Environment Agency

enhancing... improving... cleaning... restoring...
changing... tackling... protecting... reducing...
create a better place... influencing... inspiring...
advising... managing... adapting...

Environment Agency Closed Pension Fund

Annual Report and Financial Statements 2006-2007

GEHO0807BMYH-E-E

We are the Environment Agency. It's our job to look after your environment and make it **a better place** - for you, and for future generations.

Your environment is the air you breathe, the water you drink and the ground you walk on. Working with business, Government and society as a whole, we are making your environment cleaner and healthier.

The Environment Agency. Out there, making your environment a better place.

The Environment Agency Closed Pension Fund is registered with the Pension Schemes Registry No. 10079068

Environment Agency Closed Pension Fund
Annual Report and Financial Statements 2006-2007

Presented to Parliament pursuant to section 46 of the Environment Act 1995

Ordered by the House of Commons to be printed 25 July 2007

HC889 London: The Stationery Office £13.50

Contents

Chairman's statement

As Chairman of the Environment Agency's Pensions Committee, which is responsible for overseeing the management and administration of the Environment Agency Closed Pension Fund (the "Fund"), I am pleased to present the Fund's Annual Report and Financial Statements for the year ended 31 March 2007.

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

Since the Closed Fund has no contribution income, the Government has accepted that under Section 173 of the Water Act 1989 it has a statutory obligation to ensure that the Closed Fund can always meet its pensions and other related liabilities. Deferred members, pensioners and their dependants can therefore be completely reassured about the long-term security of their pension entitlements.

Under the terms of the Memorandum of Understanding between the Accounting Officers of the Department for Environment Food & Rural Affairs ("Defra") and the Environment Agency the Closed Fund has, from 1 April 2006, received Grant-in-Aid from Defra. During the year two payments totaling £90.9 million were received and used to meet the Fund's obligations to meet pensions and other liabilities.

During the year the total number of current and deferred pensioners fell by 815 to 24,009. The investment management of the Fund's remaining assets was simplified with Sarasin Chiswell being appointed. The Fund's assets are valued at £99.9 million.

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

John Edmonds
Chairman
The Environment Agency Pensions Committee
11 July 2007

Report by the Pensions Committee

Governance

Chairman and members
John Edmonds served as Chairman of the Pensions Committee throughout the year. During the year Board members Kay Twitchen and Peter Matthews retired from the Pensions Committee and were replaced by Suzanne Warner and Larry Whitty. David Webster resigned from the Pensions Committee upon leaving the Environment Agency Wales. Since the end of the year the Board has re-appointed Member representative Alan Broughall for a further two year term and David Edwell has been appointed as the management representative for Environment Agency, Wales on the Pensions Committee.

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 three times.

In February 2007 the Environment Agency Board approved an update to the Governance Policy Statement, which takes effect on 1 April 2007 and incorporates the Pensions Committee Terms of Reference and Standing Orders and the Pension Funds Scheme of Delegation. The revisions made this year take account of changes to the LGPS regulations or clarify the scope/delivery of some responsibilities. The Governance Policy Statement may be found at www.environment-agency.gov.uk/pensions .

Committee training
The Pensions Committee's training strategy takes 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 self-assessment training needs questionnaire is being developed to assist members in focussing on the most important areas for training. A detailed log of all Committee members training undertaken and planned is maintained.

Pensions changes

Government pensions reform
The Committee has in previous years, 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 Finance Act 2004** – on 6 April 2006 ("A" Day) a new tax regime for all pension schemes came into force, replacing the previous tax regimes.

- **The Employment Equality (Age) Regulations 2006** – took effect from 1 October 2006, although the regulations relating to pensions were delayed and took effect from 1 December 2006.

- **The Local Government Pension Scheme (Amendment) Regulations 2006 (SI 2006 No. 966)** – introduced a number of significant scheme changes resulting from the Finance Act 2004 and the age discrimination regulations referred to above. Significant changes were:

    1. facility for members to commute some of their pension in order to receive a larger tax-free lump sum;
    2. introduction of flexible retirement;

3. employees can join/remain in the Scheme until age 75;
4. 15% limit on employee contributions removed;
5. earnings cap removed, with service adjustments to avoid windfall gains;
6. limit on maximum period of membership (40 years) removed.

   The Amendment Regulations also removed the Rule of 85 with effect from 1 October 2006 and brought in measures to deal with the cost protecting the rights of older members and the delay in its removal.

- **The Local Government Pension Scheme (Amendment)(No.2) Regulations 2006 (SI 2006 No. 2008) –** were made on 24 July 2006 and provided additional protection for the rights of older members following the removal of the Rule of 85 from the Scheme.

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

Pensions administration
The Environment Agency has a contractual arrangement with Capita Hartshead, a trading division of Capita Business Services Limited, to undertake the day-to-day administration of the Fund. We would like to express our thanks to Capita for resolving over 1,600 fund member queries and for paying pensions to almost 19,000 pensioners

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 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. The latest exercise highlighted 15 unreported pensioner deaths, which are currently under investigation. 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
On 1 April 2006 responsibility for managing the Fund's investments was transferred to Sarasin Chiswell with a mandate to invest in long-dated index-linked gilts. They are required to manage the investments so that the returns they achieved were in line with their benchmark. The unquoted securities’ portfolio is managed internally, but with expert advice as required.

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

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

A detailed Memorandum of Understanding between the Accounting Officers of Defra and the Agency was completed in 2005. Since 1 April 2006, ring-fenced Grant-In-Aid that is sufficient to meet pensions obligations and the running costs of the fund has been paid. Members and their dependants can rest assured that the future of their benefits are statutorily guaranteed and are safe.

