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Environment Agency Active 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 Active Pension Fund (‘the Fund’), I am pleased to present the Fund’s Annual Report and Financial Statements for the year ended 31 March 2006.

Several changes to the Local Government Pension Scheme (the ‘LGPS’) were made during the year. Members have been kept informed about these. The Civil Partnership Act 2004 and the Gender Recognition Act 2004 both came into effect. The LGPS Regulations introduced a requirement for all funds to prepare, maintain and publish policy statements on Governance and Communications.

I am delighted to report that membership has continued to grow. Over the last year, total membership increased by over 1,100 to 18,278. This comprises 11,844 employees, 3,521 deferred members and 2,913 pensioners.

In last year’s report I advised you that our new investment strategy was implemented successfully in March 2005. I am pleased to report that the investment performance of all of our new managers was ahead of the benchmarks we set for them. The investment return of the whole portfolio was 0.8 per cent ahead of the Fund’s benchmark return.

The Fund’s net assets rose to £1,397 million as at 31 March 2006. The positive return increased our estimated solvency level to 98 per cent as at 31 March 2006 from 94 per cent as reported at the last triennial actuarial valuation as at 31 March 2004. Notwithstanding this our actuary has advised that the employer’s contribution should increase in 2006-07 in line with his 2004 valuation.

During the year our work in integrating financially material environmental issues was recognised and we were the proud winners of the Global Money Management Public Pension Fund of the year, the Investments and Pensions Europe SRI and Corporate Governance award and the UK Local Government Chronicle Corporate Governance Award.

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

John Edmonds 12 July 2006
Chairman
The Environment Agency Pensions Committee

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 in May 2006 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, a policy statement on Governance. In March 2006 the Agency Board approved a Governance Policy 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. The Governance Policy Statement may be found at *www.environment-agency.gov.uk/pensions*.

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 roadshows 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 member's 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).

Pensions Update No.8 was issued in February 2006, informing active members of the Scheme changes and giving details of proposed changes due to take place over the next year.

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 Fund. We would like to express our thanks to Capita for resolving fund member queries, and for successfully delivering eighteen roadshow/briefings to more than 1,000 Environment Agency employees.

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 Active 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 Active Fund fraud cases have come to light as a result of this exercise 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

Responsibility for managing the Fund's investments has been allocated to eight managers. Our managers, their investment styles and the division of the portfolio is as follows

Manager	Percentage of portfolio %	Investment style
Hermes Investment Management	37.0	Low-risk, passive index tracking
Standard Life Investments	16.8	Active UK Equities
European Credit Management	12.1	Active Corporate Bonds
State Street Global Advisors	9.5	Active Global Equities and low-risk, eco-enhanced UK index tracker
Sarasin Chiswell	7.8	Active Global Equities (SRI mandate)
Capital International	6.9	Active Global Equities
Morley Fund Management	4.4	Property
Robeco Alternative Investment	1.5	Private Equity
Other, principally cash	4.0	Pending allocation to managers

In July 2005 Morley Fund Management and Robeco Alternative Investments were appointed to manage the Fund's allocations to property and private equity respectively. During the year the Committee received regular reports on the investment performance of our external fund managers.

Corporate Governance and environmental policy

The Committee's Environmental Overlay Strategy (Annex 3) and Corporate Governance Policy (Annex 4) were implemented across the whole Fund during the year. These set out the principles that the Committee expect our Fund managers to adhere to. In line with our fiduciary duty our fund managers are required to take account of financially material environmental risks and to seek out investment opportunities to enhance their prospective investment performance. The Fund has continued to support the Local Authority Pension Fund Forum campaign to encourage environmental reporting by large companies. It has also supported the work of the UK Social Investment Forum, the Institutional Investors Group on Climate Change and the Carbon Disclosure Project. Further information on non-financial performance is included on pages 14 and on our web site www.environment-agency.gov.uk/pensions.

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
Mercer Investment Consulting – Investment Consultants
bFinance Ltd – Fund Manager Selection Consultants
Rathbone Greenbank – Sustainable Responsible Investment Consultants

Pension Fund membership

Unless they have elected in writing not to be members, all full and part-time employees of the Environment Agency, whether permanent or temporary, become active members of the Fund. The 12 months ended 31 March 2006 have seen an increase in the Fund's active membership of 2.0 per cent (2005: 5.3 per cent).

		2006 No.	2005 No.
Active membership			
At 1 April 2005		**11,615**	11,031
Add			
Entrants	– new starters	**1,208**	1,261
	– late notifications	**140**	0
		1,348	1,261
Less			
Exits	– late notification of previous year leavers	**(233)**	0
	– options pending	**(2)**	(15)
	– new retirement pensions	**(191)**	(200)
	– deaths in service	**(7)**	(8)
	– deferred benefits	**(608)**	(379)
	– transfers	**(2)**	(4)
	– refunds of contributions	**(25)**	(71)
	– new starters opted out before contributions made	**(51)**	0
		(1,119)	(677)
At 31 March 2006		**11,844**	11,615

Age profile at 31 March 2006

		2006 No	**%**	2005 No	%
Under 50	Male	**5,060**	**42.7**	5,058	43.5
	Female	**3,820**	**32.3**	3,633	31.3
		8,880	**75.0**	8,691	74.8
50 to 59	Male	**1,933**	**16.3**	1,933	16.6
	Female	**575**	**4.9**	535	4.6
		2,508	**21.2**	2,468	21.2
60 and over	Male	**396**	**3.3**	400	3.4
	Female	**60**	**0.5**	56	0.5
		456	**3.8**	456	3.9
Total		**11,844**	**100.0**	11,615	100.0

The Fund also has		
Current pensioners *(including spouses' and children's pensions)*	**2,913**	2,721
Deferred pensioners	**3,521**	2,801
Total	**18,278**	17,137

Based on data supplied by Capita Hartshead on 13 April 2006. Capita Hartshead's contact details are included on the back cover.

The figure for Deferred Pensioners includes 331 cases (2005: 359) where there is no entitlement to a deferred pension, and the only entitlement is to a refund of contributions. These are former employees whom we are unable to trace, with refunds being paid as and when we do make contact with them.

Communications

Pensions Update 6 was mailed to Active members in May 2005. It mainly focussed on changes due to take effect on 1 April 2005, explaining that, in spite of the Deputy Prime Minister's announcement on 18 March that he intended to revoke the changes, the changes would remain in force until revocation.

Pensions Update 7 was mailed to Active members in early September. It covered the effect of the revocation of the 1 April 2005 changes and described the formation by the Deputy Prime Minister of a Tripartite Committee to assist in the development of a way forward for the LGPS.

Pensions Update 8 was mailed to Active members during March 2006. It explained the introduction of measures to take account of the Civil Partnership Act 2004 and the Gender Recognition Act 2004. It also covered the requirement for Funds to produce and maintain policy statements on Governance and Communications and outlined proposals for changes to the LGPS to take effect during 2006-2007.

Further newsletters are planned to inform members of pension developments, including the final LGPS changes as a result of the new HM Revenue & Customs rules effective from April 2006 and the LGPS changes planned for 2008.

Active and deferred members will receive an annual statement of their accrued pension benefits during the year.

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

During the year our Members Guide, which is sent to all new starters and made available electronically to all active members was updated twice. The first update in April reflected the 1 April 2005 changes to the LGPS Regulations and the second, in August, reflected the revocation of those changes. Further updates will be produced during 2006-2007 to reflect the forthcoming changes to the LGPS Regulations.

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.

The pensions administration contract with Capita Hartshead includes the provision of annual presentations on pensions and related matters at each Region and Head Office. These are known as Pensions Roadshows. They are targeted at employees, and several regions held additional presentations over and above the contractual requirements. The Regions pay for these extra presentations. In total, more than 1,000 Environment Agency staff attended the 2005-2006 Roadshows.

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 these Financial Statements.

Investment limits

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended) require the Environment Agency to invest 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, the 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;
  - 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;
  - 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;
  - the value of any single insurance contract.

Statement of Investment Principles

All LGPS funds are required to publish a Statement of Investment Principles. This is reproduced in Annex 2. The Pensions Committee will review the Statement of Investment Principles during 2006-2007.

Environmental Overlay Strategy

The Pensions Committee has adopted an Environmental Overlay Strategy to be applied across all of the Fund's assets. Details of this strategy can be found in Annex 3.

Investment strategy

Although the management of the Fund's investments is vested in the Environment Agency, responsibility for altering its investment policy is delegated to the Pensions Committee.

The investment strategy developed by the Committee aims to maximise the return of the Fund, within an acceptable level of risk, by diversifying its investments throughout world markets. In developing the strategy the Pensions Committee was mindful both of recent disappointing returns and of the declining number of 'balanced' managers available to actively manage multi-asset portfolios. Consequently the Committee agreed to adopt a specialist investment manager approach for the Active Fund.

