



House of Commons
Environmental Audit
Committee

**Government Response to
the Committee's Fourth
Report, Session 2003–04 on
Water: The Periodic Review
2004 and the Environmental
Programme**

**Fourth Special Report of Session
2003–04**

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The Environmental Audit Committee

The Environmental Audit Committee is appointed by the House of Commons to consider to what extent the policies and programmes of government departments and non-departmental public bodies contribute to environmental protection and sustainable development; to audit their performance against such targets as may be set for them by Her Majesty's Ministers; and to report thereon to the House.

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A list of Reports of the Committee in the present Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are: Mike Hennessy (Clerk); Lynne Spiers (Second Clerk); Eric Lewis (Committee Specialist); Elena Ares (Committee Specialist); Anna O'Rourke (Committee Assistant); Caroline McElwee (Secretary); and Robert Long (Senior Office Clerk).

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References

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by page number as in 'Ev12'.

Fourth Special Report

Water: The Periodic Review 2004 and the Environmental programme—Government Response.

1. The Environmental Audit Committee published its report on Water: The Periodic Review 2004 and the Environment Programme on Thursday 6 May 2004 as HC 416.
2. The Government's Response to the Committee's Report was received on 8 July 2004 in the form of a memorandum to the Committee. It is reproduced as an Appendix to this Special Report.

Appendix

GOVERNMENT RESPONSE TO ENVIRONMENTAL AUDIT COMMITTEE REPORT: Water: The Periodic Review 2004 and the Environmental Programme (Fourth Report of Session 2003-04)

Introduction

1. The Government welcomes the report of the Environmental Audit Committee into Ofwat's Periodic Review 2004 and the environmental programme, as a constructive and timely contribution to the debate on the Periodic Review of water price limits for 2005-2010. The Review is currently in progress. Ofwat is reviewing companies' final business plans and will publish its draft determinations of price limits in August for consultation. The Secretary of State will issue Final Guidance in September 2004. This will be informed by companies' final business plans, Ofwat's draft price limits and their implications for customers' bills, any further advice from regulators and the Government's regulatory impact assessment. Ofwat will issue its final determinations in December 2004.

Response to the Committee's Conclusions and Recommendations

Recommendation 1: We welcome the improvements to the Review process following our predecessor Committee's report, in particular the joint customer survey, the improved cost-benefit analysis of the environmental programme and the new sustainable development duty of the Regulator. However, there has been little progress in other areas, in particular that of diffuse pollution, for which the Government has yet to put any significant measures in place.

2. The Government agrees with the Committee that there have been improvements made to the Review. The joint customer survey has been successful and has arrived at a more consistent view between all stakeholders. The improved cost-benefit analysis of the environment programme and the new sustainability duty for the Regulator are covered later in this response. The Government takes the issue of diffuse pollution very seriously and the progress being made in addressing it is outlined in the response to Recommendation 22.

Recommendation 2: We accept that there may be difficulties with estimating the costs and benefits of the proposed environmental programme. However, we are not clear as to why the concerns expressed by the Regulator and water companies were not raised earlier in the process when they might have had greater effect. We are driven to conclude that timing of their raising these concerns was related to their wish to influence the debate of the size of the programme.

3. The Principal Guidance from the Secretary of State to the Director-General of Water Services recognised and welcomed the commitment of the environmental regulators to recommending realistic programmes to meet existing commitments in a cost-effective way and to ground further policy choices on a proper assessment of costs and benefits.

4. In order to ensure value for money, Ofwat has continued to advocate the use of cost benefit analysis where this is practicable to assess value for money. The position of Ofwat has been highlighted by the debate on the issues triggered by the companies' draft business plans last year.

Recommendation 3: Future reviews would benefit from a formal timetable for carrying out the cost-benefit analysis which should include clear opportunities for those involved in developing the methodology to raise any concerns they may have. Greater sharing of information between the Agency, who have expertise in determining benefits, and water companies, who have the expertise in determining costs of projects, would be beneficial. This would help prevent the unsatisfactory situation where the estimated cost of implementing the environmental programme in preferred plans differed by £1 billion between the Agency and water companies.