Membership of the Pensions Committee and its advisers as at 31 March 2007

Chairman
John Edmonds *Board Member*

Members

Richard Percy *Board Member*

Suzanne Warner *Board Member*

Larry Whitty *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*

To be appointed *Environment Agency, Wales **

Howard Pearce *Head of Environmental Finance and Pension Fund Management*

Alan Broughall *Member Representative*

Phil Chappell *Member Representative*

Dave Cowley *Member Representative*

Chris Galvin *Member Representative*

Aileen Parry *Member Representative*

Brian Engel *Retired Member Representative*

* David Edwell *Environment Agency, Wales - appointed June 2007*

Advisers

Comptroller and Auditor General, National Audit Office – External Auditor

National Westminster Bank plc – Bankers
Cater Allen Private Bank Ltd

The Northern Trust Company – Custodian

Douglas Anderson, Hymans Robertson – Consulting Actuary

Capita Hartshead – Pensions Administrator

Osborne Clarke – Lawyers

Carolan Dobson – Independent Investment Adviser

Pension Fund membership

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

During the year since 1 April 2006, the number of deferred pensioners has fallen by 5%, from 5,368 to 5,102 (2006: 4.8%). The number of pensions in payment fell by 2.8% from 19,456 to 18,907 (2006: 3.3%). With no active members in the Fund, this will be the pattern for the future. However, dependants' and deferred pensions coming into payment will serve to maintain the number of current pensioners for some years to come.

Movement in number of pensioners	Current	Deferred
At 1 April 2006	19,456	5,368
Adjustment for late notifications	9	(24)
Revised opening balance	19,465	5,344
Add:		
Deferred pensions into payment	195	-
New spouse's/children's pensions	302	-
	497	-
Less:		
Deaths/no longer eligible	(1,055)	(14)
Transfers to other schemes	-	(33)
Deferred pensions into payment	-	(195)
	(1,055)	(242)
At 31 March 2007	**18,907**	**5,102**

The figure for Deferred Pensioners includes 640 cases where there is no entitlement to a deferred pension, and the only entitlement is to a refund of contributions. These are members whom we are unable to trace, with refunds being paid as and when we do make contact with them.

Age Profile of current pensioner at 31 March 2007	2007		2006	
	No	%	No	%
Children	86	0.5	98	0.5
Pensioners and spouses				
Under 55	277	1.5	327	1.7
55 - 59	345	1.8	381	2.0
60 - 64	1,407	7.4	1,357	7.0
65 - 69	1,629	8.6	1,873	9.6
70 - 74	2,905	15.4	3,231	16.6
75 - 79	4,292	22.7	4,523	23.1
80 - 84	4,316	22.8	4,369	22.5
85 and over	3,650	19.3	3,297	17.0
TOTAL	**18,907**	**100.0**	**19,456**	**100.0**

Communications

Changes to the LGPS occurred during the year and in the autumn of 2006 Update 9 was sent to deferred members of the Closed Fund. It explained the effect of the tax simplification changes on those members and offered them the opportunity to opt out of those changes. Further newsletters are planned to inform members of pension developments including the LGPS changes planned for 2008.

Fundfare 2007 will be mailed to deferred members and pensioners towards the end of the year. It will summarise the Fund's Annual Report and Financial Statements as at 31 March 2007 and provide information on other pension-related matters. Deferred members will receive an annual statement of their accrued pension benefits during the year.

In the second half of the year we produced an addendum to update our Retirement Guide, which is aimed at members who have retired or are approaching retirement. A full update is planned for 2007/08.

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 3.6% (2006: 2.7%) to be awarded from 9 April 2007 (10 April 2006). 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 2006.

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 21 June 2007 and is reproduced in Annex 1 to this document.

Statement of investment principles

The Statement of Investment Principles was adopted by the Pensions Committee on 21 June 2007 and is reproduced in Annex 2 of this document'.

Custody arrangements

The Northern Trust Company ("Northern Trust") acts as global custodian on behalf of the Fund's assets. All assets are held in the name of Nortrust Nominees.

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

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

Investment Limits

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

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

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

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

- **5%**
  - a single sub-underwriting contract, i.e. a contract with a person who is underwriting a share issue to acquire the shares from him/her if that is what he/she requires, but with the total value of all sub-underwriting contracts not exceeding 15%;
  - as a limited partner in any single partnership (but not exceeding more than a total of 15% in such partnerships).
- **10%**
  - 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%**
  - total investments in unlisted securities, i.e. securities not quoted on a recognised stock exchange.
- **35%**
  - 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.

Investment management

Following the agreement with Defra over the future funding arrangements of the Fund, the Committee agreed that the Fund's investment strategy should be simplified by switching to investment in long-dated index-linked gilts. During the year Sarasin Chiswell Limited managed the long dated gilt portfolio. They were required to manage the investments so that the returns they achieved were in line with their benchmark. They had full discretion in the management of their portfolio, subject to complying with the statutory limits, the Statement of Investment Principles and the ranges of asset distribution defined by the Pensions Committee. During the year the book-value of the remaining unquoted securities was reduced to zero reflecting the limited marketability of these assets. Any further realisations will be credited to the Fund.

Portfolio analysis

Distribution of net assets at market value as at 31 March 2007

	Sarasin Chiswell £M	Total Other £M	Total Fund £M	% of Total Fund
UK Index linked gilts	97.5	-	97.5	97.2
Cash	-	2.4	2.4	2.4
Other (mainly accrued income)	-	0.4	0.4	0.4
	97.5	**2.8**	**100.3**	**100.0**

Unquoted investments

With the agreement of the Environment Agency Board, the value of the unquoted investments was written down to £nil during the year (2006: £459,190). Income from future realisations will be credited to the Fund as it arises.