Furthermore the Committee reviewed the strategic asset allocation adopted by the Fund. It resolved that the proportion invested in UK equities should be reduced to 31.5 per cent and the proportion invested in overseas equities should be increased to 31.5 per cent. In addition, it agreed to allocate 13.5 per cent to index-linked gilts, 13.5 per cent to corporate bonds, and 5 per cent to both property and private equity. The Committee believes that this further diversification of the Fund's assets will reduce risk whilst enhancing potential returns.

Prior to implementing the new asset allocation, the Fund advertised eight new investment mandates. Almost 140 responses were received. Each response was closely evaluated with regards to potential financial returns, risk and the ability to implement the environmental overlay strategy. In March 2005 six new managers were appointed to manage a multi-asset, low-risk, index-tracking portfolio, medium-risk active corporate bonds, medium-risk active UK equities, and two medium-risk active global equity portfolios. A sixth environmental specialist equity portfolio was also awarded. The final two mandates – property and private equity – were awarded in July 2005. The table below details the mandates awarded

Manager	**Investment style**	**Asset classes**
Hermes Investment Management	Passive	UK/Overseas Equities and Index-Linked Gilts
Standard Life Investments	Active	UK Equities
European Credit Management	Active	Corporate Bonds
Capital International	Active	Global Equities
State Street Global Advisors	Active	Global Equities
Sarasin Chiswell	Active	Global Equities (SRI)
Morley Fund Management	Active	Property
Robeco Alternative Investments	Active	Private Equity

Custody arrangements

With the exception of managed fund units, The Northern Trust Company ('Northern Trust') acts as global custodian on behalf of the Fund's assets. All assets 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 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. Other procedures and controls are in accordance with the Statement on Auditing Standards document – SAS 70.

Investment management

The Fund's investment managers implement the Committee's investment strategy. Each manager has full discretion in the management of their portfolios, subject to complying with statutory limits and the Statement of Investment Principles. Each manager is required to take due regard of the Environmental Overlay Strategy.

The Committee has set the overall investment objective for the Fund in the light of the triennial actuarial valuation. It has considered the Fund's net contribution inflows and the maturity profile of its liabilities.

Fund benchmark

The Committee has set the following strategic benchmark for the Fund

UK Equities	31.5 per cent	FTSE All Share Index
Global Equities	31.5 per cent	FTSE All World ex UK
Index-Linked Gilts	13.5 per cent	FTSE Actuaries over 5 Year Index-Linked Gilts
Corporate Bonds	13.5 per cent	iBoxx Sterling all non-gilt
Property	5.0 per cent	IPD UK Monthly
Private Equity	5.0 per cent	Absolute Return

Manager benchmark

Each manager has been set a specific benchmark that reflects the asset class that they are managing. The benchmarks of the new managers are

Hermes	Passive UK Equities	FTSE All Share Index
	Passive North American Equities	FTSE World North America
	Passive European Equities	FTSE World Europe ex UK
	Passive Japanese Equities	FTSE World Japan
	Passive Asia Pacific Equities	FTSE World Asia Pacific ex Japan
European Credit	Active Corporate Bonds	iBoxx Sterling all non-gilt
Standard Life	Active UK Equities	FTSE All Share Index
Capital International	Active Global Equities	MSCI All Country World
State Street	Active Global Equities	MSCI All Country World
	Passive UK Equities Low Risk Eco-enhanced	FTSE 350 Index
Sarasin Chiswell	Active Global Equities (SRI)	MSCI All Country World
Morley	Active Property	IPD UK Monthly
Robeco	Active Private Equity	Absolute Return

Performance target

Each manager has been set a performance target over three-year rolling periods as follows

Hermes	to match their benchmarks
European Credit	to beat their benchmark by one per cent per annum
Standard Life	to beat their benchmark by two per cent per annum
Sarasin Chiswell	to beat their benchmark by two per cent per annum
Capital International	to beat their benchmark by three per cent per annum
State Street	to beat their benchmark by three per cent per annum (global equities) and to track the FTSE 350 Index (UK equities)
Morley	to beat their benchmark by one per cent
Robeco	minimum internal rate of return of 10 per cent per annum or 5 per cent greater than the return on MSCI World index

Financial performance

The Fund's overall return in the year was a positive 22.8 per cent (2005: positive 10.7 per cent) compared to the benchmark return of a positive 22.0 per cent (2005: positive 11.3 per cent).

During the same period the headline rate of the Retail Prices Index rose by 2.4 per cent (2005: 3.2 per cent).

Over the three years to 31 March 2006 the annualised rate of return was positive 19.3 per cent (2005: positive 1.9 per cent). The benchmark return was positive 19.0 per cent (2005: positive 2.6 per cent).

The table below shows the performance of the managers in place for the full year. Both Morley and Robeco were appointed during the year so full year data is not available.

Manager	**One-year benchmark return %**	**One-year return %**	**Performance relative to benchmark %**
Hermes (UK Equity)	+28.0	+27.7	-0.3
Hermes (UK Index-Linked Gilts)	+9.0	+8.9	-0.1
Hermes (North American Equity)	+24.3	+24.2	-0.1
Hermes (European Equity)	+36.0	+35.9	-0.1
Hermes (Japanese Equity)	+49.0	+48.2	+0.8
Hermes (Pacific ex-Japan Equity)	+34.1	+34.3	+0.2
European Credit Management (Corporate Bonds)	+7.8	+8.1	+0.3
Standard Life (UK Equities)	+28.0	+31.1	+3.1
Capital International (Global Equities)	+30.4	+31.7	+1.3
State Street (Global Equities)	+30.4	+31.6	+1.2
Sarasin Chiswell (Environmental Specialist)	+30.4	+39.9	+9.5
State Street (UK Equity)	+28.1	+26.7	-1.4

Portfolio analysis

Distribution of net assets at market value as at 31 March 2006

	Hermes £m	**Standard Life £m**	**ECM £m**	**SSGA £m**	**Sarasin Chiswell £m**	**Capital Int'l £m**	**Morley £m**	**Robeco £m**	**Other £m**	**Total £m**	**Per cent of Fund %**
UK equities	140.8	221.9		41.7	12.4	13.9				430.7	30.9
Fixed interest			168.0							168.0	12.1
Pooled index linked	170.9									170.9	12.3
Overseas equities	200.2	5.5		87.6	94.0	80.8				468.1	33.6
North American	117.9			53.1	20.5	33.0				224.5	16.1
Europe	44.8			20.4	50.8	19.7				135.7	9.7
Japan	23.1			11.3	8.4	12.5				55.3	4.0
Pacific Basin	14.1	2.4		2.8	2.4	3.5				25.2	1.8
Emerging markets	0.3	3.1			11.9	12.1				27.4	2.0
Property							60.4			60.4	4.3
Private equity								8.3		8.3	0.6
Cash (including current assets)	1.9	1.9		1.4	1.9	0.6	6.2	13.0	55.3	82.2	5.9
AVC investments									4.7	4.7	0.3
Other net investments	1.1	3.7		0.4	0.3	0.4	(5.3)	(0.3)	0.2	0.5	0.0
Total	**514.9**	**233.0**	**168.0**	**131.1**	**108.6**	**95.7**	**61.3**	**21.0**	**60.2**	**1,393.8**	**100**

The Fund has no employer related investments.

Geographical distribution of equity investments

	2006		2005	
	Total £m	**%**	Total £m	%
United Kingdom	**430.7**	**47.9**	352.4	50.0
North American	**224.5**	**25.0**	182.2	25.9
European (excluding UK)	**135.7**	**15.1**	105.6	15.0
Japan	**55.3**	**6.2**	38.6	5.5
Pacific (excluding Japan)	**25.2**	**2.8**	17.9	2.5
Emerging markets	**27.4**	**3.0**	8.0	1.1
Total	**898.8**	**100**	704.7	100

UK equities by sector

	2006			2005	
Sectors	**Total £m**	**%**	Sectors	Total £m	%
Banks	**87.6**	**20.3**	Banks	68.6	19.5
Oil and Gas	**71.8**	**16.7**	Oil and Gas	41.3	11.7
Industrial Goods & Services	**49.1**	**11.4**	Telecommunications	35.0	9.9
Healthcare	**30.4**	**7.1**	Pharmaceuticals	22.6	6.4
Basic Resources	**29.8**	**6.9**	Mining	22.5	6.3
Insurance	**22.8**	**5.3**	Life insurance	14.3	4.1
Telecommunications	**21.4**	**5.0**	General retailers	13.1	3.8
Travel and Leisure	**19.5**	**4.5**	Transport	13.0	3.7
Utilities	**16.9**	**3.9**	Media	12.8	3.6
Other sectors	**81.4**	**18.9**	Other sectors	109.2	31.0
Total	**430.7**	**100.0**	Total	352.4	100.0

(In January 2006 FTSE international instigated a new sector classification.)

