Airports
UK
Presale Report

BAA Funding Limited

Expected Ratings*

Class	Rating
Class A Bonds	A-
Class B Bonds	BBB
BAA Limited: Non-Migrated Bonds Senior Secured	BBB+

Outlook

BAA Funding Limited bonds	Stable
BAA Limited Non-Migrated Bonds	Stable

* Expected ratings do not reflect final ratings and are based on information provided by BAA Funding Limited as at 14 July 2008, including the prospectus dated 14 July 2008. These expected ratings are contingent on final documents conforming to information already received as well as on satisfactory legal and tax opinions. Ratings are not a recommendation to buy, sell or hold any security. The prospectus and other offering material should be reviewed prior to any purchase.

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Rating Rationale

- The bond ratings reflect the underlying operational risk profile, profitability and capex demands derived from operating and owning the UK's Heathrow, Gatwick and Stansted London airports (the Designated Airports), which represented around 53% of UK air passenger travel in 2007 and 91% of all passengers serving the South East of England. The combined profit streams are diversified as to routes, passengers and airlines. Despite both actual shocks as well as the ongoing possibility of further external shocks, the diversity of the three airports has demonstrated traffic volumes and profit streams as resilient and able to recover quickly, aided by the high existing and prospective demand for air travel in the UK.
- The independent, incentive-based, economic regulation process has now finalised pricing at Heathrow and Gatwick for FY09 to FY13 (called Q5) and provides some predictability for future profits relative to capex. Aeronautical and Commercial Revenue may vary as each airport assumes passenger volume risk within each quinquennium. Significant capex requirements (GBP6.3bn at 2007/08 prices during Q5) will result in negative Free Cash Flow, to be funded by new debt and equity, but the resultant expanding regulatory asset base (RAB) is serviced through the regulatory price cap mechanisms.
- Under a GBP50bn multi-currency debt issuance programme, BAA Funding Limited (the Issuer) routes funding to Borrowers within the ring-fenced Security Group. Other lenders' direct lending to the Borrowers ranks pari passu with the Issuer's funding as all relevant parties agree to be bound by the terms of the Common Terms Agreement and Security Trust and Intercreditor Agreement. It is proposed that GBP-equivalent 4.5bn of existing BAA Ltd unsecured bonds (whose current senior unsecured ratings are 'A-', Rating Watch Negative) are migrated into this financing's secured financing at the Class A level. Additional debt of approximately GBP4.8bn (including EIB funding of GBP0.4bn) will be raised by issuing long-dated bonds and/or using underwritten Refinancing Facilities with maturities of up to 5 years – although BAA is being incentivised to term this debt out with long-term bonds. At financial close, anticipated debt is GBP8.3bn and GBP1bn for Class A and B respectively. Using disclosed pro forma figures, at March 2009 debt is forecast to total GBP8.7bn and GBP1.2bn for Class A and B respectively, equating to around 66% and 75% respectively of the Designated Airports' combined RAB.
- The Class A and B bond ratings also reflect the structural enhancements derived from this financing including: liquidity facilities at the Issuer and Borrower level; tranching of debt and priority of payments; committed capex facilities; the Trigger Event regime; and ring-fencing from its ultimate owners (the Ferrovial-led consortium), including dividend payout restrictions. The financing will include security over the three Designated Airports.
- The 2006 referral by the OFT to the Competition Commission (CC) concerning "features of the market" that prevent, restrict and distort competition in the UK – also citing BAA's common ownership of the three South-East airports – may be completed by end-March 2009. At this stage, likely remedies include BAA being forced to divest airport(s). If Stansted and/or Gatwick have to be sold, disposal proceeds have to reduce Class A leverage to below 70% net debt/RAB (until April 2018 and less than 72.5% thereafter) and Class B leverage to below 85% net debt/RAB. Disposal of one airport is not expected to affect the ratings

however, Fitch expects to revisit the ratings of a sole-Heathrow financing taking into account other sector and regulatory changes that the CC enquiry may recommend for future implementation.

Key Rating Drivers

- Particularly for this highly-leveraged structure: the cost of (re)financing debt.
- Longevity of any profit decline most probably due to an exogenous shock.
- Inherent risks and funding of the sizeable capex programme.
- Actions following unknown parameters of the CC review.

Liquidity and Debt Structure

The rated Issuer bonds benefit from: liquidity facilities at the Issuer level (Class A: 12 months' interest, Class B: six months); minimum liquidity requirements for future capex; and the restriction on dividend payments upon a Trigger Event (whose covenant thresholds are 70% net debt/RAB for the next 10 years for Class A and 85% for Class B). Additional debt can be issued provided that the Class A 72.5% and the Class B 85% (both ratios while the Refinancing Facility is outstanding and 90% for the Class B only thereafter) net debt/RAB ratios are not breached. This financing's covenanted interest cover ratios (ICRs) use a synthetic cash maintenance spend figure of 2% of RAB instead of regulatory depreciation and are set at a comparatively weaker (lenient) level than other utility financings of this type which use the regulatory depreciation post-tax post-maintenance interest cover ratio (PMICR). In its analysis, Fitch uses the PMICR.

NB: To aid comprehension and ability to cross-reference this report's descriptions with the published Preliminary Prospectus, Fitch has used capitalised terms in line with precise meanings with that public document. In the Operational section of this presale report (p.1-24) "BAA" refers to the three Designated Airports.

At a Glance – The Three Designated Airports

	Heathrow (including HEX OpCo)	Gatwick	Stansted
Passenger numbers (m) year to Dec 2007	67.9	35.2	23.8
Estimated business/leisure mix	36/64	18/82	19/81
CAGR in pax since Mar99 to Mar08 (%)	1.2	2.1	13.7
As % of total UK pax 2007 data	30	14	10
Capacity	Currently operating above terminal capacity Although T5 (opened March 2008) increases the terminal capacity, ready for larger aircraft and passenger numbers, landings and take-offs remain constrained by runway capacity Q5's Heathrow East redevelopment is passenger capacity-neutral during construction. Eventually, airline groupings/alliances will have dedicated terminals at Heathrow Two-runway capacity is expected to remain unchanged during Q5, except if mixed-mode operations are allowed	Not yet at full capacity (other than during peak periods) Under an agreement with the local authority, significant redevelopment of the airport (i.e. additional runway) is prohibited until after 2019 Although Gatwick has two runways, the second runway is only used in the event of a major disruption	Reaching a point of full capacity and the need for a second runway and additional terminal capacity ("Stansted Generation 2") for 2012
Aircraft movements (ATMs)	Planning limited: 480,000 To Dec 07 actual 475,713	Physical limited: 275,000 To Dec 07 actual: 258,795	Allowed 241,000 To Dec 07 actual 191,488
Characteristics	World's third-busiest airport in terms of total pax Busy airport, European hub Estimated 34% connecting traffic Benefits from close proximity to city of London	World's tenth-busiest airport by international pax Leisure-orientated (seasonal: April to October concentrated) Benefits from proximity to prosperous South-East area	Major base for LCCs High-growth, low-cost operator airport Mostly point-to-point traffic Not dependent on London traffic
Main routes	90 airlines serving approx 180 destinations, including European, North American, Asian	75 airlines serving approx 195 destinations. Weighted to continental European	30 airlines serving 160 destinations, heavily weighted to point-to-point continental European
Main airlines	BA (41% of pax), Virgin (6%), bmi (6%) After the March 2007 purchase by BA of bmi slots, Heathrow slot-holders were: BA: 41%, bmi: 11%, Lufthansa: 5%, and Virgin Atlantic 3%	BA (20%) mainly north terminal, easyJet (16%), TUI Travel (9%) and Virgin (4%)	Ryanair (around 60%), easyJet (around 20%)
Other comments	• To benefit from increased traffic resulting from Open Skies • Mixed mode (perhaps by 2015) will increase runway capacity • Additional runway subject to planning and environmental hurdles • Suffers from poor quality terminals and overcrowding in general	• Will lose out from Open Skies as existing US routes migrate to Heathrow over time but this capacity has been back-filled from other airlines	• Low-cost operator airport with (over)concentration on Ryanair and easyJet
Year to March 2007 (regulatory accounts)			
Aeronautical revenue (GBPm)	580	164	81
Commercial revenue (GBPm)	616	213	108
Regulatory EBITDA (GBPm)	596	152	74
YE RAB (GBPbn)	8.8	1.5	1.0
Aeronautical rev./pax (GBP)	8.6	4.8	3.4
Commercial rev./pax (GBP)	9.2	6.3	4.5

Source: Various documents including the BAA Funding Limited Prospectus

Overview of Business & Operational Profile

BAA owns and operates the three regulated London airports. Given their monopoly characteristics, they are remunerated within an incentive-based economic regulatory framework that provides some predictability as to tariffs per pax, and financial return on an expanding RAB as capex is undertaken.

The company may face the following downside risks:

- Passenger volume risk and other shocks to revenue during a price control period that directly affect profit given the group's estimated 75-80% fixed cost base;
- As per Q4, opex underperformance affects profits with no recovery mechanism within a quinquennium;
- Capex overspends (to the extent not included in RAB) and other inherent risks in undertaking a sizeable capex programme;
- Evolutionary or otherwise changes in routes, type of traveller mix and airlines;
- A key variable in each regulatory determination being the weighted-average cost of capital, WACC;
- Although an independent and objective regulatory appraiser, the Civil Aviation Authority (CAA) has no overt duty to enable BAA to finance its activities and financeability criteria other than the existing duty to promote the efficient, economic and profitable operations of the airports. Fitch believes that the CAA's approach has been less than robust compared with other regulators'; and
- Potential adverse cost of refinanced, or new, debt and the availability of financing.

A key risk that affects turnover, profitability and capex during the price control period is passenger volumes. Fitch has analysed the historical pax of each airport and the behaviour of flows relative to actual events such as 9/11, SARS, recent security scares and traffic, route and airline concentrations. Where unforeseen events have caused volume shocks, such is the demand for air travel to and from this island, these volume declines have quickly recovered. BAA's profile is also greatly enhanced by the diversity of airports, their routes, passenger types, airlines, affordability and near-London locations.

Non-aeronautical revenue is not as vulnerable to change as the sub-label of "retail" would imply. The terminals' consumer behaviour does not mirror UK national consumer spend trends; also, this Commercial Revenue is a mixture of minimum rentals, concession fees, some turnover-derived flows and some directly operated activities. It is acknowledged that in the long run, terminal outlets and operators may negotiate lower rentals if profits drop due to lower volumes, but they too will ride the short-term downturn given the sizeable footfalls on offer at these airports.

BAA has suffered from a lot of bad press because of terminal overcrowding, poor quality of service, particularly if delays accumulate. Recently, passenger delays were exacerbated by the sudden government-stipulated security changes of summer 2006. A reflection of years of underinvestment, such problems are not going to be completely fixed by the opening of T5 (March 2008) and other near-term terminal refurbishment/developments, thus the phrase "Heathrow Hassle" looks set to stick. Even after taking into account CAA's maximum penalties for potential poor quality of service performance, BAA is not heavily penalised financially and cannot be "sacked" as airport operator.

Heathrow remains constrained by runway capacity. Only larger airplanes using the same finite number of slots and "mixed mode" represent potential increased pax, until a third runway is built. Gatwick is reaching near-permit constraints and has tired infrastructure. Stansted requires expansion to meet near-term demand and is

exposed to the non-publicity-shy Ryanair, its low-cost carrier (LCC) model and provocative management style.

BAA has failed to work within the opex base projected by the regulator during Q4. The regulator largely accepted this cost base as the starting point for Q5's cost base, albeit with an on-going efficiency factor. Partly explained by increased security and staff-related pension costs, previous management stated that pax movement within its outdated and overcrowded terminals was kept fluid by its staff. Fitch believes that a combination of current management not wanting to tamper with the sensitive issue of security, or its heavily unionised terminal-based workforce, means that opex cost outperformance (financial performance rather than service quality) is not at the fore of Q5's business plan.

BAA has significant capex demands during Q5 (particularly Heathrow East and the Stansted Generation 2). Construction risk has been well managed to date with T5 receiving many awards and setting industry standards. A genuine tool available to management in response to a fall in pax is the flexibility to delay or cancel capex and/or opex accordingly. However, the CAA has linked revenue to certain capex projects being completed on time.

In comparing this asset class with other regulated utilities, Fitch believes that BAA has a higher risk profile compared with the regulated gas and electricity distribution, UK water and electricity transmission companies. If, as expected, and as a result of the CC and DfT enquiries, the regulatory framework is updated, Fitch does not expect significant changes other than BAA's ability to pledge assets as security and perhaps the creation of a special administrative receivership regime – both of which require a change in law.

In this Section

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- Passenger (pax) Numbers
- Pax Numbers – Evidence of Historical Traffic Figures
- Financial Penalties
- Commercial Revenue
- Operating Cost Base
- Capital Expenditure
- Regulatory Asset Base

The Three Designated Airports

Aeronautical Revenues

Aeronautical revenues, consisting of a tariff per passenger as set by the CAA, constituted 47% of the three Designated Airports' turnover in FY07 (to March). As shown in the *At A Glance* table above, BAA gains more revenue from each airport's commercial income per pax than from the regulatory tariff. This is expected to change as capex expands RAB and Aeronautical Revenue increases to around 60% of total revenue. The tariff itself is set as a result of the financial building blocks explained in *Appendix I*.

Such tariffs are low compared with many European peer equivalents as they are subsidised by the non-aeronautical profit stream. It is estimated that airport charges and costs total around 5-10% of an airline's own costs. Obviously, the tariff per pax is less onerous for long-haul price tickets, but for LCC operators with low price tickets at Stansted, and for easyJet at Gatwick, rising airport tariffs are a sensitive issue.

Past regulated tariffs per airport are shown in Table 1 below.

Table 1: Q4 Aeronautical Tariffs

(GBPm)	FY04 A	FY05 A	FY06 A	FY07 A	FY08 F
Heathrow					
Allowable yield after adj/pax	6.48	7.08	7.83	8.50	9.28
Actual average yield/pax	6.42	7.05	7.86	8.61	9.28
Actual pax (m)	64.3	67.7	67.4	67.3	68.1
Actual revenue	414.9	479.0	532.1	579.6	641
CAA forecast revenue	435.9	491.7	543.6	601.0	n.a.
Gatwick					
Allowable yield after adj/pax	4.32	4.44	4.65	4.73	4.92
Actual average yield/pax	4.25	4.42	4.61	4.76	4.91
Actual pax (m)	30.1	32.0	32.9	34.8	35.2
Actual revenue	129.8	143.5	153.4	163.8	177
CAA forecast revenue	135.3	150.9	165.2	183.0	n.a.
Stansted					
Allowable yield after adj/pax	4.89	5.03	5.64	5.83	6.44
Actual average yield/pax	2.46	2.61	2.94	3.38	5.82
Actual pax (m)	19.5	21.3	22.3	23.8	23.7
Actual revenue	54.3	62.4	72.5	80.7	138
CAA forecast revenue	91.3	104.2	112.8	100.7	n.a.

FY07 data is from the designated airports' regulated accounts to March 2007
Source: CAA March 2007, November 2007 and March 2008 determination papers

Comparing the actual total Aeronautical Revenue in Q4 years with that forecast by the regulator, BAA has not recovered the full Aeronautical Revenue expected, by some 6%. This is primarily due to (i) actual lower passenger volumes than forecast for the period at Heathrow and Gatwick, and (ii) at Stansted, volumes were higher than forecast, but BAA management decided not to charge the full regulated tariff (instead, it provided discounts as a means to encourage higher passenger volumes). Stansted's discounts ceased and near-full tariffs were levied starting 1 April 2007.

Table 2: Q5 Aeronautical Tariffs

	End-Q4	Q5				
2007/08 prices (GBPm)	FY08 adj.	FY09 F	FY10 F	FY11 F	FY12 F	FY13 F
Heathrow						
Pax (m)		70.4	72.5	74.5	76.2	78.2
Tariff per pax	10.36	12.80	13.72	14.76	15.84	16.99
Year-on-year increase (%)		+23.9	+7.5	+7.5	+7.5	+7.5
Revenue		901	995	1,100	1,207	1,329
Nominal revenue	641	924	1,048	1,187	1,336	1,508
Gatwick						
Pax (m)		35.9	36.4	36.8	37.2	37.7
Tariff per pax	5.61	6.79	6.92	7.06	7.20	7.34
Year-on-year increase (%)		+21.3	+2.0	+2.0	+2.0	+2.0
Revenue		244	252	260	268	277
Nominal revenue	177	250	265	280	296	314
Stansted						
Pax (m)		22.7	23.5	24.7	26.6	28.5
Tariff per pax	5.82	6.39	6.20	6.30	6.60	7.18
Year-on-year increase (%)		+9.8	-3.0	+1.6	+4.8	+8.8
Revenue		145	146	156	176	205
Nominal revenue	138	148	153	167	194	231

FY08 tariffs (compared with Table 1) are adjusted for additional activities now included in Q5's tariff
Source: CAA Mar 2008 final determination documents for Heathrow and Gatwick, inflated with RPI forecast. Stansted: BAA

Q5's tariffs are a function of the regulatory revenue building blocks with FY09's opening step-up resulting from new activities included in the tariff, BAA's increased opex base (including security) and sizeable capex profile over the period, net of a lower pre-tax, real, WACC of 6.2% for Heathrow, 6.5% for Gatwick (and a

conservative estimate of 6.5% for Stansted pending its pricing review for FY10 onwards).

Passenger (Pax) Numbers

Whereas Heathrow's pax are some 4% lower than Q4's CAA projections, Gatwick has continued to underperform to some 11% from the CAA's Q4 projections. Heathrow has remained runway slot constrained and terminal crowded thus its pax CAGR has been broadly flat since December 2000 (an additional 3.6m pax) and even after Terminal 5 opened in March 2008, the airport will remain runway capacity constrained, thus its main area of growth will stem from more and larger aircraft, serving long-haul, and improved load factors using the same finite number of slots. Gatwick has seen net growth in its pax (more recently, partly to the detriment of Stansted as some airlines have switched routes from Stansted to Gatwick) although this airport is also becoming increasingly slot constrained.

Reflecting the planning or physical capacity constraints under which all three Designated Airports are operating, until new capex is undertaken, *Table 3* below (*Q4 and Q5 Pax)* shows limited growth expectation over Q5.

The regulatory process tried to achieve a consensus on pax but this was not reached. BAA maintained its slightly lower numbers (Q5 total: 370m at Heathrow, compared with CAA final determination's 372m, and 181m at Gatwick, compared with CAA's 184m). The CAA arrived at its figures after it estimated the effect of the following:

- Heathrow: The effect of Open Skies (from 1 April 2008) as existing and new airlines operate US-bound flights, thereby increasing FY09's seat capacity by around +3.1%. All of Heathrow's growth expected for FY09 comes from US routes.
- The next phase of significant growth will stem from Heathrow adopting "mixed mode", which will increase ATMs by 12.5%. This is not expected until mid-Q6.
- Gatwick: Open Skies (as some routes are switched to Heathrow) and charter consolidation net of backfill of slots vacated will result in between 0.3-0.7m less pax before compensatory growth to reach a net flat year-on-year profile in FY09.