Investment performance

The Fund's overall performance was +8.2% (2006: +8.4%). Over the 3 years to 31 March 2007 the annualised rate of return is +8.4% (2006: +10.5%).

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

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

The Fund is a statutory public service pension scheme (as defined by the Pension Schemes Act 1993) under the Local Government Pension Scheme Regulations 1997 (as amended) – (“the 1997 regulations”). It provides the minimum contracted-out pensions required by the State Second Pension Scheme (“S2P”) and is a Registered exempt approved Pension Scheme.

Roles and responsibilities of the Pensions Committee

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

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

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

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

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

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

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

Summary of the financial statements

The financial statements have been prepared on a market value basis. However, the valuation of unquoted investments is taken as the lower of cost or estimated market value. After realised gains and changes in portfolio valuations, and Grant-In-Aid funding for benefits and other outgoing payments, the value of the Fund has increased by £9.4m to £100.0m (2006: reduced by £78.8m to £90.6m).

Retirement benefits payable in the year have decreased by £0.9m to £84.9m (2006: decreased by £0.6m to £85.9m), and transfers to other schemes decreased by £0.5m to £1.3m (2006: increased by £0.4m to £1.8m).

Since 1 April 1990 the Fund has been liable for the pensions increase costs arising in respect of local authority pensioners formerly employed on water or sewerage functions. The total costs for the 12 months ended 31 March 2007 have fallen to £2.2m (31 March 2006: £2.7 million). This reflects the continuing low rate of inflation (and resulting pensions increase awards) and the fact that all the beneficiaries or their late spouses ceased pensionable employment before 1 April 1974.

In overall terms the net additions from dealings with pensioners and deferred members after Grant-In-Aid funding in the year was £1.6m (2006: net withdrawals of £91.2m before Grant-In-Aid funding).

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

Accounting Officer's statement on internal control

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 is 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) *Pension Funds Governance Policy Statement* which includes:

- *The Pensions Committee Terms of Reference and Standing Orders* ñ details the status, composition and responsibilities of Pensions Committee and Members;and
- *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 its Governance Policy Statement annually before the start of each financial year to take account of regulatory changes and operational needs to comply with the LGPS Regulations. The latest update was approved by the Pensions Committee on 24 January 2007 and ratified by the Agency Board on 6 February 2007.

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.

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 2007 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 on page 14.

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.

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 service level agreement, risk management document and 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 preparing 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 detailed risk register has been developed by officers covering all aspects of the pensions function, together with a more detailed Key Risks document that highlights the top risks. These documents assist the Pensions Committee in managing strategic risks across all pensions activities. This has been enhanced for ongoing risk management purposes and will form the basis of future internal audit strategy and planning. Management actions have been 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
- Regular reviews of periodic and annual financial reports which include administration and investment expenses and returns against budgets, targets and forecasts

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

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

Review of effectiveness

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

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

a) The operation of the Agency Board and Pensions Committee that sets strategic direction approves the Funds' investment and administration strategies and reviews performance. The Board receives reports from the Pensions and Audit Committees on the standards of corporate governance and internal control operating in the Funds.

b) The operation of the Audit Committee that reviews standards of internal control and financial reporting. It also considers audit reports and advises on the Funds' approach to risk management and corporate governance, and discusses with the appointed external and internal auditors the nature and scope of forthcoming audits.

c) The independent reviews by Internal Audit on the adequacy and effectiveness of the internal controls. These reviews are informed by an analysis of the risks to which the Funds are exposed and conducted in accordance with Government Internal Audit Standards.

d) Officers of the Agency act on the recommendations made by external and internal auditors.

Significant internal control issues

The reviews undertaken and reported by internal audit in 2005 and 2006 concluded that the governance framework in place to manage the Funds is well designed and covers all the main areas of activity.

The external audit report and the Pension Committee response were not delivered to Defra within the required time scale. These reports were submitted on 8 May 2007 and will be submitted by the Environment Agency in future.

Due to changes to the Local Government Pensions Scheme (LGPS) in 2006/07 and the new LGPS Regulations that are due to come into force from April 2008, the requirements of the Financial Memorandum no longer accurately reflect statutory requirements or the latest LGPS regulations.

In particular, the internal compliance audit highlighted that the current Schedule 8 requirement for ‘Guidelines for Prudent Risk Management’ have been superseded by a number of other LGPS regulatory requirements. A joint Defra and Environment Agency review of the current Schedule 8 is to take place to reflect the more recent and new LGPS regulations before April 2008.

Barbara Young

Barbara Young
Chief Executive and Accounting Officer
11 July 2007

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.

The Fund's liability profile is particularly mature, with only pensions in payment and a declining number of deferred pensioners. There are no new accruals of benefits.

The Fund's benefits are underwritten by the Department for the Environment, Food and Rural Affairs ("the Guarantor"). Since the 2004 actuarial valuation, the Guarantor has committed to a funding plan that involves half-yearly cash injections to meet the following 6 months' expected benefit expenditure. Also, following a discussion on investment strategy for the assets, it was agreed to invest wholly in two long-dated inflation-protected government bonds, known as index-linked gilts.

Security of Prospective Rights
In my opinion, the resources of the Fund are likely in the normal course of events to meet the liabilities of the Fund, as required by the Regulations. In giving this opinion I have taken into account the contributions payable by the Guarantor.