Largest UK equity holdings

Company	**Total £m**	**% of UK Equity**
BP	32.6	7.6
HSBC Holdings	29.3	6.8
GlaxoSmithKline	20.8	4.8
Royal Bank of Scotland Group	20.6	4.8
Royal Dutch Shell	17.5	4.1
Vodafone Group	17.4	4.0
HBOS	14.5	3.4
Anglo American	13.2	3.1
Barclays Bank	12.6	2.9
Aviva	10.0	2.3

Largest overseas equity holdings

Company	Country	£m	Percentage of equities %
Texas Instruments	United States	3.2	0.5
Canon	Japan	3.2	0.5
International Business Machines	United States	3.2	0.5
Oest Elektrizitats	Austria	3.1	0.5
Deutsche Telekom	Germany	2.7	0.4
Statoil	Norway	2.7	0.4
Solarworld	Germany	2.6	0.4
Encana Corporation	Canada	2.5	0.4
Westpac Banking	Australia	2.5	0.4
Home Depot	United States	2.4	0.4

Non-financial performance

The Environment Agency Pension Fund seeks to manage its investments in a financially robust and environmentally responsible way. Non-financial issues are increasingly important in assessing the quality of management and its management of risks relating to environmental and social issues which may impact on the future performance and prospects of a company.

Corporate governance, engagement and voting

We believe that well governed companies produce better and more sustainable returns than poorly governed companies. To assess polices, processes and practices, all of our equity fund managers regularly engage with companies either directly or through a specialist provider. Examples of engagements on environmental issues include companies' management of risks relating to Waste Electrical and Electronic Equipment Directive (WEEE) and their intention to use the Defra Environmental KPI's.

We aim to vote on all environmental resolutions in the UK, Europe and North America and, where practical, worldwide. During the year we voted on 32 environmental resolutions, 91 per cent of which were in North America. The two recurring issues during the year were the publications sustainability reports and reports on climate change. The Fund makes its voting record on environmental resolutions and votes against management information publicly available.

United Nations Principles of Responsible Investment

The Fund's Corporate Governance and Environmental Overlay strategies set out how we achieve or seek to achieve all of the stated principles. A more detailed compliance assessment report is on our website at www.environment-agency.gov.uk/pensions.

Environmental overlay

The Committee's Environmental Overlay Strategy applies across all of the Fund's mandates and we monitor and report on the progress of its implementation every quarter.

We were delighted that our work in integrating financially material environmental issues was recognised during the year. We were proud winners of three awards and runner-up in the *Socially and Ethically Responsible Investment and Asset Management Award* by Liveable City Awards by City of London Corporation and UK Social Investment Forum.

- *Winner of the Global Money Management Awards 2006 Public Pension Fund of the Year*

Open to all public sector pension funds throughout the world the Environment Agency Pension Fund was commended for balancing good investment performance and its role as an environmental watchdog. In particular for the evaluation of investment manager's processes using an environmental overlay strategy on all asset classes, including equity, private equity, bonds and property.

- *Winner of the Investments and Pensions Europe Fund Awards 2005 SRI and Corporate Governance Award*

Leading pension funds from over 25 EU countries entered the awards. The Environment Agency Pension Fund won the corporate governance and socially responsible investment (SRI) award and was cited for environmentally friendly investment whilst maintaining the best risk/reward ratio.

- *Winner of the UK Local Government Chronicle Pension Fund Awards 2005 Corporate Governance Award*

There are approximately 100 funds in the LGPS and over half entered these awards run by the Local Government Chronicle. The judge said the Environment Agency Fund stood out from the others because it has embraced responsible investing to a level seldom seen in the whole UK pension industry and placed it central to the whole investment process.

Footprinting

The Fund is undertaking a groundbreaking project to 'ecologically footprint' the pension fund. We have already undertaken preliminary footprinting of each of our segregated funds against their respective benchmarks. The footprinting aims to provide a fresh perspective on risk, stock selection and sector exposures. We will be developing the methodology during 2006-2007.

Class actions

Where shareholder value has been eroded by malevolent action by company directors, sometimes it is possible for monies to be recovered via the courts by a shareholder class action against the company or its directors. We have retained Northern Trust to monitor these class actions and to recover for the Fund any monies due, although the total involved is currently not significant.

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**	
Effective decision-making		**Explicit mandates**	
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 Active Pension Fund (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').

Being a local government pension scheme the Fund is contracted out of the State Second Pension Scheme ('S2P') and is exempt approved for the purposes of Chapter I of Part XIV of the Income and Corporation Taxes Act 1988. Full tax relief is granted on members' and the Environment Agency's contributions paid to the Fund and on all United Kingdom investment income other than dividends arising from UK equities. (Since 6 April 2006 the Fund is a Registered Pension Scheme under Chapter 2 of Part 4 of the Finance Act 2004).

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' (revised November 2002).

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 (Defra). 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 responsible for keeping records of contributions received in respect of active members of the Fund and for ensuring that contributions are made to the Fund in accordance with the Pensions Act 1995, the 1997 regulations and with the recommendations of the Consulting Actuary.

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.

Contribution income has risen by £7.4 million to £54.4 million (2005: risen by £5.2 million to £47.0 million). The increase for the year ended 31 March 2006 was due mainly to the increase in the employer's rate and the rise in the number of members contributing during the year.

Net income from all transfer values received has increased by £0.8 million to £6.7 million (2005: increased by £1.3 million to £5.9 million).

Retirement benefits and other payments made to or in respect of members during the year have increased by £5.4 million to £29.9 million (2005: increased by £1.3 million to £24.6 million).

In overall terms the net additions from dealings with members during the year amount to £25.1 million (2005: £25.3 million).

The value of the net assets of the Fund at 31 March 2006 has increased by £277.3 million to £1,396.9 million (2005: increased by £133.4 million to £1,119.5 million). This is primarily due to a significant increase in the market value of its investments.

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 in 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 individual performance is monitored formally twice a year by the Head of Environemental Finance and Pension Fund Management.

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 are conducted in accordance with Government Internal Audit Standards.

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 pension data to Capita Hartshead and in Finance to enhance the Funds' risk register for ongoing risk management purposes.

Paul Leinster 12 July 2006
Chief Executive (Acting) and Accounting Officer

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 assumed that the following amounts will be paid to the Fund

Employees – Contributions in accordance with the Local Government Pension Scheme Regulations 1997.

Employer – Contributions, for the period commencing 1 April 2005 as specified in our Certificate dated 7 March 2005 contained in our valuation report as at 31 March 2004.

Summary of methods and assumptions used

Full details of the method and assumptions are described in our valuation report dated 7 March 2005.

My opinion on the security of the prospective rights is based on the projected unit valuation method. This assesses the cost of benefits accruing to existing members during the year following the valuation, allowing for future salary increases. The resulting contribution rate is adjusted to allow for any difference in the value of accrued liabilities (allowing for future salary increases) and the market value of assets.

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 were as follows

Financial assumptions	**March 2004**	
	% per annum Nominal	**% per annum Real**
Minimum Risk rate of return	4.7	1.8
Investment return		
Equities	6.7	3.8
Bonds (50 per cent gilt/50 per cent corporates)	5.1	2.2
Discount rate *(70 per cent equities/30 per cent bonds)*	6.2	3.3
Pay Increases	4.9	2.0
Price Inflation/Pension Increases	2.9	0

In order to value both those liabilities which have accrued at the valuation date and those accruing in respect of future service I have assumed that the Fund's assets are invested in a portfolio consisting of 70 per cent equities and 30 per cent bonds. The stream of future liability payments is converted into a capital value today by assuming a return on Fund assets of 6.2 per cent a year.

The 2004 valuation revealed that at 31 March 2004 the Fund's assets were sufficient to meet 94 per cent (112 per cent at 31 March 2001) of the liabilities accrued up to that date. Assets were taken into account at their then market value of £983 million (£937 million smoothed market value at 31 March 2001).

The employer's contributions have been set in accordance with the Fund's Funding Strategy Statement. The deficit is being spread over a period of 13 years, equivalent to the remaining working lifetime of scheme members, and the rise in contributions is being phased in over four years. Employer's contributions will rise from 12 per cent of pay in 2005-2006 to 13.5 per cent of pay in 2006-2007. Employer's contributions will rise to 15 per cent of pay in 2007-2008, with a further planned increase to 16.5 per cent of pay in 2008-2009, subject to the results of next valuation of the Fund.

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

Experience since April 2004

The financial experience of the Fund since the 31 March 2004 valuation has been mixed, with significant rises in the value of equity investments but, partially offsetting this, falls in long-term rates of interest. The benefit promise has been amended to remove an early retirement right (known as the Rule of 85) for service from 1 October 2006. However, further changes have been proposed by the Department for Communities and Local Government that would delay this change to 1 April 2008 for existing members.

