

Energy Working for Québec

Hydro-Québec's Mission

"The objects of the Corporation are to supply power and to pursue endeavours in energy-related research and promotion, energy conversion and conservation, and any field connected with or related to power or energy."

(Hydro-Québec Act, section 22)

Quality of Service and Value Creation: Staying the Course

The business objectives proposed in Hydro-Québec's *Strategic Plan 2004–2008* follow from those of the three previous Strategic Plans. A summary of the achievements and results of the *Strategic Plan 2002–2006* is given in Appendix 1. The business objectives maintained by the company are intended to consolidate the progress made toward achieving the company's major goals set forth in the *Hydro-Québec Act* and the Québec Energy Policy. They will ensure that high-quality service is provided to all Québec customers with a view to creating value for the shareholder (the Québec government) and Québec as a society, especially by increasing electricity generating capability in Québec.

Objectives

Quality of customer service

Value creation for the shareholder and Québec society

Increased generating capability in Québec

Hydro-Québec has many advantages that will help it achieve these objectives:

- improved customer service
- hydroelectric potential that can be developed at competitive costs
- favorable locations for thermal generation projects
- marketing and price arbitraging potential on wholesale markets in the U.S. Northeast, based on hydroelectric generating stations, reservoirs and interconnections
- the expertise to gain prominence on international markets in the field of high-voltage transmission
- a presence in the development of energy transmission and natural gas distribution through its interest in Noverco

Building on its strengths, Hydro-Québec will concentrate on improving its overall performance in five key areas:

- quality of customer service
- employee motivation and expertise
- value creation for the shareholder and Québec society
- sustainable development
- organizational efficiency

Improving Hydro-Québec's Overall Performance

Given the value of its assets and the scope of its operations, Hydro-Québec is the largest energy company in Québec. Therefore, it is important to ensure that the company continues to grow and to create new wealth for Québec. While continuing to support the province's economy with a view to sustainable development and maximum efficiency, Hydro-Québec must ensure that its customers receive the best possible service for their money. It must also ensure that its employees are motivated, productive and satisfied with their jobs, and that its shareholder obtains a maximum rate of return.

Maintain the Quality of Customer Service

The actions arising out of the *Strategic Plan 2002–2006* have allowed Hydro-Québec to achieve very positive results in terms of service to Québec customers. For example, the rate of public satisfaction with Hydro-Québec stood at 95% in 2002. This reflects the general image that the public has of the company's management and service performance. The public satisfaction level held steady in 2003, with an overall rate of 94%, including 42% who were "very satisfied."

By building on the achievements of recent years, Hydro-Québec is committed to taking action with regard to service quality and reliability so as to maintain a satisfactory price-quality ratio for its customers.

With respect to rates, Hydro-Québec Distribution is aiming for a normal return in a regulated environment. Hydro-Québec remains convinced that the rates paid by Québec customers will continue to be among the lowest in North America.

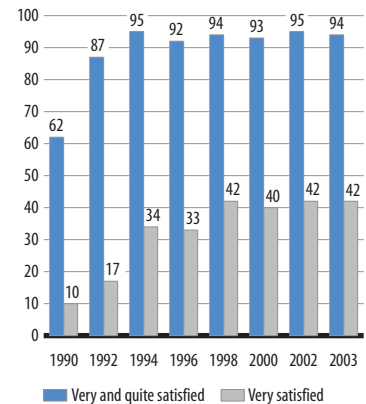
Motivate Employees and Develop Expertise

Hydro-Québec is mindful that its performance depends above all on the men and women who work for it. The company will therefore continue its efforts to motivate employees and to ensure they are committed to the strategic business objectives of each of its divisions.

The company also plans to take measures to improve the performance and productivity of its human resources while providing a safe workplace.

Furthermore, in the context of an aging work force and a growing number of retirements, Hydro-Québec will deploy the necessary strategies to ensure that its expertise is maintained and developed. The company's initiatives and strategies to achieve these objectives are described in Appendix 2.

Rate of Public Satisfaction (%)



Create Value for the Shareholder and Québec Society

The actions stemming from the previous Strategic Plans have helped improve the company's profitability, to the benefit of its shareholder, the Québec government, which is in a better position to pass on the benefits to Québec society. Net income for 2002 was a record \$1.5 billion, almost double the net income posted in 1997. This performance is due mainly to additional revenues from short-term sales on external markets, higher sales in Québec and management of the debt, which took advantage of lower interest rates. Pursuing its profitability and value creation objectives for the shareholder and Québec society, Hydro-Québec will continue to develop its generating fleet and electricity sales on the retail market in Québec as well as on wholesale markets.