Summary of Methods and Assumptions Used
My opinion on the security of the prospective rights is based on the projected accrued benefits method. A comparison is made of the value of the assets with the value of benefits for past service (but allowing for future pension increases).

In order to value the liabilities for future pension and lump sum payments, I have anticipated returns from a notional portfolio consisting of 100% government bonds.

The 2004 valuation revealed that at 31 March 2007 the Fund's assets were sufficient to meet 21% of the liabilities accrued up to that date. Assets were taken into account at their then market value of £240m.

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

Separate valuations are carried out in respect of the Active Fund.

Outlook for 2007 Valuation
A further valuation of the Fund will be carried out as at 31 March 2007. This will focus on how the mortality experience and inflation conditions affect the benefit payments of this mature pension fund.

It will also estimate the sum of money that would be required to invest in bonds to meet the liabilities as they fall due.

The financial experience for the Fund since the 2004 valuation has been characterised by falls in long-term rates of interest and increases in inflation expectations. As at 31 March 2007, gilt yields were 4.5% a year (2004: 4.7%) and bond market implied inflation was 3.2% a year (2004: 2.9%). This means that the sum required to meet each £1 of pension is up to 5% higher than it was three years ago, although the extent of the rise depends on the age of the pensioner.

Copies of the 2004 valuation report are available on request from the Finance Department of the Environment Agency, the administering authority to the Fund.

W Douglas B Anderson
Fellow of the Institute of Actuaries
For and on behalf of Hymans Robertson LLP
5 June 2007

Hymans Robertson LLP
20 Waterloo Street
GLASGOW
G2 6DB

The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament, the Board of the Environment Agency and the Secretary of State for Environment, Food and Rural Affairs.

I certify that I have audited the financial statements of the Environment Agency Closed Pension Fund for the year ended 31 March 2007 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

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

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

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Environment Agency Financial Memorandum issued by Defra. I also report whether, in all material respects, the financial transactions conform to the authorities which govern them.

In addition, I report to you 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 Internal Control reflects the Environment Agency's compliance with HM Treasury's guidance, and I report if it does not. I am not required to consider whether this statement 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, which consists of the Report by the Pensions Committee, the Investment Report and the Actuarial Statements, and consider whether it is consistent with the audited financial 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 opinions

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

Audit Opinion

In my opinion:

- the financial statements give a true and fair view, in accordance with the Government Resources and Accounts Act 2000 (Audit of Public Bodies) Order 2003 and under Schedule 8 to the Environment Agency Financial Memorandum issued by Defra in accordance with Local Government Pension Schemes Regulations 1997, of the financial transactions of the Fund for the year ended 31 March 2007 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

- the financial statements have been properly prepared in accordance with Schedule 8 to the Environment Agency Financial Memorandum issued by Defra in accordance with Local Government Pension Schemes Regulations 1997.

Audit Opinion on Regularity

In my opinion, in all material respects, the financial transactions conform to the authorities which govern them.

Report

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General
National Audit Office
London SW1W 9SP

16 July 2007

Financial statements for the year ended 31 March 2007

	Notes	2007 £000	2006 £000
Fund Account			
Income			
Grant-In-Aid		90,939	-
Benefits and other payments			
Benefits payable	4	(84,927)	(85,869)
Leavers	5	(1,321)	(1,806)
Other payments	6	(2,197)	(2,672)
Administration expenses	7	(926)	(845)
		(89,371)	(91,192)
Net additions/ (withdrawals) from dealings with pensioners and deferred members		**1,568**	(91,192)
Return on investments			
Investment income	8	**2,692**	3,868
Change in market value of investments	9	**5,133**	8,706
Investment management expenses	10	**(47)**	(163)
Net returns on investments		**7,778**	12,411
Net increase/ (decrease) in the Fund during the year		**9,346**	(78,781)
Opening Net Assets of the Fund at 1 April		**90,626**	169,407
Net Assets of the Fund at 31 March		**99,972**	90,626
Net assets statement			
Investments	9	100,325	91,485
Current assets and liabilities	11	(353)	(859)
Net assets of the Fund at 31 March		**99,972**	90,626

The notes on pages 19 to 23 form part of these Financial Statements.

John Edmonds
Chairman
Environment Agency Pensions Committee
11 July 2007

Barbara Young
Chief Executive & Accounting Officer
Environment Agency
11 July 2007

Notes to the Financial Statements

1. Basis of preparation

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

The financial statements summarise the transactions and net assets of the Fund. The financial statements do not take account of liabilities to pay pensions and other benefits that fall due after the end of the Scheme year. The actuarial position of the Fund, which does take account of such liabilities, is dealt with in the statement by the Consulting Actuary on page 15 and these financial statements should be read in conjunction with it. The Actuary's statement, dated 5 June 2007 is based on a valuation as at 31 March 2004.

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 year end.
(ii) Unquoted securities are valued by fund managers on the basis of latest dealings, professional valuations and financial information at the year end, and fully written down where not realisable.
(iii) The Fund's global custodian is authorised to enter into stock lending arrangements and a small amount of stock lending has taken place in the year.
(iv) Acquisition costs are included in the purchase cost of investments.
(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) 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.
(v) Income from cash and short-term deposits is accounted for on an accruals basis.

Exchange Rates
(i) Other assets and liabilities in foreign currencies are translated into sterling at the rates of exchange ruling at the year end.
(ii) Overseas dividends are valued at rates of exchange on the date when stocks are quoted ex-dividend.
(iii) Surpluses and deficits arising on conversion or translation are dealt with as part of the change in market value of investments.