The updated funding level as at 31 March 2006 was estimated to be 98 per cent. This figure was calculated using a method and assumptions that are consistent with those used at the previous formal valuation, with the financial assumptions updated to reflect market conditions at 31 March 2006.

As at May 2006, I would not expect the employer contribution rate following the 2007 valuation to be lower than the 16.5 per cent of pay planned for 2008-2009, given the combined effects of changes in investment market conditions, the removal of the Rule of 85 and the inclusion of a reserve for mortality improvement.

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

27 June 2006

The Comptroller and Auditor General's Statement about contributions to the Board of the Environment Agency and the Secretary of State for Environment, Food and Rural Affairs

I have examined the summary of contributions to the Environment Agency Active Pension Fund for the Fund year ended 31 March 2006 which is set out on page 27.

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

As described in the statement of the Pensions Committee's responsibilities, the Pensions Committee is responsible for ensuring that contributions are made to the Fund in accordance with the Local Government Pension Scheme Regulations 1997 and the recommendations of the Consulting Actuary. It is my responsibility to provide a statement about contributions paid in accordance with the Local Government Pension Scheme Regulations 1997 and with the recommendations of the Consulting Actuary and to report my opinion to you.

Basis of statement about contributions

I planned and performed our work so as to obtain the information and explanations which I considered necessary in order to give reasonable assurance that contributions reported in the attached summary of contributions payable have been paid in accordance with the relevant requirements. For this purpose the work that I carried out included examination, on a test basis, of evidence relevant to the amounts of contributions paid to the Fund and the timing of those payments in accordance with the Local Government Pension Scheme Regulations 1997 and the recommendations of the Consulting Actuary. My Statement about contributions is required to refer to those breaches of the Local Government Pension Scheme Regulations 1997 and the recommendations of the Consulting Actuary which come to my attention in the course of my work.

Statement about contributions

In my opinion contributions for the Fund year ended 31 March 2006 as reported in the attached summary of contributions payable have been paid in accordance with the Local Government Pension Scheme Regulations 1997 and the recommendations of the Consulting Actuary.

John Bourn
Comptroller and Auditor General

18 July 2006

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

Summary of contributions payable in the year

During the year, the contributions payable to the Scheme in accordance with the Local Government Pension Scheme Regulations 1997 (as amended) by the Employee and Employer for the year ended 31 March 2006 were as follows

	Employee £000	Employer £000
Required by the Schedule of Contributions		
Normal contributions	16,914	33,760
Special contributions	0	2,910
Total	**16,914**	**36,670**
Other contributions payable		
Additional voluntary contributions (AVCs)	340	0
Purchase of added years	479	0
	819	**0**
Total (as per Fund Account – see note 3)		**54,403**

Signed on behalf of the Environment Agency Pensions Committee

John Edmonds
Chairman
The Environment Agency Pensions Committee
12 July 2006

Paul Leinster
Chief Executive (Acting) and Accounting Officer
The Environment Agency
12 July 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 18 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 Pensions 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 20 to 23 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			
Contributions and benefits			
Contributions receivable	3	**54,403**	46,950
Transfer values received	4	**6,688**	5,888
		61,091	52,838
Benefits payable	5	**(29,948)**	(24,591)
Payments to and on account of leavers	6	**(4,950)**	(2,046)
Administration expenses	7	**(1,130)**	(935)
		(36,028)	(27,572)
Net additions from dealings with members		**25,063**	25,266
Returns on investments			
Investment income	8	**21,555**	26,950
Change in market value of investments	9	**234,685**	83,106
Investment management expenses	10	**(3,927)**	(1,904)
Net returns on investments		**252,313**	108,152
Net increase in the Fund during the year		**277,376**	133,418
Net assets of the Fund at 1 April 2005		**1,119,560**	986,142
At 31 March 2006		**1,396,936**	1,119,560
Net Assets Statement			
Investments	9	**1,393,831**	1,115,838
Current assets and liabilities	11	**3,105**	3,722
Net assets of the Fund at 31 March 2006		**1,396,936**	1,119,560

The notes on pages 31 to 37 form part of these Financial Statements.

John Edmonds
Chairman
The Environment Agency Pensions Committee
12 July 2006

Paul Leinster
Chief Executive (Acting) and Accounting Officer
The 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 pages 24 to 25 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.

c In the prior year liquidated investments previously included as current assets have been reanalysed as Other Investment assets.

d 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, which reflect the underlying investments.

iii The Fund's global custodian is not authorised to enter into stock lending arrangements and no stock lending has taken place in the year.

iv Acquisition costs are included in the purchase cost of investments.

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. Income on investments in property pooled investment vehicles is distributed and recognised on an accruals basis.

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.

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.

iv Surpluses and deficits arising on conversion or translation are dealt with as part of the change in market value of investments.

Contributions

Normal contributions, both from the members and from the employer, are accounted for as they fall due under the Schedule of Contributions. The employer's contributions are made at a rate determined by the Consulting Actuary necessary to ensure that the Fund is able to meet its existing and prospective liabilities including indexation.

Special contributions made by the employer are payments in accordance with regulation 80(1) of the Local Government Pension Scheme Regulations 1997 (as amended) to cover the cost of additional membership awarded to leavers aged 50 and over by the Agency under regulation 52 of those regulations. Special contributions are accounted for in accordance with the agreement under which they are paid, or, in the absence of such an agreement, when paid.

Contributions from members for the purchase of added years and additional voluntary contributions are accounted for in the month deducted from the payroll.

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 I 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. 'The Fund became a registered pension scheme under Chapter 2 Part 4 of the Finance Act 2004 with effect from 6 April 2006.

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 Contributions receivable

	2006	2005
	£000	£000
Employer		
normal	**33,760**	29,465
special	**2,910**	788
Members		
normal	**16,914**	15,906
purchase of added years	**479**	411
additional voluntary contributions (AVCs)	**340**	380
	54,403	46,950

4 Transfer values received

	2006	2005
	£000	£000
Individual transfers from other schemes	**6,520**	5,792
AVC transfers	**168**	96
	6,688	5,888

Transfer values have been paid ('cash equivalents' within the meaning of Part 1 of Schedule 5 to the Pensions Scheme Act 1993), and service credits given for transfers received, calculated in accordance with the method and assumptions approved by the Pensions Committee on the advice of the Actuary and based on guidelines issued by the Institute and Faculty of Actuaries.

No discretionary benefits have been included in the calculation of transfer values.

5 Benefits payable

	2006 £000	2005 £000
Retirement and dependants' pensions	**21,499**	18,952
Lump sum retirement grants	**7,854**	5,006
Lump sum death grants	**595**	626
Purchase of annuities	**0**	7
	29,948	24,591

Benefits payable exclude £1.6 million (2005 £1.5 million) for unfunded pensions liabilities paid via the Fund in respect of compensatory added years. This has been recharged to the Agency and funded by Grant-In-Aid from Defra.

6 Payments to and on account of leavers

	2006 £000	2005 £000
Individual transfers to other schemes	**4,801**	1,825
Refunds of contributions	**66**	108
Payments to SERPS	**24**	56
AVC transfers	**59**	57
	4,950	2,046

7 Administration expenses

	2006 £000	2005 £000
Scheme administration	**616**	458
Professional fees		
Actuarial	**57**	41
Audit	**23**	27
Legal	**90**	91
Consultancy	**30**	0
Other administration costs		
Environment Agency administration	**239**	217
Communications to members	**52**	80
Miscellaneous	**23**	21
	1,130	935

8 Investment income

	2006 £000	2005 £000
Income from fixed-interest securities	**230**	3,245
Dividends from equities	**16,801**	20,695
Interest on cash deposits	**4,010**	3,010
Income from property unit trusts and managed funds	**514**	0
	21,555	26,950

For unit trust expenses, both income and expenditure are shown gross of initial expenses – £334,000 (2005: £452,000).