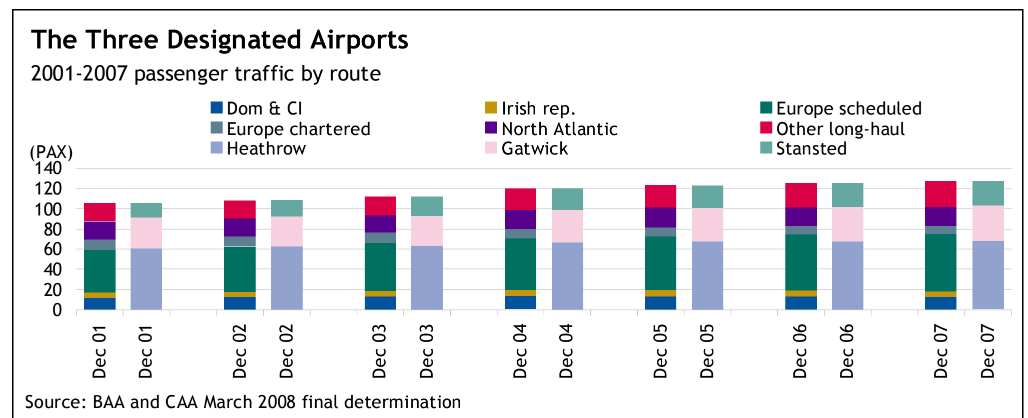
The recent data on the state of the global economy did not affect the CAA's March 2008 assessment of Heathrow and Gatwick's pax forecasts. Furthermore, it was proposed by the International Air Transport Association (IATA) that Heathrow's high business traffic will protect it somewhat from economic downturns. Pax numbers at Heathrow in the period January to June 2008 were 0.4% below the same period in 2007 with increases in long haul versus a decline in domestic & Irish traffic. Gatwick showed a net increase of 2% over the same period with declines in North Atlantic traffic associated with services switching to Heathrow as a result of Open Skies more then offset by increased European & Irish flights. At Stansted, traffic is down by 4.6% over the period with declines in most markets.

Concerning Stansted, 2007 pax figures are distorted by its Low Cost Carriers (LCCs) for the first time, and perhaps in retaliation to the full tariffs implemented by BAA as discount-to-pax volume arrangements ceased in April 2007, reallocating their aircraft to other European airport bases (including Edinburgh and Bristol) and other routes in the winter months. Thus mid-single digit year-on-year growth at Stansted ceased in 2007 with year-on-year volumes flat. Partly due to increased charges to full tariff and Maxjet, Globespan and SkyEurope ceasing operations, 2008's volumes are set to decline by around 4%. BAA is planning for volumes to increase thereafter as discounts are used again to lure airlines and ensure passenger volumes, also targeting longer haul operators. Not all of the resultant growth is expected to be concentrated on the existing LCCs. Most of the capacity growth at Stansted will be possible by 2015 when the Stansted Generation 2 (runway and prospective

terminals) is due to be completed. Although short-term volumes may dip due to short-term economic conditions, BAA remains confident of the long-term (by 2015) demand for planned expansion at the airport.

Across all three airports, if passenger volumes for the quinquennium prove to be worse than expected, BAA has some flexibility to adjust its cost base. Given that the company states that 75%-80% of its cost base is fixed, it is most likely to change this if any volume drop is viewed as permanent. Furthermore, if volumes decline on a permanent basis there would be reasonable grounds to reassess capex requirements.

Pax - Evidence of Historical Traffic Figures



Source: BAA and CAA March 2008 final determination

The following commentary on 9/11, SARS and other individual adverse events, shows that external shocks can be detrimental to passenger volumes, but not necessarily for a long period. The recovery period for passengers to regain confidence in air travel in general after such events has become increasingly quick, within the context of demand for overseas travel from the UK. Furthermore, if a particular region/route is affected, the profile of the combined three airports represents some diversity.

Table 3: Q4 and Q5 Pax

	Q4					Q5				
FY to 31 March pax (m)	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Heathrow										
Actual	64.3	67.7	67.4	67.3	68.0					
Year-on-year (%)		+5	+0	-0	+1					
Q4 projections	67.1	69.0	69.9	70.3	70.7	75.5	80.0	81.5	83.0	84.7
Q5 final determination projections						70.4	72.5	74.5	76.2	78.2
Year-on -year (%)						+3	+3	+3	+2	+3
Gatwick										
Actual	30.1	32.0	32.8	34.4	35.6					
Year-on-year (%)		+6	+3	+5	+3					
Q4 projections	31.2	33.8	36.0	38.6	39.7	40.0	40.5	41.0	41.5	42.0
Q5 final determination projections						35.9	36.4	36.8	37.2	37.7
Year-on-year (%)						-0	+1	+1	+1	+1
Stansted										
Actual	19.4	21.2	22.2	23.8	23.5					
Year-on-year (%)		+9	+5	+7	-1					
Q4 projections	16.4	17.1	18.0	19.3	20.5	21.0	21.6	23.0	24.6	26.3
BAA projections						22.7	23.5	24.7	26.6	28.5
Year-on-year (%)						-4	+4	+5	+8	+7
Total designated airports	113.8	120.9	122.4	125.5	127.1					
Year-on-year (%)		+6	+1	+2	+1					

Source: CAA documents and March 2008 final determination documents for Heathrow and Gatwick, Stansted: Forecast BAA

BAA is exposed to traffic risk as each airport's aeronautical tariff is applied to a basket of charges related to the actual number of pax per year. Despite the expected effect of passenger number declines from SARS (November 2002-July 2003), the invasion of Iraq (early 2003), the London bombings (July 2005), the August-September 2006 security scare and smaller events such as the Gate Gourmet dispute and BA strikes, the following characteristics stand out:

- The Overall Diversity of the Airports: Heathrow – 34% connecting traffic, Gatwick – predominantly leisure, Stansted – growth in low-cost operators, while the overall breadth of routes, types of traveller and airlines, coupled with overall demand, means that BAA has not been markedly affected by a catalogue of recent external events of varying scales. In many of these events, volumes recovered quickly to pre-shock levels.
- LCCs: The decline in chartered flight volumes has been mitigated by new volumes for Europe-bound LCCs. Furthermore, evidence shows that for some European and domestic routes LCC competition (easyJet versus BA) has created more volume on certain routes rather than cannibalise existing flag carrier volumes.
- The much warned-about outbreak of the Iraq War (in early 2003) did not seriously affect passenger volumes during this fallow period of the year for airline travel. Certainly, the combination of SARS and Iraq resulted in much lower yoy growth (flat at Gatwick and Heathrow during January to December 2003).
- SARS, covering November 2002 to July 2003, did not adversely affect individual Heathrow traffic on long-haul (+7% to 9% yoy, after post-9/11 declines of only -1%), but significantly affected Gatwick (-23%, after post-9/11 declines of -20%). Across all three airports, other long-haul passenger volumes (probably Asia-driven) have seen significant increases since 2003 (Mar 03: +4%, Mar 04: +4%, Mar 05: +6%, Mar 06: +1%. Mar 07: +2%, Mar 08: +1%).
- At Gatwick, although the Atlantic routes were affected more markedly after 9/11 (-17% by December 2002 on a rolling 12-month basis, and another -13% by December 2003), these volumes have since stabilised at some 14% of Gatwick's total passenger volume. At Heathrow, also starting at around 20% of total passenger volumes, volumes have broadly increased and took two years to get back to the overcapacity airline volumes for the route in the year 2000 (-11% by December 2002 but back to pre-9/11 volumes by December 2003). Across the two airports (as there was switching from Gatwick to Heathrow during 2002), the total North Atlantic passenger volumes leaving the UK have been broadly static yoy on a 12-month rolling basis, except for a 7% step-increase in 2004.

Weighting the above data by tariffs by airport, one can begin to draw up a picture of the contributions of the different routes and airports to Aeronautical Revenue (which largely drops down to EBITDA).

Table 4: Aeronautical Revenue by Destination

As % of FY09e's total Aeronautical Revenue, given different tariffs per airport (2007/08 prices)	All three Designated Airports	Of which Heathrow 70% of FY09e Aero Revenue
Domestic & Irish Republic	14	12
European Scheduled and Charter	46	38
North Atlantic	17	21
Other Long-Haul	23	29

Source: BAA data and Fitch calculations

Fitch ran certain sensitivities through a simple model to assess external – but feasible - volume shocks, and the effect on the combined EBITDA of the three airports. Using prospective FY09 passenger data per route per airport, known full

tariffs per airport and the three airports' prospective FY09 income statements, the assumptions within these scenarios and its model are thus:

- The percentage drop in cited passenger volumes represents travel volumes for one year only (neither a larger drop in particular months nor a smaller drop elsewhere in the year).
- The simple model assumes that Commercial Revenue attributable to those passengers drops by a similar percentage, although Fitch has attributed a higher weighting of Commercial Revenue to certain categories of routes (long-distance) that yield higher retail or car park income.
- The model assumes that a total three-airport EBITDA margin of (i) around 45% is maintained – therefore it assumes that BAA actively adjusts the opex base accordingly, or (ii) adversely, FY09's actual cost base is maintained and the profit margin reduces accordingly.

Scenario 1: A hypothetical 10% drop in North Atlantic traffic (representing a terrorist-related incident) across Heathrow and Gatwick: Fitch estimates that this would result in the combined three airports' FY09 EBITDA declining by (i) 2% if opex reduced proportionately, or (ii) 5% if opex remained unchanged.

Putting this 10% into context, across the three airports, North Atlantic passenger volumes were down yoy during 2002, but by the 12 months to December 2002 the reduction was only down 10% compared with the year to December 2000.

Scenario 2: A hypothetical 5% drop in scheduled European traffic (reflective of overcapacity being realised amongst the flag carrier airlines' less profitable European routes and prices going up accordingly, thereby reducing intra-European travel): Fitch estimates that this would result in the combined three airports' FY09 EBITDA reducing by (i) 2% if opex declined accordingly, or (ii) 5% if opex remained unchanged.

Mitigating such a scenario, scheduled airline volume is also represented by the LCCs where this overcapacity or price sensitivity scenario is less evident.

This percentage drop is also comparable to a scenario of targeting a particular European country, if it is tenable that no air travel to that country would occur throughout the year. Scheduled European traffic has great diversity: France, Germany, Italy and Spain each represent around 5%-6% of the three airports' total passenger volumes.

Scenario 3: Within the long-haul category of passenger traffic, Fitch has isolated the SARS-affected countries and assumed a 50% drop in this traffic during the year: Fitch estimates that this would result in the combined three airports' FY09 EBITDA declining by (i) 2% if opex reduced accordingly, or (ii) 4% if opex remained unchanged.

In all three of these scenarios the (non-tax adjusted) regulatory depreciation-based PMICR (see *Financial Ratios*) would drop from the transaction's template 1.60x to (i) around 1.54x if opex reduced accordingly, and (ii) 1.43-1.46x if opex remained unchanged.

Fitch concludes that route diversity affords great resilience to these scenarios. Therefore the underlying issue is the backdrop of passenger demand for air travel from the UK, which is high. Furthermore, London attracts origin and destination traffic as well as transfer passengers. BAA's passenger forecasts are conservative in this respect, and reflect a runway rather than terminal capacity-constrained Heathrow, and little growth at Gatwick. Stansted has higher volume prospects although this LCC-weighted passenger traffic is likely to have different behaviour patterns than those in the above scenarios.

Financial Penalties

There are two sets of financial penalties upon BAA within the regulatory model: (i) annual tariff reductions related to service quality rebate (SQR) – security queues, also available passenger-sensitive equipment, arrivals reclaims, stands, jetties and fixed electrical power, and (ii) tariff reductions if certain new capex-related projects are not completed (see Capital Expenditure). The financial abatements are larger than those possible in Q4 and the possible bonuses are new to Q5. Although BAA will not quantify what 2007's actual service measures translate to if the new Q5 financial penalties are superimposed, it is understood that the maximum penalty would represent a "catastrophic failure of service quality". As some measures are new, BAA expects to be paying a certain amount of penalties from April 2008 until systems are in place. Abatements for the three months to June 2008 are not indicative of the expected full year figures; suffice to say that the maximum fines in Table 5 are not expected to be suffered. BAA can apply for a suspension of particular elements of the regime if, say, another August 2006 sequence of events occurred.

Table 5: Annual Maximum Penalties and Bonuses

As % of airport charges	Q4 max penalties	Q5 max penalties T1 - 4/T5 only		Q5 max bonuses
Heathrow		**South**	**North**	
Pax-facing measures covered by QSM	0.50	1.44	1.44	1.44
Passenger sensitive equipment	0.14	0.40	0.40	0.40
Central passenger security queuing	0.27	0.77	0.77	n.a.
New elements	n.a.	1.80	1.98	n.a.
Other airline-facing measures	1.09	1.60	1.44	0.40
Aerodrome congestion	1.00	1.00	1.00	n.a.
	3.00	**7.01**	**7.03**	**2.24**
(2007/08 prices GBPm)			Maximum penalty	Maximum bonus
Potential effect to FY09 Aero. Revenues			-63	20
Gatwick		**South**	**North**	
Pax-facing measures covered by QSM	0.50	1.44	1.44	1.44
Passenger sensitive equipment	0.14	0.40	0.40	0.40
Central passenger security queuing	0.27	0.77	0.77	n.a.
New elements	n.a.	1.60	1.42	n.a.
Other airline-facing measures	1.09	1.80	1.95	0.40
Aerodrome congestion	1.00	1.00	1.00	n.a.
	3.00	**7.01**	**6.98**	**2.24**
(2007/08 prices GBPm)			Maximum penalty	Maximum bonus
Potential effect to FY09 Aero. Revenues			-17	5

Source: CAA March 2008 final determination documents

Commercial Revenue

It is widely acknowledged that BAA has developed expertise in improving Commercial Revenue, particularly from the retail experience at its terminals. Few European airports currently have the retail offer, or the proportion of Commercial Revenue that BAA has built up. Within the "single till" regulatory system, the CAA's assessment of projected Commercial Revenues and resultant profit are deducted from the revenue requirement to determine the Aeronautical Revenue/pax.

Following on from *Table 4* on Aeronautical Revenue per route, an equivalent table representing retail spend (or rather the flow through to BAA through its concessions or World Duty Free) per route or type of passenger is not available. Commercial Revenue/pax is subject to variances due to many factors:

- Types of traveller relative to the type of retail offer;
- Types of contracts between the concessionaires and BAA, some being more

turnover-related or having minimal rental structures;

- Conducive environment at the terminal, including increased dwell times (reduced security queues) and awareness of airports' price competitive offer;
- Airside retail space available and product on offer per type of passenger (Gatwick South Terminal is increasing its retail space); and
- EU enlargement and its effect upon passenger purchases.

The oft-quoted headline ratio of BAA's retail revenue per passenger is not necessarily a reflection of increased spend, but the net concession or rental fee arrangement that BAA has periodically negotiated with its third-party retail outlet or car park operators. Although increased rents are a reflection of the demand for space at the terminals, they are also a reflection of such aspects as the phasing of concessions renegotiations. Retailers are aware that the footfall of Heathrow's current near-70 million passengers, albeit over four terminals (T5: 30 million passengers) is a better footfall than the best regional shopping centres in the UK (Bull Ring, Birmingham 36.5 million people in the first year of operation, Oxford Circus tube station 44 million people per year).

BAA's retail revenue (excluding car parks) is not ultra-sensitive to pax falling over a particular period, as an estimated 80-85% of this income is represented by guaranteed minimum rents from retail, catering and bureau de change operators (particularly as separately owned World Duty Free is now paying BAA under a guaranteed minimum rental mechanism). Whilst the top slice of this income is more outlet turnover resultant, the bulk of the income stream is less so.

It is acknowledged that there is some seasonality to the total net retail income per airport. Thus an airline or airport staff strike or security sensitivity can prove detrimental to passenger traffic, its flow and retail spend in particular months. Assuming that once-a-year holiday-bound passengers at Gatwick or Heathrow decide to cancel their travel, BAA is susceptible to potential loss of earnings: Within the year, Heathrow has a generally flat monthly profile, with January and February as fallow months. Generally, Gatwick peaks in the school holiday and general holiday seasons (June to September) whereas Stansted has a flat Commercial Revenue spend profile throughout the year.

Tables 6 and 7 show historical and projected retail revenue/pax. Growth halted in FY07 (to March 2007) unaided by the security scare in July 2006 when confusion reigned over which items, if any, could be purchased, as well as the disruption due to fog in December 2006. Gatwick's figures will be more adversely affected by these events and also by retail space refurbishment in the South Terminal. BAA management was expecting a significant decline in retail revenue/pax whereas the above stable profile occurred.

Recently, car parking income /pax for BAA has been impacted by off-airport competition combined with a propensity for passengers to pre-book from third-party operators (thereby reducing BAA's own revenue). BAA is seeking to address these problems.

For Q5 the CAA was expecting a decrease in Heathrow's Retail + Car Park/pax in FY09 and significant growth of 5% p.a. thereafter. BAA is targeting the same end-Q5 revenue/pax but has an earlier improving profile. BAA's business case represents a 3-4% p.a. outperformance on the CAA's assumptions, with the CAA's opening Q5 retail income/pax (GBP4.42 nominal) already being achieved. Whereas the CAA assumed that T5 would generate the same Retail spend/pax, BAA management is confident of prospective higher-than-Heathrow-average spend/pax at T5 given the breadth and quality of merchandise and staff, more outlets, better terms with its outlets, multiplied by the terminal's potential 27-30m pax. By end-Q5, T5 could represent a disproportionately larger percentage, some 35-50%, of the airport's Commercial Revenue. Also, within Heathrow, BAA management is expecting less

disruption than anticipated when T4 is refurbished (2009 to 2010) and good retail income when the retail offer comes back on-stream.

Table 6: Q4 Non-Aeronautical Revenue

(GBPm)	FY04 A	FY05 A	FY06 A	FY07 A	FY08 F
Heathrow	594	625	653	657	691
Gatwick	193	203	205	217	226
Stansted	94	102	103	108	116
Total Commercial Revenue	**881**	**930**	**961**	**982**	**1,033**
Heathrow					
Retail revenue incl. car park	281	295	305	305	314
Per pax (GBP)	4.38	4.36	4.53	4.53	4.62
Year-on-year (%)	-	-0.3	+3.8	+0.1	n.a.
Property	89	87	77	78	83
Other income	224	243	270	274	294
Of which Heathrow Express	n.a.	n.a.	n.a.	n.a.	n.a.
Gatwick					
Retail revenue incl. car park	128	136	142	144	160
Per pax (GBP)	4.25	4.26	4.32	4.17	4.49
Year-on-year (%)	-	+0.2	+1.4	-3.4	n.a.
Property	28	29	26	33	24
Other income	37	38	37	41	42
Stansted					
Retail revenue incl. car park	66	74	81	85	93
Per pax (GBP)	3.38	3.48	3.65	3.54	3.96
Year-on-year (%)	-	+3.1	+4.7	-2.8	n.a.
Property	12	11	6	7	8
Other income	16	17	16	17	15

FY05 figures are distorted by one-off income gains following contractual re-negotiations and provision movements
These figures for retail spend are not consistent with the classification of “Retail” cited in CAA documents.
Source: BAA business plan

Table 7: Q5 Non-Aeronautical Revenue (BAA Business Case)

(GBPm)	FY09	FY10	FY11	FY12	FY13
Heathrow	749	799	835	866	911
Gatwick	219	224	235	252	261
Stansted	122	127	133	152	167
Total commercial revenue	**1,090**	**1,148**	**1,203**	**1,269**	**1,338**
Heathrow					
Retail rev. incl. car park	328	361	381	401	422
Per pax (GBP)	4.66	4.98	5.11	5.26	5.40
Year-on-year (%)	+1.2	+6.9	+2.7	+2.9	+2.5
Gatwick					
Retail rev. incl. car park	154	158	168	180	186
Per pax (GBP)	4.29	4.34	4.57	4.84	4.93
Year-on-year (%)	-6.4	+1.2	+5.2	+6.0	+2.0
Stansted					
Retail rev. incl. car park	96	101	107	122	136
Per pax (GBP)	4.23	4.30	4.33	4.59	4.77
Year-on-year (%)	+7.8	+1.6	+0.8	+5.9	+4.0

Source: BAA business plan

Gatwick’s revenue/pax is set to decline by some 6% in FY09 with year-on-year increases thereafter. The FY09 decline represents the switch of some airlines to Heathrow due to Open Skies (UK travellers to the US enhance retail spend data). The refurbished South Terminal retail offer will better reflect the focus on European short-haul routes. In all, Commercial Revenues at Heathrow and Gatwick, as forecast by BAA, are expected to at least meet the CAA’s assumptions.