Hydro-Québec will help sustain economic development and employment in all regions of Québec through its operating activities, its investments in generating, transmission and distribution facilities and its purchases from independent power producers, as well as its international projects and the operations of its technology subsidiaries.

Hydro-Québec will participate in the diversification of Québec's economy. Its industrial business development efforts will target value-added sectors, with a view to creating maximum wealth and jobs in Québec for each megawatt of new industrial demand.

In this way, Hydro-Québec will be involved in the collective development effort in the regions, reconciling its development needs and priorities, as determined by its core mission and its commercial reality, with customers' expectations and the communities' legitimate concerns regarding its role as a development partner.

Contribute to Sustainable Development

As a forward-looking company, Hydro-Québec adopted the concept of sustainable development in 1989. It regards sustainable development as a long-term commitment that combines preservation of the environment, social equity and economic efficiency.

In line with its vision and values, Hydro-Québec uses mainly hydroelectric facilities to generate safe, clean, renewable energy. More than 95% of the energy it generates is derived from water resources; moreover, the company is the largest purchaser of wind energy in Canada. Hydro-Québec intends to pursue these efforts by placing priority on development of Québec's hydroelectric potential.

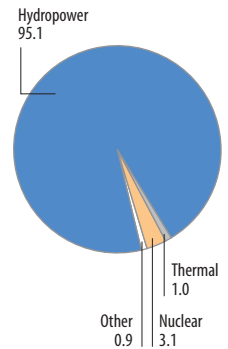
However, since hydropower and wind power are expected to be insufficient to meet demand, despite the gains made through energy efficiency, Hydro-Québec will have to use thermally generated electricity, over and above the output of Gentilly-2 and Tracy generating stations. The company will have to obtain energy from some proposed thermal projects, which can be commissioned much faster than hydroelectric facilities.

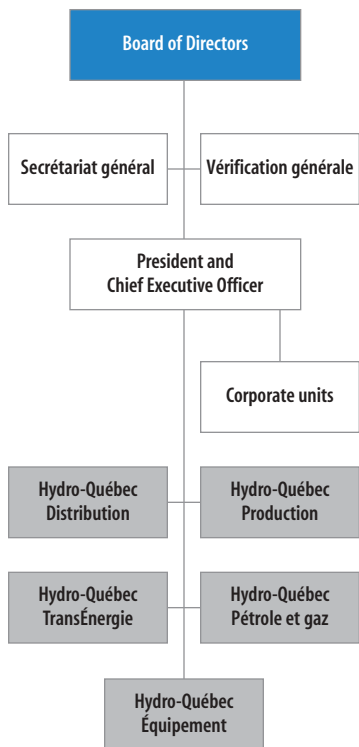
In energy efficiency, Hydro-Québec continues to play a leadership role. Thus, if the same technologies and behaviors that prevailed in 1990 continued until 2006, an additional 23.5 TWh would be needed to meet Québec's requirements. These recurring energy savings will be achieved through Hydro-Québec's direct initiatives with respect to its power system (8 TWh) and energy efficiency programs (3 TWh), and their indirect effects on customer behavior and the use of more efficient technologies (12.5 TWh).

Hydro-Québec also dedicates substantial sums to the development of technologies that promote sustainable development. Through its technology subsidiary Hydro-Québec IndusTech, the company is developing a lithium-metal-polymer battery—a key component for electric vehicles. Hydro-Québec is also investing, through Hydro-Québec CapiTech, in a company that is developing a technology designed to eliminate waste, produce a synthetic gas and generate electricity.

Finally, through its social involvement, programs for low-income customers, and donations and sponsorships, Hydro-Québec will continue to be actively involved in Québec's development as a society.

Sources of Supply in 2002 (%)





Context:

*End of the freeze
on electricity rates*

Objective:

Freeze operating expenses

Make Hydro-Québec Even More Efficient

As a state-owned corporation with a commercial vocation, Hydro-Québec has developed a more flexible structure that helps it provide first-rate service at the lowest possible cost. By improving its efficiency, the company increases its contribution to society's prosperity by paying dividends to its shareholder, the Québec government.

Like most North American electric utilities, Hydro-Québec is now structured according to three core areas of activity: generation, transmission and distribution. This division of functions reflects the new operating modes of a market that is open to competition between electricity producers. By clearly separating profit centres from services to the divisions and corporate support activities, the new organizational model enables the company to track the improved efficiency of each division more effectively.

To improve its performance, Hydro-Québec will freeze its operating expenses until 2006, keeping them at their budgeted 2003 level. To absorb cost increases, including the wage indexation provided for in collective agreements, the company plans to bolster various measures, including efficiency gains, optimization of operations, reduction of personnel costs, downsizing through attrition, and postponement of certain expenses related to support activities.