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
Equities	535,089	244,458	(245,109)	148,232	682,670
Pooled investments	321,182	202	(991)	66,838	387,231
Cash deposits and instruments	91,037	0	(8,842)	0	82,195
Pooled investment vehicles					
Fixed-interest securities	155,333	0	(502)	13,149	167,980
Pooled investment vehicles					
Property	0	55,534	0	4,851	60,385
Private equity	0	10,028	(2,755)	1,028	8,301
AVC investments	4,124	440	(461)	587	4,690
	1,106,765	**310,662**	**(258,660)**	**234,685**	**1,393,452**
Other	9,073				379
	1,115,838				**1,393,831**

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 £000	2005 £000
Equities		
UK quoted	**430,580**	347,131
Overseas quoted	**252,090**	187,958
	682,670	535,089
Pooled investment vehicles		
Unit trusts equities - UK	**179**	0
Unit trusts equities - overseas	**216,157**	164,319
Unit trusts bonds - index linked gilts	**170,895**	156,863
	387,231	321,182
Cash deposits and instruments	**82,195**	91,037
Pooled investment vehicles - fixed-interest securities		
Overseas quoted	**167,980**	155,333
Pooled investment vehicles - property		
Unit Trusts - UK	**46,555**	0
Managed Funds - UK	**9,861**	0
Limited partnership - UK unquoted	**3,969**	0
	60,385	0
Private equity		
UK - unquoted	**1,301**	0
Overseas - unquoted	**7,000**	0
	8,301	0
Other		
Income tax recoverable	**62**	173
Accrued income	**4,129**	5,563
Due to brokers	**(3,812)**	(466)
Liquidated investments	**0**	3,803
	379	9,073

AVC investments

The Environment Agency holds assets with The Equitable Life Assurance Society, Clerical Medical and Standard Life. These are in the form of with-profits, unit-linked and building society fund accounts and secure additional benefits on a money purchase basis for those members electing to pay additional voluntary contributions. Members participating in this arrangement each receive an annual statement made up to 31 March confirming the amounts held to their account and the movements in the year.

The aggregate amounts of AVC investments as at 31 March are as follows

	2006	2005
	£000	£000
The Equitable Life Assurance Society		
Equitable with-profits funds	**681**	789
Equitable unit-linked funds	**958**	885
Equitable building society funds	**205**	235
	1,844	1,909
Clerical Medical		
With-profits funds	**415**	332
Unit-linked funds	**776**	556
	1,191	888
Standard Life	**1,655**	1,327
Total AVC investments	**4,690**	4,124

Total investments

Including pooled investment vehicles total investments may be restated as follows

	2006	2005
	£000	£000
Total equities (includes pooled and private equity)	**907,308**	699,408
Total bonds (includes pooled and index-linked)	**338,874**	312,196
Property	**60,385**	0
Total cash	**82,195**	91,037
Total AVC	**4,690**	4,124
Total other	**379**	9,073
Total investments	**1,393,831**	1,115,838

Investments exceeding 5 per cent of net assets

At 31 March 2006 the holding in European Credit (Luxembourg) S.A. Medium Term Note was valued at £114.0 million; this represents 8.2 per cent of the net assets of the Fund (2005: £105.1 million and 9.4 per cent).

10 Investment management expenses

	2006	2005
	£000	£000
Fund manager fees	**3,615**	1,561
Global custody	**156**	148
Investment advisers	**100**	162
Performance and risk measurement	**56**	33
	3,927	1,904

Total fund manager fees include management charges for the UK non-gilt Fixed Interest mandate with European Credit Management that are settled directly within the portfolio in accordance with the investment management agreement.

11 Current assets and liabilities

	2006 £000	2005 £000
Debtors		
Amounts due from the Environment Agency	**4,055**	4,033
Cash	**1,430**	700
	5,485	4,733
Creditors		
Other accrued expenses	**(2,380)**	(1,011)
	3,105	3,722

Amounts due from the Environment Agency are

i employers' and employees' contributions of £2,634,000 (2005: £2,520,000) and £1,350,000 (2005: £1,416,000) respectively outstanding in the normal course of collection at the year end and subsequently paid over within the statutory time limit; and

ii invoices for £57,000 (2005: £97,000) in respect of pensions paid from, but not chargeable to, the Fund.

12 Related party transactions

During the year ended 31 March 2006 there have been the following related party transactions

i pensions administration costs of £239,000 (2005: £217,000) recharged to the Fund by the Environment Agency (see Note 7);

ii eleven members of the Pensions Committee are contributing members of the Fund and contributions are paid by the Environment Agency in accordance with the Local Government Pension Scheme Regulations 1997 (as amended) (the 1997 regulations) and the recommendations of the Consulting Actuary; and

iii one member of the Committee is in receipt of a retirement pension payable from the Fund, calculated and paid in accordance with the 1997 regulations.

13 Apportionment of common expenditure

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

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

Annex 1 – Funding Strategy Statement

Introduction

This document constitutes the Funding Strategy Statement (FSS) of the Environment Agency Active 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. The Employer pays 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 is part of the family of Local Government Pension Schemes (LGPS).

The Fund was established in 1989 at the time of the privatisation of the water industry in England and Wales. The Fund inherited active members' accrued liabilities from the predecessor pension arrangements, but no pensioners' or deferred pensioner liabilities. Since then, the Fund has been gradually maturing.

A separate Closed Fund, which is guaranteed by the Department for the Environment, Food and Rural Affairs, exists for pensioners and deferred pensioners that did not transfer to one of the privatised water companies' pension schemes in 1989. The Closed Fund has its own FSS.

Profile of liabilities

As at 31 March 2004, the Fund contained 11,031 active members, 2,501 pensioners and 2,668 deferred pension members whose benefits have yet to come into payment.

Unlike typical LGPS funds, the Fund only has a single participant employer – the Environment Agency.

Regulatory framework

The FSS forms part of a framework, which includes

- the Local Government Pension Scheme Regulations 1997;
- the Rates and Adjustments Certificate, which can be found appended to the Fund Actuary's triennial valuation report;
- actuarial factors for valuing early retirement costs and the cost of buying extra service; and
- the Statement of Investment Principles.

The FSS has been prepared by the Administering Authority with advice from the Fund's Actuary, Douglas Anderson of Hymans Robertson, in consultation with the Employer and the Fund's investment consultant, Nick Sykes of Mercer Investment Consulting.

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 in Section 3, the Administering Authority has focused on balancing the desirability of affordability of contributions, transparency of processes, stability of the employer's contributions, and prudence in the funding basis.

Purpose of the Fund

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

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

Aim of the Funding Policy

The Administering Authority's approach to funding the Employer's pension liabilities is focused on

- building up assets to provide for new benefits of current employees as they are earned; and
- aiming to recover any shortfall in assets relative to the value placed on accrued liabilities over broadly the expected remaining working lifetime of current employees.

Solvency issues and target funding levels

Derivation of Employer contributions

Employer contributions are normally made up of two elements

a the estimated cost of future benefits being accrued, referred to as the 'future service rate'; plus

b an adjustment for the funding position (or solvency) of accrued benefits relative to the Fund's solvency target. This is called the 'past service adjustment'. If there is a surplus there may be a contribution reduction. If there is a deficit there may be a contribution addition. Any surplus or deficit will be spread over an appropriate period.

The Fund's Actuary is required by the regulations to report the Common Contribution Rate[1] for the Employer at each triennial valuation. It combines items (a) and (b) and is expressed as a percentage of pay.

Solvency and target funding levels

The Fund's Actuary is required to report on the 'solvency' of the whole fund at least every three years.

1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998.

'Solvency' is defined as the ratio of the market value of assets to the value placed on accrued benefits on the Fund Actuary's on-going funding basis. This quantity is known as a funding level.

As at 31 March 2004, 94 per cent of the liabilities of the Fund were covered by its assets.

The ongoing funding basis is that used for each triennial valuation. The Fund Actuary agrees the financial and demographic assumptions to be used for each such valuation with the Administering Authority.

On-going funding basis

The demographic assumptions are intended to be best estimates of future experience in the Fund.

The key financial assumption is the anticipated return on the Fund's investments. The investment return assumption makes an allowance for anticipated returns from equities being in excess of bonds. Although there is no guarantee that equities will out-perform bonds, historical data demonstrates that, over the long-term, returns from investing in equities tend to be greater than those from investing in bonds. When returns are measured over short periods such as the three years between formal actuarial valuations, actual returns and assumed returns can deviate sharply.

Given the very long-term nature of the liabilities, a long-term view of prospective returns from equities is taken. For the 2004 valuation, it is assumed that the Fund's equity investments will deliver an average additional return of two per cent a year in excess of the return available from investing in index-linked government bonds at the time of the valuation.

It is assumed that 70 per cent of the Fund's assets are invested in equity-type growth assets.

The assumptions are described in the Actuary's report on the valuation.

Future service contribution rates

The employer's future service rate will be based upon the cost (in excess of members' contributions) of the benefits which employee members earn from their service each year. Technically these rates will be derived using the Projected Unit Method of valuation with a one-year control period.

The funding method is described in the Actuary's report on the valuation.

If future experience is in line with assumptions, and the employer's membership profile remains stable, this rate should be broadly stable over time. If the membership of employees matures (e.g. because of lower recruitment) the rate would rise.

The future service rate includes expenses of administration, to the extent that they are borne by the Fund, and an allowance for benefits payable on death in service and ill health retirement.

Stability of employer contributions

Deficit recovery period

Recovery of any deficit in respect of accrued benefits will be spread over a period equivalent to the expected future remaining working lifetime of active members, around 13 years as at 31 March 2004.

This period is used in calculating the employer's minimum contributions.