Operating Cost Base

The opex base of the three Designated Airports includes the following items:

Table 8: Operating Cost Base

(GBPm)	Total	As (%)	Heathrow	As (%)	Gatwick	Stansted
FY08 (to March) opex base						
Staff	369	31	224	27	90	55
Police	53	4	33	4	13	7
Rent and rates	131	11	95	12	25	11
Utility	113	9	78	10	23	12
Maintenance & equipment	139	12	100	12	28	11
Other costs	180	15	125	15	45	10
Inter-company costs	171	14	112	14	33	26
Heathrow express	49	4	49	6	-	-
Total opex	**1,207**	**100**	**817**	**100**	**258**	**132**
FY09	1,389		952		280	156
FY10	1,344		898		286	161
FY11	1,388		926		295	167
FY12	1,447		960		310	177
FY13	1,505		996		320	189

Source: BAA business plan

BAA estimates that some 75%-80% of its opex base is fixed. One key constituent is staff costs, which range from 30% to 40% of each of the three airports' opex base. This cost largely relates to security and target service levels. Staffing levels and costs at the three airports soon exceeded regulatory forecasts during Q4 (by some 11-13% in FY06 and FY07). At around GBP100m a year, constituting the key reason for underperformance against the CAA's forecasts, this underperformance reflected (i) increased staff numbers, (ii) increased pension contributions, and (iii) designated security costs up to (and in the latter years of Q4, above) the minimum (cumulative) trigger of GBP14m for the 'S' factor (see below) within the tariff basket at Heathrow (GBP6m at Gatwick, GBP3m at Stansted), all are nominal prices. In Q4, 75% of costs above these triggers could be recouped through the tariff. In Q5, the cumulative trigger amounts are GBP16.5m and GBP7m (in nominal prices for Heathrow and Gatwick) but with 90% recovery. Q4's underperformance was due to increased security staffing levels following a requirement to increase screening to include coats and clothing. This arose after the Q4 pricing determination was finalised. The security pass-through mechanism in the regulatory tariff mechanism ('S' factor) applies to new government security directives – to which not all of the above increased costs in Q4 could be allocated.

In its final determination for Q5, the regulator largely accepted BAA's costings (with some adjustments), reflecting recent changes in security requirements, also taking into account airlines' terminal relocations. The CAA took FY06's cost base as its starting base but applied its Q5 opex efficiency factor of 1.5% p.a. to the intervening years to reach the basis for FY09's starting opex. Consequently, Heathrow is set to underperform the CAA's opex base by some GBP80m, or 9% in FY09, and 2-3% p,a. thereafter. This includes the benefit and implementation in FY09 of the Simplification Plan (see below). BAA states that it does not intend to apply an efficiency factor to the sensitive issue of savings in security costs although staff costs are set to reduce over Q5 due to more efficiency in less congested terminals.

Inherited over-staffing has been an issue at BAA, particularly the layers of central management. The previous management's "Delivering Excellence Programme" (a reduction of 700 full-time equivalents), which started in 2005, was supposed to tackle personnel issues at the central level. In fact, this programme was not implemented in full, and subsequent heightened security resulted in increased personnel at the terminal level. The 2008 "Simplification Plan" is set to reduce

central support function personnel and their costs. Fitch calculated that the allocated net savings from this programme are expected to average 1.5% of Heathrow and Gatwick's opex base. BAA has to tread very carefully as frontline workforce unions at the terminals are strong, and previous management did not try to create a mentality of efficiency or cost-reduction. Fitch waits to see if the new management including CEO, Colin Matthews, is able to address these issues.

In Fitch's view, neither does the three airports' new Shared Services Agreement with BAA Ltd, a product of this financing rather than a true incentive-based agreement with a true third-party with profit/loss sharing arrangements (and penalty pass-throughs), create a framework for promoting operating efficiency.

Capital Expenditure

The underlying reason for the significant increase in tariffs is capex driven. Heathrow's tariff increases during Q4 and Q5 were Terminal 5-related, and for Q5 and Q6 will be predominantly related to Heathrow East Phase I and Phase II (respectively), mixed mode and preparations for a third runway. For Stansted, Q5 and prospective Q6 tariff increases relate to new terminals and/or a new runway. A second operational runway at Gatwick can be considered but it is thought that existing expansion-related agreements with its local council block such prospective plans until after 2019.

Construction risk has been successfully managed by BAA in building T5 to budget and on time. As well as the successful engineering feats, construction workforce safety records, and intricate planning and assembling of such a building in an operational airport, BAA championed a partnering approach with its sub-contractors such that difficulties during construction (the construction of the air traffic control tower) were actively solved with no distracting legal suits flying around. BAA's demonstrated ability to construct T5 has given it the confidence to undertake Heathrow East, albeit with the construction workforce competition feature of London's 2012 Olympics. BAA's Q4 WACC from the regulator included a premium for the construction and start-up operational risks assumed by the company. Although Ferrovial has a construction arm, BAA will conduct open tenders and Ferrovial bids over a certain size must be approved unanimously by the board.

During Q4, the CAA set milestones for completion of certain capex projects (e.g. T5, Pier 6 at Gatwick). All of the milestones were achieved by management in Q4. In Q5, monthly abatements of the tariff are linked to delays in completing some 60% (GBP2.7bn at 2007/08 prices) of Heathrow's capex and around 60% (GBP0.5bn at 2007/08 prices) of Gatwick's smaller capex programme. Relative to Heathrow's RAB at GBP10-14bn (nominal basis) during Q5, which the regulatory approach provides a return on, the capex triggers puts at risk 5% and 4.3% of Heathrow's and Gatwick's total Aeronautical Revenue respectively during Q5. Table 9 details the potential payments in relation to latter years' revenue and EBITDA.

The CAA's mid-period review of capex is not designed to re-open the pricing determination due to capex spend changes, but to evaluate progress to date. The CAA has been very clear that deferred capex will be closely scrutinised as to the underlying reason for this.

Heathrow

At this under-invested capacity-constrained airport, the March 2008 opening of the British Airways-dedicated, 30m pax capacity, T5 has freed-up space at other terminals so that the existing Terminal 1 will be expanded and rebuilt and Terminal 2 demolished to form Heathrow East Terminal (HET) to a similar modern specification and size as T5 (30m pax). Phase I is scheduled to be completed by end-2012. A refurbished Terminal 4 will house the Skyteam alliance. By 2016, Phase II of HET will be delivered and T3 is expected to be refurbished with new piers (housing Virgin Atlantic). HET will house the STAR Alliance. The other terminals, 3

and 4, will be renovated and house other airline groupings. BAA expects that by 2013, 70% of Heathrow's passengers will be travelling through new terminal facilities.

The brand new T5, Phase 1, opened in March 2008. This project's cost totals a significant GBP4.6bn (nominal). T5 Phase II (the second satellite) should be open for operation by 2010 (cost in Q5: GBP0.3bn at 2007/08 prices). HET programme (cost in Q5: GBP2.0bn at 2007/08 prices) will have its Phase I completed by end-2012, and Phase II during Q6.

Table 9: Capex Triggers – Heathrow

Using 2007/08 prices (GBPm)	Monthly penalty	Trigger date	FY09	FY10	FY11	FY12	FY13	Total Q5
T5 satellite C	1.47	May 11				14.73	17.67	[a]
T4 check-in extension	0.10	Jun 09		0.80	1.20	1.20	1.20	
T4 check-in extension	0.10	Jan 10		0.20	1.20	1.20	1.20	
T4 new CIP lounge	0.10	Feb 09	0.10	1.20	1.20	1.20	1.20	
T4 baggage sorter	0.10	Jan 09	0.20	1.20	1.20	1.20	1.20	
T4 380 jetty facilities	0.10	May 09		1.10	1.20	1.20	1.20	
T3 integrated baggage system	1.19	Mar 12					14.28	[a]
T3 refurbishment	0.10	Jul 09		0.80	1.20	1.20	1.20	
T3 refurbishment	0.10	Aug 09		0.70	1.20	1.20	1.20	
T3 refurbishment	0.10	Mar 10			1.20	1.20	1.20	
T3 refurbishment	0.16	Mar 11				1.92	1.92	
HET phase 1	2.78	Jun 10				33.36	33.36	[a]
HET phase 1	3.03	Feb 12				3.03	36.36	[a]
HET phase 1	1.22	Nov 12					4.84	
T1 bmi nose building facility	0.10	Jan 09	0.20	1.20	1.20	1.20	1.20	
Midfield pier north	0.50	Jan 10		1.00	6.00	6.00	6.00	
Midfield pier centre	0.67	Nov 12					2.68	
Midfield pier centre	0.31	Nov 12					1.24	
Outer pier northern section	0.49	Jan 12				0.98	5.89	[a]
Eastern maintenance redevelopment	0.17	Mar 10			2.04	2.04	2.04	
Eastern maintenance redevelopment	0.79	Nov 11				3.16	9.48	[a]
Post T5: transfer baggage system	0.41	Jun 12					3.69	
T4-T1 refurbishment	0.10	Jan 09	0.20	1.20	1.20	1.20	1.20	
HET multi-storey car park	0.48	Mar 13	-	-	-	-	-	
Total per year		**Sub-total**	**0.70**	**9.40**	**20.04**	**77.22**	**151.45**	**258.81**
Maximum abatements		**CAA total**	**0.70**	**9.43**	**42.15**[a]	**73.67**	**152.40**	**278.35**
CAA Aeronautical Revenue			901	995	1,099	1,207	1,329	5,531
As % using CAA figures			0	1	4	6	11	5
CAA total revenue			1,601	1,716	1,841	1,959	2,104	
As % using CAA figures			0	1	2	4	7	
CAA EBITDA			750	879	1,000	1,113	1,251	
As % using CAA figures			0	1	4	7	12	
Significant weighted abatements projects[a]						57.30	137.53	
As % of Aeronautical Revenue						5	10	
As % total revenue						3	7	
As % EBITDA						5	11	
Main capex (2007/08 prices for tariff calculation GBPm)								
T5 satellite C			79	182	32			293
T3 integrated baggage system					52	48		100
HET phase 1			77	236	324	403	104	1,144
Midfield pier centre			1	19	101	76	4	201
Eastern maintenance redevelopment			30	59	54	15	1	159
Post T5: transfer baggage system			20	109	94	19		243
HBS VIVID replacement prog. (no trigger)			20	25	5			50
Various			155	50	-	-	-	205
Sub-total			**383**	**680**	**662**	**561**	**109**	**2,395**
As % of total Heathrow capex (%)			**36**	**57**	**62**	**63**	**19**	**50**
Total Heathrow capex			**1,067**	**1,193**	**1,059**	**886**	**580**	**4,787**

[a] These figures do not total the above amounts and seem to be an error by the CAA
Source: CAA March 2008 final determination documents and Fitch calculations

Concerning runway capacity, if permitted by government and environmental restrictions, BAA is likely to deploy mixed-mode operation to enhance existing runway resources. This will require capex, particularly in Q6. A third runway is a commercial objective of BAA, but the airport has to meet environmental requirements, and gain planning consents, before the runway can be planned in earnest. The CAA has allowed some GBP0.6bn (2007/08 prices) of capex to progress with this project, including the purchase of land subject to government approval for the expansion. Obviously, there is environmentalist opposition to this expansion – the danger (as per T5) is that planning consents get bogged down in politics. In the meantime, capacity considerations will switch to encourage existing airlines to use larger, environmentally friendly, planes and to better utilise existing capacity.

Table 9 illustrates Heathrow's main projects that are subject to capex triggers and the scheduling of their associated capex. The monthly tariff abatements represent a 6.2% WACC on the cumulative spend per project so, whilst pre-completion capex (assets in the course of construction) is remunerated through the tariff, if the relevant project is delayed after the CAA's trigger date, the tariff does not remunerate the cumulative capital outlay.

The main projects that form the bulk of the capex triggers in FY13 are T5's Satellite 3, the T3 integrated baggage system, HET Phase I, various piers, the eastern maintenance area redevelopment and the post-T5 transfer baggage system. These significant projects, whose trigger dates are weighted in the latter two years of the quinquennium, constitute some 5% and 10% of Aeronautical Revenue in FY12 and FY13, respectively, and a potential significant EBITDA reduction of 5% and 11% (using CAA's projected EBITDA for Heathrow) in those years.

These potential reductions in turnover and profits in Table 9 are calculated on a worst case basis (they are levied per month of delay so the calculations assume a delay for the remainder of the year) and are considered an utmost worst case scenario, especially given the track history of BAA in undertaking such projects.

Significant capex is forecast for Q6 if the third runway expansion is given the go-ahead.

Gatwick

Most of the investment programme at Gatwick is maximising airfield and runway capacity, including the introduction of larger aircraft to the airport, and improving the South Terminal operating and passenger environment.

Stansted

The company is seeking planning permission to build a parallel runway at the airport. Meanwhile, existing capacity is being expanded through terminal extensions and a new satellite. Stansted Generation 2, Phase 1 (cost now GBP1.4bn at 2006/07 prices), which includes additional land being acquired and the runway being built, is expected to be open in time for FY16. Later phases up to 2030 will take the overall cost to GBP2.27bn. At that point, the airport will have a capacity of 68 million passengers a year.

Regulatory Asset Base (RAB)

Using the above capex figures, BAA's RAB is expected to continue to increase during the next two quinquennia of significant expansionary capex at Heathrow and Stansted.

Effectively, capex is part-funded through the regulatory depreciation component, which is remunerated through the revenue tariff, net of actual maintenance capex (which Fitch is informed has historically averaged 2-3% per year of an airport's assets), with the remainder financed by a mix of additional debt and fresh (or retained) equity.

In this financing, each Designated Airport's period-end RAB is calculated using the formula shown in Table 10, thus the figure will be a "real time" RAB as opposed to the water sector's scheduled RAB for the quinquennium. Consequently, delayed capex – thereby lower RAB – will be reflected in the period-end figure, which will be compared with the corresponding lower debt in the net debt/RAB calculation.

Table 10: Regulatory Asset Base

2007/08 prices (GBPm)	FY09	FY10	FY11	FY12	FY13
Heathrow					
Opening RAB	8,978	9,865	10,804	11,537	12,022
Capex	1,068	1,193	1,059	886	580
Depreciation	-409	-420	-442	-455	-488
Q4/Q5 pricing profile adj.	205	151	106	80	-13
Q5 pricing smoothing adj.	24	14	11	-27	-22
Closing RAB	**9,865**	**10,804**	**11,537**	**12,022**	**12,079**
Equivalent nominal	10,264	11,533	12,624	13,483	13,886
Gatwick					
Opening RAB	1,524	1,639	1,806	1,965	2,028
Capex	195	249	239	147	90
Depreciation	-74	-79	-83	-86	-98
Q5 pricing smoothing adj.	-5	-3	2	3	4
Closing RAB	**1,639**	**1,806**	**1,965**	**2,028**	**2,024**
Equivalent nominal	1,706	1,928	2,150	2,275	2,327
Stansted					
Opening RAB	n.a.	n.a.	n.a.	n.a.	n.a.
Capex	129	135	76	255	364
Depreciation	-41	-44	-46	-46	-46
Closing RAB	n.a.	n.a.	n.a.	n.a.	n.a.
Equivalent nominal	1,309	1,442	1,508	1,757	2,130

Source: CAA March 2008 final determination documents for Heathrow and Gatwick, inflated with RPI forecast. Stansted: BAA

Q5's Financial Profile

Table 11: Illustrative Financial Figures

Nominal (GBPm)	Actual				CAA-based operational figures (RPI-adj)				
FY to 31 March	FY04	FY05	FY06	FY07	FY09	FY10	FY11	FY12	FY13
Heathrow									
Revenue	978	1,068	1,141	1,196	1,642	1,807	1,988	2,169	2,387
Of which Aeronautical Revenue	415	479	532	580	924	1,048	1,187	1,336	1,508
Of which Commercial Revenue	563	589	609	616	718	759	801	833	879
Opex	-458	-497	-554	-600	-873	-882	-908	-936	-967
EBITDA	520	571	587	596	769	925	1,080	1,233	1,420
Margin (%)	53	53	51	50	47	51	54	57	59
Regulatory depreciation	-162	-178	-185	-197	-419	-442	-477	-503	-554
Synthetic 2% RAB	-108	-127	-152	-177	-205	-231	-252	-270	-278
PBIT (regulated depreciation basis)	358	393	402	399	350	483	603	730	866
CAA regulatory profit for Q4	381	409	438	490					
PBIT (2% RAB basis)	412	445	435	419	564	694	828	963	1,142
Weighted-avg. pre-tax return on RAB (%)	7.4	6.7	5.8	4.9	3.6	4.4	5.0	5.6	6.3
Gatwick									
Revenue	319	342	355	377	471	494	516	541	568
Of which Aeronautical Revenue	130	144	153	164	250	265	280	296	314
Of which Commercial Revenue	189	199	202	213	221	229	236	245	254
Opex	-184	-194	-223	-225	-283	-290	-297	-306	-313
EBITDA	134	149	132	152	188	204	219	235	255
Margin (%)	42	43	37	40	40	41	42	43	45
Regulatory depreciation	-63	-65	-64	-70	-76	-82	-89	-95	-111
Synthetic 2% RAB	-26	-27	-28	-30	-34	-39	-43	-45	-47
PBIT (reg. depreciation basis)	72	83	68	82	112	122	130	140	144
CAA regulatory profit for Q4	78	94	109	148					
PBIT (2% RAB basis)	108	121	103	122	154	165	176	190	208
Weighted-avg. pre-tax return on RAB (%)	5.7	6.2	4.9	5.6	6.9	6.7	6.4	6.3	6.3
Stansted									
Revenue	148	164	176	189	270	279	300	346	398
Of which Aeronautical Revenue	54	62	73	81	148	153	167	194	231
Of which Commercial Revenue	94	102	103	108	122	126	133	152	167
Opex	-81	-91	-101	-115	-156	-161	-167	-177	-189
EBITDA	66	74	75	74	114	118	133	169	209
Margin (%)	45	45	43	39	42	42	44	49	53
Regulatory depreciation	-32	-32	-36	-41	-42	-46	-49	-50	-51
Synthetic 2% RAB	-17	-17	-18	-21	-26	-29	-30	-35	-43
PBIT (reg. depreciation basis)	35	42	39	33	72	72	84	119	158
CAA regulatory profit for Q4	55	67	68	74					
PBIT (2% RAB basis)	49	56	57	53	88	89	103	134	166
Weighted-avg. pre-tax return on RAB (%)	4.0	4.8	4.4	3.4	5.5	5.0	5.6	6.8	7.4
Total three airports									
Revenue	1,445	1,575	1,672	1,762	2,383	2,580	2,804	3,056	3,353
Of which Aeronautical Revenue	599	685	758	825	1,322	1,466	1,634	1,826	2,053
Of which Commercial Revenue	846	890	914	937	1,061	1,114	1,170	1,230	1,300
Opex	-724	-781	-878	-940	-1,312	-1,333	-1,372	-1,419	-1,469
EBITDA	721	794	794	822	1,071	1,247	1,432	1,637	1,884
Margin (%)	50	50	47	47	45	48	51	54	56
PBIT (reg. depreciation basis)	464	518	509	514	534	677	817	959	1,168
PBIT (2% RAB basis)	569	622	595	594	805	949	1,106	1,287	1,517

Table 11: Illustrative Financial Figures (cont.)

