chartered Accountant, Gestion Jacques Leblanc inc.

Sophie Martin[d, j]
Barrister and Solicitor,
Desjardins Ducharme Stein Monast

Michel Noël de Tilly[b, k]
Chairman of the Board, Sépaq

Michel Plessis-Bélair[a, e, f]
Vice-Chairman and Chief Financial Officer,
Power Corporation of Canada

Marie-France Poulin[c, h, i]
Executive Vice President, Groupe Camada inc.

Board Committees

a Executive Committee
b Distribution
c Environment and Corporate Social Responsibility
d Ethics and Corporate Governance
e Finance
f Pension Plan Financial Management
g Generation
h Human Resources
i Technology
j Transmission
k Audit

Corporate Governance

Hydro-Québec's Board of Directors is concerned with maintaining the highest possible standards of corporate governance. It abides by the corporate governance guidelines established by the Canadian stock exchanges even though, legally speaking, it is not required to do so because Hydro-Québec is not a publicly traded company.

Mandate

The Board administers the company's business in accordance with the *Hydro-Québec Act*, the *Companies Act* and the energy policies of the Québec government. Its most important functions involve the analysis and adoption of the Strategic Plan, which describes the company's main objectives, and the annual Business Plan, which presents the capital and operating budgets along with annual performance objectives for members of the management team. Other functions include the monthly review of financial results, the four-month review of management results, the annual evaluation of integrated business risk management, and the selection and evaluation of senior executives. The Board regularly receives and analyzes the subsidiaries' activity reports, financial results and accountability reports.

Independence

Most Board members come from outside the company. In fact, only one director — the President and Chief Executive Officer — is a member of Senior Management. The Board is responsible for compliance, at all times, with the rules stated in the *Code of Ethics and Rules of Professional Conduct for Directors, Executives and Controllers of Hydro-Québec* based on the *Regulation respecting the ethics and professional conduct of public office holders*.

Information

Directors are all offered a complete information session on the energy sector and Hydro-Québec's business environment and principal activities. They also receive a director's guide describing the company's specific technical, business and regulatory context, along with the roles and responsibilities of a Board member.

In 2004, manuals were prepared for the members of most Board committees. In addition to basic information about the committees, the manuals contain reference information and reports to facilitate decision making.

Operation

The Board benefits from the expertise and experience of its members, who sit on 11 committees: Executive Committee, Distribution, Environment and Corporate Social Responsibility, Ethics and Corporate Governance, Finance, Pension Plan Financial Management, Generation, Human Resources, Transmission, Audit, and the Technology Committee, the latter created in December 2004. After every committee meeting, a verbal report by the committee chair is presented at the next Board meeting. The Ethics and Corporate Governance Committee is responsible for assessing the Board's performance and operation. The Executive Committee may exercise the Board's powers, except those reserved to the Board by law.

In 2004, to comply with the generally accepted principles of good governance, the company agreed to update the mandates of the various Board committees every year. Each committee's mandate now reflects company reality and has been restated to confirm the authority that Board committee members have to obtain opinions from outside experts on topics relevant to their areas of responsibility.

Deintegration

In 1997, Hydro-Québec created an organizational structure that allows certain units to work independently from each other while remaining part of the same company. That is the principle of deintegration, or unbundling.

The operations of these units are subject to set rules of ethics. The electricity supply process is governed by the *Code of Ethics on Conducting Calls for Tenders*, which has been adopted by Hydro-Québec Distribution and approved by the Board. Its main purpose is to ensure that calls for tenders are conducted fairly for all electricity suppliers. A register of omissions and corrective measures is kept up-to-date and filed once a year with the Régie de l'énergie.

In autumn 2004, Hydro-Québec amended the *Standards of Conduct* describing the unbundling of Hydro-Québec's transmission operations from the merchant function to reflect the changes in the Federal Energy Regulatory Commission's rules. These standards are now known as the *Transmission Provider Standards of Conduct*.

In June 2004, the Régie de l'énergie approved the *Transmission Provider Code of Conduct* issued by Hydro-Québec TransÉnergie at the Régie's request. This code governs the relations between the Transmission Provider and Hydro-Québec affiliates. Breaches of either the *Transmission Provider Code* or the *Standards* are recorded in a single register.

Access to documents and protection of personal information

Hydro-Québec takes the necessary measures to assure its customers, suppliers and employees of the confidentiality of the personal and commercial non–public domain information it possesses, in accordance with the *Act respecting Access to documents held by public bodies and the Protection of personal information*.

During the year, the company completed implementation of its action plan for the protection of personal information, formulated in 2001. Information regarding implementation of the Act was also posted on the company's website (www.hydroquebec.com).

Sarbanes-Oxley Act

The Audit Committee continued to work closely with the Finance Group and the office of the General Auditor to ensure that the company adopts the best corporate governance practices, in the spirit of the *Sarbanes-Oxley Act* enacted in the United States in 2002. Several related initiatives were taken during the year:

- An employee grievance and protection process was introduced to enable staff members to report, confidentially, any fraud or internal control irregularities. This process is managed by the corporate General Auditor.
- A mandate was assigned to develop a procedure for documenting processes, risks and internal controls related to financial information in order to certify that controls are effective.
- A rotation rule was adopted for partners of the two external auditing firms that perform the annual audit.
- Hydro-Québec's Annual Report notes the rules adopted by the company in its policy on the independence of external auditors and their fees (see next page).

