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(Audit of Public Bodies) Order 2003

Environment Agency Closed Pension Fund Accounts 2005-2006

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Chairman's Statement

As Chairman of the Environment Agency's Pensions Committee, which is responsible for overseeing the management and administration of the Environment Agency Closed Pension Fund (the Fund), I am pleased to present the Fund's Annual Report and Financial Statements for the year ended 31 March 2006.

During the year the total number of current and deferred pensioners fell by 930 to 24,824. Investment returns continued to be positive. The Closed Fund achieved an overall investment return of 8.4 per cent. However, as a consequence of the continued draw down to pay benefits, the Closed Fund's net assets fell from £169.4 million to £90.6 million.

Until water privatisation in 1989, the Water Authorities Superannuation Fund served the former Regional Water Authorities in England and Wales and other bodies. At privatisation that fund's active members were transferred to other schemes. Only deferred and current pensioners were transferred into the Closed Fund.

Since the Closed Fund has no contribution income, the Government has accepted that in due course the Closed Fund would have insufficient assets to meet its pensions and other liabilities. Under Section 173 of the Water Act 1989 the Government has a statutory obligation to ensure that the Closed Fund can always meet its pensions and other related liabilities.

I am pleased to report that under the terms of the Memorandum of Understanding between the Accounting Officers of the Department for Environment Food and Rural Affairs (Defra) and the Environment Agency the Closed Fund will, from 1 April 2006, receive payments from Defra sufficient to meet pensions and other liabilities as they fall due. The first payment from Defra was received in April 2006.

Deferred members, pensioners and their dependants can therefore be completely reassured about the long-term security of their pension entitlements.

May I take this opportunity to thank everyone involved, both Environment Agency staff and external contractors, for helping the Pensions Committee to manage the Closed Fund, over the last year.

John Edmonds
Chairman
The Environment Agency Pensions Committee

12 July 2006

Report by the Pensions Committee

Governance

Chairman and members

John Edmonds served as Chairman of the Pensions Committee throughout the year. Giles Duncan, Director of HR retired from the Agency during the year and was replaced as Director of HR and on the Pensions Committee by Graham Ledward. Member Representative Aileen Parry was re-appointed by the Environment Agency Board for a further three-year term. There were no other changes to the Pensions Committee during the year. Since the end of the year the Board has confirmed two further Pensions Committee membership changes. Member representative John Garraway reached the end of his second three year term of office and has been replaced by Phil Chappell and Judith Evans, the management representative for Environment Agency, Wales has been replaced by David Webster, who is the Finance Manager for Environment Agency, Wales. In October 2005 Carolan Dobson was appointed to the role of Independent Investment Adviser.

Committee governance

During the past year the Pensions Committee met on three occasions to fulfil its responsibilities as a sub-committee of the Environment Agency Board. The Board appoints members in accordance with the Governance Policy Statement. It has delegated responsibility to manage the investment and administration of the Agency's pension funds. The Committee's Investment Sub-Group met on four occasions, and an ad-hoc working group on LGPS changes met four times.

LGPS regulations, which took effect in December 2005 introduced the requirement that all LGPS funds prepare, maintain and publish, by 1 April 2006, policy statements on Governance. In March 2006 the Agency Board approved a Governance Statement, which takes effect on 1 April 2006 and incorporates the Pensions Committee Terms of Reference and Standing Orders and the Pension Funds Scheme of Delegation. The document includes a number of revisions to the Pension Funds Scheme of Delegation. These take account of changes to LGPS Regulations, assist in the implementation of the Investment Strategy, and reduce bureaucracy.

Committee training

At the beginning of the year the Committee formalised and extended its existing training strategy to take account of the requirements of the Pensions Act 2004. The Act requires that trustees of occupational pension schemes should have knowledge and understanding of the law relating to pensions and role of trustees, the principles of scheme funding and investment, and the management and administration of pension scheme benefits.

The training needs of Pension Committee members are assessed on an individual basis and take account of members' existing expertise, and interests in specific areas. Within this flexible framework the following structure is operated.

All new members receive a comprehensive Pensions Committee Handbook and a half-day induction session before attending their first meeting. They are also given the opportunity to attend more specialist courses on a specific core competence and regional road-shows for Agency employees presented by HR staff and Capita Hartshead. In each subsequent year of membership they are expected to undertake two to three days training aimed at building or refreshing their knowledge and skills in specific topics in greater depth.

A detailed log of all Committee members' training undertaken and planned is maintained.

Pensions changes

Government pensions reform

The Committee has, as in the previous year, given priority to understanding and preparing for Government proposals to reform pensions and the LGPS in particular. It has set up an ad-hoc LGPS Changes Working Party to undertake the detailed planning and work required to inform all Fund members and to review relevant Agency policies and administrative procedures at Capita Hartshead offices.

During the year, the following legislative changes became effective

- **The Civil Partnership Act 2004** – enabling same-sex partners to register a civil partnership from 21 December 2005. This generates pension rights for the surviving partner of an active, deferred or pensioner member of the LGPS.
- **The Gender Recognition Act 2004** – came into force on 4 April 2005 and allows transsexual people to apply to a Gender Recognition Panel for legal recognition of their new gender. This enables the transsexual person to obtain a new birth certificate reflecting their new gender, which can then be recognised for pension purposes.
- **The Local Government Pension Scheme (Amendment)(No.2) Regulations 2005 (SI 2005 No. 3199)** – came into force on 14 December 2005 and introduced a requirement that all LGPS funds prepare, maintain and publish policy statements on both Governance and Communications. These policies come into force on 1 April 2006, and in order to comply with the legislation, have been made available on the Pension Fund website (www.eapf.capitahartshead.co.uk).

Members will continue to be kept informed of changes that affect them via Newsletters and the annual Fundfare.

Pensions administration

The Environment Agency has a contractual arrangement with Capita Hartshead, a trading division of Capita Business Services Limited, to undertake the day-to-day administration of the Closed Fund. Thanks were expressed to Capita for resolving member queries.

External Audit

The Comptroller and Auditor General is the appointed external auditor of the Fund under the Government Resources and Accounts Act 2000 (Audit of Public Bodies) Order 2003. He has contracted PricewaterhouseCoopers LLP to undertake the detailed audit work on his behalf.

Pension Fund Fraud/National Fraud Initiative

The Environment Agency Closed Pension Fund has a formal policy and procedure for handling frauds linked to the unreported deaths of pensioners. It also participates in the Audit Commission's bi-annual National Fraud Initiative. No new fraud cases have come to light during the last year but any cases where fraud is suspected will be pursued. We will seek to agree a repayment plan or, where necessary, take legal action or involve the police.

Fund management and investment

Fund Managers

Until 31 March 2006 responsibility for managing the Closed Fund's main investments was delegated to Legal & General Investment Management Limited (Legal & General) on a low-risk, passive, index-tracking basis. On 1 April 2006 responsibility for managing the Fund's investments was transferred to Sarasin Chiswell with the exception of private equity investments, totalling £0.5m, which is managed internally.

During the year the Committee has received quarterly reports on the financial performance of Legal & General.

In view of the continuing decline in the value of the fund and the signing of the agreement with Defra on the future funding of the Fund, the Committee has agreed a change in the Fund's investment strategy. With effect from 1 April 2006 the Fund will be entirely invested in index-linked gilts.

Future funding of the Closed Fund

At each meeting the Committee has received a report on the progress of discussions with Defra over the future funding of the Closed Fund, which the Government has a statutory duty to fund until all the Fund's liabilities have been met.

Before privatisation in August 1989, the basic pensions of the water authorities' staff were funded by contributions to the Water Authorities Superannuation Fund (WASF). This fund fell within the Local Government Superannuation Scheme. On privatisation, the WASF was divided in three ways: company schemes for employees transferring to the new water companies; an Active Fund for employees joining the National Rivers Authority; and a Closed Fund for existing and deferred pensioners. As part of the pension rationalisation carried out in 1989, the Government recognised that, in the longer term, the Closed Fund would require support to meet its ultimate liabilities. Parliament therefore placed a legal obligation on the Secretary of State for the Environment (under section 173 of the Water Act 1989 above) to meet the pension and other related liabilities of the Closed Fund.

The valuation of the Closed Fund as at March 2004 indicated that assets available would not meet the future liabilities. The Chief Secretary to the Treasury has therefore agreed that provisions should be made by Defra to allow the Secretary of State's statutory obligation under the 1989 Act to be met from April 2006.

Following receipt of the Secretary of State's proposals by the Chairman of the Environment Agency, the Agency Board accepted Defra's proposal for the future funding of the Fund. Subsequently a detailed Memorandum of Understanding between the Accounting Officers of Defra and the Agency has been completed. With effect from 1 April 2006, ring-fenced grant-in-aid will be paid that is sufficient to meet pensions obligations and the running costs of the fund. Members and their dependants can rest assured that the future of their benefits are statutorily guaranteed and are safe.