(GBPm) Nominal	Actual				CAA-based operational figures				
FY to 31 March	FY04	FY05	FY06	FY07	FY09	FY10	FY11	FY12	FY13
Interest Expense[a]									
Class A	n.a.	n.a.	n.a.	n.a.	-340	-432	-492	-566	-571
Class A & B	n.a.	n.a.	n.a.	n.a.	-417	-510	-625	-717	-747
PMICR (reg. depreciation basis)									
Class A (x)	n.a.	n.a.	n.a.	n.a.	1.5	1.6	1.7	1.7	1.9
Class B (x)	n.a.	n.a.	n.a.	n.a.	1.3	1.3	1.3	1.4	1.5
PMICR (2% RAB basis)									
Class A (x)	n.a.	n.a.	n.a.	n.a.	2.3	2.2	2.3	2.3	2.5
Class B (x)	n.a.	n.a.	n.a.	n.a.	1.9	1.9	1.8	1.8	1.9
FFO/Interest									
Class A (x)	n.a.	n.a.	n.a.	n.a.	3.1	2.9	2.9	2.9	3.2
Class B	n.a.	n.a.	n.a.	n.a.	2.5	2.4	2.3	2.3	2.4
Closing RAB Heathrow	5,406	6,328	7,597	8,834	10,264	11,533	12,624	13,483	13,886
Closing RAB Gatwick	1,309	1,364	1,417	1,516	1,706	1,928	2,150	2,275	2,327
Closing RAB Stansted	874	862	912	1,028	1,309	1,442	1,508	1,757	2,130
Total RAB	7,588	8,554	9,926	11,378	13,279	14,904	16,283	17,515	18,343
Net Debt/RAB[b]									
Class A (%)	n.a.	n.a.	n.a.	n.a.	68	68	68	68	67
Class B (%)	n.a.	n.a.	n.a.	n.a.	76	79	80	81	81
Net Debt/EBITDA									
Class A	n.a.	n.a.	n.a.	n.a.	8.4	8.1	7.7	7.3	6.6
Class B	n.a.	n.a.	n.a.	n.a.	9.4	9.5	9.1	8.7	7.9

Although Stansted is going through a pricing review process (for 2010 onwards) the above figures assume a maximum allowable yield and a 6.5% WACC on expected capex
[a] Interest expense is cash interest including fees (excluding indexation accretion) and, for this illustration, includes the effect of prepaid interest on certain derivatives
[b] For this illustrative purpose, the scenario has assumed that the Net Debt/RAB ratio is profiled to be comfortably within the Trigger Event covenants' levels
Source: FY04-07 BAA regulatory accounts. FY09-13: CAA March 2008 final determination documents for Heathrow and Gatwick, inflated with RPI forecast (Stansted: BAA) and Fitch calculations/assumptions

The figures in Table 11 use the discloseable CAA figures for Q5, nominal. These CAA-based figures do not include the (theoretical) charge to FY09's profits due to the Simplification Plan (GBP43m for Heathrow, GBP17m Gatwick and GBP8m Stansted before netting off resultant savings, which the CAA figures already include by virtue of the 1.5% p.a. efficiency factor). In fact, this exceptional cost was provisioned in BAA group's December 2007 accounts. In any event, Fitch expects to exclude this one-off item from underlying EBITDA/PBIT in its coverage ratios.

BAA's publicly undiscloseable RA16 Business Case is broadly in-line with the above financial profile but with underperformance in the early years as operational restructuring takes place.

Financial Ratios

The main financial ratios that Fitch has focused upon have been (i) the net debt/RAB and (ii) the post-maintenance post-tax interest cover ratio (PMICR) using regulatory depreciation instead of this transaction's PMICR, which has a synthetic "maintenance spend" at 2% of RAB. Although it may seem simplistic to focus on just two ratios, any EBITDA/interest ratio would be similar to the PMICR (just a higher threshold) and a post-capex cash flow measure to debt is less meaningful for regulated companies that have a negative post-capex cash flow (and because it is negative, they have an assured/regulatory return on their capital). These two key ratios are familiar to UK utility investors (regulated water, gas distribution networks and rail infrastructure).

Fitch has also had to adapt BAA's ratios for the distortive effect of the (unique to the CAA) PPA which benefited Q4's unadjusted interest coverage ratios but has had a negative effect on Q5's. BAA has correctly mitigated the effect of this by choosing to prepay interest costs in FY09, FY10 and FY11 (see overleaf and Appendix III).

Fitch has also assessed the amount of Excess Cash flow – cash that mechanisms can trap within the Security Group (before servicing the Subordinated Debt's interest), after allowing for debt funding of capex.

Net Debt/RAB: In this transaction, the net debt/RAB ratio will be "real time" (as opposed to scheduled RAB for the following five years) and is more sensitive to changes in RAB and debt due to lower, or higher, capex.

For this transaction, regulatory RAB uses the CAA's opening figure for each quinquennium as its base. Each airport in its annual regulatory accounts then recalculates regulatory RAB by looking at the previous closing balance plus cumulative regulatory capex spent, plus indexation, less regulatory depreciation and adjusting for any price profiling undertaken by the CAA. The documentation provides that if the CAA has indicated that any capex will not be included in RAB, or the auditors qualify their statement of opinion in relation to any regulatory accounts, these amounts will not be included in this transaction's definition of RAB.

For this transaction's ratios, debt will include the RPI accretion on index-linked debt and on any index-linked swaps. Given the seniority of interest rate (including index-linked) swaps in the priority of payments, the Trigger Event regime also has a cap on index-linked swap accretion at 8% of Class A debt outstanding.

PMICR: The PMICR that Fitch uses is basically EBITDA less regulatory depreciation, less cash-based tax divided by cash-based net interest expense.

Particularly in water utilities, the PMICR uses regulatory depreciation as the deduction for "maintenance" spend within this ratio. This does not always reflect actual year-by-year maintenance spend as, in BAA's case, regulatory depreciation is some 3% to 5% of year-end RAB in Q4 and some 4% to 5% in Q5 (higher for Stansted), whereas BAA states that attributable maintenance cash spend figures are typically some 2% to 3% of RAB. Instead, the regulatory depreciation deduction reflects the regulatory remuneration of the economic value of RAB. That is, an amount of capex similar to depreciation must be spent if the economic value of RAB is to be maintained. In Fitch's view, within the income statement's building blocks this form of remuneration has been granted to maintain the value of RAB, thus debt service (interest expense) should be measured against a return on RAB after deduction of regulatory depreciation, whereas an EBITDA figure would not do this.

For capital-intensive regulated businesses, the much-loved EBITDA/interest cover ratio flatters the credit profile. For such businesses, a significant proportion of necessary cash costs in the business are capitalised and are therefore not deducted in arriving at EBITDA. In many cases, these capital costs are not avoidable beyond the very short term, as the company has to maintain its assets. In addition to maintenance of its physical assets, companies have to maintain the economic value of RAB. Each year, the regulator provides revenue to cover regulatory depreciation, which is equal to the amount by which the real RAB is reduced before capex is taken into account. The PMICR deducts this regulatory depreciation on the assumption that maintenance of the real economic value of the RAB is more important to the ongoing financial profile of the business than a given year's cash maintenance capex.

In summary, the regulatory depreciation-based PMICR says that the tariff-remunerated amount of capex needed to maintain the real value of the RAB (that is, the regulatory depreciation) is not available to service interest costs and should be deducted in arriving at a meaningful PMICR. Fitch, mainly for comparative purposes, expects to monitor this regulated utility financing using the regulatory depreciation PMICR.

This transaction's interest cover ratio takes a cash flow EBITDA less 2% of RAB, less tax, divided by cash-based net interest expense. Fitch believes that the rationale

for using this synthetic ratio for regulated utilities is questionable, and cautions investors to take care when comparing this synthetic ratio with the PMICR used in other regulated utility financings. Furthermore, the ratio has been set at lenient levels, which exhibit significant headroom, compared with PMICR equivalents. Table 11 has illustrated how far apart these two interest cover ratios are. Concerning the levels of PMICR per rating, because of the distortive effect of the PPA (which, in summary (see *Appendix II*), prepaid revenue from Q5 into Q4 thus Q5 has lower income), Fitch has had to assess this ratio in two ways:

1. Fitch has reversed the effect of the PPA, which is particularly onerous in FY09 and FY10 and is minimal by FY13, to see what a resultant synthetic ratio would be. As the PPA adjustments are minimal in the latter years of Q5, the actual projected ratio levels of FY12 and FY13 are sustainable going into the next quinquennium (assuming no change in WACC, etc.).

2. However, the actual PMICRs without the PPA write-backs are extremely tight in FY09: Class A's is below 1.0x. Fitch believes that this level, even for one year, is not consistent with an investment-grade rating and would have stated this to an economic regulator assessing financeability. In line with the CAA's views that "it follows that it is reasonable to suppose that the advanced revenue [PPA paid in Q4] would be available to the airport in Q5" (Source: Paragraph 15.25 of March 2008 Final Determination), but Fitch would prefer actual cash to have been reserved, Fitch has included the benefit of BAA's choice to prepay interest on certain interest rate and/or cross-currency instruments to reduce earlier years' cash-based interest payments. This has the effect of raising the actual PMICR above a minimum level Fitch believes is comfortable for the ratings of the Class A and Class B debt.

In Fitch's view, BAA has correctly mitigated the distortive effect of the PPA on interest coverage ratios by choosing to prepay interest on certain interest rate derivatives in FY09, FY10 and FY11 to largely reverse the effect of the PPA. This prepayment of interest mechanism responds to a peculiar regulatory mechanism and is only applicable to the early years of the transaction, mirroring the severity of the PPA's effect. FY12 and FY13's sustainable ratios are less distorted by the effect of either mechanism.

Table 12: Prepayment of Interest vs. PPA

(GBPm)	FY09	FY10	FY11	FY12	FY13
Prepaid interest[a]	205	129	76	-	-
PPA (nominal)	210	159	114	88	-15

[a] Prepaid interest on certain debt instruments (the FY09 amount assumes April 2008 to March 2009 full 12 months, whereas the amount may be lower depending on the date of financial closing)
Source: BAA

Including the prepayment of interest, using BAA's undiscloseable RA16 Business Case, and using projected leverage levels, the FY10-FY13 PMICRs are expected to be above 1.5-1.6x for Class A and above 1.2-1.3x for Class B.

In this Section
- Financial Ratios
- Balance Sheet Dividends

Balance Sheet Dividends

Before considering funding of capex, the above cash-based interest coverage ratios do not convey much headroom for equivalent income statement profits, which can be upstreamed as equity dividends or to remunerate other subordinated tranches of capital, or (more importantly) inherent liquidity in the structure. However, these types of utility financings raise cash by keeping leverage at an optimal level, in BAA's case by keeping Class A and B debt/RAB at near-70%/82%, and the cash drawn from debt financing to achieve this, net of capex, is released to service subordinated capital, or not, if dividends are trapped within the structure. Fitch has labelled this debt-capacity feature, "balance sheet dividends". Effectively,

debt is raised to fund the 70%/up to 85% of the year-on-year increase in RAB attributable to capex, and 70%/up to 85% against the year-on-year RPI increase in RAB (70%/up to 85% of the 2-3% RPI increase on GBP12-13bn of RAB). The covenant thresholds for this financing are detailed in Table 15.

After the all-important WACC, and gearing assumption, the other key sensitivity is that the average cost of debt does not weaken the Class A and Class B interest coverage ratios. The quantum of additional subordinated forms of capital is sized relative to the cash (since they have fixed coupons) returns on these instruments relative to their risk profile.

Table 13: BAA Average Cost of Debt

(%)	FY09	FY10	FY11	FY12	FY13
Class A	6.9	6.7	6.6	6.3	6.3
Class B only	7.7	7.5	7.7	7.8	7.8

Resultant of cash interest divided by opening year outstandings and 50% FY capex, and reversing the effect of interest prepayments and RPI accretion.
Source: BAA and Fitch calculations

At around 6.3%-6.9% (nominal equivalent), BAA will have a higher cost of debt than comparable UK water and gas distribution utilities' Class A equivalent debt.

This actual cash cost of debt benefits from the expectation that around 37-55% of the Security Group's total debt going forward will be raised from index-linked instruments (bonds and/or derivatives). Some of the index-linked hedging exists

Table 14: Illustrative Summary Cash flow

(GBPm rounded)	FY09	FY10	FY11	FY12	FY13
EBITDA	1,071	1,248	1,434	1,637	1,884
Tax	-11	-3	-	-1	-70
Class A debt interest	-336	-429	-490	-569	-581
Class B debt interest	-77	-78	-133	-151	-176
Post-interest cash flow	**647**	**738**	**811**	**915**	**1,057**
Capex	-1,185	-1,662	-1,485	-1,426	-1,171
Net debt drawings	695	1,662	1,090	993	477
Cash available post-interest	**157**	**738**	**416**	**483**	**363**
Net debt raised against capex (%)	59	100	73	70	41
Cash yield as % of the non-debt RAB (%)	5	24	13	15	10
For information only					
Resultant debt					
Opening debt	**9,303**	**10,053**	**11,808**	**13,027**	**14,187**
Net drawings	695	1,662	1,090	993	477
(Assumption) cash flow	-	-	-	-	-
Indexation on index-linked debt	55	93	129	168	193
Closing debt	**10,053**	**11,808**	**13,027**	**14,187**	**14,857**
Resultant debt/RAB (%)	76	79	80	81	81
Resultant RAB					
Opening RAB	**11,872**	**13,279**	**14,904**	**16,283**	**17,515**
Capex	1,392	1,578	1,375	1,289	1,033
Depreciation	-525	-543	-572	-587	-632
Q4/Q5 PPA & revenue smoothing	228	164	114	34	-63
Year-on-year indexation	312	426	461	497	489
Closing RAB	**13,279**	**14,904**	**16,282**	**17,516**	**18,342**

As per Table 11 Fitch has used the discloseable CAA figures inflated with RPI forecast, and assumed leverage in line with Table 11
FY09 forecast capex is for the period from financial close to the year-end
Source: BAA and Fitch calculations

from the time of acquiring the company in 2006, and the company expects to incur other forms of index-linked debt instruments.

This form of financial engineering, the balance sheet dividend approach, partly also explains why such regulated entities can be purchased at a premium to RAB and can service other forms of quasi-debt outside the financing or appointee ring-fence. This dividend income stream (if without debt service reserves, and if there are cash lock-ups at the OpCo level) is sensitive to one-off shocks in the cash flow.

This debt-capacity balance sheet financial engineering is illustrated in the summary cash flow in Table 14.

In this Section

- Structure Diagram
- Group Structure
- Transaction's Ring-Fencing
- Shared Services Agreement
- Existing BAA Ltd Bonds
- Credit Default Swaps - Issuer Bonds Guaranteed by BAA Ltd
- Permitted Disposals & Acquisitions
- Financial Covenant Ratios
- Trigger Event Regime
- Events of Default
- Debt Structure
- Refinancing Facility
- Interest Rate Hedging
- Debt Maturities
- Liquidity Provisions
- Subordinated Class B Debt
- Priority of Payments
- Provision of Security

Overview of Transaction Structural Issues

This sector-specific, highly geared, secured, tranched and covenanted utility financing is similar in many respects to the structured water financings of Glas Cymru (2001), Anglian Water (2002) and Southern Water (2003). Unique to this transaction are the Non-Migrated Bond mechanism, the Shared Services Agreement (SSA) with BAA Ltd, the credit default-swap (CDS)-related BAA Ltd guarantee of the Issuer's bonds which replace the existing bonds and, given present market conditions, the need for a Refinancing Facility (and its Liquidity Facility) at the Borrower level.

Since BAA does not currently require a licence for its economically regulated activities (unlike electricity transmission and distribution, gas distribution, rail and water), this transaction replicates some ring-fencing measures including a dividend lock-up, limitations on types of activity and potential acquisitions, no on-lending, no cross-default or reliance (other than arm's length) on group-related entities outside the Security Group, thereby enabling a standalone financial assessment. Weaknesses in this transaction include the lack of independent directors on the Designated Airports' boards, and the BAA Ltd-dependent SSA.

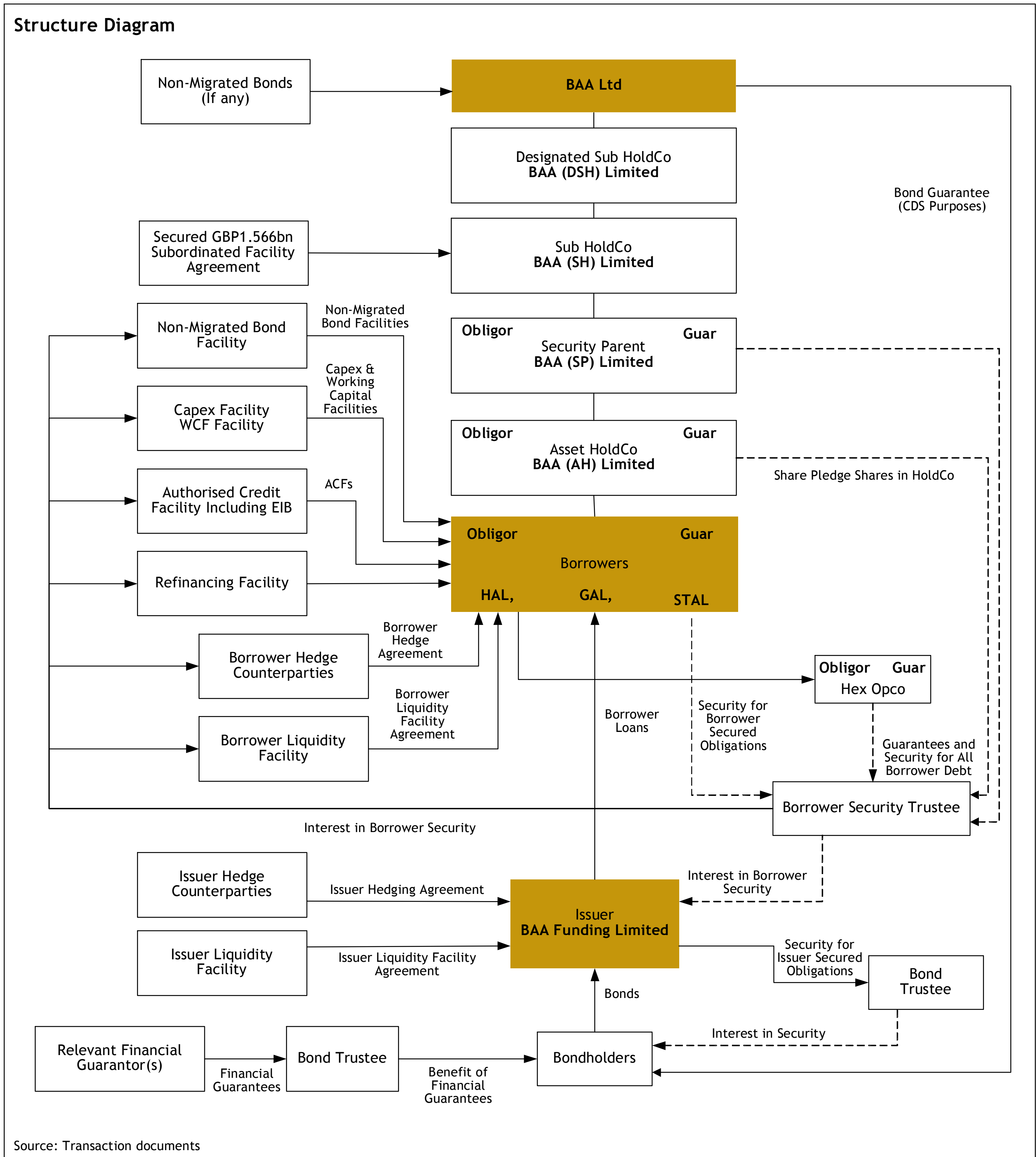
Financial covenants limiting leverage per tranche are linked to the Trigger Event regime whose main teeth is a dividend lock-up, thus equity has an incentive to not push the capital structure to the specified limits (which are not necessarily consistent with existing credit ratings). Other covenants include debt maturity profile, additional debt, interest rate hedging, and look-forward liquidity for capex requirements. Given the sizeable capex profile, predominantly funded by debt, the ability of the Borrowers to refinance outstandings under its GBP2.7bn capex facility, and the Refinancing Facilities (to the extent drawn at financial closing) by accessing longer-dated debt, requires active liability management.