Language guidelines

Efforts to improve the quality of French used at Hydro-Québec continued during the year. Various proficiency courses in written French (grammar, business correspondence, report writing and other subjects) were offered to employees. Nearly 450 people participated in the 45 sessions. Further improvements were also made to the terminology and language tools available to employees. In addition, various promotional and awareness activities were organized to highlight Francofête, a celebration of French language and culture.

The standing committee on language reviewed various issues related to the application of the *Charter of the French Language*, including the language of communication with people and businesses, the quality of the terminology in the new Customer Information System (CIS), and francization of the nominative database for this system.

Policy on the independence of external auditors

Hydro-Québec is not subject to the provisions of the *Sarbanes-Oxley Act,* nor to comparable Canadian regulations on corporate governance. However, the following mechanisms enable the Audit Committee to ensure that the external auditors remain independent:

- A process whereby any assignment to be given to external auditors is analyzed first to ensure that it will not affect their independence; external auditors are not authorized to provide services that are prohibited by the *Sarbanes-Oxley Act*
- Rules requiring prior approval of all requisitions for services sent to the external auditors
- Reports to the Audit Committee on the fees billed by the external auditors
- Measures to guarantee compliance with the rotation rules for partners

Auditors' fees

Samson Bélair/Deloitte & Touche s.e.n.c.r.l. (SBDT) and PricewaterhouseCoopers LLP (PwC) are the joint auditors for Hydro-Québec for 2004.

The table below shows the fees that SBDT and PwC charged Hydro-Québec and its subsidiaries for services rendered during the past two years.

EXTERNAL AUDIT FEES

	Samson Bélair/Deloitte & Touche		PricewaterhouseCoopers	
$M	**2004**	2003	**2004**	2003
Audit fees[a]	**1.8**	1.3	**1.7**	1.6
Fees for audit-related services	**–**	0.1	**–**	0.2
Fees for tax-related services	**0.4**	0.5	**0.2**	0.3
Other fees	**0.4**	0.7	**0.2**	0.1
Total	**2.6**	2.6	**2.1**	2.2

a) Includes the fees for the 2004 and 2003 audits of Hydro-Québec and its subsidiaries and fees billed for other mandates directly related to audits.

Audit fees. These fees cover professional services for auditing the annual financial statements, reviewing interim financial statements, auditing the Pension Plan, providing advice on accounting standards and the presentation of financial information, and other audit operations required by current regulations.

Fees for audit-related services. These fees cover accounting and due-diligence audit advice relating to acquisitions, as well as other accounting advice and certification assignments.

Fees for tax-related services. These fees cover professional services for tax compliance, tax services offered to Hydro-Québec expatriates, tax advice and tax planning.

Other fees. These fees cover professional services for external support in the Distributor's tendering process, foreign financial market studies and other consulting services.

Report of Activities of the Board of Directors and Board Committees

The Board of Directors is composed of a maximum of 16 members appointed by the Québec government for terms of no more than five years, as well as the President and Chief Executive Officer, who is appointed by the Board with government approval. The Deputy Minister of Natural Resources is an ex officio, non-voting member of the Board.

The Board of Directors met 11 times in 2004 and its committees met 46 times.

In 2004, the Board welcomed four new members: Marie-France Poulin, Michel Plessis-Bélair, Jacques Leblanc and Norman E. Hébert Jr.

During the year, the Board approved the agreement in principle on the sale of Hydro-Québec's interest in Noverco, various outlays for construction projects and draft-design studies, and the rate cases filed by Hydro-Québec TransÉnergie and Hydro-Québec Distribution. A call for tenders for a second 1,000 MW of wind power was also authorized. In addition, the Board approved increases in the Energy Efficiency Plan budget and in the Distributor's total contribution to the Agence de l'efficacité énergétique for energy efficiency programs to be deployed for low-income customers by 2006.

In addition, the Board approved an emergency aid budget to enable Hydro-Québec to help restore the electricity distribution system in Gonaïves, Haiti, a town that sustained heavy damage during hurricane Jeanne. It authorized the company to join the United Nations Global Compact and support the Compact's ten universal principles regarding human rights, labor standards, environmental protection and anticorruption.

The Board also monitored changes in the company's budgets, objectives and financial results, as well as those of its wholly owned subsidiaries.

Distribution

The Distribution Committee's role is to advise the Board on matters involving Hydro-Québec Distribution and the delivery of electricity to Québec consumers, especially cases that must be filed with the Régie de l'énergie, and on any other matter related to those activities of the Distributor that require Board approval.

In 2004, the committee examined the criteria and grids used to evaluate wind power, biomass and cogeneration bids, as well as the situation regarding short- and long-term calls for tenders. It reviewed the Energy Efficiency Plan and the Electricity Supply Plan 2005–2014. It monitored the progress of the Customer Information System (CIS) project, which will modernize the company's information systems and revamp the commercial practices and business procedures related to sales and customer services.