Membership of the Pensions Committee and its advisers as at 31 March 2006

Chairman	John Edmonds Board Member
Members	Peter Matthews Board Member
	Richard Percy Board Member
	Kay Twitchen Board Member
	Barbara Young Board Member and Chief Executive
	Nigel Reader Director of Finance
	Graham Ledward Director of Human Resources
	Ric Navarro Director of Legal Services
	Judith Evans Chief Accountant, Environment Agency, Wales (retired May 2006)
	Howard Pearce Head of Environmental Finance and Pension Fund Management
	Alan Broughall Member Representative
	Dave Cowley Member Representative
	Chris Galvin Member Representative
	John Garraway Member Representative (retired May 2006)
	Aileen Parry Member Representative
	Brian Engel Retired Member Representative

Advisers

Comptroller and Auditor General, National Audit Office – External Auditor
National Westminster Bank plc – Bankers
Cater Allen Private Bank Ltd
The Northern Trust Company – Custodian
Douglas Anderson, Hymans Robertson – Consulting Actuary
Capita Hartshead – Pensions Administrator
Osborne Clarke – Lawyers
Carolan Dobson – Independent Investment Adviser

Pension Fund Membership

The Fund exists to pay the current and deferred benefits of employees of the former water authorities and associated bodies, which existed prior to 1 September 1989. There are no contributing members.

During the year since 1 April 2005, the number of deferred pensioners has fallen by 4.8 per cent, from 5,641 to 5,368 (2005: 4.06 per cent). The number of pensions in payment fell by 3.3 per cent from 20,113 to 19,456 (2005: 3.46 per cent). With no active members in the Fund, this will be the pattern for the future. However, dependants' and deferred pensions coming into payment will serve to maintain the number of current pensioners for some years to come.

Movement in number of pensioners

	Current	Deferred
At 1 April 2005	20,113	5,641
Adjustment for late notifications	55	(49)
Revised opening balance	<u>20,168</u>	<u>5,592</u>
<i>Add</i>		
Deferred pensions into payment	169	0
New spouse's/children's pensions	323	0
	<u>492</u>	<u>0</u>
<i>Less</i>		
Deaths/no longer eligible	(1,204)	(13)
Transfers to other schemes	0	(42)
Deferred pensions into payment	0	(169)
	<u>(1,204)</u>	<u>(224)</u>
At 31 March 2006	<u>19,456</u>	<u>5,368</u>

Based on data supplied by Capita Hartshead on 13 April 2006.

The figure for Deferred Pensioners includes 642 cases where there is no entitlement to a deferred pension, and the only entitlement is to a refund of contributions. These are members whom we are unable to trace, with refunds being paid as and when we do make contact with them.

Age Profile Of current pensioners at 31 March 2006

	No	2006 per cent	No	2005 per cent
Children	98	0.5	102	0.5
Pensioners and spouses under 55	327	1.7	372	1.9
55 – 59	381	2.0	406	2.0
60 – 64	1,357	7.0	1,334	6.6
65 – 69	1,873	9.6	2,114	10.5
70 – 74	3,231	16.6	3,609	17.9
75 – 79	4,523	23.1	4,737	23.6
80 – 84	4,369	22.5	4,537	22.6
85 and over	3,297	17.0	2,902	14.4
Total	19,456	100.0	20,113	100.0

Communications

Changes to the LGPS during the year only impacted on active members of pension funds. Information on the Gender Recognition and Civil Partnership legislation as well as the new regulations linked to HM Revenue & Customs 'A' day changes that take effect on 6 April will be included in a Newsletter for all deferred or pensioner members of the Fund in mid 2006.

Further newsletters are planned to inform members of pension developments including the LGPS changes planned for 2008.

Deferred members will receive an annual statement of their accrued pension benefits during the year.

Fundfare 2006 will be mailed to deferred members and pensioners towards the end of the year. It will summarise the Fund's Annual Report and Financial Statements as at 31 March 2006 and provide information on other pension-related matters.

In the second half of the year we produced our first Retirement Guide aimed at members who have retired or are approaching retirement. It includes a variety of useful information about life in retirement including EAPF and state benefits, taxation and lifestyle and leisure activities.

Pensions publications for members are provided in bi-lingual versions in order to satisfy the Environment Agency's Welsh Language Scheme. Electronic versions are available on our pensions web site www.eapf.capitahartshead.co.uk.

Pensions increase

Pensions in payment and deferred benefits are subject to annual review under the Pensions (Increase) Act 1971. The Pensions Increase (Review) Order 2006 required an increase of 2.7 per cent (2005: 3.1 per cent) to be awarded from 10 April 2006 (11 April 2005). This is reduced proportionately for pensions in payment for less than 12 months. As usual, the increase corresponds to the increase applied to State benefits and pensions paid by other public service pension schemes. It reflects the rise in the Retail Prices Index during the 12 months ended 30 September 2005.

Pension Fund Investment

Funding Strategy Statement

All LGPS funds are required to publish a Funding Strategy Statement. This statement is used by the Actuary to inform his valuation. The Funding Strategy Statement was adopted by the Pensions Committee on 17 November 2004 and is reproduced in Annex 1 to this document.

Statement of Investment Principles

The Statement of Investment Principles was adopted by the Pensions Committee on 17 November 2004 and is reproduced in Annex 2 of this document.

Custody arrangements

The Northern Trust Company (Northern Trust) acts as global custodian on behalf of the Fund's assets. All assets, with the exception of Legal & General's managed fund units, are held in the name of Nortrust Nominees.

As part of its normal procedures Northern Trust holds all assets in safe custody, collects dividend income, provides data for corporate actions, liaises closely with all the investment managers and reports on all activity during the period.

Regular service reviews are held with Northern Trust to ensure continuous monitoring of service commitments. Other procedures and controls are in accordance with the Statement on Auditing Standards document – SAS 70.

Investment Limits

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended) require the Environment Agency to invest immediately any monies not needed to make payments from the Fund. In doing so, they prescribe the limits on the type and extent of investments which the Environment Agency may pursue.

Although it may vary the types of investment adopted, the Environment Agency's policy must be formulated with a view to

- the advisability of investing Fund money in a wide variety of investments; and
- the suitability of types of investments and particular investments.

However, of the total value of the Fund's investments no more than the percentages shown below can be invested in the form of investment described:

5 per cent

- a single sub-underwriting contract, i.e. a contract with a person who is underwriting a share issue to acquire the shares from him if that is what he requires, but with the total value of all sub-underwriting contracts not exceeding 15 per cent; and
- as a limited partner in any single partnership (but not exceeding more than a total of 15 per cent in such partnerships).

10 per cent

- deposits with local authorities;
- total deposits with any single bank, or similar institution except the National Savings Bank; and
- any single holding unless the investment is made by an external investment manager in a unit trust scheme.

15 per cent

- total investments in unlisted securities, i.e. securities not quoted on a recognised stock exchange.

35 per cent

- all securities (shares, stocks, debentures, etc) which the Environment Agency transfers or agrees to transfer under stock lending arrangements;
- all investments in unit trust schemes;
- all investments in open-ended investment companies where the collective investment schemes constituted by the companies are managed by any one body;
- all investments in unit trust schemes and open-ended investment companies where the unit trust schemes and the collective investment schemes constituted by those companies are managed by any one body; and
- the value of any single insurance contract.

Investment management

During the year the quoted securities portfolio was managed by Legal & General Investment Management Limited. They were required to manage the investments so that the returns they achieved were in line with their benchmark. In so doing they had full discretion in the management of their portfolio, subject to complying with the statutory limits, the Statement of Investment Principles and the ranges of asset distribution defined by the Pensions Committee.

The unquoted securities' portfolio is managed internally, but with expert advice as required. No new investments have been made for several years and the portfolio is being run down.

Following the agreement with Defra over the future funding arrangements of the Fund, the Committee agreed that the Fund's investment strategy should be simplified by switching to investment in long-dated index-linked gilts. Legal & General were instructed to adopt a programme of realising assets to meet pension payments during 2005-2006 so that by 1 April 2006 the Fund would only be invested in index-linked gilts. However, due to the strength of equity markets the Fund still had holdings in conventional gilts at the year end.

On 21 June 2006 the Committee ratified the appointment of Sarasin Chiswell to manage the residual assets of the Closed Fund with effect from 1 April 2006. With the exception of the unquoted securities' portfolio, they completed the transition to full investment of these assets into two long-dated index-linked gilts shortly after the year end.

Portfolio analysis**Distribution of net assets at market value as at 31 March 2006**

	Legal & General £m	Total Other £m	Total Fund £m	Percentage of Total Fund
<i>UK</i>				
Fixed interest – UK quoted	23.5	0	23.5	25.7
Index-linked gilts – UK quoted	54.2	0	54.2	59.2
Pooled investment funds – UK	7.3	0	7.3	8.0
<i>Overseas</i>				
Unquoted investments	0	0.5	0.5	0.5
Cash (including current assets)	5.4	0	5.4	5.9
Other (mainly accrued income)	0	0.6	0.6	0.7
Total fund	90.4	1.1	91.5	100.0

Unquoted Investments

The value of the unquoted investments is £459,190 (2005: £470,765).