5. The methodology for cost benefit analysis was developed by the Environment Agency within the overall timetable for the review. Future economic appraisal will need to take account of the requirements of the Water Framework Directive. Key stakeholders and water companies were involved in the development of the methodology. The Government agrees that information sharing is the key to ensuring the robust appraisal of schemes.

Recommendation 4: We are satisfied that the Environment Agency has only put forward proposals which require water companies to address areas where they are having a significant environmental impact.

6. The Environment Agency, together with the nature conservation agencies, has worked to improve the robustness of its recommended programmes, to provide cost-benefit analyses to support the overall programme, available policy choices and to improve the cost-effectiveness of the programmes. This work reduced the number of schemes that the

Environment Agency and the nature conservation agencies recommended for inclusion in companies' business plans.

Recommendation 5: We are concerned that proposals put forward by Ofwat to curtail the environmental programme did not rest upon those principles of sustainable development which the Regulator insists that he upholds.

7. In December 2003, Ofwat illustrated in its public letter to Ministers the implications for bills of varying the scale of the overall capital expenditure programme. The illustrations were not concerned solely with the environmental programme, but with all aspects including maintenance, security of supply and enhancement to customer service such as sewer flooding.

8. The Water Act 2003 will place a duty on Ofwat 'to contribute to the achievement of sustainable development.' The Director General has said that he will behave as though he already has that duty.

There are four pillars to sustainable development:

- social progress which recognises the needs of everyone;
- effective protection of the environment;
- prudent use of natural resources and
- maintenance of high and stable levels of economic growth and employment.

9. Ofwat considers that its illustration for Ministers of the implications of variations in the scale of the overall capital programme was in accordance with its commitment to contribute to sustainable development by seeking to achieve an appropriate balance between the four pillars. Higher bills carry a social and economic cost, to be balanced alongside effective protection of the environment and prudent use of natural resources.

Recommendation 6: We seek assurance that the Regulator will examine all the costings put forward by water companies to ensure that the environmental programme is carried out for maximum benefit at minimum cost. We are seriously concerned that the first option examined by Ofwat for cutting back on environmental spending was the reduction of schemes rather than a rigorous examination of the water companies' estimated costs.

10. The Principal Guidance set out the policies companies were asked to cost in final business plans. Government works closely with the Environment Agency, the nature conservation agencies and the Drinking Water Inspectorate. They in turn work closely with companies, to specify the schemes necessary to meet the requirements of those policies. Government expects schemes to implement the policies in the guidance both to be costed in final business plans and allowed for in price limits.

11. Now that final business plans have been submitted, it is Ofwat's role to scrutinise them when setting draft price limits. Ofwat will, with the Environment Agency, check that

companies have costed the appropriate schemes. Ofwat will also check that schemes meet the criteria set out in its methodology paper in March 2003, i.e. that schemes:

- are required by the Environment Agency and confirmed by Ministers, or are a new obligation under current legislation;
- deliver a measurable defined output, which is enforceable;
- have a clearly defined timetable and due date for delivery in line with regulations or other legislation;
- have defined asset improvements or changes to operational procedures to deliver the output and
- have identified costs that have been challenged and validated by the company's reporter.

12. Schemes which meet these criteria will be examined carefully by Ofwat. Where schemes fail Ofwat's criteria, the Government expects notification from Ofwat so that issues may be resolved for final guidance and price limits.

13. Ofwat can and will challenge costs. Business plan proposals have already been reviewed by the reporters. Reporters are independent professionals, usually consulting engineers, who examine and test the information in the business plans and provide their opinion to Ofwat. Efficiency challenges will be applied by Ofwat to all investment programmes.

Recommendation 7: We note that the water quality and environmental programmes are the only part of the Review over which the Government had any direct control and we are troubled that the guidance has become the focus of departmental wrangling, simply because it is the only way the Government can exert any direct influence over water prices.