Environment and Corporate Social Responsibility

The Environment and Corporate Social Responsibility Committee advises the Board on environmental management, public health and safety, community relations, social responsibility and corporate image. The committee receives all reports and violation notices related to environmental incidents.

During the year, the committee closely monitored the discussions and reflections, in Québec and elsewhere, on the implementation of the Kyoto Protocol and its impact on Hydro-Québec. It studied the risks and the impact of Québec's Water Policy and the environmental legislation that could affect Hydro-Québec, and also examined the summary of environmental inspections performed in 2003. The committee reviewed the 2003 activities of the Fondation Hydro-Québec pour l'environnement and its projects for 2004. It considered the donation requests submitted to it and reviewed the list of corporate donations and sponsorships as well as the report on university research chairs funded by the company in 2003.

Ethics and Corporate Governance

The Ethics and Corporate Governance Committee assures the Board of Directors that Hydro-Québec is managed in accordance with the highest standards of corporate governance. The committee provides advice and makes recommendations on various matters, such as annual corporate performance objectives, the structure and composition of the Board of Directors and Board committees, the distribution of responsibilities between the Board, the Executive Committee and Senior Management, and application of the *Code of Ethics and Rules of Professional Conduct for Directors, Executives and Controllers of Hydro-Québec*, so that the Board will have reasonable assurance that these aspects are in compliance with current standards, laws and regulations.

In 2004, the committee analyzed accountability reports on deintegration and on the application of the policies "Our Corporate Governance" and "Our Acquisition of Goods and Services." It reviewed the progress of work related to the *Sarbanes-Oxley Act* and the changes made to the list of the Board's decision-making powers, and examined a bylaw on compensation for executives, managers and employees of the company. The committee also discussed the updating of its mandate, the annual review of the mandates of the other Board committees, and the recommendation to create a new Board committee on technology.

Finance

The main role of the Finance Committee is to advise the Board on financing, banking, integrated business risk management, and management of corporate funds, as well as the company's Business Plan and ensuing annual budget.

In light of recent changes in Canadian accounting policies, the committee's main focus in 2004 was on financial risk management. It also analyzed the business plans of some Hydro-Québec subsidiaries, and recommended the approval of and subsequently monitored the company's swap program, its borrowing program and guarantees given by the company and its subsidiaries.

Pension Plan Financial Management

The role of the Pension Plan Financial Management Committee is to advise the Board on the directions, policies, strategies and overall objectives established for various aspects of Hydro-Québec's Pension Plan, namely the portfolio summary and performance assessment, evaluation of the specialized portfolio managers' performance, exercise of voting rights for the securities held by the pension fund and the creation of companies for the fund's fixed asset investments. It also renders an opinion on the overall management of the plan, including changes in liabilities and any other aspect of pension fund management.

In 2004, the committee recommended changing the plan governance structure to separate the supervisory and pension fund management roles. To support this change, it recommended a series of measures, including rewriting the Board's decision-making powers related to the Pension Plan. In addition, it reviewed the performance of the pension fund portfolio and the specialized portfolio managers as well as the overall financial health of the Pension Plan.

Generation

The Generation Committee advises the Board on matters involving Hydro-Québec Production, particularly those relating to bids it submits to Hydro-Québec Distribution in response to calls for tenders, and on any other matter requiring approval by the Board. It also plays a role in the activities of the power generation subsidiaries.

During the year, the committee looked specifically at hydropower projects, agreements with various Aboriginal communities and electricity supply contracts with independent power suppliers.

Human Resources

The main role of the Human Resources Committee is to advise the Board on corporate directions and strategies regarding total compensation, labor relations and health and safety, as well as policies on labor planning and employee development, motivation and performance. It also expresses opinions on the organization of Senior Management and on the recruitment, evaluation, compensation, working conditions and annual performance objectives of the President and Chief Executive Officer and other senior executives.

In 2004, the committee focused its attention on the company's application of the policy "Our Human Resources" and on the progress of the program for hiring recent graduates. It also monitored the negotiations with some of the company's unions regarding renewal of their collective agreements. In addition, it analyzed certain aspects of the variable compensation of the President and Chief Executive Officer, senior executives and employees according to achievement of the company's performance objectives. Finally, it considered specific issues such as retirements, overtime and the activities of the Corporate Ombudsman.

Technology

The Technology Committee was created in December 2004. Its role is to advise the Board on directions, policies, strategies and overall objectives for Hydro-Québec with regard to new energy technologies: strategic and operations planning, technological roadmapping, and financial commitments for the development and use of new technologies. It will also periodically review the innovation and venture-capital portfolios, as well as technological intelligence operations.

Transmission

The Transmission Committee advises the Board on matters relating to Hydro-Québec TransÉnergie, particularly cases to be submitted to the Régie de l'énergie, as well as on matters related to foreign holdings and transmission subsidiaries.

During the year, the committee reviewed the Transmission Provider's 2004 rate case, the rehabilitation and upgrade project for synchronous condensers at Lévis substation, and the application to amend Hydro-Québec TransÉnergie's rates and service conditions for 2005.