The 12-months interest for Class A and six months for Class B liquidity facilities enhances the ratings of this transaction. Including other mechanisms within the pre-emptive Trigger Event regime, this transaction's private sector creditors can intervene to avert further deterioration or (upon default) insolvency, or on-sell the business.

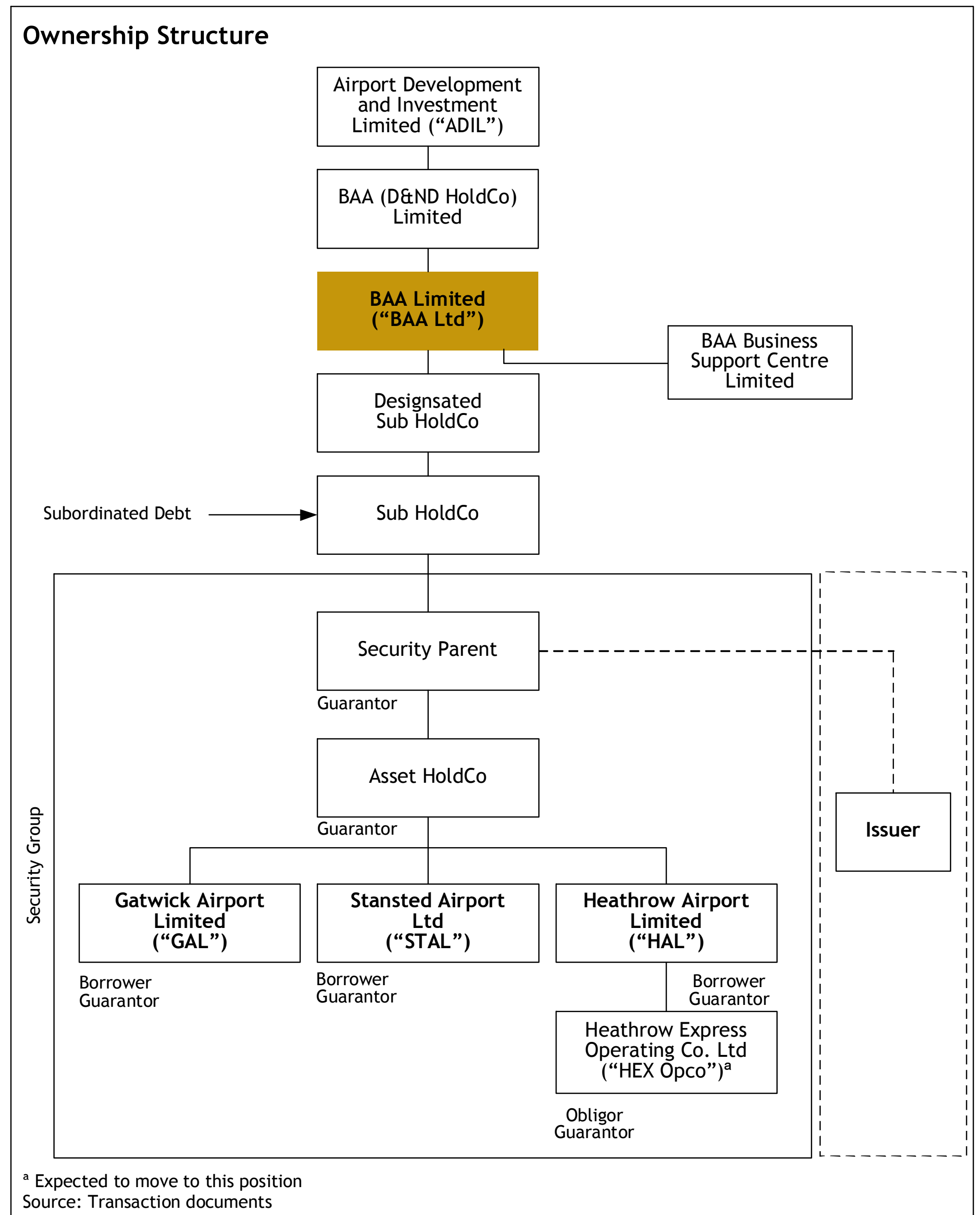
After BAA's opex and capex requirements, the priority of payments reflects the seniority of secured creditors, broadly in the following order:- certain parties' fee requirements; the liquidity facilities; the interest rate hedges; Class A creditors and then Class B creditors; prospective subordinated bonds within the Security Group; thereafter equity. When applicable, relevant quorums of Class A creditors have the right to direct certain actions, including acceleration and enforcement. The Non-Migrated Bonds are expected to rank as secured Class A creditors provided that they do not take a pre-emptive Independent Enforcement Action - in which case they will be subordinate to Class B.

The provision of security over the operating companies' assets to Class A creditors (thereafter to Class B) affords realisable value as well as control, or a threat against equity of their superseding control. Whether security provided is over physical

assets of the operating companies (to the extent allowed by a potential future regulation regime) or a pledge over the shares of the Security Group, the provision of any security is an enhancement to the structure. Transaction covenants, and other structuring provisions, limit the potential for other unsecured or non- Security Trust and Intercreditor Deed co-ordinated creditors to intervene in any actual or potential insolvency procedures, or realisation process.



Source: Transaction documents



Group Structure

The Security Group will be a sub-group within the BAA group comprising the key subsidiaries Heathrow Airport Limited (HAL), Gatwick Airport Limited (GAL) and Stansted Airport Limited (STAL). Together these entities are the Borrowers. HAL has one material subsidiary company, the Heathrow Express Operating Co Ltd (HEX OpCo), which operates the regulated Heathrow Express rail connection. Each entity owns the key operational assets for the ownership and operation of each of their respective airports. Each of the above regulated subsidiaries are 100%-owned by Asset HoldCo.

The financial transaction is a typical Borrower and Issuer structured financing. The Issuer, BAA Funding Limited, is a Jersey public company, and is owned by the BAA (SP) Limited (Security Parent).

The Security Group includes the Security Parent, Asset HoldCo, the Borrowers and Hex OpCo. At the Sub HoldCo level, there exists approximately GBP1.566bn

(originally GBP2bn) of Subordinated Debt, maturing in April 2011, a syndicated funding facility outside the Security Group. It relies upon dividends from the Security Group to service its debt obligations, and has second-ranking security interests in the Security Group's assets, but has a primary charge over the Security Parent's shares, which, if enforced and on-sold, would cause change of control implications for the Security Group. Surplus funds after required amortisations of its debt at the Sub HoldCo level remunerate equity funding further up the group structure.

BAA Ltd currently holds the non-designated airport interests of the old BAA plc – UK airports (Southampton, Edinburgh, Glasgow, Aberdeen – all also subject to a Competition Commission (see *Appendix III*) enquiry encompassing their common ownership by the BAA group) and any remaining overseas airport interests (Budapest, World Duty Free Europe, part of APP and Australian airport assets having been sold). As the non-designated assets are going to be separately owned and financed, BAA Ltd will primarily be a service-oriented company for its airport subsidiaries and the non-designated UK airports.

Transaction Ring-Fencing

Ring-fencing provisions are typically included in a regulated entity's licence, but as BAA Ltd and/or the Borrowers do not have a licence of the type seen in other regulated UK utilities to operate their respective regulated assets, this transaction's financing has put in place certain ring-fencing provisions for the protection of the Security Group entities. These provisions include:

1. No cross-default or cross-acceleration mechanisms with debt outside this transaction's – the Security Group's – financing. The Obligors are not reliant on any shareholder funding. All secured lenders to this transaction's Obligors are subject to the mechanisms and ranking details in the Common Terms Agreement (CTA) and Security Trust and Intercreditor Deed (STID).
2. Payment of dividends and similar external cash outflows (defined as Restricted Payments) are subject to the Trigger Event financial ratio thresholds, breach of which precludes a Restricted Payment.
3. All external dealings by the Obligors will be on arm's-length terms, except for dealings within the pre-agreed SSA with BAA Ltd and certain government agencies.
4. The Obligors have agreed to only undertake a Permitted Business except for any business falling within the Permitted Non-Regulated Business Limits.

   A Permitted Business means the owning, operating and developing of the Designated Airports. A Permitted Non-Regulated Business refers to all businesses that are not – or are not expected to be or have never been or were never expected to be – Permitted Businesses and its limit is calculated as the average expenses of the business as a percentage (2%) of RAB). For example, if Stansted airport were to be de-designated it would remain a Permitted Business as it was once a Permitted Business.
5. No disposal of Heathrow Airport Limited.

One of the effects of such ring-fencing is that any change in ownership of entities outside the Security Group, including BAA Ltd, is not expected to change the ratings of the transaction. However, the following transaction mechanisms illustrate some weakness in this deal:

1. An insolvency of BAA Ltd could lead to a termination of the SSA.

   Within an understanding of the nuances of this SSA being a product specific to this transaction (see below), the Borrowers, with the consent of the Borrower Security Trustee, have the ability to choose whether or not to terminate the SSA upon a BAA Ltd default. Furthermore, to minimise the effect on the

operations for the Security Group upon an insolvency of BAA Ltd and/or termination of the SSA, it is intended that relevant personnel would transfer over to relevant Obligors in a timely fashion, thus enabling the actual airport operations to continue with no break.

An automatic termination of the SSA can also be triggered by a change of ownership of the Obligors, which could occur, for example if the GBP1.566bn Subordinated Debt lenders enforce their security over the shares of the Security Parent and sell the Security Group and thereby trigger a change of control.

2. Compared with other regulated businesses, there are no independent directors on the boards of HAL, GAL and STAL. It is acknowledged that existing board members of these companies have conflicts of interest in relation to the SSA. Currently, Ferrovial bids for contracts above a certain size must be unanimously approved by the board.
3. This transaction's compliance certificates, including ratio compliance certificates, are signed by the Finance Director or CFO of BAA Ltd on behalf of the Obligors, not by independent directors.

Shared Services Agreement (SSA)

Each Obligor will enter into an SSA with BAA Ltd in its capacity as Shared Services Provider. The services to be provided encompass Designated Airport Services, which are going to be invoiced at cost, whereas the shared services Central Airport Services Charges and the Administrative and Business Support Services are at cost plus a margin. This SSA was required as all employees are in BAA Ltd not in the Designated Airports.

The SSA is a product of this financing and provides a basic contractual framework between the Designated Airport companies and BAA Ltd. It does not attempt to be a true arm's-length outsourcing contract with a non-affiliate, and is not designed to survive or operate within such a scenario. For example, there is no mechanism for the Designated Airport companies to pass on potential regulatory penalties or bonuses to BAA Ltd due to its contribution to customer services measures other than, indirectly, through their external dividends. However, it is argued that BAA Ltd has every incentive to see the Designated Airport companies succeed and for it to ensure their profitability and for them to route dividends to BAA Ltd through the Sub HoldCo – steering clear of the Trigger Event regime's restricted dividend ratio thresholds. Furthermore, a Trigger Event remedy includes the right to have the basis of the charges levied over the past 12 months under the SSA to be independently audited. Furthermore, lack of dividends to fund Sub HoldCo's debt (jeopardising its approximately GBP1.566bn Subordinated debt funding facility) could result in enforcement of these funders' security – the shares in the Security Parent – which could result in BAA Ltd no longer owning the Borrowers.

It is argued that the fact that BAA Ltd's profitability is linked to the success of the regulated group provides every incentive on the part of BAA Ltd to provide successful services to the Designated Airports. Nevertheless, if BAA Ltd performed poorly under the SSA, mechanisms to terminate the SSA or plan ahead to procure another service provider are available.

Existing BAA Ltd Bonds

BAA Ltd's existing unsecured bonds, totalling some GBP4.5bn, are expected to migrate into the structured financing as a secured creditor at the Class A level benefiting from an increase in coupon of either 0.1% or 0.7% depending on the covenants of the relevant existing bond. There is also an incentive fee to vote for the proposals by an early deadline. All bonds will have the same expected maturities. Migrated bonds benefit from becoming Class A bond ranking, security, voting mechanisms, financial covenants, and from dedicated liquidity facilities within the Security Group.

Currently, HAL, GAL and STAL unconditionally guarantee, on an unsecured joint and several basis, certain of the existing unsecured bonds of BAA Ltd (previously BAA plc). If bonds do not migrate into this transaction into Class A debt, these Non-Migrated Bonds may continue to be guaranteed by these three guarantors (who are also Borrowers). The HAL, GAL and STAL guarantees, currently on an unsecured basis, would be given “equal and rateable” treatment, ranking *pari passu* with the three Borrowers’ secured obligations. Accordingly, these creditors’ ranking in the priority of payments is *pari passu* with the Borrower Loans relating to the Class A Bonds, provided that to the extent that the Non-Migrated Bondholders take enforcement action independently of the STID (an Independent Enforcement Action), the Non-Migrated Bonds will rank in point of payment subordinate to the Borrower Loans relating to the Class B Bonds (see *Priority of Payments*).

Upon maturity, repayment of BAA Ltd’s Non-Migrated Bonds is expected to be financed through new capital markets issuance and/or facilitated with available (covenanted) headroom under the Non-Migrated Bond Facility. The latter is available as a backstop if the capital markets are not accessible. Even if some bonds do not migrate from the BAA Ltd level, this debt will be included in this transaction’s leverage and coverage ratio, and liquidity covenant requirements, thus any switch to a drawdown under the Non-Migrated Bond Facility to (p)repay the bonds will not change leverage ratios.

A more detailed explanation of the rated Non-Migrated Bonds is provided in *Appendix IV*.

Credit Default Swaps (CDS) - Issuer Bonds Guaranteed by BAA Ltd

As part of the commercial considerations when providing for the migration of existing unsecured BAA Ltd bonds to this financing, consideration has been given to a significant exposure of CDS linked to those deliverables.

If the existing bonds are prepaid or bondholders agree to transfer these bonds to this transaction’s Issuer (which is not a “succession event” under CDS contracts),the CDS would be worthless. Thus it is proposed that BAA Ltd provide a “Qualifying Affiliate Guarantee” of certain classes and maturities of the Issuer’s new bonds.

The fact that BAA Ltd provides an unsecured guarantee for certain of this transaction’s secured bonds with a maturity up to and including 2018 provides no enhancement to the Class A or B bonds’ ratings. The Bond Trustee will only be able to make a demand under the BAA Bond Guarantee following the service of a Bond Enforcement Notice but because the guarantee is an unsecured obligation of BAA Ltd this would be of limited monetary value.

Fitch was advised by the sponsors that the existence of the BAA Ltd guarantee does not delay this transaction’s creditors’ ability to enforce their security. To enforce the security granted by the Issuer to the Issuer Security Trustee, a Bond Event of Default would take place on non-payment of interest or principal of the Class A bonds, upon which the Issuer Security Trustee may accelerate the bonds and enforce its security. This course of action is unaffected by the terms and existence of the BAA Bond Guarantee.

BAA Ltd’s rights of subrogation against the Issuer in respect of any payments under its Bond Guarantee will be subordinated to this financing’s secured claims against the Issuer.

Permitted Disposals

The net proceeds of certain Permitted Disposals must be applied to reduce debt. Including the scenario of a mandatory disposal (as a result of the existing CC enquiry) of an airport company(s), the resultant Class A net debt/RAB must be less than or equal to 70% (until 1 April 2018) after repayment of drawings under the relevant Authorised Credit Facilities and/or prepayment or market purchases of

bonds. There is a further requirement for the Class B net debt/RAB to be less than 85% following such a disposal. Permitted Disposals preclude Heathrow Airport except with the consent of the required majority of Borrower Secured Creditors. If disposal proceeds are insufficient to reduce leverage to these levels, a Trigger Event will have occurred. Additionally, if the Refinancing Facility is outstanding, all proceeds must be applied to repay that facility.

Such a disposal scenario is not expected to result in premia payments for prepayment/unwinding of existing interest rate hedging and debt obligations, as for the next 12-18 months until the CC enquiry's remedies are known, sufficient floating-rate debt will exist or projected future drawings for Heathrow's capex will require existing long-dated hedging.

If both Gatwick and Stansted are sold, Fitch would expect the ratings of a sole-Heathrow financing to be revisited. Disposal of one airport is not expected to affect the ratings however, Fitch expects to revisit the ratings of a sole-Heathrow financing taking into account other sector and regulatory changes that the CC enquiry may recommend for future implementation (e.g. airport regulatory licences, forms of price capping, ability of airlines to switch airports, the extent of likely route/airline changes, and so on).

Permitted Acquisitions

Within the definitions of Permitted Business (prospective acquisitions include any new business undertaken by the Security Group whose revenues are expected to be economically regulated or would be if the relevant Designated Airport remained designated), acquisitions are permitted provided that they are no greater than 5% of RAB in the current year unless a Rating Confirmation has been achieved.

Financing's Financial Ratios

This transaction's interest cover ratios (ICRs) are not the same as the post-maintenance interest cover ratios (PMICRs) of other existing utility transactions, as this transaction uses a synthetic cash maintenance capex figure of 2% of RAB. Furthermore, in Fitch's view, this transaction's Trigger Event thresholds at 1.40x/1.20x for Class A and B, respectively, are at lower levels than other transactions (even with the lower synthetic maintenance capex figure within the PMICR) – see page Table 11 Illustrative Financial Figures.

In Fitch's view, this leniency in interest cover ratio probably reflects the potential for a one-off year's decline in revenue and/or profits due to an exogenous shock, and the sponsor's sensitivity surrounding dividends being shut-off to the Sub HoldCo and its financing facility and to BAA Ltd's owners. Although this ICR is weak, the net debt/RAB thresholds, which are also on a forward-looking basis, would capture a long-term decline in credit quality. The Additional Indebtedness ratio for Class A, at 72.5%, is lower than comparable transactions' norm of 75%.

The Security Group will provide investors with one year historical and forward looking ratios on a semi-annual basis. Where however the Security Group's financial condition deteriorates to pre-determined levels (set at or below pre-Trigger Event ratio thresholds), a Forecasting Event is deemed to occur that will require the Security Group to provide longer term forecast ratios as well as an explanation of the calculations therein.

Additional debt up to the Additional Indebtedness thresholds in Table 15, can be incurred by drawing upon the revolving Capex Facility or by issuing bonds within this structure. The transaction's Loan Event of Default financial ratios are weak at 92.5% for Class A (when the Trigger Event threshold is initially 72.5%) and a three year average Class A interest coverage ratio of 1.05x based on the synthetic 2% RAB approach.

Table 15: Financial Ratios

	Trigger event ratios	Forecasting event ratios	Additional indebtedness ratios	Loan event of default
Class A ICR (x)	Less than or equal to 1.40	Less than 1.60	-	June 2012 onwards: preceding 3 year average ICR 1.05, and/or
Class B ICR (x)	Less than or equal to 1.20	Less than 1.40	-	
Class A net debt/RAB (%)	More than 70 during Q5 and Q6 More than 72.5 thereafter	More than 70 during Q5 and Q6 More than 72.5 thereafter	More than 72.5	92.5
Class B net debt/RAB (%)	More than 85,	More than 85	More than 85.0 while the Refinancing Facility is outstanding. Thereafter 90.0	

The above trigger event ratios are tested for each "Relevant Period" (covering the past year and each subsequent year to the start of the next regulatory period).