Investment performance

The Fund's overall performance was a positive 8.4 per cent (2005: positive 8.7 per cent,). The 3 year return is a positive 10.5 per cent p.a.

Legal & General

Legal & General's return was also a positive 8.4 per cent (2005: positive 8.7 per cent). The 3 year return is a positive 10.5 per cent p.a.

Statement of compliance with the Myners Principles

In October 2001 the Government published its response to the review carried out by Paul Myners into institutional investment in the UK.

In its response to the review, the Government confirmed that the ten investment principles promulgated by Myners would be applied to the Local Government Pension Scheme by means of a combination of a one-off amendment to the LGPS regulations and authoritative guidance developed by CIPFA (Chartered Institute of Public Finance and Accountancy).

The regulation requires administering authorities, such as the Environment Agency, to state their compliance (or otherwise), with the ten principles and to justify non-compliance.

Myners Principle/CIPFA Checklist		Myners Principle/CIPFA Checklist	
<i>Effective decision-making</i>		<i>Explicit mandates</i>	
Define who takes investment decisions	✓	Written mandate included in management contract containing elements specified	✓
Consider whether members have sufficient skills	✓	Constraints on the types of investments are in line with regulations	✓
Determine whether appropriate training is being provided	✓	Reasons stated if soft commissions permitted	✓
Assess whether in-house staffing support is sufficient	✓	Activism	
Establish an investment committee with suitable terms of reference	✓	Incorporate US principles on activism into mandates	Note 2
Draw up a business plan	✓	Engage external voting agencies if appropriate	✓
Clear objectives		Review manager strategies	✓
Set overall investment objective specific only to the Fund's liabilities	✓	Establish means to measure effectiveness	✓
Determine parameters for employer contributions	✓	Appropriate benchmarks	
Specify attitude to risk and limits	✓	Consider whether index benchmarks selected are appropriate	✓
Identify performance expectations and timing of evaluation	✓	Limits on divergence from index are relevant	✓
Peer group benchmark in use for comparison purposes only	✓	Active or passive management considered	✓
Focus on asset allocation		Targets and risk controls reflect performance expectations	✓
Priority is given to strategic asset allocation decisions	✓	Performance measurement	
All asset classes permitted within the regulations have been considered	✓	Formal structure for regular monitoring in operation	✓
Asset allocation is compatible with liabilities and diversification requirements	✓	Arrangements in place to assess procedures and decisions of members	✓
Expert advice		Similar arrangements established for advisers and managers	✓
Separate contracts in place for actuarial services and investment advice	✓	Transparency	
Terms of reference specified	✓	SIP updated as necessary	✓
Specify role of Section 151 officer in relation to advisers	Note 1	Consultation undertaken on amendments	✓
Tender procedures followed without cost constraint	✓	Changes notified to stakeholders	✓
		Regular reporting	
		Publish changes to SIP and its availability	✓
		Identify monitoring information to report	✓
		Inform scheme members of key monitoring data and compliance with principles	✓

Notes

- 1 Whilst the best value process and the statutory responsibilities of Section 151 of the Local Government Act 1972 do not apply to the Environment Agency, it nevertheless abides by and aspires to the principles of best practice.
- 2 In common with many other Local Government Pension Scheme Funds, the Pensions Committee has delegated engagement with companies to its fund managers. This engagement may not be in line with the US principles.

Foreword to the Financial Statements

The Environment Agency Closed Pension Fund provides benefits for current and deferred pensioners of the ten former statutory water authorities in England and Wales, the Foundation for Water Research, WRc plc, Water Training International, the former Water Authorities Association and the former British Water International.

The Fund is a statutory public service pension scheme (as defined by the Pension Schemes Act 1993) under the Local Government Pension Scheme Regulations 1997 (as amended) – (the 1997 regulations). It provides the minimum contracted-out pensions required by the State Second Pension Scheme (S2P) and is exempt approved for the purposes of Chapter 1, Part XIV of the Income and Corporation Taxes Act 1988. (Since 6 April 2006 the Fund is a Registered Pension Scheme).

Roles and responsibilities of the Pensions Committee

With a membership of nominated Environment Agency Board members, senior officers, member representatives and a retired member representative, the Committee (which is a sub-committee of the Board) has been delegated the responsibility for Fund matters. It receives advice from its external advisers and is charged with appointing managers and agents required for the effective management of the duties outlined below.

The Environment Agency Pensions Committee (the Committee) is responsible for obtaining audited financial statements for each financial year which give a true and fair view of the financial transactions of the Fund and the disposition of its assets and liabilities at the year end other than the liabilities to pay pensions and benefits after the scheme year end. In preparing the financial statements the Committee has

- selected suitable accounting policies and then applied them consistently;
- made judgments and estimates that are reasonable and prudent; and
- followed applicable accounting standards, in particular the Statement of Recommended Practice *Financial Reports of Pension Schemes*.

The Committee is responsible for keeping proper accounting records which disclose, with reasonable accuracy at any time, the financial position of the Fund and enable it to ensure that the financial statements comply with Schedule 8 to the Financial Memorandum issued by the Department for Environment, Food and Rural Affairs. However, responsibility for the regulations governing the Local Government Pension Scheme (LGPS) lies with the Local Government Pensions Unit at the Department for Communities and Local Government (formerly Office of the Deputy Prime Minister).

The Committee is also responsible for safeguarding the assets of the Fund and hence for taking reasonable steps for the prevention and detection of error, fraud and other irregularities.

This Annual Report and Financial Statements is available on the Environment Agency's website. The maintenance and integrity of the website is the responsibility of the Environment Agency. The work carried out by the Auditors and the Scheme Administrator does not involve consideration of these matters. Accordingly, the Auditors and Administrator accept no responsibility for any changes that may have occurred to the information contained in the financial statements since they were initially presented on the website.

Legislation in the United Kingdom governing the preparation and dissemination of the financial statements and other information included in annual reports may differ from legislation in other jurisdictions.

Summary of the financial statements

The financial statements have been prepared on a market value basis. However, the valuation of unquoted investments is taken as the lower of cost or estimated market value. After realised gains and changes in portfolio valuations, and outgoings in benefits paid with no corresponding income, the value of the Fund has reduced by £78.8m to £90.6m (2005: reduced by £70.9m to £169.4m).

Retirement benefits payable made in the year have decreased by £0.6m to £85.9m (2005: decreased by £1.0m to £86.6m), and transfers to other schemes increased by £0.4m to £1.8m (2005: decreased by £0.3m to £1.4m).

Since 1 April 1990 the Fund has been liable for the pensions increase costs arising in respect of local authority pensioners formerly employed on water or sewerage functions. The total costs for the 12 months ended 31 March 2006 have risen to £2.7m (31 March 2005: £2.6 million). This reflects the continuing low rate of inflation (and resulting pensions increase awards) and the fact that all the beneficiaries or their late spouses ceased pensionable employment before 1 April 1974.

In overall terms net withdrawals from dealings with pensioners and deferred members in the year amount to £91.2m (2005: £91.4m).

Responsibility for ensuring that the Fund can meet all future liabilities rests with the Secretary of State at the Department for Environment, Food and Rural Affairs.

Accounting Officer's Statement on Internal Control

1 Scope of responsibility

As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of the Environment Agency's policies, aims and objectives, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting. To that end I share with the Board of the Environment Agency responsibility for maintaining a sound system of internal control and the mechanism by which both the Board and I assure ourselves that it is working effectively are the same. I am personally accountable to the Board and to Parliament, and the Board are accountable to Government.

The Environment Agency (the Agency) is responsible for the administration of the Environment Agency Active and Closed Pension Funds (the Funds). The Board has assigned responsibility for management of the Funds and custody of their assets to the Pensions Committee. The Committee is supported by its Investment Sub-Group, a working group on Local Government Pension Scheme (LGPS) changes, officers of the Agency and external fund managers in accordance with the Local Government Pension Scheme Regulations 1997 (as amended) and the Local Government Pension Scheme (Management and Investment of Funds) 1998 Regulations (as amended).

The roles and responsibilities of the Agency Accounting Officer in respect of propriety and regularity of management of the administration of the Funds are the same as for the Agency as a whole.

The responsibilities and duties of those responsible for management of the Funds and their assets are set out in the following governance documents

- a Schedule 8 of the Environment Agency's Financial Memorandum.
- b Pensions Committee Terms of Reference and Standing Orders – details the status, composition and responsibilities of Pensions Committee and Members.
- c Pension Funds Scheme of Delegation – prescribes the arrangements for, and limitations to, the delegation of powers and duties within the Agency under the LGPS Regulations 1997 (as amended) and (Management and Investment of Funds) Regulations 1998 (as amended) in its capacity as Administering Authority and encompassing the Employing Authority Discretions.