Profit Centres

With mandates and responsibilities specific to their lines of business, Hydro-Québec's divisions and subsidiaries are well positioned to act on new growth opportunities in their market niches.

High management targets have been set for each division, and the degree to which they are achieved will be measured with precise indicators. The company's overall performance depends on rigorous management whereby each division is accountable for optimizing its own processes and achieving its own business objectives.

With the creation of the divisions, Hydro-Québec has better control over the development of each market niche. The divisions operate in their own areas of excellence according to the laws of the marketplace and, in this way, stimulate vitality and entrepreneurship within the company.

Hydro-Québec Distribution, whose operations are regulated on the basis of cost of service, is a virtual monopoly, serving 97% of Québec customers. It is responsible for supplying Québec customers with electricity and must ensure equal treatment of all producers that respond to the calls for tenders it issues to meet needs over and above the heritage pool. It must also provide quality service to its Québec customers. Hydro-Québec Distribution must obtain a normal return, as determined by the Régie de l'énergie, in a regulated environment. The method for determining the authorized rate of return has been approved by the Régie de l'énergie. According to this method, Hydro-Québec Distribution would be entitled to a return of 8.71% for 2004. It should be noted that the division has scaled back its international operations.

Hydro-Québec TransÉnergie, whose operations are also regulated on the basis of cost of service, is responsible for the reliability and safety of the transmission system in Québec. The division ensures that all wholesale customers have nondiscriminatory access to Québec's transmission system, in accordance with North American regulatory provisions. In April 2002, the Régie de l'énergie rendered its decision allowing Hydro-Québec TransÉnergie to adjust its rates retroactively, as of January 1, 2001. Furthermore, the Régie established its rate of return at 9.66% for 2001. However, based on recent decisions by the Régie de l'énergie, it is expected that this rate will be reduced. Thanks to its expertise in very-high-voltage transmission, the division has developed profitable operations on the international scene.

Hydro-Québec Production must supply Québec customers with a heritage pool of up to 165 TWh of electricity a year, at an average commodity rate of 2.79 cents a kilowatthour. Apart from this obligation, the division competes against other producers on wholesale markets, especially in Québec. Hydro-Québec Production has obtained from the Québec government a monopoly over the development of hydroelectric projects of 50 MW or more in Québec. It sees to the development and profitable marketing of Québec's energy resources—including the optimization of its reservoirs' storage capacity—on markets in the U.S. Northeast, without affecting the supply to Québec customers. This profit centre has obtained substantial, ever-increasing returns in recent years. These returns are justified, especially in view of the risk of low runoff, whose impact in a single year could reach \$1.2 billion.

Profit Centres

*Monopoly situation –
Regulated on the basis
of cost of service*

*Hydro-Québec Distribution
Hydro-Québec TransÉnergie*

Competitive situation

*Hydro-Québec Production
Hydro-Québec CapiTech
Hydro-Québec IndusTech*

*Rate of return authorized
by the Régie de l'énergie for
Hydro-Québec TransÉnergie
and Hydro-Québec
Distribution*

*Return determined on the
basis of the return from a risk-
free investment (long-term
government of Canada
bonds), plus a premium
that reflects the market risk*

Hydro-Québec CapiTech and **Hydro-Québec IndusTech** are wholly owned subsidiaries of Hydro-Québec operating in the energy technology field. Hydro-Québec CapiTech is a venture capital company whose mandate is to make profitable investments in technology companies related to Hydro-Québec's core business lines. It also provides strategic and commercial intelligence to support the company's technology innovation strategy. Hydro-Québec IndusTech's mandates are to industrialize and to market, in partnership with the private sector, technologies arising out of Hydro-Québec's research activities.

Services to the Divisions and Corporate Support

Hydro-Québec ensures that each profit centre's objectives reflect a high level of customer service, the shareholder's profitability requirements and the development of employees' expertise. Like any commercial company, it must also manage substantial risks, allocate capital, practise effective financial control and monitor the financial returns earned by its various units.

The services to the divisions and corporate support are intended to promote value creation by improving the profit centres' performance. These support functions allow the divisions to focus on their core activities.

The objective of human resources management is employee motivation and satisfaction, harmonious labor relations, development of competencies, development of managerial leadership and training of a new generation of employees who will contribute to the company's growth.

To improve its efficiency, optimize its costs and improve customer satisfaction, Hydro-Québec has set up a shared services centre, which follows the best practices in this field. The centre encompasses a range of operations, including information technologies, the procurement of goods and services, real estate and documentation management.

As regards technological innovation, the objectives of which are described in Appendix 3, Hydro-Québec aims to support the divisions' performance and ensure the company's long-term viability. Consequently, innovation focuses on the needs of core businesses. Innovative technology projects are defined in cooperation with the divisions and are directly related to improvement of their operations.

