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Transaction Update: BAA Funding Ltd.

Up To £50 Billion Multicurrency Program For The Issuance Of Asset-Backed Notes

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Table Of Contents

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Ratings Detail

The Issuer						
BAA Funding Ltd.						
Notes	**Ratings to***	**Ratings from**	**Final amount (Mil.)§**	**Interest¶ (%)**	**Expected maturity§**	**Final maturity§**
A1	A-/Negative	A-	£299.93	12.45	March 31, 2016	March 31, 2018
A2	A-/Negative	A-	£249.81	9.2	March 29, 2021	March 29, 2023
A3	A-/Negative	A-	£199.91	7.075	Aug. 4, 2028	Aug. 4, 2030
A4	A-/Negative	A-	£899.97	6.45	Dec. 10, 2031	Dec. 10, 2033
A5	A-/Negative	A-	999.879	3.975	Feb. 15, 2012	Feb. 15, 2014
A6	A-/Negative	A-	£396.37	5.85	Nov. 27, 2013	Nov. 27, 2015
A7	A-/Negative	A-	749.899	4.6	Sep. 30, 2014	Sep. 30, 2016
A8	A-/Negative	A-	749.97	4.6	Feb. 15, 2018	Feb. 15, 2020
A9	A-/Negative	A-	£749.60	5.225	Feb. 15, 2023	Feb. 15, 2025

*Standard & Poor's ratings address timely payment of interest and payment of principal not later than the legal final maturity. ¶The class A notes are subject to a step-up fee from March 2016 (for the class A1 notes), March 2021 (for the class A2 notes), August 2028 (for the class A3 notes), December 2031 (for the class A4 notes), February 2012 (for the class A5 notes), November 2013 (for the class A6 notes), September 2014 (for the class A7 notes), February 2018 (for the class A8 notes), and February 2023 (for the class A9 notes). As part of Standard & Poor's analysis, the step-up fee was modeled fully subordinated to the payments on the class A and B notes and not rated. §Debt totaling no more than 30% of regulatory asset base (RAB) (at issuance) matures during any biennial, or 50% of RAB (at issuance) within any "quinquennium" (a five year period).

Transaction Summary

Standard & Poor's Ratings Services has reviewed its credit ratings on the £50 billion multicurrency program by BAA Funding Ltd. (the issuer), a limited liability company incorporated in Jersey. We have also reviewed our ratings on the tranche A and B refinancing facility lent to Heathrow Airport Ltd. (HAL), Gatwick Airport Ltd. (GAL), and Stansted Airport Ltd. (STAL), all non-bankruptcy-remote operating entities, which together form part of the borrower group.

As a result of this review we have assigned a negative outlook to all classes of notes issued by BAA Funding, following the release of a consultation paper on March 9 by the U.K. Department for Transport (DfT) that, subject to final consultation, is calling for a revamped regulatory framework for the U.K.'s regulated airports.

We also assigned a negative outlook to the tranche A and tranche B refinancing facility lent to Heathrow Airport Ltd., Gatwick Airport Ltd., and Stansted Airport Ltd.

At the same time, all the ratings were affirmed.

The negative outlook reflects our view of the uncertainty arising from the changes proposed in the consultation paper to the insolvency and security regime applicable to certain airport companies which, if enacted and implemented, could lead to a different rating approach and, all other things being equal, to potentially lower ratings on BAA Funding's notes.

The rating affirmations reflect that, based on statements made by the DfT and the provisions made in its consultation paper, we understand that the DfT is aware of existing bondholder security concerns over BAA's regulated airports transitioning to a new regime. We note that the DfT is working with BAA and seeking engagement with key stakeholders, including the Association Of British Insurers (ABI), to manage this issue. We also understand that the process is not likely to conclude in the near future, with final enactment not expected before 2010. However, we could take rating actions in the interim, related to the process and/or to other factors such as asset sales or the poor economic environment.

The credit ratings on the class A bonds and the tranche A and B refinancing facility are based on the assumption that all three airports are included in the transaction at financial closing, and on certain existing security structure and enforcement mechanisms within the BAA Funding transaction that allow for the appointment of an administrative receiver through enforcement of the floating charge granted to the issuer trustee for the benefit of the noteholders.

On March 9, 2009, the DfT put out a consultation paper for a review of the economic regulation of British airports. The main takeaways from the document include, in our view:

- The DfT is seeking views on the relative merits of introducing a special administration regime for certain major airports, including the airports included in BAA Funding.
- A price-setting process more in line with other regulated sectors, which would give the Civil Aviation Authority (CAA, the primary economic regulator of U.K. airports) greater freedom to decide details of the price control, but with the Competition Commission as an appellate body.
- A clearer financial framework, including a duty on the regulator to ensure that airports can finance their licensed activities, complimented by license conditions including financial ring-fencing of the regulated business and an obligation on the licensee to maintain an investment-grade credit rating.

Expected future milestones for the review are as follows:

- Autumn 2009: DfT to issue final decision on new regulatory proposals.
- Second half of 2010: proposed legislation.

The DfT has made clear that current price controls at Heathrow and Gatwick for 2008-2013, and at Stansted for 2009-2014, will not be reopened.