The Pensions Committee reviews annually its Terms of Reference and Standing Orders and the Pension Funds Scheme of Delegation before the start of each financial year to take account of regulatory changes and operational needs to comply with the LGPS Regulations. These documents were integrated into a Governance Policy Statement that was approved by the Pensions Committee on 25 January 2006 and ratified by the Agency Board on 22 March 2006.

The appointment of members of the Pensions Committee, its Investment Sub-Group and officers and advisers to manage and administer the Funds, pays due regard to the nature of their responsibilities and the need to avoid conflicts of interest. Written guidance is issued to each member and adviser on the meaning of and procedures for dealing with conflicts of interest. A register of interests is maintained and reviewed by the Chairman of the Environment Agency Audit Committee annually.

2 The purpose of the system of internal control

The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the Funds' policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically.

The system of internal control has been in place within the Agency and in the operation of the Funds for the year ended 31 March 2006 and up to the date of approval of the annual report and accounts. It accords with Defra and Treasury guidance and best practice and has identified the significant issues set out at section 6.

3 Capacity to handle risk

The Agency has a statement setting out its strategic approach to risk management that has been agreed with its Board and Directors.

The 2004 Pension Act requires trustees of occupational pension schemes to have knowledge and understanding of the law relating to pensions and the role of trustees, the principles of scheme funding and investment, and the management and administration of pension scheme benefits.

Whilst the LGPS is exempted from these requirements, the Funds have a structured training programme covering from new member induction to those with extended periods of service. Training of Pensions Committee members is assessed on an individual needs basis, taking account of members' existing expertise, and interests in specific areas. All Pensions Committee members identify their personal training needs and a training log is maintained. Officers' training needs are identified in training and personal development plans.

4 The risk and internal control environment

The Agency's risk management strategy recognises that effective risk management is a key component to the delivery of its objectives. The strategy promotes the taking of well-managed risks that balance the needs of stakeholders. The strategy recognises the importance of prioritising how the Funds respond to risk and that the response must be to reduce the residual risk to an acceptable and justifiable level. Clear accountability for risk ownership and the regular monitoring and reporting of progress to management are mandated to ensure risk management plans are delivered.

Pensions administration

The Agency has a contractual arrangement with Capita Hartshead for third-party administration of the Funds. This includes administration of all member and pensioner records, maintenance of LGPS and Fund rules, processing of contributions, payment of benefits, communications and scheme accounting in accordance with the Local Government Pension Scheme Regulations 1997 (as amended). Arrangements are in place for checking the validity of pension claims to avoid fraud and ensure propriety. Regular reports are provided at quarterly progress meetings. More information about Capita Hartshead's risk and control environment is provided in its FRAG 21 report.

Global custody

The Agency also has a contractual arrangement with the Northern Trust Company who, with the exception of managed fund units, act as global custodian of the Funds' assets. As part of its normal procedures Northern Trust holds all assets in safe custody, collects dividend income, provides data for corporate actions, liaises closely with all of the investment managers and reports on all activity during the period. Regular service reviews are held with Northern Trust to ensure continuous monitoring of service commitments. More information about Northern Trust's internal control framework is included in its SAS 70 report.

In addition to the above, the key elements of the internal control environment include

Procedures for the setting and monitoring of the achievement of the Funds' objectives

The Funds have an established strategic planning process in place. The Pensions Committee prepares triennial Funding Strategy Statements after taking advice from the Actuary, investment advisers and officers. The Actuary uses the Funding Strategy Statements to prepare the triennial actuarial valuation of the Funds, and, in the case of the Active Fund, to set the common contribution rate for the employer. The Funds' strategic investment strategies are established taking into account the results of the triennial actuarial valuations.

The Funds operate within a framework of common procedures and control points as a means of ensuring all staff work towards, and identify with, common aims. This includes the members' handbook, Financial Scheme of Delegation and performance management arrangements, which authorise officers to act on behalf of the Funds within a defined framework of procedural control.

A risk management process is used to identify the principal risks to the achievement of the Funds' objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically.

A risk register has been developed by officers covering all aspects of the pensions function to assist the Pensions Committee in managing strategic risks across all pensions activities. This is currently being enhanced for ongoing risk management purposes and will form the basis of future internal audit strategy and planning. Management actions are being taken to mitigate the prioritised risks, and these are being monitored and reported to the Pensions Committee on a regular basis.

The facilitation of policy making and decision making

The Pensions Committee, and senior management of the Agency together with external advisers, jointly contribute to the Funds' strategic planning process including reviews of strengths, weaknesses, opportunities, threats and risks combined with consideration of the impact of updated, new or proposed legislation.

Key performance targets and benchmarks for fund managers are set by the Investment Sub-Group, including financial commitments, for approval by the Pensions Committee. Lead Officers cascade Pensions Committee strategy requirements to managers, teams and individuals through policies and procedures, performance appraisal and personal development plans.

Ensuring compliance with established policies, procedures, laws and regulations

The Pensions Committee and its Investment Sub-Group meet regularly to consider plans, performance and the strategic direction of the Funds through formal monitoring reports.

An annual report is submitted to the Agency Board on the performance of the fund managers, pensions administrator, and other professional advisors. Qualitative and quantitative information is provided on their compliance with the Myners principles for good investment management.

Ensuring the economical, effective and efficient use of resources and for securing continuous improvement in the way in which the functions of the Funds are exercised.

The Pensions Committee is committed to optimising the efficiency and effectiveness of the Funds' administration and investment management through continuous improvement of key processes, regular contract reviews, competitive tendering and benchmarking exercises.

The Funds have a formal policy and procedure for handling frauds linked to the unreported deaths of pensioners. It also participates in the Audit Commission's bi-annual National Fraud Initiative and Life Certificate Exercises. Where fraud is suspected full repayment is sought and the police and courts involved as required.

The financial management and reporting of the Funds

The system of financial management is based on a financial control framework that includes the Agency's Procurement, Purchase Order Management and financial accounting systems, the Agency's Financial Memorandum and Scheme of Delegation, and the Funds' Scheme of Delegation (now in the Funds' Governance Policy Statement), together with administrative procedures, and management supervision. This includes

- comprehensive annual budget setting process and monitoring systems;
- setting targets to measure financial and other performance; and
- regular reviews of periodic and annual financial reports which include administration and investment expenses and returns against budgets, targets and forecasts.

The system of internal financial control can provide only reasonable and not absolute assurance that assets are safeguarded, that transactions are authorised and properly recorded, and that material errors or irregularities are either prevented or would be detected in a timely period.

The performance management of the Funds and the reporting of performance management

The performance of the Funds is reported quarterly to the Investment Sub-Group and Pensions Committee and annually to the Board. Team Business Plans are monitored and the Head of Environmental Finance & Pension Fund Management monitors individual performance formally twice a year.

5 Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control is informed by the work of the internal auditors and the executive managers of the Funds who have responsibility for the development and maintenance of the internal control framework, and comments made by the external auditors in their management letter and other reports. I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by the Board and the Audit Committee and a plan to address weaknesses and ensure continuous improvement of the system is in place.

The process that has been applied in maintaining and reviewing the effectiveness of the system of internal control includes

- a the operation of the Agency Board and Pensions Committee that sets strategic direction approves the Funds' investment and administration strategies and reviews performance. The Board receives reports from the Pensions and Audit Committees on the standards of corporate governance and internal control operating in the Funds;
- b the operation of the Audit Committee that reviews standards of internal control and financial reporting. It also considers audit reports and advises on the Funds' approach to risk management and corporate governance, and discusses with the appointed external and internal auditors the nature and scope of forthcoming audits;
- c the independent reviews by Internal Audit on the adequacy and effectiveness of the internal controls. These reviews are informed by an analysis of the risks to which the Funds are exposed and conducted in accordance with Government Internal Audit Standards; and
- d officers of the Agency act on the recommendations made by external and internal auditors.

6 Significant internal control issues

The reviews undertaken and reported by internal audit in 2005 concluded that the governance framework in place to manage the Funds is well designed and covers all the main areas of activity. There were, at that time, known issues over capture and transmission of member data to Capita Hartshead (the third party pensions administrator) which related to the process of inputting and verifying such data, and these are being resolved. Improvements are being made to employee pensions related data collection, data maintenance, data integrity and the timely submission of membership data, including the transfer of data from the Environment Agency to Capita Hartshead. Ownership and accountability is assigned to Human Resources under the Pensions Committee governance structure. Governance arrangements are being further enhanced by the introduction of a Pension Fund risk register to assist in the management of strategic risks across all pension activities.

Actions are taken to ensure these risks, once recognised, are appropriately managed. In 2006-2007, work will continue in Human Resources to improve the provision of employee related pensions data to Capita Hartshead and in Finance to enhance the Funds' risk register for ongoing risk management purposes.

Paul Leinster
Chief Executive (Acting) and Accounting Officer

12 July 2006

Statement by the Consulting Actuary

Actuarial statement for the purpose of Regulation 77 of the Local Government Pension Scheme Regulations 1997.