The first debt/RAB ratio is expected to be reported as at December 2008 and ICR for the year to 31 December 2009.

Source: Prospectus

To comply with its regular compliance certificates, the company also calculates the Projected Excess Cash flow (effectively the external prospective dividend payment) as this is used to calculate liquidity available under the Capex Funding trigger (see *Liquidity*).

As Fitch has stated in relation to other water utility transactions with these types of financial ratios, the ratio levels do not ensure that the current ratings are maintained if the transaction operates within these triggers. Indeed, Fitch may downgrade relevant classes of notes prior to underlying credit deterioration causing a breach of these ratios' thresholds.

Trigger Event Regime

This mechanism seeks to provide an early warning signal of financial distress. Upon a Trigger Event, bondholders (through the Borrower Security Trustee) can investigate what has caused the deterioration and, if necessary, progressively take a more active control of events way before an event of default occurs.

One of the most powerful consequences, or threats, of a Trigger Event being triggered is the cessation of dividends to equity and any subordinated funding outside the financing structure. Thus equity players are focussed on not encouraging over-distribution of dividends that would have a detrimental effect to the business over the immediate or long term. They may also correct the financial distress by injecting fresh equity.

A Trigger Event will be triggered upon:

1. Breach of the Trigger Event financial ratios;
2. Breach of the Capex Funding Trigger, or the Issuer's Debt Service Funding Trigger;
3. Class A bonds downgraded below 'BBB+' by at least two rating agencies; Class B bonds downgraded below 'BBB-';
4. Drawings under the Issuer Liquidity Facility or the Borrower Liquidity Facility/Liquidity Reserve Account;

5. The issue of a compliance order or enforcement order by any regulator made pursuant to Section 41 of the Airports Act (subject to MAE considerations);
6. The issue by any regulator of any termination of any licence required for the carrying on of the business of any Obligor (subject to MAE considerations);
7. Draft legislation relating to the business of any Obligor which, if passed into law, would reasonably be expected to have a MAE;
8. The occurrence of a Loan Event of Default; and
9. Accretions by indexation to the notional amount of inflation-linked permitted treasury-orientated derivatives exceeds 8% of Class A ranking debt.

If a Trigger Event occurs and is continuing, then:

a. No Restricted Payments may be made by any Obligor;
b. Following breach of the Trigger Event debt/RAV ratios, the amount equal to intended Restricted Payment will be applied to prepay Class A amounts outstanding;
c. The Security Group will provide required information to the Borrower Security Trustee;
d. If the Trigger Event has continued for more than six months, if requested, a termination plan for the SSA has to be compiled;
e. If requested, a review of the fees, costs and charges charged by BAA Ltd as the Shared Services Provider to the Security Group over the preceding 12 months is compiled;
f. The Borrower Security Trustee will be entitled to commission an independent review to look into the Trigger Event and the remedy;
g. The Borrower Security Trustee shall be entitled to be consulted with respect to, and participate in, any discussions with the regulator (subject to the regulator's comments) regarding the ramifications for the Trigger Event and its remedy;
h. No disposals to joint venture entities (unless required by regulators); and
i. Net proceeds of any Designated Airport disposal made after the occurrence of a Trigger Event that have not been applied to repaying relevant debt are placed in a disposal proceeds account.

Unlike similar utility transactions, there are no covenants that provide a warning signal that the Designated Airports have materially (usually a 10% threshold) deviated from planned capex. Fitch understands the inclusion of such a covenant was resisted by the CAA. In its final determination for Heathrow and Gatwick, the CAA has put in mechanisms to abate Aeronautical Revenue if identified capex is delayed or not undertaken.

The Borrower Authorised Credit Facilities remain available for drawing during a Trigger Event regime provided that the Additional Indebtedness test is met while a Trigger Event is continuing.

Events of Default

Loan Events of Default

Loan Events of Default shall include, with certain minimum materiality thresholds, and some subject to a (traditionally open to interpretation) Material Adverse Effect (MAE) materiality consideration, and grace/remedy periods:

1. Non-payment by an Obligor amounts due under the finance documents;
2. Breach of financial ratios summarised on Table 15;
3. An Obligor does not comply with any term of any covenant or undertaking in any finance document;

4. Breach of the Obligors' representations;
5. Any non-Authorised Credit Facility financial indebtedness (including the Non-Migrated Bonds) not being paid when due, or being declared due and payable prior to its maturity as a result of an event of default;
6. Any Obligor is unable to pay its debt, winding-up or administration order in respect of any Obligor;
7. Termination of any material licence or authorisation that is required for the carrying on of a material part of the permitted business of any Obligor;
8. Repudiation of, or it becomes unlawful for any Obligor to perform, its obligations under any Transaction Document;
9. Any of the Borrower Security ceasing to be in full force and effect;
10. Government action (including nationalisation);
11. Any Obligor fails to comply with a judgment of any court;
12. Any Obligor not having the legal power to perform its obligations under the Transaction Documents;
13. Any change in law;
14. Any execution proceedings are enforced in relation to any assets of any Obligor;
15. A Borrower ceases to carry on its business or any substantial part of its business;
16. Commencement of litigation against an Obligor which would be expected to have a MAE; and
17. Bond Event of Default.

Upon a Loan Event of Default, the Borrower Security Trustee (as instructed by the requisite majority of Borrower Senior Creditors) will be entitled to accelerate the advances outstanding under the Borrower Loan Agreement and each financial party may declare amounts outstanding under the Authorised Credit Facilities as immediately due and payable and/or enforce the Security Group security. The Borrower Security Trustee may enforce any guarantee or security for the Borrowers' obligations to the Issuer and the other Borrower Secured Creditors or the Obligors' obligations under the security documents.

Relating to the potential for the CC and/or resultant legislation to change the transaction's existing security arrangements: if a Restructuring Event occurs upon an actual or proposed legal regulatory change which: (i) restricts the ability of the Borrowers to grant security; (ii) restricts the ability of the Borrower Security Trustee to appoint a receiver and/or the Issuer or the Bond Trustee to appoint an Admin Receiver; or (iii) establishes a special insolvency regime, a standstill will apply for up to 12 months in respect of any Loan Event of Default caused by such a restructuring event (other than where such Loan Event of Default is due to non-payment or insolvency related events). Instead, during the standstill period, a Trigger Event will be in effect.

Table 16: Indicative Issuances (At Financial Closing)

	Ratings	Type	Currency	Equivalent (GBPm)	Sub-totals (GBPm)	Gross debt as % of RAB [a]	Scheduled/final maturity dates
Existing bonds							
Class A		Fixed	GBP	400			2013/2015
Class A		Fixed	GBP	300			2016/2018
Class A		Fixed	GBP	250			2021/2023
Class A		Fixed	GBP	750			2023/2025
Class A		Fixed	GBP	200			2028/2030
Class A		Fixed	GBP	900			2031/2033
Class A		Fixed	EUR	680			2012/2014
Class A		Fixed	EUR	513			2014/2016
Class A		Fixed	EUR	510	4,503	38	2018/2020
New issuance							
Class A including EIB		Various	GBP equiv	3,839	3,839	32	Various
Class B		Various	GBP equiv	1,000	1,000	8	Various
					9,342	**78**	
And/or new issuance is funded by some/all of the refinancing facility							
Refinancing facility				**Committed available**			
Class A			GBP equiv	3,400			Various: 2 to 5 years
Class B			GBP equiv	1,000			Various: 2 to 5 years
EIB			GBP	439			Amortising to 2018
Non-Migrated Bond Facility Class A			GBP equiv	[b]			To match the maturity date of the longest dated Non-Migrated Bond
Capex Facility							5 years
Class A			GBP equiv	2,300			
Class B			GBP equiv	400			
Working capital facility Class A				50			5 year
Issuer Liquidity Facility				12 + 6 months			
Borrower Liquidity Facility				Interest service			

The Issuer and Borrower Liquidity Facility are not available to the Capex, Working Capital, and Non-Migrated Bond Facility.
[a] Gross debt as percentage of RAB is estimated mid-year RAB of GBP12bn
[b] The amount of the Non-Migrated Bond Facility is covenanted to be the amount of Non-Migrated Bonds
Source: Prospectus. EIB is the European Investment Bank

Bond Events of Default

The Issuer's Bond Events of Default are limited to:

- Non-payment by the Issuer of the Class A bonds (for so long as there are any Class A bonds outstanding and thereafter the Class B bonds);
- Breach of other obligations by the Issuer;
- An Insolvency Event occurs in relation to the Issuer; or
- It becomes unlawful for the Issuer to perform or comply with its obligations.

Upon a Bond Event of Default, the Bond Trustee may only enforce against the Issuer if so directed by the holders of the Class A bonds (or Issuer Qualifying Creditors, which include any monolines and Class A-related cross currency hedge counterparty) for so long as there are any Class A bonds outstanding and thereafter the Class B bonds.

Debt Structure

The proposed debt structure includes the existing BAA Ltd bonds. These existing unsecured bondholders are expected to form up to GBP4.5bn of Class A secured bonds. New issuance, either through bonds and/or by using the committed and available Refinancing Facility, will total up to GBP4.4bn (GBP3.4bn Class A, GBP1bn Class B). The transaction has a mechanism for subordinated bonds (expected to be subordinated to Class A and B notes) to exist.

Authorised Credit Facilities (ACFs) are typically bank funding facilities as permitted under the CTA, and include the Borrower Loan Agreements, the Capex Facility, the Working Capital Facility, the Non-Migrated Bond Facility, the Refinancing Facility, the Borrower Liquidity Facility, the Borrower Hedging Agreements and any prospective Finance Leases. The EIB credit facility will be an ACF and be bound by the CTA, including its financial covenants and security provisions.

Table 17: Borrower Authorised Credit Facilities

Authorised Credit Facility	Ranking	Amount committed (GBPm)	Purpose	Maturity
Working Capital Facility	Class A	50	Working capital requirements of the borrowers	5 years
Capex Facility	Class A Class B	2,300 400	Capex requirements of the Borrowers And/or refinancing of other amounts initially funded from other sources	5 years
Non-Migrating Bond Facility	---	[a]	Scheduled or the applicable early redemption of the Non-Migrated Bonds	Longest maturity date of the non-migrated bond
Refinancing Facility	Class A Class B	3,400 1,000	Term loan to finance issuance at financial closing, to the extent that bonds not immediately issued	5 years
EIB Facility	Class A	439	EIB funding to Heathrow specifically	Amortising to 2018
Potential Finance Leases	Class A	Nil		

[a] The amount of the Non-Migrated Bond Facility is covenanted to be the amount of Non-Migrated Bonds
Source: Prospectus

These Authorised Credit Facilities remain available for drawing during a Trigger Event regime (subject to Additional Indebtedness carve-outs). Also the Non-Migrated Bond Facility remains available for drawing if the Additional Indebtedness covenant has been breached and if a Non-Migrated Bond related non-payment exists.

Even if Authorised Credit Facility lenders are lending more directly to the airport-owning Borrowers than others, the CTA and STID equalise their ranking with the Issuer and its creditors.

Interest Rate Hedging

Group interest rate hedging is covenanted at a minimum 75% of debt at fixed interest rates (including index linked) until the end of the current regulatory period, and at 50% of debt for the following regulatory period. The total notional hedged amounts must not exceed 102.5% of debt. The group should not bear currency risk in respect of any foreign currency denominated debt. The Borrower may incur cross-currency swaps for the non-migrated bonds, and the Issuer for existing bonds that are migrated and other foreign currency debt issuances at its level. In both cases, hedging should not be for speculative purposes. A substantial amount of existing hedging (post ADIL acquisition) is being novated from ADIL to the Borrowers. This means that BAA is not that sensitive to current interest rates at the time of issuing bonds, but is sensitive to the margin/spread incurred for the new issuance of bonds and/or drawdowns under the Refinancing Facility.

If there is a forced sale of Stansted and/or Gatwick (whose disposal proceeds will reduce the leverage of the Security Group down to at least 70/85% debt/RAB for Class A/B respectively), the profile of capex at Heathrow is such that capex drawings of at least GBP1.0-1.5bn a year will mean that over-hedging (to the extent allowed in the 102.5% over-hedging covenant) will soon be used to fund new drawings in the near term. Thus no prepayment of derivatives is expected.

Index-linked debt and/or derivatives are appropriate for regulated income derived from the RPI+/-X regime and with an appreciating (RPI-indexed) regulated asset base. Such instruments also have the effect of alleviating near-term pressure on the ICR where this is measured by cash interest paid, although the outstanding debt has year-on-year accretion. The indexation that accrues on principal outstanding and in derivatives is included in the net debt/RAB ratios. Given the supra-senior status of derivatives in the priority of payments, the Trigger Event regime caps accretion due to indexation at 8% of Class A debt outstanding. Breach of this cap would result in a full distribution lock-up and other Trigger Event regime consequences.

Refinancing Facility

To the extent that the group is unable to issue bonds at financial closing, probably due to market and/or pricing conditions, the underwritten, committed and available-for-drawdown Refinancing Facility will be used accordingly. This facility will be provided by predominantly bank (minimum 'A-' rated) lenders plug into the financing's CTA and STID, ranking as Class A and B creditors according to their allocated tranche of debt. The facility's terms and conditions and pricing include financial incentives designed to encourage the issuance of long-dated bonds. If these facilities are fully drawn down at financial closing, their shorter-dated maturities, together with Capex Facility requirements, should still enable the group to meet the debt maturity bucket covenants (maximum 30% of RAB within any two years, 50% within five years) but nevertheless raises the prospect of concentrated refinance risk. Fitch has stressed this risk by assuming that refinanced funding will be available, but at penal pricing – see *Debt Maturity and Refinance Risk*. The Refinancing Facility benefits from prepayment mechanisms that repay this term loan upon bond issuance, and disposal proceed receipts, but balances this with prospective liquidity for the remaining group capex requirements.

In the Refinancing Facility there is an additional covenant that no Restricted Payment will be made while the Refinancing Facility has more than GBP1.3bn outstanding. However, during this period payments for the Subordinated Debt interest (Restricted Payments) can be paid provided no Trigger Event has occurred and is continuing. As noted in Table 15, there is also an additional covenant for Additional Indebtedness for Class B (capped at a lower 85% debt/RAV whilst any amounts remain outstanding under the Refinancing Facility).

Debt Maturity Profile and Refinance Risk

Bond debt has bullet maturities with refinance risk. There is no covenant to pre-fund such debt maturities. This risk is mitigated by normal corporate active treasury management; ability to access different funding markets (as to currency, maturity, bank or bond); forward-looking net debt/RAB ratios; and covenants on bunching of debt maturity buckets – (a) < 30% of Total RAB (meaning opening RAB) in any 24-month period, and (b) < 50% of Total RAB within any five-year period. (That is 26% of total debt for two years, and 43% for five years given template expected leverage.) These percentages are larger than other utility transactions due to the quantum of BAA's likely capex and drawdown under the Capex Facility and subsequent bond issuance requirements over the next 10 years.

Current market conditions have highlighted what could happen if the bond market dries up, and shorter-dated bank lending becomes more expensive. Subject to the appetite for issuing new debt at financial closing of this transaction, particularly the extent to which the Refinancing Facility is used, BAA may have various scenarios of near-term debt maturities that require refinancing during Q5. This maturity profile is also unaided by the scale of capex during Q5 (more so Q6), which is scheduled to be largely debt-funded.

In response to this refinance risk, if the Refinancing Facility remains drawn due to a lack of long-term bond issuance, BAA shareholders have committed to not take a dividend out of the Security Group until the Refinancing Facility has been repaid to

less than GBP1.3bn. This voluntary dividend trap has the effect of reducing leverage (as debt is not drawn to an optimised debt/RAB leverage to pay the "Balance Sheet Dividend").

Fitch also stressed a scenario of the Refinancing Facility being fully used but on being refinanced with bank debt at penal credit spreads (total 3% for Class A, total 5% for Class B). This had the adverse effect of reducing the PMICR by some 0.05x, widening to some 0.15x on the Class A debt by the end of the quinquennium. However, it is a valid argument that if such penal credit spreads become representative of the cost of finance by FY13, this would be reflected in the CAA's WACC for BAA's Q6 pricing review.

Typical for this type of transaction, the structure can be tapped subject to certain restrictions, particularly the Additional Indebtedness ratios – see *Financial Ratio Thresholds*. Unsecured overdrafts from any institution up to a maximum of 0.5% of Total RAB net of all current account balances with such entity are allowed.

The Trigger Event regime has a 12-month capex look-forward liquidity requirement. This is largely met by the GBP2.7bn Capex Facility, but as BAA's capex totals GBP7.0bn (nominal) during Q5 the Capex Facility's outstandings will need refinancing as the facility reaches around GBP1.5bn (leaving enough liquidity headroom for the next 12 months' capex). To the extent that bonds are issued to prepay the Refinancing Facility, front- or back-loaded prepayments of the Refinancing Facility are made so as to preserve the liquidity profile (Capex Facility headroom and debt maturity buckets). Breach of either of these covenants means that external dividends may be trapped until the Trigger Event's trigger is rectified.

Liquidity Provisions

The Debt Service Funding Trigger (breach of which is a Trigger Event) obliges the Borrowers to ensure that the estimated interest and equivalent finance charges for the following 12 months (Class A) and six months (Class B) debt at the Issuer level is less than the undrawn available commitment under the Issuer Liquidity Facility and/or dedicated cash reserves. Correspondingly, there is also a requirement (breach of which is a Trigger Event) for the Borrower to have an undrawn available commitment under the Borrower Liquidity Facility for 12 months' (i) aggregate forecast net payments under Treasury Transactions (derivatives), (ii) fees and debt service for the Tranche A Refinancing Facility, (iii) debt service for the EIB facility, and (iv) 6 months' interest and debt service for the Tranche B Refinancing Facility.

The Capex Funding Trigger (breach of which is a Trigger Event) obliges the Borrowers to ensure that the amount of the relevant Security Group's remaining (unspent) budgeted capex over the next 12 months is less than (a) undrawn available commitment under the Capex Facility, (b) Borrowers' cash, and (c) Projected Excess Cash flow for such 12-month period. (Projected Excess Cash flow is effectively the amount of likely dividend payment from the Obligors.)

The Borrower Liquidity Facility is drawable despite a Loan Event of Default (other than a Liquidity Facility (LF) Borrower Event of Default that includes non-payment of any sums due under the Borrower Liquidity Facility Agreement) and enforcement by the Borrower Security Trustee (but not for an acceleration event).

The Borrower Liquidity Facility ranks and acts like the Issuer Liquidity Facility but at the Borrower level. The transaction has created a trust account mechanism to mitigate problems surrounding the Borrowers not being bankruptcy-remote entities.

Table 18: Issuer and Borrower Liquidity Facilities

	Obligor	Amount	Purpose	Maturity
Borrower Liquidity Facility	Borrower	-	Interest shortfall under the refinancing facility (12 months Class A, six months Class B) Net payments under the Borrower's treasury/hedging transactions related to hedging outstanding advanced under an Authorised Credit Facility Liquidity shortfall for EIB Facility Liquidity is not provided for the Capex Facility, Working Capital Facility or the Non-Migrated Bond Facility	364 days But effectively through the term of the financing
Issuer Liquidity Facility	Issuer	-	12 months interest for Class A bonds Six months interest for Class B bonds	364 days But effectively through the term of the financing
		To total around GBP600m		

Source: Prospectus

Subordinated Class B Debt

Class B debt is subordinated to Class A debt. If, prior to a Bond Enforcement Notice, there are insufficient funds to pay Class B interest due to the Issuer, even after use of the Issuer's Class B six-month Liquidity Facility, interest and principal on Class B debt can be accrued and will be treated as not having fallen due and will be deferred until the earliest of (i) the next interest date when the Issuer may have sufficient funds to pay deferred amounts; and (ii) Class A debt has been repaid in full; (iii) the date on which a bond enforcement notice has been received. If no Class B interest or principal is paid, no additional rights (such as voting mechanisms for acceleration and/or enforcement) arise from this.