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

The valuation of the Closed Fund as at March 2004 indicated that assets available would not meet the future liabilities. The Chief Secretary to the Treasury therefore agreed that provisions and Grant-In-Aid payments should be made to the Fund by Department for Environment, Food and Rural Affairs to allow the Secretary of State's statutory obligation under the 1989 Act to be met from April 2006. Grant-In-Aid is accounted for on an accruals basis.

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 an exempt approved registered pension scheme and is therefore not liable to UK income tax on interest and dividend income (other than dividends arising from UK equities), or to capital gains tax.

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

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

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

3. Financial Security

The Secretary of State at the Department for Environment, Food and Rural Affairs has a duty under section 173(3) of the Water Act 1989 to ensure the Fund can always meet its liabilities, including future indexation awards. This has been formally documented in a Memorandum of Understanding and is included in Annex 3. Since 1 April 2006, Grant-In-Aid has been paid that is sufficient to meet the pensions obligations and running costs of the Fund.

4. Benefits payable

	2007 £000	2006 £000
Retirement and dependants' pensions	82,523	83,970
Lump sum retirement grants	2,255	1,833
Lump sum death grants	149	66
	84,927	85,869

Benefits payable exclude £11.8m (2006: £11.8m) for historic unfunded pensions liabilities of the Agency in respect of compensatory added years and water company pension scheme charges paid via the pensions administrator. This has been recharged to the Agency and funded by Grant-In-Aid from Defra.

5. Payments to and on account of leavers

	2007 £000	2006 £000
Individual transfers to other schemes	1,320	1,805
Refunds of contributions	1	1
	1,321	1,806

6. Other payments

	2007 £000	2006 £000
Pre-1 April 1974 local authority pensions increase recharges	**2,197**	2,672

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

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

7. Administration expenses

	2007 £000	2006 £000
Scheme administration	588	573
Professional fees:		
Actuarial	47	33
Consultancy	31	20
Audit	21	16
Legal	7	9
Other administration costs:		
Environment Agency administration	194	159
Communications to members	18	22
Miscellaneous	20	13
	926	845

8. Investment income

	2007 £000	2006 £000
Income from index linked gilts	1,161	1,232
Income from fixed-interest securities	66	1,483
Dividends from equities	-	201
Interest on cash deposits	1,330	935
Stock lending income	4	17
Income from unquoted overseas equities	131	-
	2,692	3,868

9. Investments

	Market Value at 1.4.06 £000	Purchases at Cost £000	Sales Proceeds £000	Change in Market Value £000	Market Value at 31.03.07 £000
Index linked gilts	54,202	85,125	(47,755)	5,882	97,454
Fixed interest	23,489	-	(23,200)	(289)	-
Pooled investment funds	7,296	-	(7,296)	-	-
Equities	460	-	-	(460)	-
	85,447	**85,125**	**(78,251)**	**5,133**	**97,454**
Cash deposits and instruments	5,405				2,448
Other	633				423
	91,485				**100,325**

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.

The change in market value of the equity investments represents a provision against the market value of these assets as they are not considered to be readily marketable.

	2007 £000	2006 £000
Index linked		
UK index linked gilts	**97,454**	54,202
Fixed interest		
UK public sector quoted bonds	**-**	23,489
Pooled investment funds	**-**	7,296
Equities		
UK quoted	-	1
Overseas unquoted	-	459
	-	460
Cash deposits and instruments		
Sterling	**2,448**	5,405
Other		
Accrued income	383	592
Insurance policies and associated shares	39	39
Income tax recoverable	1	2
	423	633

Total investments

Including pooled investment vehicles and index-linked, total investments may be analysed as follows:

	2007 £000	2006 £000
Bonds	97,454	77,691
Equities	-	7,756
Cash	2,448	5,405
Other	423	633
Total Investments	**100,325**	91,485

10. Investment Management Expenses

	2007 **£000**	2006 £000
Fund manager fees	15	113
Global custody	29	39
Investment advisers	-	7
Performance and risk measurement	2	4
Stock lending fees	1	-
	47	163

11. Current assets and liabilities

	2007 **£000**	2006 £000
Current assets		
Debtors	79	91
Cash at bank	1,225	741
	1,304	832
Current liabilities		
Creditors		
PAYE	(867)	(855)
Pre 1 April 1974 local authority recharges (see note 6)	(560)	(604)
Administration and investment expenses	(149)	(185)
Benefits payable	(81)	(47)
	(1,657)	(1,691)
Net current liabilities	**(353)**	(859)

12. Related party transaction

During the year ended 31 March 2007, the Environment Agency recharged pensions administration costs to the Fund of £194,000 (2006: £159,000) (see Note 7).

Benefits payable exclude £11.8m (2006: £11.8m) for historic unfunded pensions liabilities of the Agency in respect of compensatory added years and water company pension scheme charges paid via the pensions administrator. This has been recharged to the Agency and funded by Grant-In-Aid from Defra (see note 4).

13. Apportionment of common expenditure

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

	2007 **%**	2006 %
Custodial arrangements	20/80	20/80
Other (e.g. Environment Agency administration costs)	40/60	40/60

14. Events after the balance sheet date

The financial statements were authorised for issue after approval by the Pensions Committee on 21 June 2007, and were approved and signed at a meeting of the Board on 11 July 2007. There are no adjusting events that need to be recognised in the financial statements after the balance sheet date.

Annex 1 – Funding strategy statement

1. Introduction

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

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

1.1 Fund History

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

1.2 Profile of Liabilities

As at 31 March 2007, the Fund contained some 18,900 pensioners and around 5,100 deferred pension members (including unpaid refunds) whose benefits have yet to come into payment. The average age of members in receipt of pensions in payment was around 75 years, and almost 54 years for the deferred pensioners.