As required by regulations, an actuarial valuation of the Fund's assets and liabilities was carried out as at 31 March 2004.

Security of prospective rights

In my opinion, the resources of the Fund are likely in the normal course of events to meet the liabilities of the Fund, as required by the Regulations. In giving this opinion I have taken into account the contributions payable by the Department for the Environment, Food and Rural Affairs from April 2006.

Summary of methods and assumptions used

Full details of the method and assumptions are described in our valuation report dated 18 October 2004.

My opinion on the security of the prospective rights is based on the projected accrued benefits method. A comparison is made of the value of the assets with the value of benefits for past service (but allowing for future pension increases). If there is an excess then there is a past service surplus. If the converse applies there is a past service shortfall.

Since I have taken assets into account at their market value it is appropriate for me to take my lead from the market when setting the financial assumptions used to value the ongoing liabilities, to ensure consistency of the asset and liability valuation bases.

The key financial assumptions adopted for this valuation are as follows

Financial assumptions

	March 2004	
	per cent p.a. Nominal	per cent p.a. Real
Minimum risk rate of return	4.7	1.8
Discount Rate (100 per cent government bonds)	4.7	1.8
Price Inflation/Pension Increases	2.9	0

In order to value those liabilities, which have accrued at the valuation date I have assumed that the Fund's assets are invested in a portfolio consisting of 100 per cent government bonds. The stream of future liability payments is converted into a capital value today by assuming a return on Fund assets of 4.7 per cent a year.

The 2004 valuation revealed that at 31 March 2004 the Fund's assets were sufficient to meet 21 per cent of the liabilities (44 per cent at 31 March 2001) accrued up to that date. Assets were taken into account at their then market value of £240m (£517m at 31 March 2001).

A separate valuation has been carried out in respect of the Active Fund.

Copies of the valuation report are available on request from the Finance Department of the Environment Agency, the administering authority to the Fund. The next valuation of the Fund will be carried out as at 31 March 2007.

W Douglas B Anderson
Fellow of the Institute of Actuaries
For and on behalf of Hymans Robertson LLP

Hymans Robertson LLP
20 Waterloo Street
GLASGOW
G2 6DB

16 May 2006

The Certificate And Report of The Comptroller and Auditor General to the House of Commons, the Board of the Environment Agency and the Secretary of State for Environment, Food and Rural Affairs

I have audited the financial statements for the year ended 31 March 2006 under the Government Resources and Accounts Act 2000 (Audit of Public Bodies) Order 2003. These comprise the Fund Account, the Net Assets Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Agency and its Pensions Committee, and the Auditors

As described on page 16 the Accounting Officer of the Environment Agency is responsible for preparing an annual report and accounts under Schedule 8 to the Environment Agency Financial Memorandum issued by Defra in accordance with Local Government Pension Schemes Regulations 1997. These responsibilities are set out in the Statement of the Pension Committee's responsibilities.

My responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements, and with International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Environment Agency Financial Memorandum issued by Defra. I also report whether, in all material respects, the financial transactions conform to the authorities which govern them. I also report to you if, in my opinion, the Foreword is not consistent with the financial statements, if the Agency has not kept proper accounting records, if I have not received all the information and explanations I require for my audit, or if information specified by relevant authorities is not disclosed.

I review whether the statement on pages 16 to 19 reflects the Environment Agency's compliance with HM Treasury's guidance on the Statement on Internal Control, and I report if it does not. I am not required to consider whether the Accounting Officer's statements on internal control cover all risks and controls, or to form an opinion on the effectiveness of the Agency's corporate governance procedures or its risk and control procedures.

I read the other information published with the financial statements, and consider whether it is consistent with the audited financial statements. This information comprises only the Report by the Pensions Committee, the Investment Report and the Actuarial Statements. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

Bases of audit opinion

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of transactions included in the financial statements. It also includes an assessment of the significant estimates and judgements made by or on behalf of the Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Fund's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error and that, in all material respects, the financial transactions conform to the authorities which govern them. In forming my opinion I have also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinions

In my opinion

- the financial statements show a true and fair view of the financial transactions of the Fund for the year ended 31 March 2006 and of the amount and disposition at that date of its assets and liabilities, other than liabilities to pay pensions and benefits after the end of the Fund year, and
- in all material respects the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General

18 July 2006

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP

Financial Statements for the year ended 31 March 2006

	Notes	2006 £000	2005 £000
Fund account			
Benefits and other payments			
Benefits payable	4	(85,869)	(86,552)
Leavers	5	(1,806)	(1,417)
Other payments	6	(2,672)	(2,565)
Administration expenses	7	(845)	(847)
Net withdrawals from dealings with pensioners and deferred pensioners		(91,192)	(91,381)
Returns on investments			
Investment income	8	3,868	7,699
Change in market value of investments	9	8,706	12,979
Investment management expenditure	10	(163)	(201)
Net returns on investments		12,411	20,477
Net decrease in the Fund during the year		(78,781)	(70,904)
Net assets of the Fund at 1 April 2005		169,407	240,311
At 31 March 2006		90,626	169,407
Net assets statement			
Investments	9	91,485	170,364
Current assets and liabilities	11	(859)	(957)
Net assets of the Fund at 31 March 2006		90,626	169,407

The notes on pages 24 to 29 form part of these Financial Statements.

John Edmonds
Chairman
Environment Agency Pensions Committee

12 July 2006

Paul Leinster
Chief Executive (Acting) and Accounting Officer
Environment Agency

12 July 2006

Notes to the Financial Statements

1 Basis of preparation

The financial statements have been prepared in accordance with the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 and with the guidelines set out in the Statement of Recommended Practice, 'Financial Reports of Pension Schemes' (Revised November 2002) (the SORP).

The financial statements summarise the transactions and net assets of the Fund. The financial statements do not take account of liabilities to pay pensions and other benefits that fall due after the end of the Scheme year. The actuarial position of the Fund, which does take account of such liabilities, is dealt with in the statement by the Consulting Actuary on page 20 and these financial statements should be read in conjunction with it. The Actuary's statement, dated 16 May 2006, is based on a valuation as at 31 March 2004.

A number of revisions to the classification and presentation of certain balances were made in the current year to ensure the financial statements are in compliance with the SORP. As a result of these changes the prior year comparative balances have been restated, the principal changes are

- a Investment income due to the Fund at the year-end has been disclosed as 'other investments'; in the prior year this balance was disclosed within net current assets;
- b Amounts due to and from brokers in respect of investment transactions have been disclosed as 'other investments'; in the prior year these balances were disclosed as investment cash; and
- c Lump sum benefits payable have been accrued in the current year; in the prior year they were accounted for on a cash basis.

2 Accounting policies

The following principal accounting policies have been applied consistently in the preparation of the financial statements.

Investments

Investments are included at their market values, which are determined as follows

- i quoted securities listed on recognised stock exchanges are valued at middle market prices at the year end. Unquoted securities are valued by fund managers on the basis of latest dealings, professional valuations and financial information at the year end;
- ii pooled investment vehicles are stated at the mid point of the latest prices quoted by the relevant fund managers prior to year end;
- iii the Fund's global custodian is authorised to enter into stock lending arrangements and a small amount of stock lending has taken place in the year;
- iv acquisition costs are included in the purchase cost of investments; and
- v Investment management fees are accounted for on an accruals basis.

Investment income

- i income from fixed interest and index linked securities and other interest receivable is taken into account on an accruals basis. Income from all other marketable securities is taken into account on an accruals basis on the date when stocks are quoted ex-dividend;
- ii income from overseas investments is recorded net of any withholding tax where this cannot be recovered;
- iii accrued interest is excluded from the market value of fixed interest securities but is included in investment income receivable;
- iv income on investments in pooled investment vehicles with accumulation units is reflected in the unit price;
- v the change in market value of investments during the period comprises all increases and decreases in the market value of investments held at any time during the period, including profits and losses realised on sales of investments and unrealised changes in market value; and
- vi income from cash and short-term deposits is accounted for on an accruals basis.

Exchange rates

- i where forward contracts are in place for assets and liabilities in foreign contracts, the contract rate is used;
- ii other assets and liabilities in foreign currencies are translated into sterling at the rates of exchange ruling at the year end;
- iii overseas dividends are valued at rates of exchange on the date when stocks are quoted ex-dividend; and
- iv surpluses and deficits arising on conversion or translation are dealt with as part of the change in market value of investments.

Contributions

The Environment Agency Closed Pension Fund has no contributing members. Unlike other statutory Local Government Pension Funds, it is being maintained solely to pay current and deferred benefits (or transfer values to other pension arrangements) awarded to or in respect of employees of former water authorities and associated bodies which existed prior to 1 September 1989.

Benefits payable

Members can choose whether to take a proportion of their retirement benefits as a pension and/or lump sum. Pensions and lump sums are accounted for on an accruals basis from the date the option is exercised. Lump sum death grants and refunds of contributions are included from the date of death or date the member leaves the Scheme.