14. At privatisation, Parliament created an independent regulator to regulate the water industry, including setting water price limits. This has worked well. The Government recognises the independence of the regulator.

15. Ministers influence customers' bills, by setting policies affecting companies' outputs. These policies, whether on quality improvements or other issues, are set out to inform Ofwat and companies in the Secretary of State's guidance to the Director General of Water Services. The process of agreeing these policies stimulates debate, as one would expect with such significant decisions, though the Secretary of State's guidance represents the agreed, collective position of Government.

Recommendation 8: We are concerned that some Government Departments and Ofwat may still see environmental spending as the first option for cutting costs for water companies and that other parts of the capital expenditure programme may not be subject to equal scrutiny.

16. All policies and all parts of companies' capital expenditure are scrutinised. Government policy decisions have regard to the cost effects on customers. Ofwat has made

clear throughout the Periodic Review that its price limits must, under its primary statutory duty, allow as much as is needed to enable efficient companies to carry out their functions but, in customers' interest, they should also be no higher than is necessary. See also the response to recommendation 6.

Recommendation 9: It is important that when the final guidance is issued in September 2004 we do not see the environmental programme again under renewed threat. We seek reassurance from Ministers in their response to this report that this will not be the case.

17. There is a continuing process whereby all the players work to ensure that existing commitments are delivered pragmatically and at lowest cost to the consumer. The Principal Guidance conveyed the Government's main decisions and policies affecting the 2004 Periodic Review of water prices. The Government welcomes the appraisal work undertaken by Regulators to inform their advice on the content of the programme and expects this work to continue, for example, through additional Environment Agency scrutiny of the schemes to deliver the outcomes identified in the principal guidance and Ofwat scrutiny of the cost of those schemes. In addition, as signaled in the Principal Guidance, the Government will be preparing a regulatory impact assessment to aid decision making on those policies which go beyond existing commitments

Recommendation 10: We are concerned that the delay regarding publication of the ministerial guidance together with the extensive debate between Departments will have added to the concerns the finance sector have when investing in the water industry, particularly at a time when there is a reduced level of equity finance available to water companies.

18. The Government is aware of the concerns of the financial sector about the importance of regulatory certainty and recognises that it is vital to get these decisions right. It does not accept the Committee's view that there is necessarily a reduced level of equity finance available to water companies.

Recommendation 11: We would like Defra and Ofwat to ensure that in future any investigations included in the environmental programme for the current and future reviews are set out clearly and a definite timetable established for them to be completed. This will ensure that the results can be fed into the next review period. We would expect Defra, in their response to this report, to set out how this will be achieved.

19. The Government agrees that it is important that investigations are completed to an appropriate timetable to inform future decisions. Ofwat, in accordance with its stated policy, will be defining the timetable for investigations as part of its determinations. The outcomes of investigations may trigger further investigations or the need for investment. In both instances there are mechanisms in place to enable progress to be made within the review period.

Recommendation 12: We are not convinced that enough is being done by all water companies to make customers directly aware of the benefits of the environmental programme to them. We would urge Ofwat and water companies to do more, particularly by direct communication with customers, including sending out information on the environmental programme with their water bills.

20. At this price review customers' bills are expected to rise in 2005-06 and over the five-year period for which the Director General of Water Services will set price limits. All stakeholders will need to play their part in explaining to customers what improvements they will see for the increases in bills. The Government expects the water companies to inform their customers what their bills will deliver in terms of improvements to services, supplies and their assets as well as improvements to the environment.

21. All companies have published summaries of their final business plans. Some have produced leaflets to inform their customers.

22. Ofwat will set out in its draft and final determination documents the outputs it expects each company to deliver. The companies will also produce monitoring plans, in March 2005, which will set out the outputs they will be delivering and by when. This will allow the WaterVoice committees and others to monitor how companies are performing against their plans.

23. The Environment Agency jointly with the nature conservation agencies has published information on the environmental benefits of further investment by the water industry. This includes its advice to Ministers, which summarises the benefits of all aspects of the environment programme, and reports for local stakeholders.