Audit

The main function of the Audit Committee is to assure the Board of Directors that the financial statements accurately present the company's financial position, that internal controls are adequate and effective, and that suitable mechanisms are being applied to identify and manage the major internal and external risks to which the company is exposed. It is composed of independent members, including one financial expert, Yvon Lamontagne. The committee reads the internal audit reports and resulting action plans. It meets regularly with the external auditors and directly oversees their work.

During the year, the committee examined audit results, reviewed the company's financial statements and those of Hydro-Québec International and monitored the progress of Hydro-Québec's work relating to the *Sarbanes-Oxley Act*.

The committee also studied several action plans, including those related to economic spinoffs of Hydro-Québec Production's MATH and Scompi technological innovation projects, office building maintenance, and security of the SAP R/3 system.

Code of Ethics and Rules of Professional Conduct for Directors, Executives and Controllers of Hydro-Québec

Part I – Interpretation and application

1. In this Code, unless the context indicates otherwise:
   a) **"director"** means, with respect to the Company, a member of the Board of Directors of the Company, whether or not working full-time within the Company;
   b) **"Committee"** or "Ethics and Corporate Governance Committee" means the Ethics and Corporate Governance Committee established by resolution of the Board of October 17, 1997 (HA-173/97), a copy of which is attached in Schedule D;
   c) **"spouse"** includes marriage partners and persons living as if married for more than one year;
   d) **"Board"** means the Board of Directors of the Company;
   e) **"contract"** includes a proposed contract;
   f) **"control"** means the direct or indirect ownership of securities, including shares, conferring more than 50% of voting rights or economic interest without this right depending on the occurrence of a particular event or allowing the election of the majority of directors;
   g) **"controller"** means the controller of the Company and the controllers of divisions or groups or units reporting to the President and Chief Executive Officer of the Company;
   h) **"executive"** with respect to the Company means any contractual manager whose employment conditions are subject to the approval of the Board;
   i) **"enterprise"** means any form that can be taken by the organization for the production of goods or services or any other business of a commercial, industrial or financial nature or any group seeking to promote certain values, interests or opinions or to exercise an influence on public officials; however, this does not include the Company or a non-profit association or group that has no financial link with the Company or is not incompatible with the objects of the Company;
   j) **"affiliated enterprise"** means a legal person or company in which the Company owns, directly or indirectly, securities, including shares, conferring more than 10% of voting rights or economic interest;
   k) **"immediate family"** means spouse and dependent children;
   l) **"subsidiary"** means a legal person or company controlled directly or indirectly by the Company.
   m) **"Regulation"** means the *Regulation respecting the ethics and professional conduct of public office holders* (Order-in-Council 824-98 of June 17, 1998 (1998) 130 G.O. II., 3474, pursuant to sections 3.01 and 3.02 of the *Act respecting the Ministère du Conseil exécutif,* R.S.Q., c. M-30), as amended from time to time;
   n) **"Company"** means Hydro-Québec.
2. In this Code, the prohibition to perform an act also applies to any attempt to perform it and any participation in it or incitement to perform it.

2.1 This Code applies to the directors, the President and Chief Executive Officer, other executives of the Company and its controllers.

The directors and the President and Chief Executive Officer are also subject to the Regulation.

Part II – Ethical principles and general rules of professional conduct

3. The director, executive or controller is appointed to contribute to the achievement of the Company's mission in the best interest of Québec. Accordingly, he is expected to use his knowledge, abilities and experience in a way that will promote the effective, fair and efficient accomplishment of the objectives assigned to the Company by law and the good administration of the property it owns as mandatary of the State.

   His contribution shall be made with respect for the law and with honesty, loyalty, prudence, diligence, efficiency, application and fairness.

3.1 The director, executive or controller respects the following principles in the performance of his duties:

- a vision of the Company that seeks to make it a world leader in the energy industry by developing its expertise for the benefit of its customers, employees and shareholder and by working with partners in business ventures;
- the values underlying the activities of the Company as a government-owned business Company, which include customer satisfaction, a "business first" approach, respect for employees, quality improvement, respect for the environment, partnership with local communities and safeguarding the future; and
- the principles set out in the basic policies of the Company, expressing commitments and conveying a business culture with regard to customers, human resources, acquisition of assets and services, business partners, finance, assets, the environment, social role and corporate governance.

3.2 The director, executive or controller is required, in the performance of his duties, to respect the ethical principles and rules of professional conduct provided by law, the Regulation as applicable, and those defined in this Code. In case of discrepancy, the more stringent rules and principles apply.

When in doubt, act according to the spirit of these principles and rules.

A director, executive or controller who, at the request of the Company, serves as director or member of an undertaking or a company, is held to the same standards.

4. The director, executive or controller shall not merge the assets of the Company with his own; he may not use the assets of the Company or information he obtains as a result of his duties for his own profit or the profit of others. These obligations continue even after the director, executive or controller has ceased to hold his position.
5. The director, executive or controller shall seek, in the performance of his duties, only the interest of the Company to the exclusion of his own interest or that of others.