Around 50% of the liabilities are expected to be discharged over the next 10 years, but the remaining liabilities could take a further 40-50 years to come close to being extinguished. The final payment from the Fund may not be paid until the end of the 21st century.

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

As at 31 March 2007, the fund assets were £100.0m (£240.3m at 31 March 2004) and the value placed on the liabilities (discounted in line with the minimum risk return available on Government bonds) were £1,170m (£1,120m) resulting in a funding level of 9% (21%) and a funding deficit of £1,070m (£879.7m). Benefit expenditure flowing out of the Fund is running at around £90m a year[1].

1.3 Regulatory Framework

The FSS forms part of a framework which includes:

- the Local Government Pension Scheme Regulations 1997 (regulations 76A, 77 and 144 are particularly relevant); and
- the Statement of Investment Principles.

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

1.4 Reviews of FSS

This is Version 2.0 of the FSS, which is adopted with effect from 31 March 2008 for contributions payable in the Fund's financial year 2008/09 and thereafter. The principles documented herein have been used for the actuarial valuation as at 31 March 2007.

The FSS is reviewed in detail at least every three years ahead of triennial valuations being carried out, with the next full review due to be completed by 31 March 2011. The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues.

---

[1] This excludes the additional ëunfundedí pension payments of around £12m a year which are paid to Closed Fund members for added years awarded on retirement. The Administering Authority receives grant-in-aid from DEFRA for these payments.

2. Purpose

2.1 Purpose of FSS

The Office of the Deputy Prime Minister (now the Department for Communities and Local Government (DCLG)) 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 employers' contributions, and prudence in the funding basis.

2.2 Purpose of the Fund

The Fund is the vehicle used to pay the pensions and related benefits of certain former employees in the water industry in England and Wales prior to its privatisation. The Fund was created by the Water Act 1989 and the benefit payments are guaranteed by DEFRA. In addition to paying the pensions of its own scheme members, the Fund is also liable for the pension increase costs of pensioners in certain Local Authority funds who retired before 1974. The costs are billed to the Fund by the Local Authorities – they amount to around £2.4m a year.

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

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

2.3 Aim of the Funding Policy

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

3. Solvency Issues and Target Funding Levels

3.1 Reviews of Funding Position

The Fund's actuary is required by the regulations[2] to report the funding position (or "solvency") of accrued benefits relative to the Fund's solvency target at least every three years. Unlike standard LGPS funds there is no requirement to certify an employer contribution rate.

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

3.2 Solvency

The Fund defines 'solvency' to be the ability to continue to meet ongoing benefit expenditure. As at 31 March 2007, the liabilities of the Fund were only 9% (2004 21%) covered by its assets. Without additional Government funding, the Fund was expected to be exhausted in 2006/07.

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

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

3.3 Ongoing Funding Basis

The Fund actuary agrees the financial and demographic assumptions to be used for each triennial valuation with the administering authority.

[2] Regulation 77, as amended by Regulation 144 for the Environment Agency Closed Fund

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

The key financial assumption is the rate of RPI inflation applied to pension increases, which has been taken to be 3.2% a year in the 2007 valuation.

For the 2007 valuation, it is assumed that the Fund's investments will deliver a long-term real return (i.e. in excess of price increases) in line with index-linked government bonds at the time of the valuation. As at 31 March 2007, the real return on index-linked gilts was 1.3% a year more than RPI increases.

The Guarantor agreed to commence making contributions to the Fund from April 2006. Payments are made every six months, and are calculated to meet projected benefit expenditure over the following six months. These payments are currently around £45m every six months (£90m a year). This mechanism is detailed in the Memorandum of Understanding between the Secretary of State for Environment, Food and Rural Affairs and the Environment Agency – Pensions Committee.

4. Links to Investment Strategy

Funding and investment strategy are inextricably linked. However, going forward the Fund's assets are expected to be modest (approximately £100m) compared to the value of the prospective liabilities (some £1,170m as at 31 March 2007). The performance of the assets will only have a limited effect on the Fund's finances.

4.1 Investment Strategy

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

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

The Fund has a low risk investment strategy, being invested in a portfolio of index-linked government bonds.

4.2 Consistency with Funding Basis

The funding policy anticipates returns of 1.3% a year in excess of price increases, in line with the return on index-linked government bonds as at 31 March 2007. The valuation of liabilities makes an allowance for expected future investment expenses.

4.3 Balance between risk and reward

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

The principal remaining uncertainties for the funding and investment policies are:

Longer Term – Greater longevity improvement than anticipated. Higher RPI than assumed increasing liabilities. Inability to re-invest investment income in future to achieve a return of 1.3% a year in excess of RPI.

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

4.4 Intervaluation Monitoring of Funding Position

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

5. Key Risks & Controls

5.1 Types of Risk

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

- financial;
- demographic; and
- regulatory.

5.2 Financial Risks

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

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

5.3 Demographic Risks

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

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

5.4 Regulatory

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

Approved by the Pensions Committee on 21 June 2007

Annex 2 – Statement of investment principles

This is the Statement of Investment Principles adopted by the Environment Agency as Administering Authority of the Closed Pension Fund ("the Fund") on 21 June 2007, as required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended). It is subject to periodic review by the Pensions Committee, which acts on the delegated authority of the Environment Agency's Board.