Recommendation 13: We are very disappointed that the opportunity for placing sustainable development at the heart of the Authority's duties, through the Water Act 2003, was missed. We are also concerned that the duty of the new Authority to consider sustainable development will always be in danger of losing out to the Authority's primary economic duties, despite the Regulator's assurance that this will not be the case.

Recommendation 14: In the light of recent events, which have highlighted the conflicting duties of the Regulator, we believe it is vital that the new Authority should have a specific duty to report on how sustainable development is incorporated into its other regulatory duties. The Government should use its powers to require this.

24. The Government considers that the range of primary and secondary duties that the Water Act 2003 places on the Regulator is appropriate. The new Water Services Regulation Authority is an economic regulator; so while sustainable development is an important part of that role, there must be a proper balance between its various duties. The Director General has said that he will behave as though that duty already had effect and welcomed its inclusion in the Act. However, Ofwat is obliged to put all its actions in the context of its statutory duties as a whole. The Act also provides a power for the Secretary of State to issue guidance to the Regulator on social and environmental matters which can be used to explain the duty to contribute to the achievement of sustainable development.

25. Following the Water Act 2003, the Regulator's annual report will have to include a general survey of developments falling within the scope of its functions. The Government would expect this to cover the regulator's statutory functions relating to sustainable development. Although the Act allows the Secretary of State to require the regulator to report on matters which she specifies, the Government believes that the power should not be needed in this respect.

Recommendation 15: We do not believe it is the role of the Regulator to decide what should or should not be included in the environmental programme.

26. The Government agrees that the distinction between the roles of the economic and environmental regulators and of Ministers should be maintained. But the effectiveness of the Periodic Review also depends on the interaction between the various players and discussion and debate on their contributions. While the Government sets broad environmental policies, the Environment Agency and the conservation agencies recommend the programme of schemes to meet those policies and Ofwat ensures that funding for schemes is included in price limits.

Recommendation 16: We do not think that the current five year review period is appropriate. It should be extended to a six-year period, or a twelve-year period with a mid term review, so as to fall into step with the Water Framework Directive. Extending the review in this way would result in greater certainty for water companies, investors and customers. However, this would be with the proviso that a satisfactory system for interim determinations can be developed, which would be particularly important in view of increasing understanding of the effects of climate changes and how these will impact on water companies' activities in the future.

27. In 'Setting price limits for 2005-10: Framework and approach' (October 2002) Ofwat consulted on whether the 2009 price review should cover a longer period than five years. In their responses some companies supported a longer period between price reviews but this was contingent on there being a robust system for dealing with changes between reviews. There was no consensus about the period between reviews, suggestions ranging from six to ten years. WaterVoice in its response suggested that it was unconvinced by a move to a longer period between price reviews.

28. Some suggested a longer period between price reviews would help with long-term planning, although others felt that a longer period could not accommodate the costs of new environmental regulations. A number of environmental bodies felt there would be benefits in tying the price review periods to the six-year cycle of the Water Framework Directive.

29. 'Ofwat forward programme 2004-05 to 2006-07' sets out the Regulator's intention to consult following the current review on whether to extend the period between future reviews. A regulatory impact assessment will be produced. Decisions on the period between price reviews following the current review will be for the Water Services Regulation Authority which will conduct the Price Review in 2009.

Recommendation 17: It would be much more useful in our view, for the section of the customer survey dealing with reactions to the proposed price rises to be carried out using information from water companies' final business plans. These figures are likely to be much closer to those of the final determinations and therefore more closely reflect customers' actual reactions to likely price movements. We appreciate that time constraints may make this difficult, nevertheless we would like to see the feasibility of this option being explored.

30. There would not be time to carry out the customer survey after the publication of companies' final business plans, if the results were to have a meaningful impact on decisions made. Surveys carried out in this Periodic Review have produced results at a time which enabled them to inform key decisions and so fulfil their purpose. For example, the second survey informed the Principal Guidance and then preparation of companies' final business plans

Recommendation 18: The emphasis of the Review and the Regulator's analysis should be on what the proposed new price limits will mean to customers in individual water company regions not on a national average price rise, which gives little indication to customers of the likely changes to their water bills.