Hydro-Québec Équipement carries out construction projects for the divisions that operate in the electricity sector. Société d'énergie de la Baie James has a mandate to carry out construction projects north of the 49th parallel. Their main objective is to reduce project costs and lead times.

Hydro-Québec Pétrole et gaz manages Hydro-Québec's stake in Noverco, the holding company that controls Gaz Métropolitain. It also promotes oil and gas exploration on the Gaspé Peninsula and in the estuary and Gulf of St. Lawrence. Once it obtains the necessary permits, the division will contribute up to 25% of the investment required for the drilling of the geological structure known as Old Harry.

A Strategic Plan to Develop the Electricity Market

Hydro-Québec proposes objectives regarding the development of the electricity market for the benefit of its customers, its shareholder and Québec society. As the table on the next page shows, a number of important parameters of the *Strategic Plan 2004–2008* are uncertain, while others are more definite.

Main Parameters Related to the Development of Hydro-Québec's Electricity Market

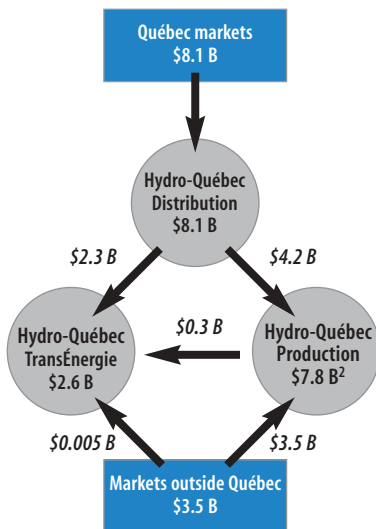
Parameters Subject to Uncertainty

- Weather (maximum variation for Hydro-Québec Distribution: ± 4.5 TWh/year; $\pm 4,300$ MW)
- Runoff (annual standard deviation: ± 20 TWh, or $\pm \$1,200$ million a year for Hydro-Québec Production)
- Nature and impact of the harmonization of North American accounting rules
- Terms of the Kyoto Protocol applicable to electricity producers
- Hydroelectric generating station projects that will be approved and carried out
- Whether Gently-2 operates until 2028 or is replaced
- Volume of possible imports on the U.S. portion of the direct-current transmission line

Known Parameters

- Obligation to serve Québec customers; fairly predictable electricity demand
- Maximum financial results required by the shareholder
- No other interconnections to be commissioned before the end of the current Plan (2008)
- Hydroelectric generating station projects: 10 to 12 years from the initial studies until a project is commissioned
- Sustainable development requirements for all projects

Revenue Flow Among the Divisions in 2002¹



1. Excluding revenue from the natural gas segment, international investments, Hydro-Québec Équipement and service units (total consolidated Hydro-Québec revenue: \$13.0 B).
2. All figures have been rounded.

Revenue for each division – electricity segment (\$11.6 B)

- Hydro-Québec Distribution: \$1.6 B
- Hydro-Québec TransÉnergie: \$2.6 B
- Hydro-Québec Production: \$7.5 B

Hydro-Québec's three main divisions work in synergy to deliver the kilowatthours that customers need. The chart in the sidebar shows the breakdown of the \$11.6 billion of revenue that the company earned from the electricity segment in 2002, as it would have been distributed among Hydro-Québec Distribution, Hydro-Québec TransÉnergie and Hydro-Québec Production. The *Strategic Plan 2004–2008* reflects this structure and presents business objectives and development strategies for each division. It also presents business objectives and strategies for the technological subsidiaries, Hydro-Québec CapiTech and Hydro-Québec IndusTech, whose results are incorporated into the results for corporate units.

Business Objectives of the *Strategic Plan 2004–2008*

An analysis of Hydro-Québec's main strategic issues has led it to develop the following business objectives:

Hydro-Québec Production

- Increase electricity generating capability
- Increase the division's profitability
- Ensure the reliability and quality of operations

Hydro-Québec TransÉnergie

- Offer transmission service that meets customer needs
- Maintain the reliability of the transmission system
- Ensure the division's profitability

Hydro-Québec Distribution

- Ensure an adequate, diversified supply of electricity
- Emphasize Hydro-Québec's energy efficiency leadership
- Offer Québec customers service that meets their expectations
- Achieve the authorized rate of return in 2004 and then maintain it

Hydro-Québec CapiTech

- Continue to increase the value of the existing portfolio
- Maximize the strategic and commercial spinoffs of investment activities for Hydro-Québec

Hydro-Québec IndusTech

- Ensure profitable sales growth and maximize the value of the investment in AVESTOR
- Ensure profitability of TM4 in the very near term and maximize its value
- Facilitate development of mainly electric vehicle prototypes for a market that would use AVESTOR and TM4 products