5.1 The director, executive or controller is bound to discretion in regard to anything that comes to his knowledge in or during the performance of his duties and is at all times bound to maintain the confidentiality of such information.

5.2 In the performance of his duties, the director, executive or controller shall make decisions without regard for any partisan political considerations.

The Chairman of the Board, the director working full-time within the Company, the executive and the controller shall demonstrate reserve in the public expression of their political opinions.

6. The director, executive or controller may not directly or indirectly grant, solicit or accept a favor or an undue advantage for himself or for a third party.

   In particular, he may not accept or solicit an advantage from a person or undertaking doing business with the Company or a subsidiary or acting in the name of or on behalf of such a person or undertaking if this advantage is intended or likely to influence him in the performance of his duties or generate expectations of this nature.

6.1 The director, executive or controller shall, in making decisions, avoid allowing himself to be influenced by offers of employment.

6.2 The director, executive or controller may not accept any gift or hospitality except what is customary and modest in value.

   Any other gift or hospitality shall be returned to the giver.

7. The director may not make a commitment to a third party or grant them any guarantee relative to a vote he may be asked to make or any decision whatsoever that the Board may be asked to make.

7.1 The director, executive or controller may not, in the performance of his duties, deal with a person who has ceased to be a director, executive or controller of the Company for less than one year if this person is acting on behalf of a third party with respect to a proceeding, negotiation or other transaction to which the Company is a party and about which he has information not available to the public.

7.2 After ceasing his duties, no director, executive or controller may disclose confidential information he has obtained or give anyone advice based on information not available to the public concerning the Company or any other undertaking or company with which he had direct and substantial dealings during the year preceding the date on which he ceased his duties.

   In the year following that date, he may not act on behalf or on account of another party with respect to a procedure, negotiation or other transaction to which the Company is a party and about which he has information not available to the public.

8. The director, executive or controller shall collaborate with the Chairman of the Board or the Ethics and Corporate Governance Committee on an issue of ethics or professional conduct when asked to do so.

8.1 The director, executive or controller who intends to be a candidate for elective office shall inform the Chairman of the Board of this intention.

   The Chairman of the Board or President and Chief Executive Officer with the same intention shall inform the Secretary General of the Conseil exécutif.

Part III – Duties and obligations of directors, executives and controllers with respect to conflicts of interest

Prevention of conflicts of interest

9. The director, executive or controller shall avoid placing himself in a situation in which his personal interest is in conflict with the duties of his position or in which reasonable doubt is cast on his ability to perform these duties with undivided loyalty.

   A director who is employed full-time within the Company or one of its subsidiaries shall also avoid performing duties or being bound by commitments that prevent him from devoting the time and attention that the normal exercise of his duties requires.

   As for other directors, they shall be sure to devote the time and attention reasonably required in the circumstances for the execution of their duties.

10. No director holding a full-time office with the Company, under pain of forfeiture of office, may have any direct or indirect interest in an undertaking, company or association that puts his personal interest in conflict with that of the Company.

   However, such forfeiture is not incurred if that interest devolves to him by succession or gift, provided that he renounces or disposes of it with all possible dispatch. Meanwhile, sections 12, 13, 15 and 18 apply to this director.

   Every other director who has an interest in an undertaking shall, on pain of forfeiture of his office, comply with the provisions of sections 12, 13, 15 and 18.

11. A director, executive or controller of the Company who serves as director, executive or controller of an affiliated enterprise shall be specifically authorized by the shareholder or shareholders who control the enterprise concerned to:

   a) hold shares, rights or any other security issued by such enterprise and conferring voting rights or economic interest in it or the right to subscribe or buy such shares, rights or securities;

   b) benefit from any profit-sharing program, unless this director, executive or controller works full-time for the enterprise and the profit-sharing program is closely linked with the individual performance of the director, executive or controller within the affiliated enterprise;

   c) benefit from a pension plan granted by the affiliated enterprise if he does not hold a full-time position within the enterprise; or

   d) benefit from any advantage granted in advance in the case of a change of control of the affiliated enterprise.

12. A director, executive or controller who:

   a) is party to a contract with the Company or a subsidiary; or

   b) has a direct or indirect interest in an enterprise that is a party to a contract with the Company or a subsidiary or is a director, executive, controller or employee of this enterprise;

   shall disclose the nature and extent of his interest in writing to the Chairman of the Board.

   The same applies to a director who has a direct or indirect interest in any issue being considered by the Board of Directors.

   The director shall at all times abstain from conveying any information of any kind to any employee, controller, executive or director of the Company with respect to this contract or interest.

   The director shall abstain from deliberating or voting on any question linked to this interest and avoid trying to influence the related decision. The director shall also withdraw from the meeting for the duration of deliberations and voting on this question.

12.1 A director who is a member of the Audit Committee of the Board of Directors may not have an interest in the Company or a subsidiary. In particular, he may not accept from the Company or a subsidiary fees with respect to consulting, consulting services or any other similar service.

13. The disclosure required by section 12 occurs, in the case of a director, during the first meeting:

   a) in the course of which the contract or question concerned is under study;

   b) following the time at which the director who had had no interest in the contract or question concerned acquires such interest;

   c) following the time at which the director acquires an interest in the already concluded contract; or

   d) following the time at which any person with an interest in a contract or a question under study becomes a director.