31. The statutory outcome of the review will be price limits set for each individual company. These will be translated into tariff charges which are subject to the regulator's approval. Ofwat has already published on 7 May (PN17/04) the price limits put forward by each of the companies in their final business plans. It has always made clear that individual bill increases will not necessarily correlate closely with the national average increase.

Recommendation 19: The Regulator, as part of his duty to protect customers' interests, must ensure that more substantive information, where it exists such as is the case with levels of customer debt, is made available to customers in an accessible manner which makes clear the costs incurred in their own water region. Where this information does not already exist, as in the case of diffuse pollution, more effort should be made to obtain it and make it publicly available.

32. Ofwat has sought more substantive information from companies on levels of long term customer debt and will make this information available in its regular annual reports on company performance.

33. The Environment Agency is responsible for collecting information on diffuse pollution. As part of this periodic review, the Environment Agency published reports for each of its operational Areas. These reports described the benefits of the proposed environment programme, and also included information on what action would be required by other sectors.

Recommendation 20: Water prices are going to continue to rise for the foreseeable future. As a result there will be an increasingly large proportion of the population on lower incomes that will find it difficult to pay water bills. If the Regulator is to continue to price water realistically, as is his duty, the Government is going to have to address this issue seriously. We strongly support the EFRA Committee recommendation that people suffering from serious difficulty in paying their bills should be helped through the benefits and tax system.

34. A cross-Government steering group, led by Defra and involving Ofwat, Treasury, Department for Work and Pensions, Department of Trade and Industry and Welsh Assembly Government, is reviewing the way in which lower income households are helped with their water and sewerage charges. The Group is reviewing the existing Government, regulatory and individual water company provisions which provide assistance to vulnerable and low income customers and will be considering the options for providing

further assistance. The views of others from outside Government are welcome. Defra held a seminar, involving a range of stakeholders, on 18th June, which set the scene for further discussions. These will inform the decisions to be made by Ministers.

35. In general the tax credit and benefit systems do not provide targeted support for the costs of particular goods or services. There are exceptions to this, for example Housing Benefit and the childcare element of the Working Tax Credit. But rents and childcare costs typically represent a far larger proportion of household expenditure than water and sewerage charges. Extending the range of the goods and services whose costs are directly supported through tax credits or benefits in a targeted way would complicate the systems and increase administration costs.

36. The Vulnerable Groups regulations under the 1999 Water Industry Act set out a number of qualifying criteria for low income and vulnerable metered customers, who are able to switch to a reduced tariff (based on the company's average bill) where they have an above average charge. Changes are being brought forward in the coming months to make the Regulations more effective from April 2005. This is likely to include changes to the eligibility criteria to bring a greater number of households within the scheme.

37. Financial support for families and for pensioners on low and moderate incomes has risen significantly in recent years. For example, as a result of personal tax and benefit measures implemented since 1997, by September this year families in the poorest fifth of the population will be, on average, £3,000 better off in real terms. Further, the poorest third of pensioner households will be, on average £1,750 better off this year in real terms, compared with 1997.

Recommendation 21: It is unacceptable that paying customers subsidise bad debt by an average of £10 per year, an amount which is likely to increase as water prices rise unless the issue of affordability is addressed. This also results in less money

38. Ofwat's duty is to ensure that customers do not pay for inefficient behaviour by companies. It has encouraged companies to improve their billing procedures and to share best practice but accepted that the overall rise in long-term bad debt is in part associated with the statutory ban on disconnection of domestic water customers. This ban exists to protect less well off customers from the effects of disconnection. It does however have consequences for costs.

Recommendation 22: We are very concerned at the slow progress by the Government in reaching a decision on how diffuse pollution from agriculture will be tackled. In view of this, we would expect Defra's response to this report to include details of the timetable for the implementation of measures to which they are working.