Transfers to and from other schemes are those amounts paid to or received from other pension schemes relating to previous periods of pensionable employment. Individual transfers are included in the accounts when paid or received, but bulk transfers are accounted for an accruals basis when the amounts have been agreed.

Other expenses

Investment management and administration expenses are accounted for on an accruals basis. Expenses are recognised net of any recoverable VAT. The fees of the Fund's external investment managers reflect their differing mandates. Fees are linked to the market value of the Fund's investments and therefore may increase or reduce as the value of the investment changes. Fees are also payable to the Fund's global custodian.

*Taxation***UK income tax and capital gains tax**

The Fund is exempt approved under Chapter 1 of Part XIV of the Income and Corporation Taxes Act 1988 and is therefore not liable to UK income tax on interest and dividend income (other than dividends arising from UK equities), or to capital gains tax.

Value added tax

As the Environment Agency is the administering authority for the Fund, VAT input tax is recoverable on all Fund activities including expenditure on investment and property expenses. The accounts are shown exclusive of VAT.

US withholding tax

The income earned from investments in stocks and securities in the United States is exempt from US tax pursuant to Section 892 of the Income Tax Code and is not subject to the withholding of any tax under Section 1441. This exemption has continued to be applied thus far under the US Tax Reform Act of 1986.

Overseas tax deductions

Where possible, tax deducted at source is recovered by the investment managers.

3 Financial Security

The Secretary of State at the Department for Environment, Food and Rural Affairs has a duty under section 173(3) of the Water Act 1989 to ensure that the Fund can always meet its liabilities, including future indexation awards. This has been formally documented in a Memorandum of Understanding, which can be found at Annex 3.

4 Benefits payable

	2006	2005
	£000	£000
Retirement and dependants' pensions	83,970	84,970
Lump sum retirement grants	1,833	1,511
Lump sum death grants	66	71
	<u>85,869</u>	<u>86,552</u>

5 Payments to and on account of leavers

	2006	2005
	£000	£000
Refunds of contributions	1	0
Individual transfers to other schemes	1,805	1,417
	<u>1,806</u>	<u>1,417</u>

6 Other payments

	2006	2005
	£000	£000
Pre-1 April 1974 local authority pensions increase recharges	<u>2,672</u>	<u>2,565</u>

Until 31 March 1990, local authorities recovered from the former water authorities and successor water plc's the pensions increase costs in respect of pensioners employed on water functions prior to their leaving, retirement or death in service before 1 April 1974.

Since 1 April 1990 the regulations have provided for such costs to be charged to the appropriate pension fund. The regulations require the Fund to meet the corresponding increase in the pensions liabilities previously recovered from the water authorities/water plcs.

Benefits payable exclude £11.8m (2005 £11.8m) for unfunded pensions liabilities paid via the Fund. This has been recharged to the Agency and funded by Grant-In-Aid from Defra.

7 Administration expenses

	2006	2005
	£000	£000
Scheme administration	573	559
<i>Professional fees</i>		
Actuarial	33	73
Consultancy	20	0
Audit	16	14
Legal	9	27
<i>Other administration costs</i>		
Environment Agency administration	159	112
Communications	22	48
Miscellaneous	13	14
	845	847

8 Investment income

	2006	2005
	£000	£000
Income from fixed-interest securities	2,715	3,729
Dividends from equities	201	2,806
Interest on cash deposits	935	1,159
Stock lending income	17	5
	3,868	7,699

9 Investments

	Value at 1 April 2005 £000	Purchases at cost £000	Sales proceeds £000	Change in market value £000	Value at 31 March 2006 £000
Index-linked securities	51,078	4,295	(4,274)	3,103	54,202
Pooled investment vehicles	53,646	23,881	(74,011)	3,780	7,296
Equities	22,398	65	(23,399)	1,396	460
Fixed-interest securities	25,274	6,737	(8,949)	427	23,489
Cash deposits	17,303	0	(11,898)	0	5,405
	169,699	34,978	(122,531)	8,706	90,852
Other	665				633
	170,364				91,485

The change in the market value of investments during the year comprises all increases and decreases in the market value of investments held at any time during the year, including profits and losses realised on sales of investments during the year.

	2006	2005
	£000	£000
Index-linked securities		
UK public sector quoted	54,202	51,078
Pooled investment funds	7,296	53,646
Equities		
UK quoted	1	21,902
Overseas quoted	0	25
Overseas unquoted	459	471
	460	22,398
Fixed-interest securities		
UK public sector quoted	23,489	25,274
Cash deposits and instruments		
Sterling	5,405	17,303
Other		
Accrued income	592	624
Insurance policies and associated shares	39	39
Income tax recoverable	2	2
	633	665
Total investments		
<i>Including pooled investment vehicles, total investments may be restated as follows</i>		
Total Equities (includes pooled)	7,756	76,043
Total Bonds (includes pooled and index-linked)	77,691	76,353
Total Cash	5,405	17,303
Total Other	633	665
Total investments	91,485	170,364

10 Investment Management Expenses

	2006	2005
	£000	£000
Fund manager fees	113	102
Global custody	39	63
Investment advisers	7	25
Performance and risk measurement	4	11
	163	201

11 Current assets and liabilities

	2006	2005
	£000	£000
Current assets		
Debtors	91	87
Cash at bank	741	620
	832	707
Current liabilities		
Creditors		
Pre-1 April 1974 local authority recharges (see Note 6)	(604)	(559)
Benefits due	(47)	0
Administration and investment management expenses	(185)	(241)
Other	(855)	(864)
	(1,691)	(1,664)
	(859)	(957)

12 Related party transaction

During the year ended 31 March 2006, the Environment Agency recharged pensions administration costs to the Fund of £159,000 (2005: £112,000) (see Note 7).

13 Apportionment of common expenditure

In cases where expenditure relates to both the Closed Fund and the Environment Agency Active Pension Fund, this has been apportioned during the year as follows

	2006	2005
	per cent	per cent
Custodial arrangements	20/80	30/70
Other (e.g. environment agency administration costs)	40/60	34/66

Annex 1 – Funding Strategy Statement

Introduction

This document constitutes the Funding Strategy Statement (FSS) of the Environment Agency Closed Pension Fund (the Fund), which is administered by the Environment Agency (the Administering Authority).

Members' accrued benefits are guaranteed by statute. Members' contributions are fixed in the regulations. Employers pay the balance of the cost of delivering the benefits to members. The FSS focuses on the pace at which these liabilities are funded.

Fund history

The Fund has been closed to new entrants and accruals of future service since 1989. The Fund's liabilities are statutorily guaranteed by the Secretary of State for Environment, Food and Rural Affairs (the Guarantor) under section 173 of the Water Act 1989 and it is unique in this respect in the family of Local Government pension funds. A Memorandum of Understanding between the Secretary of State for Environment, Food and Rural Affairs and the Environment Agency sets out the mechanism whereby the Guarantor makes payments to the Fund.

Current profile

As at 31 March 2004, the Fund contained 20,833 pensioners and approximately 5,880 deferred pension members whose benefits have yet to come into payment. The average age of members in receipt of pensions in payment was almost 74 years, and is approximately 53 years for the deferred pensioners.

Around 50 per cent of the liabilities are expected to be discharged over the next 10 years, but the remaining liabilities could take a further 50 years to come close to being extinguished. The final payment from the Fund may not be paid until the middle of the 21st century.

The discounted mean term of the liabilities – a measurement of duration of the liabilities which can be useful in matching liabilities to bond durations – is currently around 10 years, and will only fall very gradually.

As at 31 March 2004, the fund assets were £240.3m and the value placed on the liabilities (discounted in line with the minimum risk return available on Government bonds) was £1,120m. This resulted in a funding level of 21 per cent and a funding deficit of £879.7m. Benefit expenditure flowing out of the Fund is running at approximately £95m a year.

Regulatory framework

The FSS forms part of a framework, which includes

- the Local Government Pension Scheme Regulations; and
- the Statement of Investment Principles.

The FSS has been prepared by the Administering Authority with written advice from the Fund's actuary, Douglas Anderson of Hymans Robertson, and in consultation with the Guarantor and its investment consultant, Paul Potter of Hymans Robertson.

Reviews of FSS

This is Version 1.0 of the FSS, which is adopted with effect from 31 March 2005 for contributions payable in the Fund's financial year 2005-2006 and thereafter. The principles documented herein have been used for the actuarial valuation as at 31 March 2004.

The FSS is reviewed in detail at least every three years, ahead of triennial valuations being carried out. The next full review is due to be completed by 31 March 2008. The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues.

Purpose

Purpose of FSS

The Department for Communities and Local Government (DCLG) (formerly Office of the Deputy Prime Minister (ODPM)) has stated that the purpose of the FSS is

- "to establish a clear and transparent fund-specific strategy which will identify how employers' pension liabilities are best met going forward";
- "to support the regulatory framework to maintain as nearly constant employer contribution rates as possible"; and
- "to take a prudent longer-term view of funding those liabilities."