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

Funding objective

This Statement is consistent with the Fund's funding strategy, which is set out in the Funding Strategy Statement adopted on 21 June 2007. The Fund's solvency is guaranteed by the Government, in the form of the Secretary of State for Environment, Food and Rural Affairs ("the Guarantor"). The level of the Guarantor's contributions is reviewed every six months. The Fund's invested assets are small relative to the value of its prospective liabilities. The Fund's assets are invested in long dated index linked gilts on the basis that the Guarantor will meet pension payments until the value of the remaining liabilities is equivalent to the Fund's remaining assets.

Investment principles

The assets comprise a portfolio of index-linked government bonds invested with Sarasin Chiswell and a small unquoted portfolio which is managed internally and is currently being run down.

In order to achieve its investment objectives, the Pensions Committee has agreed the following in respect of the Sarasin Chiswell portfolio:-

***Choosing Investments**:* The Committee will appoint an investment manager (currently Sarasin Chiswell) authorised under the Financial Services and Markets Act 2000 to undertake investment business. The Committee, after seeking appropriate investment advice, has given the manager specific directions as to the securities to be held. The assets are held on a non-discretionary basis by Sarasin Chiswell.

***Kinds of investment to be held**:* The Fund will invest in index linked government bonds and cash only. The Committee considers these classes of investment to be suitable in the circumstances of the Scheme.

***Balance between different kinds of investments**:* The Committee believes that the investments held represent an appropriate balance of investments relative to the Fund's liabilities.

***Risk**:* The Committee provides a practical constraint on the Fund's investments deviating from the intended approach by specifying the particular bonds to be held.

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

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

***Exercise of Voting Rights**:* There are no voting rights attached to index-linked government bonds.

***Social, Environmental and Ethical Considerations**:* The Committee does not feel there are any such considerations by investing in index-linked government bonds.

Investment strategy

The Pensions Committee has translated its objectives into a suitable investment strategy for the Fund. The investment strategy takes due account of the specific liability profile of the Fund, together with the planned funding arrangements agreed with the Fund's Guarantor.

The strategy is consistent with the Committee's views on the appropriate balance between maximising the long-term return on investments and minimising volatility and risk. The Committee is adopting a low-risk approach by investing in index-linked government bonds.

It is intended that the investment strategy will be reviewed at least every three years following actuarial valuations of the Fund.

Approved by the Pensions Committee on 21 June 2007

Annex 3 – Memorandum of understanding

Between:

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

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

Background

1. The Environment Agency Closed Fund ("the Closed Fund") is vested in, and required to be maintained by, the Environment Agency by regulation 2(1) of the Local Government Pension Scheme (Environment Agency) Regulations 1996.

2. Before 1989, the Water Authorities Superannuation Fund ("WASF") served the former Regional Water Authorities in England and Wales. Under the Water Act 1989 their water supply and sewerage functions were transferred to newly created water companies, together with the relevant employees. The pension liabilities and assets in respect of such employees were transferred from the WASF to the new water company pension schemes. The pension liabilities and assets in respect of the remaining employees, and also of the former employees and pensioners, were transferred with the WASF to the National Rivers Authority ("the NRA"), which set up a pension fund for its own employees ("the Active Fund") into which were transferred the pension liabilities and assets in respect of the said remaining employees.

3. Following the transfer of active employed members to both the water company pension schemes and the Active Fund, the only remaining members of the WASF were deferred and pensioner members. No further members were admitted to it, so that it became a closed scheme ("the Closed Fund"). The Secretary of State and the NRA accepted the possibility that, in due course, the Closed Fund could have insufficient resources to meet its pension liabilities. With effect from 1 April 1996 the Agency assumed the functions of the NRA and the Closed Fund is now known as the Environment Agency Closed Fund.

4. The Closed Fund is maintained for the purposes of Section 7 of the Superannuation Act 1972, and accordingly the Secretary of State has the function conferred by Section 173 of the Act to make such payments into the Closed Fund as may be considered appropriate in respect of the actual and prospective liabilities falling from time to time to be met out of the Closed Fund for the benefit of its members ("the Closed Fund members").

5. As at 31 March 2004, the Closed Fund's FRS 17 valuation indicated that it had a net deficit for accounting purposes of £826,600,000 and its actuarial valuation indicated that it had a funding level of 21% which corresponded to a net past service reserve deficit of £880,000,000. The value of the liability under both valuations is sensitive to future mortality rates, inflation rates, and the discount rate used.

6. This Memorandum of Understanding sets out the mechanism whereby the Secretary of State will exercise the function under section 173 of the 1989 Water Act with a view to addressing the deficit in the Closed Fund.

7. This Memorandum has been agreed between the Secretary of State and the Environment Agency and the arrangements for funding the Closed Fund have been approved by Her Majesty's Treasury pursuant to that section, as indicated in the letter of 15 April 2004 from the Chief Secretary to the Secretary of State, subject to the conditions referred to in that letter.

Payments into the Fund

8. The Closed Fund's funding level continues to deteriorate, and on actuarial advice it is assumed that the value of the assets will reduce to a level of between £50 million and £60 million by about April 2006. With effect from that date the Secretary of State will ensure that cash payments are made into the Fund each year totalling an amount equivalent to its total annual outgoings (defined as total anticipated payments to pensioners, transfers out of the Closed Fund, investment management or other agents' fees, administration costs, and all other liabilities or expenses whatsoever, less interest earned on such cash payments made to the Agency for the Closed Fund during the year) to be calculated and properly certified by the Agency in accordance with actuarial advice received.