14. An executive or controller who is not a director shall make the disclosure required in section 12 immediately after:

a) having learned that the contract or question concerned was or will be studied at a meeting;

b) having acquired the interest, if it is acquired after the contract was concluded or the decision made; or

c) having become an executive or controller, if he becomes one after acquiring the interest.

The executive or controller may not try to influence the directors' decision in any way.

15. The director, executive or controller shall make the disclosure required in section 12 as soon as he has knowledge of a contract contemplated by this section which, as part of the normal business of the Company, does not require the approval of the directors.

16. Sections 12 to 15 apply also when the interest concerned is held by a member of the immediate family of the director, executive or controller.

17. The director, executive or controller shall notify the Chairman of the Board in writing of the rights he may invoke against the Company, by indicating their nature and their value, as soon as these rights come into existence or when he acquires knowledge of them.

18. The director, executive or controller shall submit to the Chairman of the Board, within 60 days of being appointed and on January 31 of each year in which he remains in office, an attestation in the form provided in Schedule B and containing the following information:

a) the name of any enterprise in which the director, executive or controller owns, directly or indirectly, securities or assets, including common shares, specifying the nature and quantity in number and proportion of securities owned and value of assets;

b) the name of any enterprise for which he performs functions or in which he has an interest in the form of a debt, right, priority, mortgage or significant commercial or financial benefit; and

c) to the best of his knowledge, the information specified in the preceding paragraphs concerning his employer and the corporation, company or enterprise of which he is owner, shareholder, director, executive or controller.

A director, executive or controller to whom the provisions of paragraphs a) to c) do not apply shall fill out an attestation to that effect and present it to the Chairman of the Board.

The director, executive or controller shall also produce such an attestation within 60 days of the occurrence of a significant change in its content.

The attestations presented pursuant to this section are treated as confidential.

19. The Chairman of the Board submits the attestations received pursuant to sections 12 to 18 to the Secretary of the Company, who keeps them at the disposal of the members of the Board and the Ethics and Corporate Governance Committee.

Moreover, the Secretary of the Company notifies the Ethics and Corporate Governance Committee of any failure to satisfy the obligations provided for in sections 12 to 18 as soon as the Secretary becomes aware of them.

Waivers

20. This Code does not apply:

a) to owning securities when the size of the holding probably does not place the director, executive or controller in a conflict of interest;

b) to owning an interest by way of a mutual fund in whose management the director, executive or controller plays no role directly or indirectly;

c) to owning interests through a blind trust whose beneficiary cannot know its makeup;

d) to owning a minimum number of shares required to be eligible as director of a corporation;

e) to an interest which, by its nature and extent, is common to the public at large or a particular sector in which the director, executive or controller operates;

f) to a directors' liability insurance agreement; or

g) to the owning of shares issued or guaranteed by the Company, a government or municipality under the same conditions for everyone.

Attestation

20.1 Within sixty days of the adoption of this Code by the Board, each director, executive or controller shall submit to the Chairman of the Board and the Secretary of the Company the attestation appearing in Schedule C.

Each new director, executive or controller shall do the same within sixty days of his appointment to this position.

Part IV – Remuneration

20.2 The director, executive or controller, for the exercise of his duties, is entitled solely to the remuneration related to those duties. Such remuneration may not include, even partially, monetary advantages such as those established, in particular, by a profit-sharing plan based on the variation in the value of shares or on a stake in the capital stock of the Company.

20.3 A director, executive or controller dismissed for just and sufficient cause may not receive a severance allowance or payment.

20.4 A director, executive or controller who quits his duties, who has received or is receiving a severance allowance or payment and who holds an office, employment or any other remunerated position in the public sector during the period corresponding to that allowance or payment shall refund the part of the allowance or payment covering the period for which he receives a salary or shall cease to receive it during that period.

However, if the salary he receives is lower than that he received previously, he shall be required to refund the allowance or payment only up to the amount of his new salary, or he may continue to receive the part of the allowance or payment that exceeds his new salary.

20.5 Anyone who has received or is receiving a severance allowance or payment from the public sector and receives a salary as director, executive or controller during the period corresponding to that allowance or payment shall refund the part of the allowance or payment covering the period for which he receives a salary or shall cease to receive it during that period.

However, if the salary he receives as director, executive or controller is lower than that he was receiving previously, he shall be required to refund the allowance or payment only up to the amount of his new salary, or he may continue to receive the part of the allowance or payment that exceeds his new salary.

20.6 A President and Chief Executive Officer who has ceased to perform his duties, who has received so-called assisted departure measures and who, within two years after his departure, accepts an office, employment or any other remunerated position in the public sector shall refund the sum corresponding to the value of the measures received by him, up to the amount of the remuneration received, by the fact of his return to the public sector, during that two-year period.

20.7 Part-time teaching by a director, executive or controller is not covered by sections 20.4 to 20.6.

20.8 For the application of sections 20.4 to 20.6, "public sector" means the bodies, institutions and companies referred to in the Regulation in Schedule A.