The deficit recovery period starts at the commencement of the revised contribution rate (1 April 2005 for 2004 valuation). The Administering Authority expects the same period to be used at successive triennial valuations, but reserves the right to propose alternative spreading periods, for example to improve the stability of contributions.

Surplus spreading period

If the fund is deemed to be in surplus, the Administering Authority is permitted to reduce the employer's contribution rate to below the cost of accruing benefits. This is achieved by spreading the surplus element over a period of not less than the remaining working lifetime of scheme members.

However, to help meet the stability requirement, the employer may prefer not to take such reductions.

Phasing in of contribution rises

In order to provide some added stability for the employer's contributions, the administering authority has agreed that contribution rises may be phased over a four-year period.

Phasing in of contribution reductions

Any contribution reduction will be phased in over a period of not less than six years.

Early retirement costs

Non ill-health retirements

The Actuary's funding basis makes no allowance for premature retirement except on grounds of ill health. The employer is required to pay a lump sum contribution whenever an employee retires before attaining the age at which the valuation assumes that benefits are payable.

It is assumed that members' benefits on age retirement are payable from the earliest age that the employee could retire without incurring a reduction to their benefit and without requiring their employer's consent to retire.

The additional costs of premature retirement are calculated by reference to these ages.

Ill-health monitoring

The Fund monitors the employer's ill health experience on an ongoing basis. If the cumulative number of ill-health retirements in any financial year exceeds the allowance at the previous valuation, the employer may, after the Administering Authority has consulted with the Actuary, be charged additional contributions on the same basis which applies for non ill-health cases.

Links to investment strategy

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

Investment strategy

The investment strategy currently being pursued is described in the Fund's Statement of Investment Principles.

The investment strategy is set for the long-term, but is reviewed from time to time to ensure that it remains appropriate to the Fund's liability profile. The Administering Authority has adopted a benchmark, which sets the proportion of assets to be invested in key asset classes, such as equities and bonds. As at 31 March 2004, the proportion held in equities and property was around 70 per cent of the total Fund assets.

The Administering Authority has agreed to implement a new investment strategy whereby the proportion invested in equities and bonds is reduced to 63 per cent and 27 per cent respectively and new allocations of five per cent each are made to property and private equity. It is expected that this new strategy will be implemented from 1 April 2005.

The investment strategy of lowest risk – but not necessarily the most cost-effective in the long-term – would be 100 per cent investment in index-linked government bonds.

The Fund's benchmark includes a significant holding in equities in the pursuit of long-term returns higher than those from investing in just index-linked bonds. It is the Administering Authority's belief that in the long term this strategy will result in a better funded and more affordable scheme.

Consistency with funding basis

The Fund Actuary's current best estimate of the long-term return from equities is around three per cent a year in excess of the return available from investing in index-linked government bonds.

In order to reduce the volatility of Employers' contributions, the funding policy currently anticipates returns of two per cent a year, that is one per cent a year less than the best estimate return.

The anticipated future returns from equities used to place a value on employers' liabilities only relate to the part of the Fund's assets invested in equities (or equity type investments). This is currently around 70 per cent of all the Fund's assets.

Non-equity assets invested in bonds and cash are assumed to deliver long-term returns of 0.2 per cent per annum more than the prevailing redemption yield on Government bonds.

In this way, the Employer contributions anticipate returns from Fund assets which in the Fund Actuary's opinion there is a better than 50:50 chance of delivering over the long-term (measured over periods in excess of 20 years).

However, in the short term – for example with the formal triennial valuations – there is the scope for considerable volatility. There is a material chance that, in the short and even medium term, asset returns will fall short of this target. The stability measures described in Section 5 will dampen down, but not remove, the effect on employer's contributions.

The Fund does not hold a contingency reserve to protect it against the volatility of equity investments.

Balance between risk and reward

In setting the investment strategy, the Administering Authority considered the balance between risk and reward by altering the level of investment in potentially higher yielding, but more volatile, asset classes such as equities. This process was informed by the use of asset-liability techniques to model the range of potential future funding levels and the impact on future contribution rates.

Intervaluation monitoring of funding position

The Administering Authority monitors investment performance relative to the change in the value of liabilities by means of quarterly inter-valuation monitoring reports.

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;
- regulatory; and
- governance.

Financial risks

Risk	*Summary of control mechanisms*
Fund assets fail to deliver returns in line with the anticipated returns underpinning the valuation of liabilities over the long term.	Only anticipate long-term returns on a relatively prudent basis to reduce risk of under-performing. Analyse progress at three yearly valuations. Inter-valuation roll-forward of liabilities between formal valuations on a quarterly basis.
Inappropriate long-term investment strategy.	Set Fund-specific benchmark, informed by asset-liability modelling.
Fall in risk-free returns on Government bonds, leading to rise in value placed on liabilities.	Inter-valuation monitoring, as above. Some investment in bonds helps to mitigate this risk.
Active investment manager under-performance relative to benchmark.	Short-term (quarterly) investment monitoring analyses market performance and managers relative to their index benchmark.
Pay and price inflation significantly more than anticipated.	The focus of the actuarial valuation process is on real returns on assets, net of price and pay increases. Inter-valuation monitoring, as above, gives early warning. Some investment in index-linked bonds also helps to mitigate this risk. Investment in other 'real' assets (e.g. equities and property) also helps to mitigate risks.
Effect of possible increase in employer's contribution rate on service delivery.	Mitigate impact through deficit spreading and phasing in of contribution rises.

Demographic risks

Risk	*Summary of control mechanisms*
Pensioners living longer.	Actuary quantifies potential scale of risk associated with continuing improvements in longevity. Fund Actuary monitors combined experience of about 50 funds to look for early warnings of lower pension amounts ceasing than assumed in valuation.
Deteriorating patterns of early retirements.	Employers are charged the extra capital cost of non ill-health retirements following each individual decision. Employer ill-health retirement experience is monitored.

Regulatory risks

Risk	*Summary of control mechanisms*
Changes to regulations, e.g. more favourable benefits package, potential new entrants to scheme, e.g. part-time employees.	The Administering Authority is alert to the potential creation of additional liabilities and administrative difficulties for employers and itself.
Changes to national pension requirements and/or Inland Revenue rules, e.g. effect of abolition of earnings cap for post-1989 entrants from April 2006.	It considers all consultation papers issued by the DCLG (formerly ODPM) and comments where appropriate.

Governance risks

Risk	*Summary of control mechanisms*
Administering Authority unaware of structural changes in the Employer's membership, e.g. large fall in employee members, large number of retirements.	The Administering Authority monitors membership movements on a quarterly basis, via a report from the administrator at quarterly meetings. The Actuary may be instructed to consider revising the Rates and Adjustments Certificate to increase an employer's contributions (under Regulation 78) between triennial valuations.

Approved by the Pensions Committee on 17 November 2004.

Annex 2 – Statement of Investment Principles

Under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended) the Environment Agency must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement of the principles governing its decisions about investments. This statement is required to cover the Agency's policy on

- investment objective;
- choosing investments;
- the types of investment to be held;
- the balance between different types of investment;
- risk;
- the expected return on investments;
- the realisation of investments;
- the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;
- the exercise of the rights (including voting rights) attaching to investments, if there is any such policy;
- statement of compliance with the Myners Principles.

The Environment Agency Active Fund's Statement of Investment Principles

Introduction

This Statement was made and approved by the Pensions Committee on 12 June 2002, after taking advice from the Independent Investment Adviser and the investment managers.

Investment objective

The investment objective is to achieve a return on Fund assets which

i in overall terms, seeks to out-perform a fixed benchmark;

ii is set at a level which does not force the managers to take unnecessary risks; and

iii is sufficient to meet the funding objectives by reference to the triennial actuarial valuations.

The Fund's benchmark and performance targets are shown on pages 10 to 12.

Choosing investments

The Environment Agency has delegated the management of the Fund's investments to four investment managers. These managers have each been given a performance target and benchmark asset allocation.

They are required to comply with the investment provisions and limits prescribed by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended). Subject to these statutory constraints and compliance with this Statement of Investment Principles, all four managers have full discretion over the choice of individual stocks and are expected to maintain a diversified portfolio.

Types of investment to be held: The investment managers may, subject to restrictions set by the Pensions Committee, invest in UK and overseas investments including equities, fixed and index-linked bonds, cash and pooled funds. Although no direct investment in property can be made by the managers, it is permissible for them to invest in quoted property shares.

Balance between different kinds of investments: The investment managers hold a mix of investments consistent with the benchmark set by the Committee. Within each major market the investment managers hold a diversified portfolio of stocks. The policy implied by this benchmark results in a significant weighting being given to equities. The Committee acknowledges this is appropriate given the current liability profile and funding position of the Fund.