9. Such payments will be solely to finance the Closed Fund's annual outgoings and will be treated separately from the Agency's mainstream finances. They will be made every six months, with the sums to be paid

equalling the amount of the Fund's outgoings for the previous six months. The first payment into the Fund will be made in April 2006. These payments will continue until the liabilities of the Closed Fund have been met in full. Latest actuarial projections indicate that this will occur in 2062.

10. These payments will be in the form of ring-fenced grant-in-aid from the Secretary of State and will be paid twice each year in April and October through the normal grant-in-aid procedures to the Agency.

11. The Agency will provide the Secretary of State with a copy of actuarial advice received and such information as is reasonably required to illustrate how the payments certified as payable have been calculated. Any assets held in the Closed Fund in excess of the payments will be retained to protect against minor variations in outgoings until a certificate of the actuary to the Closed Fund confirms that their retention is unnecessary. A copy of any such certificate shall be provided by the Agency to the Secretary of State.

12. Payments made by the Secretary of State into the Closed Fund will be reported in Defra's annual accounts together with the Closed Fund's liability in accordance with FRS 17 (or any replacement accounting standard).

Payments to pensioners

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

Control, monitoring and review

14. The Agency will manage the residual assets of the Closed Fund according to the high standards of financial integrity expected of those responsible for the management of public assets. The Agency will invest any surplus funds, as required by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 and in accordance with the Closed Fund's Statement of Investment Principles and Funding Strategy Statement. The Agency's procedures and the accounts of the Fund will continue to be the subject of an annual external audit, and nothing in this Memorandum affects the need for an actuarial valuation of the Closed Fund as required by the LGPS Regulations.

15. For monitoring purposes, the Agency will inform the Secretary of State of the Closed Fund's liabilities at the end of each financial year in accordance with FRS 17 (or any replacement accounting standard).

16. This information will be used to update provisions in the annual accounts of Defra. Significant variations from profiled grant-in-aid payments will be fully justified by the Agency.

17. This Memorandum shall only be amended by the agreement in writing of both the Secretary of State and the Agency.

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

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

Date of signature: 17 May 2005

Statistical summary of fund membership and value

Fund membership	**31.3.96**	**31.3.97**	**31.3.98**	**31.3.99**	**31.3.00**	**31.3.01**	**31.3.02**	**31.3.03**	**31.3.04**	**31.3.05**	**31.3.06**	**31.3.07**
Pensioners	25,671	25,128	24,575	23,996	23,364	22,761	22,117	21,476	20,833	20,113	19,456	18,907
Deferred pensioners	7,721	7,460	7,241	7,054	6,815	6,568	6,335	6,102	5,880	5,641	5,368	**5,102**
Total	**33,392**	**32,588**	**31,816**	**31,050**	**30,179**	**29,329**	**28,452**	**27,578**	**26,713**	**25,754**	**24,824**	**24,009**

Financial summary	**31.3.96 £m**	**31.3.97 £m**	**31.3.98 £m**	**31.3.99 £m**	**31.3.00 £m**	**31.3.01 £m**	**31.3.02 £m**	**31.3.03 £m**	**31.3.04 £m**	**31.3.05 £m**	**31.3.06 £m**	**31.3.07 £m**
Grant-In-Aid Income	-	-	-	-	-	-	-	-	-	-	-	91
Investment income	36	32	26	22	19	17	12	9	7	8	4	2
Benefits and other expenditure	(104)	(104)	(102)	(101)	(101)	(98)	(96)	(94)	(94)	(92)	(91)	(89)
Excess of benefits and other expenditure over income	(68)	(72)	(76)	(79)	(82)	(81)	(84)	(85)	(87)	(84)	(87)	4
Change in market value of investments	100	40	112	20	40	(28)	(9)	(44)	31	13	9	5
Net increase/ (decrease) in the Fund value	32	(32)	36	(59)	(42)	(109)	(93)	(129)	(56)	(71)	(78)	9
Market value of Fund	**724**	**692**	**728**	**669**	**627**	**518**	**425**	**296**	**240**	**169**	**91**	**100**

Printed in the UK for The Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office ID 5615591 07/07 19585
Printed on Paper containing 75% recycled fibre content minimum.

Any enquiries regarding this Report should be addressed to:

Mr H. Pearce
Head of Environmental Finance and
Pension Fund Management
Environment Agency
Rio House
Waterside Drive
Aztec West
Almondsbury
BRISTOL
BS32 4UD

Tel: 01454 624332
Fax: 01454 624031

Enquiries concerning the Environment Agency Pension Scheme or entitlement to benefits should be addressed to:

Environment Agency Pensions Team
Capita Hartshead
257 Ecclesall Road
SHEFFIELD
S11 8NX

Tel: 0114 273 7331
Fax: 0114 273 0299
Email: eapf@capita.co.uk

This Annual Report and Financial Statements is also available on the Environment Agency's websites:

www.environment-agency.gov.uk/pensions
www.environment-agency.wales.gov.uk/pensions

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail,Telephone, Fax & E-mail
TSO
PO Box 29, Norwich, NR3 1GN
Telephone orders/General enquiries: 0870 600 5522
Order through the Parliamentary Hotline Lo-call 0845 7 023474
Fax orders: 0870 600 5533
E-mail: customer.services@tso.co.uk
Textphone 0870 240 3701

TSO Shops
16 Arthur Street, Belfast BT1 4GD
028 9023 8451 Fax 028 9023 5401
71 Lothian Road, Edinburgh EH3 9AZ
0870 606 5566 Fax 0870 606 5588

The Parliamentary Bookshop
12 Bridge Street, Parliament Square,
London SW1A 2JX

TSO@Blackwell and other Accredited Agents

ISBN 978-0-10-294752-6

9 780102 947526