The period covered by the severance allowance or payment referred to in 20.4 and 20.5 shall correspond to the period that would have been covered by the same amount if the person had received it as salary in his prior office, employment or position.

Part V – Application of the code

Competent authorities

20.9 The Associate Secretary General for Senior Positions of the Ministère du Conseil exécutif is the competent authority for the application of this Code with respect to the Chairman of the Board and the other directors of the Company appointed by the Government.

The Chairman of the Board is the competent authority with respect to all directors of wholly owned subsidiaries, executives or controllers of the Company.

The Chairman of the Board shall ensure observance of the ethical principles and rules of professional conduct by the directors, executives and controllers of the Company.

21. The Ethics and Corporate Governance Committee has as its mission to advise the competent authority with respect to ethics and professional conduct.

The Committee also performs the duties invested in it by the resolution appearing in Schedule D and performs any other duties related to ethics entrusted to it by the Board.

In the performance of its duties, the Ethics and Corporate Governance Committee may become acquainted with the attestations contemplated by section 19.

22. When a director, executive or controller is accused of a violation of ethics or the rules of professional conduct, the Committee is responsible for collecting all relevant information. It makes a report of its findings to the competent authority and recommends appropriate measures, if any.

The competent authority notifies the director, executive or controller of the alleged violations and the possible penalties. It informs him that he has seven days in which to respond and if he requests, to be heard on this matter.

23. The Committee may render advisory opinions to directors, executives or controllers on the provisions of this Code and their application to specific cases, even hypothetical ones. It is not required to limit its views to the terms contained in the request.

23.1 In order to allow an appropriate decision to be made in the case of an urgent situation requiring fast response or in an alleged case of serious misconduct, the competent authority may temporarily relieve of his duties, with remuneration, the director, executive or controller who is accused of violations of ethics or the rules of professional conduct.

24. The Secretary of the Company keeps records in which are stored the statements, disclosures and attestations that must be submitted to it under this Code, the reports, decisions and advisory opinions of the Committee and the decisions of the competent authority with respect to ethics and professional conduct.

The Secretary shall also take the necessary steps to ensure the confidentiality of the information provided by the directors, executives and controllers pursuant to this Code.

25. The Committee may consult and receive opinions from outside counsel or experts on any issue it considers appropriate.

26. A director, executive or controller does not violate the provisions of this Code if he has obtained in advance a favorable decision from the Committee on the following conditions:

a) the decision was obtained before the facts on which it was based became a reality;

b) the decision was submitted to the Board;

c) all of the relevant facts were fully disclosed to the Committee exactly and completely; and

d) the director, executive or controller has complied with all the requirements of the decision.

27. The Committee and the competent authority preserve the anonymity of complainants, applicants and informers unless there is a clear intention to do otherwise. They may not be forced to reveal information likely to disclose their identity except if the law or a court so requires.

Penalties

28. Upon concluding that a provision of the law, the Regulation or this Code has been violated, the competent authority may impose either of the following penalties:

a) for an executive or a controller, the appropriate penalty, which can extend as far as termination of employment; and

b) for a director, reprimand, suspension without remuneration for a maximum of three months, or removal from the Board.

However, when the competent authority is the Associate Secretary General contemplated by section 20.9, the penalty is imposed by the Secretary General of the Conseil exécutif. If the penalty proposed consists of the removal of a public office holder appointed or designated by the Government, it can only be imposed by the latter; in this case, the Secretary General of the Conseil exécutif may immediately suspend the public office holder without remuneration for a period not exceeding 30 days.

Any penalty imposed on a director and the decision to temporarily relieve him of his duties must be in writing and give the reasons therefor.

29. In the case of a violation of section 10, the competent authority records in writing the forfeiture of office of the violator.

30. The director, executive or controller shall render an account and restore to the Company any profits earned or benefits received as a result of or on the occasion of a violation of the provisions of this Code.

31. A director's vote shall not be a casting vote if it is made in violation of the provisions of this Code or associated with such a violation, or if the director fails to produce the attestation contemplated by section 18.

The schedules may be consulted on Hydro-Québec's website (www.hydroquebec.com).