Effectively, acceleration and/or enforcement of the Borrower Loan, or against the Issuer, cannot be forced by the Class B debt unless Class A has been repaid in full beforehand.

Priority of Payments

During the enforcement of Borrower Security or in certain circumstances following a default under the CTA, proceeds shall, before the acceleration of the Borrower's Secured Liabilities, be applied according to the Borrower Post-Enforcement (Pre-Acceleration) Priority of Payments. There is no pre-enforcement Borrower waterfall.

Borrower Post-Enforcement (Pre-Acceleration) Priority of Payments

1. Various forms of transaction fees (Security Trustee, Receiver);
2. Various forms of transaction fees (Borrower Account Bank);
3. Third-party creditors of the Issuer including tax, and for the Obligors in respect of operating costs;
4. Issuer and Borrower Liquidity Facility Provider fees, Financial Guarantor fees, similar for the ACFs);
5. Scheduled amounts payable to each Issuer and/or Borrower Hedge Counterparty under any Interest Rate Hedging Agreement;
6. Class A bond interest and commitment commissions (other than principal and Subordinated Step-up Fee Amounts); amounts due to the relevant Financial

Guarantor in respect of payments of interest on any Class A wrapped debt; interest and commitment commissions in respect of Class A debt under any Authorised Credit Facility; so long as no Independent Enforcement Action has taken place, interest on Non-Migrated Bonds then outstanding; termination amounts to Issuer and Borrower interest rate hedging; Senior Finance Lease fixed interest funding; and scheduled interest for Borrower Cross Currency hedging;

7. Class A principal; termination amounts or other unscheduled sums due to the Issuer's Class A bond Cross Currency hedges; Senior Finance Lease principal amounts; Financial Guarantor Class A principal; Class A principal under the Authorised Credit Facilities; so long as no Independent Enforcement Action has taken place, principal on Non-Migrated Bonds then outstanding; scheduled principal and all termination amounts to Borrower Cross Currency hedging interest in respect of the Non-Migrated Bonds;
8. In summary as per 6 but for Class B bonds, Financial Guarantors and in respect of Junior Debt under any Authorised Credit Facilities and Junior Finance Leases;
9. In summary, as per 7, but for Class B bonds, Financial Guarantors and in respect of Junior Debt under any Authorised Credit Facilities and Junior Finance Leases;
10. Class A subordinated step-ups;
11. Class B subordinated step-ups;
12. Liquidity Subordinated Amounts to the Issuer and Borrower Liquidity Facility Providers;
13. Subordinated Hedge Amounts to the Issuer and Borrower hedge counterparties;
14. Subordinated Amounts to the Subordinated Borrower Secured Creditors; and
15. Payments into the Surplus Revenue Collection Account

During Post-Enforcement (Pre-Acceleration) disposal proceeds and amounts credited to the Surplus Revenue Collection Account, following a resolution passed by a simple majority, may be used for collateralisation or prepayment of Class A and B debt as per the Borrower Post-Enforcement (Pre-Acceleration) Principal Priority of Payments. Within this the claims of any Borrower Secured Creditor including the Non-Migrated Bond Trustee/Bondholders ranking pari passu with the Class A debt shall cease upon their taking any Independent Enforcement Action prior to the date of this transaction's Loan Acceleration Notice being delivered. If they take such actions, their claims will rank subordinate to Class A debt, the BAA pension liabilities, Class B debt and any (created) subordinated bonds.

Borrower Post-Enforcement Post-Acceleration Priority of Payments

This priority of payments is the same as the pre-acceleration priority of payments except for the switching of priorities to reflect Class A interest then Class A principal-related items, then Class B interest followed by Class B principal-related items. Unsecured creditors are not in the waterfall.

Furthermore, the BAA Pension Trustee (with a maximum pension liability amount cap of GBP300m) ranks within item vii (Class A principal).

Issuer Post-Enforcement Priority of Payments

After the service of a Bond Enforcement Notice by the Bond Trustee, the Bond Trustee shall use the funds to make payments in accordance with the following priority of payments:

1. Various forms of transaction fees (Bond Trustee, Receiver);
2. Various forms of transaction fees (Agent Banks, Issuer Account Banks, Cash Manager, Corporate Administration Provider);

3. Interest and principal for Liquidity Facility Provider, Financial Guarantor fees;
4. Scheduled amounts payable to each Hedge Counterparty under any Interest Rate Hedging Agreement);
5. Class A bond interest and commitment commissions (other than principal and Subordinated Step-up Fee Amounts); scheduled payments to each Hedge Counterparty under any Cross Currency Hedge Agreement in respect of Class A Bonds; any termination amounts or other unscheduled sums under any Interest Rate Hedging Agreements, and amounts due to the relevant Financial Guarantor in respect of payments of interest on any Class A wrapped debt;
6. Class A principal; principal amounts due to each Hedge Counterparty under any Cross Currency Hedging in respect of Class A bonds, any termination amounts or other unscheduled sums under any Class A bond Cross Currency Hedges, and Financial Guarantor Class A principal;
7. In summary as per (5) above but for Class B bonds, Cross Currency Hedging; and Financial Guarantors;
8. In summary as per (6) above but for Class B bonds, Cross Currency Hedging; and Financial Guarantors;
9. Class A subordinated step-ups;
10. Class B subordinated step-ups;
11. Liquidity Subordinated Amounts to the Liquidity Facility Provider;
12. Subordinated Hedge Amounts to an Issuer hedge counterparty;
13. payments to the Issuer Cash Manager (if it is BAA); and
14. Bond Guarantor (BAA).

Security

The centre of main interest for each member of the Security Group (except the Issuer), for the purposes of the EU Insolvency Regulation, is England and Wales. Each Obligor will provide a “qualifying floating charge” under the Insolvency Act 1986, to the Issuer. This financing will constitute a “capital markets arrangement”. There is currently no overriding “special administration” regime for this regulated utility’s assets.

Under the transaction documentation, the Issuer will be entitled to enforce Security through the appointment of an administrative receiver (through the above “capital markets” exception from the prohibition of administrative receivership, as introduced by the Enterprise Act 2002). This will enable the Issuer, through the administrative receiver, to have the power to carry on the business of the Security Group as well as the power to sell its business and assets. The documentation also enables the Issuer to enforce its security through the less preferable routes of appointing an administrator, or a fixed-charge receiver, or enforcing the security as mortgagee in possession.

Each Obligor, which guarantees each other Obligor’s obligations, will enter into a security agreement with the Borrower Security Trustee. Their security is also granted in favour of the Issuer in respect of its obligations under its Borrower-Issuer loan and/or its guarantee. The assets pledged include:

- First fixed-charge over:
  - The ordinary shares in each Obligor (other than the Security Parent);
  - Legal mortgage over any real property interests owned by it, and the disposal proceeds of any land;
  - All present and future plant, machinery and office equipment;

- Cash within the business, and other normal security provisions;

- An assignment of each Obligor's rights in respect of insurance, and all material commercial contracts; and
- A first floating charge over the whole undertaking, property, assets and rights, present and future, of each Obligor (the "Security Agreement Floating Charge").

The Borrower Security Trustee will hold the above security on behalf of the Borrower Secured Creditors. The Issuer will hold a separate floating charge granted by the Obligors (the "OFCA Floating Security") for itself. The GBP1.566bn Subordinated Debt lenders also share in this security, but are subordinated behind the Class A & B lenders.

The OFCA Floating Security will be deferred in point of priority to all fixed securities created by the Obligors under the Security Agreement. The OFCA Floating Security and the Security Agreement Floating Security will rank *pari passu* with one another and, for such purposes, will be specifically expressed to be created simultaneously.

The Designated Airport entities are able to grant security over their assets without notification to, or approval from, the CAA or the Secretary of State. Furthermore, unlike other utility financings, the Issuer/Trustee will be entitled to enforce any security without giving prior notice or receiving approval from the CAA of the Secretary of State.

Fitch is aware that, in its October 2007 pricing determination report (paragraph 6.18), the CC raised the issue that existing and prospective funding of BAA had/will grant security over airport assets and that the CC "considers it desirable that [BAA] and not the creditors of ADI should have control of the assets constituting Heathrow and Gatwick airports". It is feasible that the CC's ongoing market enquiry may propose to prohibit such infrastructure assets being pledged as security, as per other UK utility regimes.

The Standstill mechanism summarised under *Loan Event of Default* defers an otherwise default for a period upon such a change in law. There is a legal view that the authorities will have difficulties taking away this transaction's existing security already legally granted. In any event, Fitch has rated this transaction based on the existing legal regime and does not rate to a change in law.

In Fitch's analysis of the financial benefits of this structured financing, it is more the concept of senior creditors' control mechanisms over the company, its management, prospective realisation process, as also procured through the pledge of shares, rather than the realisation value of individual assets that provides ratings enhancement. Fitch would need to investigate the extent to which the introduction of a likely Special Administrative Receivership regime (as per other UK utilities) and any other provisions would impinge upon this transaction's security package and the above protection mechanisms.

In the Appendices

- 1 – Economic Regulation
- 2 – Pricing Profile Adjustment
- 3 – BAA Airports Market Investigation
- 4 – Non-Migrated Bonds
- 5 – Comparison of UK Regulated Utilities and their financings

Appendix 1: Economic Regulation

BAA's three Designated Airports are subject to economic regulation, as undertaken by the Civil Aviation Authority (CAA). After recommendations from the authoritative Competition Commission (CC), the CAA published its final pricing determination for Heathrow and Gatwick in March 2008.

Typically for UK-regulated utilities, the price control is based on an 'RPI –/+ X' basis within an incentive-based framework. It uses the main building blocks of operating costs, regulatory depreciation, tax, capital expenditure and a cost of capital on the Regulatory Asset Base/Value (RAB/RAV). Adopting the "single till" approach, Commercial Revenues are deducted from the resultant revenue requirement, and divided by passenger forecast numbers to derive a maximum charge per passenger. The next quinquennium covers 1 April 2008 until 31 March 2013, called Q5.

The regulator's remit is set out in the Airports Act 1986, Section IV, S.39. The CAA shall perform its functions, which it considers best calculated to:

- "Further the reasonable interest of users (airlines and passengers) of airports within the UK;
- To promote the efficient, economic and profitable operation of such airports;
- To encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and
- To impose minimum restrictions that are consistent with the performance of its functions".

Unlike other UK utility regulators, there is no public duty upon the CAA to determine tariffs to enable an efficient BAA to finance its obligations, since BAA has no "obligations" as such. Indeed, BAA does not have a licence, thus the CAA cannot "impose" conditions upon the company in the way that other regulators can. However, as cited above, the CAA has a duty to "encourage investment", "promote …profitable operations" and anticipate demands by the users of such airports.

Many of the above features - the lack of a licence, the hitherto light touch/minimum approach towards restriction on BAA by the CAA - and others factors (the ability of BAA to pledge its assets as security, lack of ring-fencing provisions) are being formally reviewed by the CC and Department for Transport (DfT) and may well change (see Appendix IV below).

Whereas other UK regulators have clear financeability criteria (financial ratios to enable the notionally geared entity to achieve a targeted financial profile/credit rating), the CAA begrudgingly acknowledged this requirement during 2007. Using a notional balance sheet of 60% debt/RAB, the CAA and CC seem to be targeting a 'BBB+' rating – although it is unclear if this is an Issuer Default Rating or a Senior Unsecured debt rating. In common with other utility regulators, the targeted "solid or comfortable investment grade rating" is associated with enabling the company to regularly access the debt markets. It is argued by some bankers that a company such as BAA accessing at least GBP1.0-1.5bn of debt a year should be rated in the 'A' rating category to fulfil this requirement. It is management's choice to target a capital structure, and ratings, different from the 60% debt/RAB notional capital structure modelled by the regulator.

UK utility investors are well aware of the arbitrage that leveraged utility companies are aiming to exploit: namely, to gear-up higher (typically up to 75% debt + 10-15% quasi-debt + 10% quasi-equity + 5% forms of near-equity) than the regulator's template leverage (BAA: 60% debt + 40% equity) and apportion the regulator's higher return on equity to the debt and near-debt, which funds that equity portion. By putting in place debt-protective covenanted structures, the debt risk premium

has not increased to the same extent as increased gearing in an uncovenanted capital structure would imply.

There is no formal interim pricing determination mechanism for either the airlines, BAA or the CAA to reopen the pricing determination, however if any change is proposed then it cannot be implemented without BAA's consent. However, if demand suddenly dropped, BAA does have the flexibility to take actions such as to delay capex (say, for projects linked to increased capacity) but should expect related revenue to be clawed back accordingly. As per Q4, there are mechanisms to increase tariffs due to unexpected increased security costs. However, this '+S' adjustment within the tariff formula relates only to increased security costs (above minimum thresholds) due to new government security directives.

Unlike other UK regulatory regimes, there is also no overriding Special Administrative Receiver, who would be appointed to run a (near) insolvent BAA to, foremost, maintain services and, secondly, on-sell the business. This financing currently has an enhanced security package as BAA's assets can be pledged and realised without the regulator's permission, compared with other regulated utilities where regulated assets cannot be pledged.

Constructive engagement, a process of substantial discussions with airlines and customers on features relevant for the pricing determination, has some positive repercussions for the regulatory process as input into plans for, or broad agreement can be achieved, on airport development, strategy, traffic forecasts, quality of service and capex efficiency. Equally, lack of agreement with the rather vocal airlines at Stansted has been cited as a failure of the process. Recent reports from the CC citing last-minute submissions by BAA of increased costs have been cited as a failure of constructive engagement. Such last minute changes, which increased tariffs in the final determination compared with the interim determination, may form the basis of a judicial review of Q5's regulatory determination. Indeed, a judicial review has been lodged by easyJet relating to Gatwick.

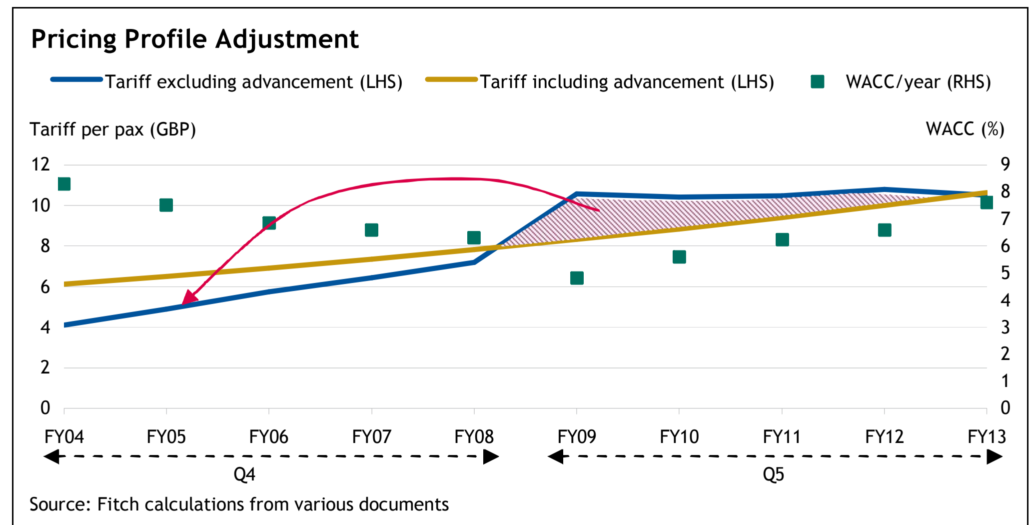
Appendix 2: Pricing Profile Adjustment (PPA)

This mechanism was established in the CAA's Q4 determination primarily for Heathrow airport's revenue profile. Tackling the issue of pre-funding assets, and given the quantum of capex for Heathrow's T5 (GBP4.2bn of capex) relative to the airport's smaller RAB (GBP4bn in 2004), using a return on RAB, tariffs would increase exponentially in 2009 (as per the red line in the chart (Pricing Profile Adjustment). But to create a more customer-conducive gradual increase in tariff per passenger, the CAA shifted the shaded Q5 quantum of income, on a net present value (NPV)-neutral basis, into the first five-year period to derive the straight line. Thus a constant increase in tariff per passenger is drawn over the two quinquennia (the blue line). Excluding the revenue advancement adjustment, the WACC for Heathrow was around 7.5% in each year over the 10-year profile. Including the distortive revenue advancement adjustment (in turnover and RAB), the WACC on RAB varies from higher figures in Q4 (8.3% in FY04 reducing to 6.3% by FY08) and lower in Q5 (dipping to 4.8% in FY09, increasing to 7.61% in YE13). Using the original Q4's WACC assumption for the two periods, this is shown by the black dots. Heathrow's actual Q4 figures were also distorted by unspent revenue brought forward from Q3 into Q4.

Although economically NPV-neutral, this switch of some GBP560m (Q5 nominal prices) of revenue from Q5 to Q4 has a distorting effect upon any interest cover or financeability ratio, even on a regulatory template 60% debt/RAB-financed company, accentuated further in this higher leveraged capital structure. Fitch acknowledges the effect of the PPA and the importance this would have on financeability criteria.

For corresponding PPA adjustments to RAV in Q5 see Table 10 (*Regulated Asset Value)*.

In Fitch's view, BAA has correctly mitigated the distortive effect of the PPA on interest coverage ratios by choosing to prepay interest on certain interest rate derivatives in FY09, FY10 and FY11 to largely reverse the effect of the PPA. This is explained in the body of this report - see also Table 12 *Prepayment of Interest vs PPA*.



Source: Fitch calculations from various documents

Appendix 3: BAA Airports Market Investigation by the Competition Commission and a Review of the Economic Regulation of the UK Airport System by the DfT

In April 2007 (as initially announced at the time of the Ferrovial-led consortium bid for BAA in 2006), the Office for Fair Trading (OFT) announced that it had made a reference to the CC for an investigation into the supply of airport services by BAA within the UK. It argues that "features of the market" prevent, restrict or distort competition. The various issues under scrutiny include: BAA's common ownership of two groups of assets (four airports in the South-East (Heathrow, Gatwick, Stansted and Southampton) and the three Scottish airports (Aberdeen, Glasgow and Edinburgh)), government policy and the economic regulatory framework.

At the time of the CC's interim publication, its "emerging thinking", in April 2008 the Department for Transport (DfT) also announced a review of the economic regulation of the UK airport system. Its review is expected to focus on bringing the economic regulation of the UK airport system – one of the oldest in the country – in line with best practices from other regulatory frameworks, and to ensure that it provides the right incentives to deliver necessary investment. The DfT stressed that it will not make changes to the basis on which the current Heathrow, Gatwick and Stansted Q5 price caps are set.

"The CC is inclined to the view that common ownership of the BAA Airports is a feature of the market that adversely affects competition between airports and/or airlines. It is also inclined to the view that shortage of airport capacity, government policy and the regulatory system for airports might also be features that adversely affect competition or exacerbate other features which do so" (Source: Emerging Thinking, April 2008).

If the CC's market investigation were to find an adverse effect on competition, reasonable remedies may require BAA to divest some of its airports, and/or recommendations may be made regarding the regulatory system. Press comment has focused on a potential forced sale of Gatwick, although the CC's report does not indicate that its remedies may require only one of the three South-East Designated Airports be sold.