At this stage, we view some of these proposed changes as positive, to the extent that they could provide an incentive to operators to perform properly and maintain sound credit profiles. There are many similarities between the proposals under consideration and the regulatory regime governing the U.K. water and electricity sectors, which suggest that the final regulatory review will not result in a radical departure from existing established regulatory practices within the U.K.

However, changes to the security regime and/or the introduction of a special administration regime may impair our ability to rate, through default/insolvency of the borrower. Our alternative approach would typically be to rate a transaction to default, but the exact rating approach or rating actions would be determined at the time of any restructuring or refinancing, taking into account all relevant factors at that time. It is not possible to say what rating action we will take in the future. However, according to the transaction documentation, the implementation of these changes will require bondholders' and lenders' approval. This could lead to a multi-notch downgrade, reflecting the possibility that debt repayments could be accelerated by the lenders in case they don't, with no funding available to meet such obligations. We also note that "effectiveness of security" is a borrowers' event of default under BAA Funding's current structure.

Outlook

The negative outlook primarily reflects our view of the possibility in the next two years of a material change in the insolvency regime for certain British airports falling under the new regulatory framework, which has not yet been adopted or enacted.

The outlook also reflects our view of the uncertainties related to the ongoing sale of Gatwick airport, and our understanding that the Competition Commission will also require BAA to dispose of Stansted airport. For more details, see "BAA Funding Debt Ratings Affirmed On Request To Sell Gatwick And Stansted Airports," published Dec. 18, 2008, on RatingsDirect.

These developments occur at a time where we believe the aviation and airport industries are being severely affected by the global economic recession. An illustration of this is BAA's London airports recent reported traffic figures, which were down 8.9% in the first two months of 2009: we note, however, that February traffic figures were impacted by exceptional events. We also note that Heathrow has proven more resilient, with a 5.7% traffic decline over the same period. BAA Funding's 2009 budget is based on 120 million passengers at the three London airports, representing a 3% decline over 2008. We expect passenger traffic for the rated European airports to decline on average by 3%-5% in 2009, and to stabilize or rebound modestly in 2010. The degree and timing of the recovery in passenger traffic in general and at BAA's London airports in particular will probably depend, however, on the duration and depth of the current economic slowdown in the global economy, and some airports may, we think, endure falls in traffic in 2010 as well.

Operational And Financial Update

BAA (SP) Limited, which is the holding company in the financing structure for Heathrow, Gatwick, Stansted, and Heathrow Express, recently released its results for the calendar year 2008. Its statutory accounts have been prepared under U.K. GAAP, with Gatwick treated as a continuing operation.

The 16% reported revenue increase to £2.29 billion was primarily driven by aeronautical fee increases, as traffic at BAA's three London airports declined 2.6%, to 123.4 million passengers. Robust retail activity saw net retail income per passenger up 2.9%. Adjusted EBITDA (before exceptional items) was up only 1.3%, to £916 million or 40% of revenues (45.7% in 2007), as operating expenditures were up 28.4% reflecting mainly increasing security costs as well as the cost of operating the new T5 terminal. Cash generated from operations of £831 million (including intercompany receivable held by group entities in accordance with the Shared Services Agreement) partially covered capital investment of approximately £1 billion. The reported £101 million outflow in 2008 reflects interest paid on bond and bank debt and derivatives between August and December 2008, or a 6.52% average cost of debt at year-end, post hedging. A forecast interest outflow for 2009 of £308 million was included in the Dec. 24, 2008 investor report.

We understand BAA (SP) Limited achieved ratios of senior and junior debt to RAB (regulated asset base) of 68% and 76% at Dec. 31, 2008, versus the total indebtedness covenant set at the senior and junior debt level up to 70.0% before April 1, 2018, and 72.5% thereafter; and 85% respectively. Net reported debt was £9.4 billion at year-end 2008, stable over August 2008 when the transaction was financially closed (the figure is the nominal value of debt and excludes intra-group loans and is before index-linked accretion of £42 million).

Liquidity at year-end 2008 was, in our view, satisfactory, with financings in place covering at least 2009 and 2010 funding needs. We note, however, that although none of BAA Funding's refinancing, liquidity, capital expenditures, or revolver facilities contains individual material adverse change (MAC) clauses, they are bound by the terms of the Common Terms Agreement and the Security Trustee and Intercreditor Deed (STID). The latter contains several references to "Material Adverse Effect", the definition of which is as follows. "Material Adverse Effect" means the effect of any event or circumstance which is materially adverse to:

- The business, assets, or financial condition of the security group taken as a whole; or
- Taking into account the resources available to it from other members of the security group, the ability of an obligor to perform its payment obligations under any transaction document; or
- The legality, validity, or enforceability (subject to the reservations) of any transaction documents in a manner which is prejudicial in any material respect to the interests of the borrower secured creditors.

Related Research

This article is based in part on the following criteria articles:

- "Methodology For Rating And Surveilling European Corporate Securitizations" (published on Jan. 23, 2008).
- "Overview Of Legal And Analytical Challenges In Rating U.K. Corporate Securitizations" (published on Jan. 18, 2007).

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