Risk: The adoption of an asset allocation benchmark (see above under Investment Objective) and the explicit monitoring of performance relative to a performance target constrain the investment managers from deviating greatly from the intended approach. However it does permit flexibility to manage the portfolio in such a way as to enhance returns. Furthermore, the decision to appoint more than one investment manager achieves a satisfactory level of diversification of manager risk.

Expected return on investments: The investment managers have been given performance targets which are expected, over the medium to long term, to give a return which exceeds the rate of return assumed in the most recent triennial actuarial valuation.

Realisation of investments: The majority of stocks held are quoted on major stock markets and may be realised quickly if required. Stocks which are not quoted on a recognised stock exchange, or are not otherwise actively traded, may not be held by the investment managers without the prior approval of the Pensions Committee.

Environmental investment: The Pensions Committee's legal responsibility is to maximise the return on the Fund but opportunities for providing best environmental practice are kept under review when they do not compromise or conflict with this responsibility.

Each manager is required to submit a regular quarterly compliance report to the Committee, indicating how it has exercised its votes and specifically detailing any environmental issues.

Corporate governance: The investment managers vote the Environment Agency's shares at their discretion and, both as an important element of the investment process and as good corporate governance, make regular contact at senior executive level with the companies in which the Fund's assets are invested.

Whilst not necessarily voting on all issues the managers have all confirmed that they subscribe to the principles of good corporate governance and that, when exercising their vote, they take this into account.

In October 2002 the Pensions Committee requested its fund managers to adopt the Association of British Insurers (ABI) disclosure guidelines on Socially Responsible Investment (SRI), with particular emphasis on environmental matters.

All managers are presently requested to vote the Fund's shares and quarterly monitoring reports are provided by global custodian Northern Trust.

Approved by the Pensions Committee on 12 June 2002.

Annex 3 – Environmental Overlay Strategy

Vision

The Environment Agency (the Agency/We) will seek to ensure that its future strategy and policies for the investment and management of pension fund assets are financially robust and environmentally credible, and where feasible, through their implementation, will seek to contribute to creating a 'greener' business world.

Aim

We will become recognised as a leader in the public sector in financially robust, environmentally responsible investment and pension fund management by 1 April 2007.

Legal compliance

We will seek to comply fully with the regulatory requirement[1] to include in the statement of investment principles (SIP) details of our policies on social, ethical, environmental (SEE) issues in respect of the selection, retention, realisation of investments and exercise of voting rights.

We will regularly update and develop new polices in light of any future changes to company law, pensions law, and codes of best practice in respect of corporate governance (e.g. new Combined Code) and environmental issues (e.g. new company annual reporting requirements).

Fiduciary duty

We will fulfil and comply with our overriding fiduciary duty to maximise investment returns on behalf of the pension fund members. As a result of which we affirm that we will assess and take account of existing and future financial risks (e.g. climate change and cost of pollution clean ups and opportunities from environmental issues on clean ups), and the exploitation of green technology and services).

Capability

We will seek to ensure our pension fund management team possesses high-quality knowledge, skills, and experience in respect of financially and environmentally responsible investment, and has access to external research, expertise, and training to maintain and develop this capability.

Statement of Investment Principles

When preparing and maintaining the SIP, we will be mindful of our overall corporate strategy (e.g. 'greening' business) and corporate environmental governance policies (e.g. encouraging company environmental reporting and disclosure of environmental risks and performance). A revised SIP will be developed with the benefit of research into best practice in respect of environmental issues from other pension funds, and will be reviewed and published annually by the Pensions Committee.

Investment strategy

Our investment strategy will seek to take account of the relationship between good environmental management and long-term sustainable business profitability.

We will seek to overlay this environmental strategy across our investment portfolio. We recognise that when the strategy is applied to investments in equities, bonds, gilts, property and private equity, this will involve considering different approaches, constraints, risks, opportunities and potential benefits.

Our main influence will be through our strategic asset allocation, manager structure, manager selection, performance benchmarks, monitoring, and reporting – and not by getting involved in the day-to-day investment decisions, which is the role of our asset managers.

We will encourage our fund managers to use research on various environmental risk and/or 'green' performance rating/ranking tools to identify and avoid financial risks attributable to environmental issues, such as climate change, that could impact negatively on investment returns.

1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998.

We will, through monitoring their performance, ask our fund managers to explain and justify financially any investment decisions, for example on stock selection, which in our view are environmentally controversial. We will favour investing on a positive 'best in class' selection basis, and encourage the use of engagement rather than negative screening.

Asset allocation

We will periodically review our asset allocation strategy between different investments. We will investigate and evaluate financially the risks/opportunities and performance/potential returns from investing more assets in various types of 'green'/SRI funds, taking into account their financial performance relative to other funds.

In 2001 we allocated two per cent of the Fund's assets to a low-risk, eco-enhanced FTSE 350 index-tracking fund with a maximum tracking error of 2.5 per cent. This allocation is less than other comparative pension funds in the UK and the EU. A seven per cent allocation to sustainable responsible investment was implemented in 2005.

We will also examine various types of private equity funds including sustainability funds, environmental funds, low carbon funds, green energy funds, green technology funds, green property funds, and sustainable forestry funds. After researching and evaluating the financial/environmental pros and cons of these funds through normal due diligence processes, we will invest up to five per cent of our assets in 'clean technologies' in order both to stimulate such 'green' investment styles and to share the returns.

Fund manager selection

When selecting the Fund's investment advisers and appointing external fund managers, we will use our standard procurement process. This includes environmental assessment tools and criteria, as well as financial performance criteria and value for money.

The environmental criteria include the relative quality, integration and impact of environmental research; the information used in external managers' investment management and performance reporting processes; and the amount of resource that external managers have available for this work.

Investment management agreements

We will seek to engage managers using our own form of investment management agreement. This has been drafted to meet industry standards of best practice, and will ensure the use of consistent terms and conditions, fund valuation methods, manager fee calculation and payment mechanisms in respect of the various investment mandates. It will also include our corporate governance/environmental policies and disclosure and reporting requirements. External fund managers will have to agree to comply with such requirements as a condition of their appointment.

Performance benchmarks

We will measure our fund managers' investment performance using either industry standard indices/benchmarks or 'customised' versions to track/monitor performance targets. Where appropriate we may separately monitor other indices, such as FTSE4Good Index, Dow Jones SD Index or Domino Social Index. We may also use specially constructed versions of these indices to assess our own and various other investment styles. Some assets (such as property and private equity) will need their own 'specialised' benchmarks.

Investment management processes

We will inform our asset managers (and those who provide their company research information) about our own environmental data, be it publicly available or obtainable from us, which is potentially financially significant (e.g. on climate change). Such information could relate to environmental risks (e.g. our operator performance risk assessment scores), emissions (e.g. our Pollution Inventory) and performance (e.g. our Spotlight publication). Our aim is to help inform, but not interfere with, independent investment management processes. We affirm that the purpose of all such information exchange with managers is to help deliver sustainable high financial returns on our investments.

Shareholder activism, engagement and voting

We will aim to comply with the Myners activism principle and to become more engaged as an active investor, especially with companies whose environmental behaviour and performance are currently impacting negatively on short or long-term investment returns – or could do so in the future. We will normally do this through partnership and alliances with other pension fund groups (e.g. UKSIF, IIGCC, LAPFF) to increase the impact of our policies. However, we reserve the right to act independently where necessary.

We will encourage our asset managers (or an engagement or voting overlay service provider) to actively engage with the top management of those companies they invest in. This is to help improve the companies' performance in both financial and environmental terms. We will also encourage voting on key resolutions concerned with corporate governance and environmental issues.

We will provide our asset managers (or an engagement and voting overlay service provider) with details of our corporate governance, environmental policies and preferred voting stances, for example, in respect of companies that do not report on their green house gas emissions and environmental performance in their annual reports and accounts.

Performance monitoring and reporting

We will assess the compliance of both the investment processes and the decisions of external fund managers with our SIP policy statements and IMA requirements. This will be part of regular review meetings to discuss quarterly fund management performance and company engagement and voting reports.

We will receive an annual report on fund managers' compliance with the SIP's 'green' policies. We will also report on our own environmentally related activities. These reports will be summarised in the Pension Fund Annual Report.

Performance benchmarking and assessment

We will periodically benchmark the environmental investment performance of our fund managers, and also this environmental investment strategy, against other public sector and private pension funds. We will take action as required to improve both their relative performance and this strategy.

Research and development

Resources permitting, we will undertake some SRI research in-house and/or support joint studies with other pension funds and organisations that have interests in environmental or sustainable investment. We will do this to inform our own policies.

Collaboration

We will join and/or collaborate with other organisations with environmental goals. Such organisations include the UK Social Investment Forum (UKSIF), Carbon Disclosure Project (CDP), Local Authority Pension Fund Forum (LAPFF) campaign on environmental reporting, and Institutional Investors Group on Climate Change (IIGCC).