BAA has stated that criticism in the report is not necessarily levelled at its common ownership, but at the lack of capacity as a result of a complex interplay of political, planning and environmental issues – all of which, it agrees, need examination. Much of the report expects to investigate what interplays have created a shortage of capacity amongst the South-East airports. The CC has cited evidence that BAA seems to have taken a sequential approach to development of its neighbouring airports (T5, then Stansted airport, etc), perhaps due to planning team resource constraints, whereas separate ownership would actively plan and apply resources to compete for such expansion.

It is true that little is going to be solved in the short term by forced divestment, more so, a Gatwick airport with no capacity increases allowed until post-2019. The CC acknowledges that, given capacity-build lead times, constraints in airlines switching airports (costs of switching, runway slot allocations, bilateral agreements), its likely remedies are not going to create capacity immediately but only in the long term. The CC believes that over time passengers will change existing preferences, if the choice was available. Nevertheless, the report's rationale implies that change is worth making now.

It is ironic that much of the criticism is levelled at the past BAA machine which, in Fitch's view, deliberately played the "regulatory game" (labelled "regulatory capture" by the CC) and the "big is beautiful" card too often. Conversely, the new Ferrovial-led team has repeatedly stated that it wants, and has the resources, to

address many of the issues raised in the CC report. Its reply slogan is "We are part of the solution, not the problem".

The CAA comes under some criticism, mainly for its "light touch" approach to economic regulation, but the CC acknowledges the difficulties that it operates within given that BAA has no formal licence. Consequently, CC recommendations on changes in economic regulation by the CAA, as reiterated by the DfT's own review, are most likely. Government also comes under criticism for supporting specific locations and timings for particular (BAA-favoured) projects, perhaps to the detriment of other airports' plans.

One argument expressed in the past, that BAA was a giant investment machine for the South-East, which benefited from holding the three main airports, seems to be questioned as the OFT report states: "We note that companies with large resources other than BAA can and do own and invest in airports … this does not necessitate ownership of adjacent airports."

Concerning timing, the CC is likely to publish provisional findings at end-August 2008 (possibly with more overt remedies then) and complete its report in early-2009 with recommendations to the Secretary of State, probably combined with the DfT's review. Forced airport sales (if BAA has not sold before the ultimatum is delivered) may be given a year's grace. Other changes that require primarily legislation (Airport Act changes, provision of a licence, pledging of security, Administrative Receivership regime) equates to some two to three years before implementation, hence the DfT said that its enquiry will not affect Q5's pricing determination.

Likely Effects Upon This Transaction

At this stage, Fitch does not expect many of the prospective changes in the CC report or the DfT review of the regulatory structure to adversely affect the ratings of this transaction. Fitch believes that the DfT review would update economic airport regulation mechanisms to the best practice of other regulators in water, electricity, rail and gas, rather than introduce a wholesale change in approach or obligations. Many of the licence provisions for ring-fencing are already enshrined in this transaction's documentation. In effect, Q5's capex triggers place an obligation upon BAA to undertake capex, and the QSM abatements place an incentive upon BAA to improve operational performance, whereas the existing absence of a licence does not formally 'oblige' BAA to undertake such requirements.

A forced disposal of an airport is already accounted for in this transaction's mechanisms in that disposal proceeds must be used to de-leverage to levels set in Table 15. Fitch has stated that disposal of one airport is not expected to affect the existing ratings, however, Fitch expects to revisit the ratings of a sole-Heathrow financing, taking into account other sector and regulatory changes that the CC enquiry may recommend for future implementation.

As mentioned elsewhere in this report, under *Security*, the granting of existing security will be an issue if the CC recommends (although there are practical and technical reasons why doing so may be challenging), and the licence requires, a prohibition on granting of security over BAA's operational assets. Equally, the (likely) introduction of a special administrative regime (which typically intervenes if the insolvency of the company or other features make it likely that such an essential public service may be disrupted) is inconsistent with this transaction's security package.

Fitch notes that the CC has voiced its concerns that, relating to BAA's pre-financial closure group structure, a default within BAA will trigger a cross-default across the whole group, across seven UK airports. If the CC went as far as to require each airport to have a separate licence and did not allow cross-default across even two or three airports - not necessarily forcing single ownership of airports but separate

financing - this transaction's mechanisms (and ratings) would not be consistent with that requirement.

The CC document raises other issues such as the potential for airlines to finance terminals (cited in relation to Stansted), and ways to encourage airline and customer switching. Fitch awaits to see if, how, and over what time-horizon, these are developed further.

Appendix 4: Non-Migrated Bonds

For whatever reason, despite the published pre-financial closing proposals and incentives by BAA to migrate all existing unsecured BAA Ltd bonds into the proposed financing structure, bondholders of the uncovenanted bonds (i.e. issued by BAA post 2002) may vote to continue to exist at the BAA Ltd level. These Non-Migrated Bonds will continue to benefit from a guarantee from HAL, GAL and STAL (for the purposes of this description the “NMB Guarantors”, some of whom are also the Security Group’s Borrowers) and to ensure that they have equal and rateable security, the Non-Migrated Bonds will also be beneficiaries of security granted under the financing. Arrangements will be in place to ensure BAA Limited (the retained issuer) has the funds to meet scheduled interest payments on any Non-Migrated Bonds that will rank pari passu with the Class A bonds at the Borrower level.

Existing BAA bonds that have financial covenants (i.e. issued by BAA pre 2002) upon the BAA group are not expected to form a potential batch of Non-Migrated Bonds. The following bonds, which do not have financial covenants, to the extent that their holders do not vote to migrate into the new financing, may become Non-Migrated Bonds:

- GBP400m 5.75% due 2013
- GBP750m 5.125% due 2023
- EUR1,000m 3.875% due 2012
- EUR750m 4.50% due 2014
- EUR750m 4.50% due 2018

Non-Migrated Bond Facility

It is intended that when the Non-Migrated Bonds reach their scheduled maturity, the Borrowers repay outstandings through the capital markets, however as a last resort this can be achieved by drawing down funds under the Non-Migrated Bond Facility or a cash collateral deposit raised from bonds to refinance the Non-Migrated Bonds. Thereafter, these borrowings will not exist at the BAA Ltd level. The Non-Migrated Bond Facility is only available to repay Non-Migrated Bond principal at par and accrued interest (if any – see below). The Non-Migrated Bond Facility remains available during a non-payment related to the Non-Migrated Bonds for so long as there is no default otherwise of the Security Group. The Non-Migrated Bond Facility for example will not remain available following a non-payment within the Security Group or upon enforcement.

It is a covenant that the Non-Migrated Bond Facility’s available commitment to the Borrowers must equal the Non-Migrated Bond Facility outstandings at all times. The banks providing these facilities must have a minimum ‘A-’ rating.

Ranking of the Non-Migrated Bonds in the Proposed Transaction

The Non-Migrated Bonds will benefit from Class A debt ranking in the financing’s priority of payments. The voting arrangements for the holders of the Non-Migrated Bonds, in respect of which the relevant Non-Migrated Bond Trustee signs up to the financing’s STID, will be subject to intercreditor arrangements, which provide that enforcement action against the Security Group can only proceed with senior debt holders (namely Class A-ranking creditors) prescribed majority voting – not a solitary Non-Migrated Bondholder.

Non-Migrated Bondholders retain certain independent rights (i.e. relating to their original bonds’ events of default), which mainly refer to:

- The right to request that the relevant Non-Migrated Bonds be declared due and payable immediately at par if:

- Default is made in the payment of any principal (i.e. the scheduled redemption payment is not made) or interest due on any of Non-Migrated Bonds and such default continues for a period of eight days; or
- If BAA or HAL, GAL or STAL fail to perform or observe any of its other obligations under the Non-Migrated Bonds and such failure continues for a period of 30 days following the service on BAA of notice requiring the same to be remedied; and

- For all of the uncovenanted Non-Migrated Bonds, the right to put their Non-Migrated Bonds to BAA Ltd at par if operating airports cease to be the major part of the business of BAA Ltd and its subsidiaries taken as a whole. And for the 2012, 2018 and 2023 bonds only, there is also a right to put such Non-Migrated Bonds at par if there is a change of control of BAA Ltd linked to a ratings downgrade to speculative grade of the "Bonds or unsecured/unsubordinated debt of BAA". Within this mechanism, other conditions as to timing, rating agency, rating, and an Independent Financial Adviser also exist.

However, if any Non-Migrated Bondholders choose to exercise these independent enforcement rights (an Independent Enforcement Action) upon which the Non-Migrated Bonds are repayable at par, the abovementioned financing's Class A pari passu ranking does not remain in place. Instead, these bondholders rank subordinate to Class A and Class B debt obligations – see Borrower and Issuer Priority of Payments.

Under the financing, an Independent Enforcement Action (which subordinates the Non-Migrated Bond holders' claim) is defined as:

a. In the case of the Non-Migrated Bondholders of any tranche of Non-Migrated Bonds:

   The delivery of any notice from the Non-Migrated Bond Trustee or any Non-Migrated Bondholder to BAA and/or HAL and/or GAL and/or STAL pursuant to which all or any of the Non-Migrated Bonds are declared or become prematurely due and payable or fall to be redeemed prior to their specified maturity date; or

   The taking of formal steps for the commencement of Insolvency Proceedings against BAA, HAL and/or GAL and/or STAL by the Non-Migrated Bond Trustee or any Non-Migrated Bondholder" (Source: BAA Funding Limited Prospectus),

   In each case prior to a Loan Acceleration Notice being delivered, and:

b. In the case of any other Borrower Secured Creditor, any breach of that Secured Creditor's undertakings under the STID.

As detailed below, no "claim" upon the NMB Guarantors is made for payment of interest and/or scheduled principal under the Non-Migrated Bonds' guarantees if BAA Ltd does not pay, thus only the above delivery of any notice, or insolvency proceedings against the entities listed above constitute an Independent Enforcement Action.

If the GBP1.566bn Subordinated Debt lenders have reason to realise their security and assume ownership of the shares of Security Parent, which acts as a holding company for the Security Group of companies, this may well trigger the "at par" puts in the Non-Migrated Bonds. However this depends on the conditions referring to "if operating airports cease to be a major part" of BAA Ltd and, and for the sub-set of the uncovenanted Non-Migrated Bonds which benefits from the change of control put, whether or not the change of control-related put mechanisms have been triggered.

Guarantees from HAL, GAL and STAL (The NMB Guarantors)

The NMB Guarantors guarantee "the due and punctual payment in accordance with the provisions of the [Non-Migrated Bonds] of the principal of, and premium (if any) and interest on, the [Non-Migrated Bonds]….."; and "if the issuer (i.e. BAA Ltd) fails… to pay any principal, premium (if any), interest or other amount…each guarantor shall cause each and every payment to be made as if it instead of the issuer were expressed to be the primary obligor…" (Source: Trust Deed). Thus, if BAA Ltd does not make a payment of interest, the NMB Guarantors are meant to make the payment instead, as if they were BAA Ltd.

Under the financing's Loan Event of Default provisions, non-payment (after relevant grace periods) by a NMB Guarantor in respect of any "Non-ACF [Authorised Credit Facility] Financial Indebtedness" (which includes the Non-Migrated Bonds) with the result that such indebtedness "is capable of being declared….prematurely due…", will constitute a default (Source: BAA Funding Limited, Prospectus). Accordingly, taking into account relevant grace periods (in particular 30 days for the financing), the whole financing is at risk of being in default.

The Security Group's Isolation from the Default of the BAA Bonds

An insolvency of BAA Ltd does not directly affect the ratings of the financing's bonds. However, it is assumed that Borrowers (the NMB Guarantors) have paid principal and interest due under the Non-Migrated Bond guarantees, and the Shared Services Agreement is still in operation.

As noted above, if the Borrowers (NMB Guarantors) have not paid interest and/or principal due under their guarantees, the financing's Loan Events of Default are at risk of being triggered.

Other Features

The quantum of interest expense, debt outstanding and maturity of the Non-Migrated Bonds are included in the Security Group financial ratios, so there is little effect upon the group when these outstandings are (at their maturity or earlier) funded at the Borrower level by the Non-Migrated Bond Facility.

Fitch's Secured Rating of the Non-Migrated Bonds

Given the benefits of the guarantee from the Borrowers, the Class A and priority of payments ranking (assuming no precipitous irrational Independent Enforcement Action by the Non-Migrated Bondholders), but acknowledging that the Borrowers (NMB Guarantors) do not have a liquidity facility for timely payment of interest for these Non-Migrated Bonds (whereas the Issuer's bonds and the Borrowers' GBP4.4bn Refinancing Facility do), Fitch expects to rate the Non-Migrated Bonds (if any exist) 'BBB+'.

To clarify, Fitch does not rate for prepayment of premiums or make-whole payments, as applicable to the Non-Migrated Bonds.

Appendix 5: Comparison of UK Regulated Utilities and their Financings

	Airport	Water	Gas DNs	DNO (electricity distribution)	Rail infrastructure
Fitch's overall ranking of relative risk profile (albeit within a narrow band)	No. 5	No. 2 (after electricity transmission)	No. 4	No. 3	No.5
Operational Characteristics					
Turnover	• Exogenous volume shock (geopolitical, airline, airport) • Diversity of route, pax-type, location, airline needed	• Effect of drought • Collection risk/increased bad debts • Volume-sensitive industrial customer content within turnover • Variability due to metering	• No volume or connections-based drivers reduces seasonality of earnings	• No Volume driver expected for next control period (ie, post-2010)	• No volume drivers • Potential for infrastructure unavailability abatements
Opex - related	• Unionised operational staff • Some cost-share mechanisms for certain increased security costs	• The sector states that many of the efficiency gains have been exhausted, with further efficiencies becoming increasingly difficult. • Recently, some companies have seen any opex efficiency (compared with the regulatory determination's expectations) wiped out by higher-then-expected power costs.	• Ofgem has introduced a mechanism to protect the GDNs from gas market volatility when paying for shrinkage gas. • Explicit re-opener if additional costs (>1% revenue) due to implementation of the Traffic Management Act or tax changes. • Relatively new regime, armed with comparative data, therefore continued opportunities to drive efficiencies.	• Sector view that low-lying fruit within opex efficiency savings are no longer available	• Unionised staff • Efficiencies needed, however these are becoming increasingly difficult given that easy wins have been all but exhausted.
Capex and maintenance-related	• Discretionary, albeit subject to revenue reduction under capex triggers This encompasses 1. Construction risk 2. Large projects 3. Undertaken within operational airports • BAA would argue that few entities can assume the risk of putting all specialised parties together to make an operational end-product.	• Non-discretionary • Although large total amounts, projects tends to be smaller and standardised • Outsourcing has forged business partnering with pain/gain-share mechanisms in order to mitigate cost over-runs and outperformance	• Non-discretionary • High proportion of capex (approx.33%) is non-operational (eg IT, vehicles) • Real input price increases (eg labour) included in new price control (2008-2012) • New incentive mechanism should reduce the risk of future capex overspend.	• Non-discretionary • Risk is weighted towards potential underspending of capex allowances, rather than overspending • Tends to be smaller projects • High-cost projects funded by generators seeking the connection, not the distributor	• Non-discretionary • Only recently been allowed to undertake enhancement projects of significant scale - this implies an increased level of risk given the company's track history.

Comparison of UK Regulated Utilities and their Financings (Continued)

	Airport	Water	Gas DNs	DNO (electricity distribution)	Rail infrastructure
Company-specific issues	• Diversity of routes, pax, airline model and locations	• Exposed to one licensed region and its concentrations	• Exposed to one licensed region and its concentrations	• Exposed to one licensed region and its concentrations	• Diversity of routes, type of line service • Monopoly over UK
Supply and demand	• Pent-up demand • In need of more capacity • BAA's airports are near or at capacity-constrained	• Demand linked to region's household growth • Weather- and infrastructure-dependent supply	• Demand linked to region's household growth and connections • Questions over long-term gas supply	• Demand growth low and stable	• Supply constrained by unavailable passage corridors for new lines or need for substantial re-modelling of network
Economic Regulatory Parameters					
Fitch's view of overall regulatory framework	• To be updated to include best practices, as implemented by other utility regulators • Lack of clear finance ability criteria, ring-fencing, licence for airport operator • Financial penalties for deficient customer service	• Established	• Relatively new, since 2005, although regulatory risk reduced with new price control in place until 2013. • Ofgem DNO-aided	• Only really tightened up since 2005	• Fledgling • Past reviews not benefited from robust financial data • Conducive re-opener mechanisms • Politically charged
Building blocks as % of Revenue [a]					
Revenue	100	100	100	100	100
Opex	55-45	36	59	27	39
Regulatory depreciation	22	28	17	44	30
Return on RAV	22-35	36	24	28	31
Current control period name and quinquennia dates	Q5 1 April 2008 - 31 March 2013	AMP4 1 April 2005 - 31 March 2010	GDPCR 1 April 2008 - 31 March 2013	DPCR4 1 April 2005 - 31 March 2010	CP4 1 April 2003 - 31 March 2008
Latest Vanilla WACC (%)	Mar 2008: 5.0	Headline Dec 04 5.8	4.94	November 2004: 5.5	June 08 Draft 4.70
Notional gearing assumed by regulator (%)	60	55-65	62.5	57.5	n.a.
Implicit target rating	'BBB+'	'A-'/'BBB+'	'BBB+'	'BBB'/'BBB+'	'BBB+'
Special Administrative Receiver regime	Currently No	Yes	Yes	Yes	Yes

[a] Revenue blocks as a percentage of revenue gives a relative idea of the sensitivity of variable opex costs and/or the quantum of fixed remuneration (i.e. Return on RAV plus Regulatory Depreciation). This illustrates that BAA and Gas DNs have a significant opex cost base component relative to their profitability. DNO depreciation at 44% of turnover is massaged by accelerated depreciation

Source: Fitch Ratings

Comparison of Utility Structured Financings' Key Financial Covenants

	BAA Funding Ltd	Welsh (Dwr Cymru) Anglian Southern	Southern Gas Networks Scotland Gas Networks	DNOs: None - tend not to be big enough financings for structured route	Rail infrastructure: None
Fitch equivalent Senior Secured rating	Expected ratings Class A: 'A-' Class B: 'BBB'	Class A: 'A' Class B: 'BBB+'	Senior unsecured: 'BBB+'		
Tranches of debt	Class A & B	Class A & B equivalent	Single tranche		
Current quantum of debt	Around GBP10bn	Welsh: GBP2.5bn Anglian: GBP4.2bn Southern: GBP2.5bn	GBP2.5bn		
Restricted Payment covenants Class A net debt/RAV Class B net debt/RAV	A: 70% B: 85%	A: 75% B: 85% (Welsh: 90%)	77.5% (But not to Ofgem RAV)		
ICR (PMICR Reg Depreciation Equiv) Class A Class B	2% RAB Synthetic: 1.40x Reg Depreciation Equiv: 1.0x 2% RAB Synthetic: 1.20x Reg Depreciation Equiv: 0.8x	A Adj: 1.3x A Avg: 1.4x B Adj: 1.1x B Avg: 1.2x (Welsh: lower)	PMICR: None		
Event of default	Class A only 2% RAB Synthetic: 1.05x Reg Depreciation Equiv: 0.7x Debt/RAV Class A 92.5%	EBITDA ICR: 1.6x Cash maintenance equivalent: 1.0x Debt/RAV A &B: 95%	PMICR: None Debt/RAV: 95%		
Maturity buckets for debt	30% of RAV in any 2 yrs 50% of RAV in any 5 yrs	20% of RAV in any 2 yrs 40% of RAV in any 5 yrs	None		
Liquidity	Class A: 12 months interest only Class B: 6 months interest only	Class A: 12 months interest only Class B: 12 months interest only	None		

Source: Fitch Ratings. In the above table BAA's Regulatory Depreciation Equivalent ratios are not covenants (instead the 2% RAB synthetic is used) but are quoted as comparables with other utility financings which have a PMICR.

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