These objectives are desirable individually, but not necessarily deliverable together.

In developing the approach described below, the Administering Authority has focused on balancing the desirability of affordability of contributions, transparency of processes, stability of employers' contributions, and prudence in the funding basis.

Purpose of the Fund

The Fund is the vehicle used to pay the pensions and related benefits of certain former employees in the water industry in England and Wales prior to its privatisation. The Fund was created by the Water Act 1989 and the benefit payments are guaranteed by Defra. In addition to paying the pensions of its own scheme members, the Fund is also liable for the pension increase costs of pensioners in certain Local Authority funds who retired before 1974. The costs are billed to the Fund by the Local Authorities – in 2003-2004 they amounted to about £3m a year.

The Fund provides a convenient and efficient vehicle to deliver scheme benefits, in particular by

- receiving contributions, transfer payments and investment income;
- paying scheme benefits, transfer values and administration costs.

Aim of the funding policy

The Fund's approach to funding the Guarantors' pension liabilities is focused on ensuring that sufficient funds are available to meet all liabilities as they fall due for payment.

Solvency issues and target funding levels

Reviews of funding position

The Fund's actuary is required by the regulations¹ to report the funding position (or solvency) of accrued benefits relative to the Fund's solvency target at least every three years. Unlike standard LGPS funds there is no requirement to certify an employer contribution rate.

Between formal valuations the Administering Authority works with the Actuary to review the cash-flow position of the scheme and the estimated expenditure for the following six months, which will fall to the Guarantor.

¹ Regulation 77, as amended by Regulation 144 for the Environment Agency Closed Fund.

Solvency

The Fund defines 'solvency' to be the ability to continue to meet on-going benefit expenditure. As at 31 March 2004, the liabilities of the Fund were only 21 per cent covered by its assets. Without additional Government funding, the Fund would be expected to be exhausted in 2006-2007.

The accrued liabilities are the future payments of pensions and lump sums, allowing for annual RPI increases on pensions in payment. The valuation allows for future investment returns when placing a value on these liabilities. This reduces the value placed on the liabilities.

The on-going basis does not anticipate future returns from equity investments in excess of Government bond investments.

On-going funding basis

The Fund Actuary agrees the financial and demographic assumptions to be used for each triennial valuation with the Administering Authority.

The demographic assumptions are intended to be best estimates of future experience in the Fund. They vary by type of member.

The key financial assumption is the rate of RPI inflation applied to pension increases. This has been taken to be 2.9 per cent a year in the 2004 valuation.

For the 2004 valuation, it is assumed that the Fund's investments will deliver a long-term real return (i.e. in excess of price increases) in line with index-linked government bonds at the time of the valuation. As at 31 March 2004, the real return on index-linked gilts was 1.8 per cent a year more than RPI increases.

The Guarantor has agreed to commence making contributions to the Fund from April 2006. It is proposed that payments will be made every six months. These payments will be calculated to meet projected benefit expenditure over the following six months. Initially these payments are expected to be approximately £50m every six months (£100m a year). This mechanism is detailed in the Memorandum of Understanding between the Secretary of State for Environment, Food and Rural Affairs and the Environment Agency's Pensions Committee.

Links to investment strategy

Funding and investment strategy are inextricably linked. However, going forward, the Fund's assets are expected to be modest (no more than £100m) compared to the value of the prospective liabilities (approximately £1,120m as at 31 March 2004). The performance of the assets will only have a limited effect on the Fund's finances.

Investment strategy

Investment strategy is set by the Administering Authority, after consultation with the employer and after taking investment advice.

The investment strategy currently being pursued is described in the Fund's Statement of Investment Principles, dated 17 November 2004.

The Fund is moving towards a low rather than least-risk investment strategy, predominantly invested in index-linked government bonds.

Consistency with funding basis

The funding policy anticipates returns of 1.8 per cent a year in excess of price increases, in line with the return on index-linked government bonds as at 31 March 2004. The valuation of liabilities makes an allowance for expected future investment expenses.

Balance between risk and reward

Prior to implementing its current investment strategy, the Administering Authority considered the balance between risk and reward from altering the level of investment in potentially higher yielding, but more volatile asset classes such as equities.

The principal remaining uncertainties for the funding and investment policies are

Longer term: Greater longevity improvement than anticipated. Higher RPI than assumed increasing liabilities. Inability to re-invest investment income in future to achieve a return of 1.8 per cent a year in excess of RPI.

Shorter term: Statistical variations between demographic assumptions and actual experience e.g. numbers of transfer payments. Unexpected surge of pension increase recharges from other local authority schemes.

Inter-valuation Monitoring of Funding Position

The Administering Authority monitors the benefit expenditure and cash flow position of the fund on a regular basis to ensure that there are always sufficient assets to meet the benefit expenditure.

Key Risks and Controls

Types of risk

The Administering Authority has an active risk management programme in place. The measures that the Administering Authority has in place to control key risks are summarised below under the following headings:

- financial;
- demographic; and
- regulatory.

Financial risks

The main financial risks are those relating to the level of future inflation and the ability to reinvest income. The development over time of these factors will be monitored regularly, alongside the cash flow monitoring.

A further risk relates to the pension increase recharges to local authorities. The Administering Authority has no direct control over these as it does not pay the individual pensions and is reliant on other funds to recharge the amounts. The Administering Authority is investigating practical ways of reducing the uncertainty associated with the amounts of the recharges, in order to minimise variations between projected costs and actual expenditure.

Demographic risks

The main demographic risk is that improvements in longevity might be greater than allowed for. At the triennial valuations the Administering Authority and the Actuary will make appropriate mortality assumptions. The appropriateness of these assumptions will be reviewed at the triennial valuations.

In the short term, there may be other areas where the demographic experience differs from that assumed (e.g. transfer payments). The regular monitoring of cash flow should highlight such variations.

Regulatory

There is a risk that new legislation could impact on the Fund. The Administering Authority considers all consultation papers issued by the DCLG (formerly ODPM) and comments where appropriate.

Approved by the Pensions Committee on 17 November 2004.

Annex 2 – Statement of Investment Principles

This is the Statement of Investment Principles adopted by the Environment Agency as Administering Authority of the Closed Pension Fund (the Fund) on 17 November 2004, as required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended). It is subject to periodic review by the Pensions Committee, which acts on the delegated authority of the Environment Agency's Board.

In preparing this statement, the Pensions Committee has taken advice from the Investment Practice of Hymans Robertson Consultants and Actuaries.

Funding objective

This Statement is consistent with the Fund's funding strategy, which is set out in the Funding Strategy Statement adopted on 17 November 2004. The Fund's solvency is guaranteed by the Government, in the form of the Secretary of State for Environment, Food and Rural Affairs (the Guarantor). The Guarantor's contributions, which will commence in April 2006, will be reviewed every six months. The Fund's invested assets are small relative to the value of its prospective liabilities.

Investment principles

The assets comprise a portfolio of bonds, equities and cash currently invested with Legal & General, and a small unquoted portfolio that is currently being run down.

In order to achieve its investment objectives, the Pensions Committee has agreed the following in respect of the Legal & General portfolio

Choosing Investments: The Committee will appoint an investment manager (currently Legal & General) authorised under the Financial Services and Markets Act 2000 to undertake investment business. The Committee, after seeking appropriate investment advice, has given the manager specific directions as to the asset allocation, but investment choice has been delegated to the manager, subject to benchmark and asset guidelines.

Kinds of investment to be held: The fund may invest in quoted and unquoted securities of UK and overseas markets, including equities and fixed-interest and index-linked bonds, cash, and pooled funds. From 1 April 2005 and under the new agreed benchmark, the Fund will migrate to and in future invest in index-linked government bonds and cash only. The Committee considers these classes of investment to be suitable in the circumstances of the Scheme. A maximum of 25 per cent of stocks may be lent under a stock-lending programme, with Northern Trust the Fund's custodian.

Balance between different kinds of investments: In each portfolio it manages, the Scheme's investment manager will hold a diversified portfolio of investments that reflect the manager's specific benchmarks for the portfolio.

Risk: The Pensions Committee stops Fund investments from deviating greatly from its intended approach by adopting a specific asset allocation benchmark and by setting its manager specific benchmark guidelines. The Committee wishes to adopt a low-risk investment approach and has decided that the assets should be invested in index-linked gilts on an index-tracking basis.

Expected return on investments: Over the long term, the overall level of investment return is expected to be consistent with the rate of return assumed by the Actuary in the Actuarial Valuation of the Scheme.

Realisation of investments: The stocks held within the Fund may be realised quickly if required.