Generating Facilities *at December 31, 2004*

Installed capacity in kW

Hydroelectric generating stations[a]					
Robert-Bourassa	5,616,000	Laforge-1	877,800	Shawinigan-2	199,775
La Grande-4	2,778,750	Bersimis-2	844,550	Manic-1	184,410
La Grande-3	2,418,059	Carillon	752,080	Shawinigan-3	183,600
La Grande-2-A	2,106,000	Outardes-4	630,400	Chelsea	153,000
Beauharnois	1,657,980	Outardes-2	471,750	Rapides-des-Îles	146,520
Manic-5	1,527,600	Brisay	469,300	Les Cèdres	135,000
La Grande-1	1,436,400	Laforge-2	319,200	Première-Chute	130,320
Manic-3	1,244,400	Trenche	302,400	La Gabelle	128,625
Bersimis-1	1,124,800	Beaumont	270,000	Grand-Mère[b]	104,975
Manic-5-PA	1,064,000	Rocher-de-Grand-Mère	230,000	Other (18 generating stations	
Manic-2	1,023,930	La Tuque	219,600	rated less than 100,000 kW)	690,359
Outardes-3	891,100	Rapide-Blanc	204,000		
Sainte-Marguerite-3	883,500	Paugan	201,975		
Thermal generating stations					
Gentilly-2 (nuclear)	675,000	Bécancour, La Citière and Cadillac		Other (24 diesel units)	122,350
Tracy (conventional)	600,000	(gas turbine)	870,200		
Wind farm					
Saint-Ulric (3 wind turbines)			2,250		
Installed capacity at December 31, 2004					
Hydroelectric (53)			31,622,158		
Thermal (29)			2,267,550		
Wind (1)			2,250		
Total			**33,891,958**[c]		
Hydroelectric generating stations under construction					
Capacity in kW					
Toulnustouc			526,000		
Eastmain-1			480,000		
Péribonka			385,000		
Mercier			50,500		

a) The installed capacity of a hydroelectric generating station is equivalent to that of its generating units operating in winter conditions (water temperature 5°C).

b) In 2004, the installed capacity of Grand-Mère generating station dropped from 149,575 kW to 104,975 kW due to the dismantling of three units.

c) In addition to the installed capacity of its own generating stations, Hydro-Québec has access to most of the output from Churchill Falls, which has a rated capacity of 5,428 MW, and to all of the output from the 141 turbines at four wind farms with a total installed capacity of 111 MW.

Transmission Facilities *at December 31, 2004*

Voltage	Lines (km)	Substations (number)
765 and 735 kV	11,422	38
450 kV DC	1,218	2
315 kV	5,013	61
230 kV	2,976	50
161 kV	1,875	40
120 kV	6,594	215
69 kV or less	3,389	100
Total	**32,487**	**506**

Major Facilities

Hydro-Québec
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Hydro-Québec International (HQI)
is responsible for investment and the sale of professional services outside Canada and the U.S. Since HQI has entrusted Hydro-Québec with the management of its operations, each Hydro-Québec division is responsible for foreign operations in its spheres of competence.
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HQ Energy Marketing
conducts energy transactions including sales, purchases and exchanges in Canada as well as in the U.S. through H.Q. Energy Services (U.S.).
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Hydro-Québec CapiTech
is a corporate venture capital company that invests in companies selling energy-related technologies and services.
1000 Sherbrooke St. West
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Montréal, Québec H3A 3G4
CANADA
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Hydro-Québec IndusTech
works with the private sector to create value from intellectual property derived from Hydro-Québec research activities.
1000 Sherbrooke St. West
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Montréal, Québec H3A 3G4
CANADA
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Société d'énergie de la Baie James
chiefly provides world-class engineering and construction services in the energy industry in Québec.
855 Sainte-Catherine St. East
20th floor
Montréal, Québec H2L 4P5
CANADA
Telephone: (514) 840-4150

Units of Measure

¢/kWh	cents ($0.01) per kilowatthour
$M	millions of dollars
kV	kilovolt (one thousand volts)
kW	kilowatt (one thousand watts)
Mvar	megavar (one million voltamperes reactive)
MW	megawatt (one million watts)
GW	gigawatt (one million kilowatts)
kWh	kilowatthour (one thousand watthours)
MWh	megawatthour (one million watthours)
GWh	gigawatthour (one million kilowatthours)
TWh	terawatthour (one billion kilowatthours)

The following publications may be obtained from our website **www.hydroquebec.com** or by calling 1 800 363-7443:

Strategic Plan 2004–2008

Annual Report 2004 (this document)

Sustainability Report 2004

Financial Profile 2004–2005

Hydro-Québec wishes to thank all the employees whose photos appear in this Annual Report.

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Hydro-Québec Production generates power and supplies Hydro-Québec Distribution with a heritage pool of electricity for the Québec market. It is also active on markets inside and outside Québec and carries out arbitrage and purchase/resale transactions.

Hydro-Québec TransÉnergie operates the most extensive transmission system in North America and makes it available to customers inside and outside Québec. It is active abroad, especially in South America, where it operates transmission systems, markets its system management products and develops construction projects.

Hydro-Québec Distribution is responsible for supplying Quebecers with electricity and a range of high-quality products and services. In accordance with the *Act respecting the Régie de l'énergie,* the division has access to an annual heritage pool supplied by Hydro-Québec Production at a fixed price. To meet needs beyond this pool, it issues calls for tenders from power producers, including Hydro-Québec Production.

Hydro-Québec Équipement and **Société d'énergie de la Baie James**, a subsidiary of Hydro-Québec, are the prime contractors of construction projects for Hydro-Québec Production and Hydro-Québec TransÉnergie. They are known worldwide for their expertise, particularly in the areas of hydroelectric power generation and high-voltage transmission.

Hydro-Québec Technologie et développement industriel is in charge of technological innovation, including research and technical support, industrial development of Hydro-Québec technologies and capital venturing.

Hydro-Québec Pétrole et gaz conducts gas exploration in Québec, in partnership with companies that have the necessary financial capacity and expertise.

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