Communication and disclosure

We will communicate our approach to sustainable environmentally responsible pension fund management, and report on the 'green' performance of our pension fund. We will do this on our intranet (Easinet), our web site pages (www.environment-agency.gov.uk) and in publications such as the Pension Fund Annual Report and Fundfare, a members' booklet. Users of this information will include staff, pensioners, and other pension funds and policy makers in Government.

Continuous improvement

We will ensure our Pensions Committee is regularly advised and updated on external developments and on our own performance in this area. We will keep our policies and approach under continual review so as to improve their efficacy.

Approved April 2006.

Annex 4 – Corporate Governance Strategy

Introduction

We believe there is a considerable body of evidence that well governed companies produce better and more sustainable returns than poorly governed companies. Also investors including pension fund managers and shareholders that influence the Board/Directors of under-performing companies can improve the management and financial performance of those companies.

In June 2004, the Pensions Committee reviewed our old fund managers' compliance with the Active Fund's policy on corporate governance. That is how they have engaged with and sought to influence the performance of companies they have invested in and how they have voted on resolutions at company AGM's, especially on environmental issues, on our behalf.

In light of this review the Committee supported the principle of increased shareholder activism by the Active Pension Fund (which is in line with the Myners' principles of best practice in investment management).

Existing policies

Investment managers can vote the Environment Agency's shares at their discretion and, as an important element of both the investment process and good corporate governance, should make regular contact at senior executive level with companies in which the Fund's assets are invested.

Investment managers should refer 'environmental' resolutions to the Agency for discussion prior to voting.

Whilst not necessarily voting on all issues the managers must confirm that they subscribe to the principles of good corporate governance and, when exercising their vote, take this into account.

All fund managers are required to adopt the Association of British Insurers (ABI) disclosure guidelines on Socially Responsible Investment (SRI), with particular emphasis on environmental matters for our mandates.

All managers are presently requested to vote the Fund's shares and quarterly monitoring reports are provided by global custodian Northern Trust.

New policies

- We will focus our attention on the quality of corporate governance (and especially corporate environmental governance) of UK, US, EU, Far East stocks in that order, this will be linked to the relative size of our holdings;
- we will adopt the ISC and ABI standards in respect of best practice in corporate governance. We expect our new fund managers and/or an engagement/voting overlay service to follow these, subject to any Agency specific instructions which should be followed in full, failure to do so could be a breach of the Investment Management Agreement;
- we will focus our engagement efforts on corporate environmental governance, Corporate Social Responsibility 'CSR', and sustainability issues and their associated resolutions at company meetings and other engagement opportunities;
- we will work in partnership with other like minded investors, fund managers, bodies, and service providers with similar objectives to influence the business and investment world on these and other issues;
- we will delegate the large volume of non-environmental corporate research, engagement, and voting to our fund managers or a third party/parties and monitor, assess and externally report on this activity; and
- we will promote the Agency's Active Pension Fund approach and voting actions on corporate governance, sustainability, CSR, and environmental issues.

Monitoring

We will monitor our fund manager's adoption of our corporate governance policies and requested they comply with it and inform us of any future environmental resolutions.

We will also meet with our global custodian Northern Trust and their contractor the Institutional Shareholder Service (ISS) through whom our fund managers vote our shares at company AGM's. We also have electronic access to their VOTEX system through which we can monitor fund managers voting actions.

Influencing partnerships

The Agency will maintain and strengthen its liaison with bodies with similar activism goals including the UK Social Investment Forum (UKSIF), Institutional Investors Group on Climate Change (IIGCC), and Carbon Disclosure Project (CDP).

The Agency will also continue to work with the Local Authority Pension Fund Forum (LAPFF) to encourage FTSE 100 companies to report on their environmental performance. We will also publish reports on the environmental disclosure of FTSE all-share companies.

The Agency will also monitor the California Public Employees Retirement System (CALPERS) which is the largest pension fund in the world and the French Pensions Reserve (FRR) who are also implementing environmental investment strategies.

Approved October 2005.

Annex 5 – Scheme Rules and Benefits

The Scheme rules and benefits described below are those effective as at 31 March 2006. It should be noted that a number of changes to LGPS Regulations came into effect on 1 April 2006.

Scheme membership and income

a All employees of the Environment Agency under the age of 65 are eligible for membership of the Local Government Pension Scheme (LGPS). Full and part-time employees, whether permanent or temporary, become members automatically with the right to opt out (back-dated to the start of membership if made within three months).

Members' contributions from pensionable pay are 6 per cent, except for employees who were carrying out manual duties immediately before 1 April 1998. For as long as they remain on manual duties their contributions are 5 per cent of pensionable pay.

Subject to limits set by the Inland Revenue, members can pay additional voluntary contributions (AVCs) to buy a larger retirement pension, to improve other specific benefits or to provide additional EAPF pension, or membership for pension purposes (if the employee has continuously paid additional voluntary contributions since prior to 13 November 2001).

b Transfer payments for pension rights in almost any other scheme can be accepted by EAPF to increase benefits which may eventually become payable.

c The Environment Agency must make the balancing contribution required to keep the Fund solvent, having regard to existing and prospective liabilities. This is usually determined as a percentage of the members' normal contributions by the Consulting Actuary following each triennial actuarial valuation of the Fund.

d Monies not immediately required for the payment of benefits and other outgoings have to be invested in accordance with the provisions of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

Benefits available

Three months membership or more (or a transfer value has been received)

a Retirement pension and lump sum awarded

1 Payable immediately on cessation of employment

i voluntarily from age 55 onwards (with the Environment Agency's consent if under age 60);

ii through permanent incapacity at any age; or

iii as a result of redundancy or efficiency after age 50.

2 Preserved and payable from retirement age in any other circumstances.

b Spouses' and children's pensions and a tax-free lump sum death grant following death

i in employment;

ii in receipt of retirement pension (a lump sum may not always be payable); or

iii before preserved benefits become payable.

c Where the member elects a Refund of contributions (only applicable to members who were a scheme member on 31 March 2004 and have less than two years membership in the EAPF and no transfer value has been received).

Under three months membership (and no transfer value has been received)

a Retirement pension and lump sum on retirement at age 65.

b Spouses' short term pension and a tax-free lump sum death grant on death in employment.

c Children's continuing pensions (based on a minimum of 10 years membership).

d Refund of contributions when no other benefit payable.

Although it will take into consideration the deceased person's wishes, the Environment Agency has absolute discretion in deciding who should receive any lump sum death grant payable.

Pensions increase awards

Retirement and dependants' pensions in payment and preserved are increased each year by the same Retail Prices Index percentage rate as that applied to State pensions.

Transfers to other schemes

When benefits are not payable immediately, a transfer can usually be made to another employer's pension scheme or to a personal pension or stakeholder plan or to purchase an insurance annuity bond.

Statistical summary of Fund membership and value

Fund membership	31 March 1996	31 March 1997	31 March 1998	31March 1999	31 March 2000	31 March 2001	31 March 2002	31 March 2003	31 March 2004	31 March 2005	**31 March 2006**
Members	6,740	8,346	8,670	9,142	9,692	9,936	10,264	10,494	11,031	11,615	**11,844**
Pensioners	1,248	1,384	1,548	1,710	1,865	1,999	2,157	2,310	2,501	2,721	**2,913**
Deferred pensioners	652	752	921	1,130	1,291	1,548	1,834	2,426	2,668	2,801	**3,521**
Total	**8,640**	**10,482**	**11,139**	**11,982**	**12,848**	**13,483**	**14,255**	**15,230**	**16,200**	**17,137**	**18,278**

Employer Contributions to the Active Pension Fund

	per cent of Employee contribution	**per cent of pay for 6 per cent contributors**
1996-1997	115	6.9
1997-1998	115	6.9
1998-1999	115	6.9
1999-2000	140	8.4
2000-2001	140	8.4
2001-2002	140	8.4
2002-2003	155	9.3
2003-2004	170	10.2
2004-2005	185	11.1
2005-2006	200	12.0
2006-2007	225	13.5
2007-2008	250	15.0

Financial summary	31 March 1996 £m	31 March 1997 £m	31 March 1998 £m	31March 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**
Contributions and investment income less investment expenses	36	46	92	47	59	58	54	62	68	78	**79**
Benefits and other expenses	(13)	(12)	(14)	(16)`	(20)	(22)	(23)	(26)	(29)	(28)	**(36)**
Excess	23	34	78	31	39	36	31	36	39	50	**43**
Change in market value of investments	87	34	124	39	113	(105)	(34)	(254)	171	83	**235**
Net increase/(decrease) in the Fund value	110	68	202	70	152	(69)	(3)	(218)	210	133	**278**
Market value of fund	**574**	**642**	**844**	**914**	**1,066**	**997**	**994**	**776**	**986**	**1,119**	**1,397**

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