Exercise of voting rights: Until the existing equity assets have been fully realised, the Pensions Committee has delegated the exercise of voting rights to the investment manager on the basis that voting power will be exercised by it with the objective of preserving and enhancing long-term shareholder value. Accordingly, the manager has produced written guidelines of its process and practice in this regard. The manager is encouraged to vote in line with its guidelines in respect of all resolutions at annual and extraordinary general meetings of companies. The Pensions Committee realises that, once the portfolio is invested entirely in government index-linked bonds and cash, there will be no equity voting rights.

Social, environmental and ethical considerations: Until the existing equity assets have been fully realised, the manager will be required to submit a regular quarterly compliance report to the Committee, indicating how it has exercised its proxy votes and specifically detailing any environmental issues. The Pensions Committee realises that, once the portfolio is invested entirely in government index-linked bonds and cash, there will be no equity voting rights and that considerations of social, environmental or ethical investment issues will not be relevant.

Investment strategy

The Pensions Committee has translated its objectives into a suitable strategic asset allocation benchmark for the Fund. All day-to-day investment decisions have been delegated to the Scheme's authorised investment manager. The Fund benchmark is consistent with the Committee's views on the appropriate balance between maximising the long-term return on investments and minimising short-term volatility and risk.

The investment strategy takes due account of the specific liability profile of the Fund, together with the planned funding arrangements agreed with the Fund's Guarantor – namely Defra.

The Committee has agreed a transition plan to move from the current position to the new agreed strategic asset allocation and benchmark by 1 April 2006. The Committee monitors strategy relative to its agreed asset allocation benchmark. It is intended that the investment strategy will be reviewed at least every three years, following actuarial valuations of the Fund.

Approved by the Pensions Committee on 17 November 2004.

Annex 3 – Memorandum of Understanding

Between

The Secretary of State for Environment, Food and Rural Affairs of Nobel House, 17 Smith Square, London SW1P 3JR (the Secretary of State); and

The Environment Agency – Pensions Committee of Rio House, Waterside Drive, Almondsbury, Bristol, BS32 4UD (the Agency)

Background

- 1 The Environment Agency Closed Fund (the Closed Fund) is vested in, and required to be maintained by, the Environment Agency by regulation 2(1) of the Local Government Pension Scheme (Environment Agency) Regulations 1996.
- 2 Before 1989, the Water Authorities Superannuation Fund (WASF) served the former Regional Water Authorities in England and Wales. Under the Water Act 1989 their water supply and sewerage functions were transferred to newly created water companies, together with the relevant employees. The pension liabilities and assets in respect of such employees were transferred from the WASF to the new water company pension schemes. The pension liabilities and assets in respect of the remaining employees, and also of the former employees and pensioners, were transferred with the WASF to the National Rivers Authority (the NRA), which set up a pension fund for its own employees (the Active Fund) into which were transferred the pension liabilities and assets in respect of the said remaining employees.
- 3 Following the transfer of active employed members to both the water company pension schemes and the Active Fund, the only remaining members of the WASF were deferred and pensioner members. No further members were admitted to it, so that it became a closed scheme (the Closed Fund). The Secretary of State and the NRA accepted the possibility that, in due course, the Closed Fund could have insufficient resources to meet its pension liabilities. With effect from 1 April 1996 the Agency assumed the functions of the NRA and the Closed Fund is now known as the Environment Agency Closed Fund.
- 4 The Closed Fund is maintained for the purposes of Section 7 of the Superannuation Act 1972, and accordingly the Secretary of State has the function conferred by Section 173 of the Act to make such payments into the Closed Fund as may be considered appropriate in respect of the actual and prospective liabilities falling from time to time to be met out of the Closed Fund for the benefit of its members (the Closed Fund members).
- 5 As at 31 March 2004, the Closed Fund's FRS 17 valuation indicated that it had a net deficit for accounting purposes of £826,600,000 and its actuarial valuation indicated that it had a funding level of 21 per cent which corresponded to a net past service reserve deficit of £880,000,000. The value of the liability under both valuations is sensitive to future mortality rates, inflation rates, and the discount rate used.
- 6 This Memorandum of Understanding sets out the mechanism whereby the Secretary of State will exercise the function under section 173 of the 1989 Water Act with a view to addressing the deficit in the Closed Fund.
- 7 This Memorandum has been agreed between the Secretary of State and the Environment Agency and the arrangements for funding the Closed Fund have been approved by Her Majesty's Treasury pursuant to that section, as indicated in the letter of 15 April 2004 from the Chief Secretary to the Secretary of State, subject to the conditions referred to in that letter.

Payments into the fund

- 8 The Closed Fund's funding level continues to deteriorate, and on actuarial advice it is assumed that the value of the assets will reduce to a level of between £50 million and £60 million by about April 2006. With effect from that date the Secretary of State will ensure that cash payments are made into the Fund each year totalling an amount equivalent to its total annual outgoings (defined as total anticipated payments to pensioners, transfers out of the Closed Fund, investment management or other agents' fees, administration costs, and all other liabilities or expenses whatsoever, less interest earned on such cash payments made to the Agency for the Closed Fund during the year) to be calculated and properly certified by the Agency in accordance with actuarial advice received.
- 9 Such payments will be solely to finance the Closed Fund's annual outgoings and will be treated separately from the Agency's mainstream finances. They will be made every six months, with the sums to be paid equalling the amount of the Fund's outgoings for the previous six months. The first payment into the Fund will be made in April 2006. These payments will continue until the liabilities of the Closed Fund have been met in full. Latest actuarial projections indicate that this will occur in 2062.
- 10 These payments will be in the form of ring-fenced grant-in-aid from the Secretary of State and will be paid twice each year in April and October through the normal grant-in-aid procedures to the Agency.
- 11 The Agency will provide the Secretary of State with a copy of actuarial advice received and such information as is reasonably required to illustrate how the payments certified as payable have been calculated. Any assets held in the Closed Fund in excess of the payments will be retained to protect against minor variations in outgoings until a certificate of the actuary to the Closed Fund confirms that their retention is unnecessary. A copy of any such certificate shall be provided by the Agency to the Secretary of State.
- 12 Payments made by the Secretary of State into the Closed Fund will be reported in Defra's annual accounts together with the Closed Fund's liability in accordance with FRS 17 (or any replacement accounting standard).

Payments to pensioners

- 13 Nothing in this Memorandum will affect the Agency's role in the making of payments from the Closed Fund which are to be made in accordance with the Local Government Pension Scheme Regulations 1997 (LGPS Regulations).

Control, monitoring and review

- 14 The Agency will manage the residual assets of the Closed Fund according to the high standards of financial integrity expected of those responsible for the management of public assets. The Agency will invest any surplus funds, as required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 and in accordance with the Closed Fund's Statement of Investment Principles and Funding Strategy Statement. The Agency's procedures and the accounts of the Fund will continue to be the subject of an annual external audit, and nothing in this Memorandum affects the need for an actuarial valuation of the Closed Fund as required by the LGPS Regulations.
- 15 For monitoring purposes, the Agency will inform the Secretary of State of the Closed Fund's liabilities at the end of each financial year in accordance with FRS 17 (or any replacement accounting standard).

- 16 This information will be used to update provisions in the annual accounts of Defra. Significant variations from profiled grant-in-aid payments will be fully justified by the Agency.
- 17 This Memorandum shall only be amended by the agreement in writing of both the Secretary of State and the Agency.

Brian Bender
Accounting Officer, Defra
On behalf of the Secretary of State for
Environment, Food and Rural Affairs

Barbara Young
Accounting Officer
Environment Agency
On behalf of the Environment Agency

Date of signature: 17 May 2005

Statistical summary of Fund membership and value

Fund membership	31 March 1996	31 March 1997	31 March 1998	31 March 1999	31 March 2000	31 March 2001	31 March 2002	31 March 2003	31 March 2004	31 March 2005	31 March 2006
Pensioners	25,671	25,128	24,575	23,996	23,364	22,761	22,117	21,476	20,833	20,113	19,456
Deferred pensioners	7,721	7,460	7,241	7,054	6,815	6,568	6,335	6,102	5,880	5,641	5,368
Total	33,392	32,588	31,816	31,050	30,179	29,329	28,452	27,578	26,713	25,754	24,824
Financial summary	31 March 1996 £m	31 March 1997 £m	31 March 1998 £m	31 March 1999 £m	31 March 2000 £m	31 March 2001 £m	31 March 2002 £m	31 March 2003 £m	31 March 2004 £m	31 March 2005 £m	31 March 2006 £m
Investment income	36	32	26	22	19	17	12	9	7	8	4
Benefits and other expenditure	(104)	(104)	(102)	(101)	(101)	(98)	(96)	(94)	(94)	(92)	(91)
Excess of benefits and other expenditure over investment income	(68)	(72)	(76)	(79)	(82)	(81)	(84)	(85)	(87)	(84)	(87)
Change in market value of investments	100	40	112	20	40	(28)	(9)	(44)	31	13	9
Net (decrease)/ increase in the Fund value	32	(32)	36	(59)	(42)	(109)	(93)	(129)	(56)	(71)	(78)
Market value of fund	724	692	728	669	627	518	425	296	240	169	91

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