39. The Government does not accept that slow progress is being made. It takes the issue of diffuse pollution very seriously. It is making active progress in addressing the specific agricultural and non-agricultural sources of diffuse pollution.

40. The Government published on June 17th a consultation document on broad approaches to the use of further policy instruments to address diffuse water pollution from agriculture by encouraging 'Catchment-Sensitive Farming.' This seeks views on a full range of possible approaches to promoting catchment-sensitive farming, including voluntary, regulatory,

economic and information instruments. This will contribute to water companies having less pollution to clear up—in developing approaches to tackling DWPA we are mindful of the polluter pays principle. Depending on the consultation outcome, this could be the first of a series of consultations on policy instruments which could be introduced from 2006 or 2007.

41. Agriculture is facing a period of considerable change over coming years, with the reform of the Common Agricultural Policy the most significant of a number of changes in the policy environment. This, together with the Entry Level and Higher Level agri-environment Schemes and the Whole Farm Approach, will help to reduce agricultural emissions to water.

42. We are mindful of the need to keep additional pressures manageable, particularly in 2005 when the changes associated with the new Single Farm Payment will take effect following the agreement in June 2003 on CAP reform. We are working with the agricultural sector and other stakeholders to achieve this.

43. Our aim in the consultation is to take forward the development of measures that will reduce diffuse pollution from agriculture without adding unnecessary regulatory burdens. This will increase the sustainability of English agriculture and allow farming to play its part in making water in England as clean and as healthy as possible.

44. In addition, the Government will be promoting practical steps that farmers can take to reduce diffuse pollution in a parallel communications strategy. It is also exploring with stakeholders the options for achieving early changes to more sustainable farming practices in priority catchments for nature conservation, with a view to achieving immediate improvements on the ground.

45. The Government is also addressing non-agricultural diffuse pollution, and recognises that in some areas this may also affect its ability to meet its water framework directive objectives.

46. The Government is currently reviewing existing research to develop its understanding of the problems. In addition, Defra and the Environment Agency have been jointly running a series of workshops targeted at a range of industry sectors. The workshops seek to identify the nature and extent of the problems, the level of awareness within the various sectors, current prevention and control measures and their effectiveness and suggestions for future action.

Recommendation 23: We are concerned that once the requirements of the Water Framework Directive become clearer there may be a large amount of work needed within a limited amount of time that may not only have a very significant impact on customer' water bills in 2010, but also on the UK's ability to meet statutory obligations.

47. The Directive will have some effect on prices to customers of water and sewerage companies from 2010, but it is difficult to estimate how much. Firstly, there are still a wide range of cost estimates. Secondly, it remains to be settled how much of that total cost should be paid by water customers and how much met by others such as farmers. The Government is working closely with Ofwat and the Environment Agency to establish costs more firmly. Schemes that are to be undertaken by water companies during the period

2005-2010 will also contribute significantly in raising water quality towards the standards required by the Water Framework Directive in 2015.

Recommendation 24: Overall we were disappointed to find that despite the concerns expressed by Government, Ofwat and water companies about the unpalatability of increasing water prices more is not being done by all of them to reduce costs to customers, particularly those less able to pay. The issues of diffuse pollution, customer debt and affordability need to be seriously addressed as they all add significantly to water customers' bills. Dealing with these will have a greater impact on the costs of water to customers than attempting to cut spending on the environmental programme, which would reduce the majority of water customers' bills by a few pounds at most.

48. The Government takes the issues of diffuse pollution, customer debt and affordability very seriously and is addressing these issues as outlined above. It will continue to balance the services and improvements expected of the water industry and the price paid by customers and expects regulators and water companies to do the same. However, it is not possible to have more investment in maintaining assets, improved quality and environmental standards, and ensured security of supply without affecting customers' bills.

Conclusion

49. The Government welcomes the Committee's interest in the Periodic Review 2004 and the Environmental Programme and will take account of its conclusions and recommendations.

June 2004

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Third	Comprehensive Spending Review: Government response and follow-up, HC 233 (<i>Reply, HC 70, Session 2000-01</i>)
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