

Transaction Update: BAA Funding Ltd.

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

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Ratings Detail

The Issuer						
BAA Funding Ltd.						
Notes	Current ratings*	Final amount (Mil.)\$	Interest† (%)	Scheduled redemption date\$	Maturity date\$	
A1	A-/Stable	£299.930	12.45	March 31, 2016	March 31, 2018	
A2	A-/Stable	£249.810	9.200	March 29, 2021	March 29, 2023	
A3	A-/Stable	£199.909	7.075	Aug. 4, 2028	Aug. 4, 2030	
A4	A-/Stable	£899.967	6.450	Dec. 10, 2031	Dec. 10, 2033	
A5	A-/Stable	€999.879	3.975	Feb. 15, 2012	Feb. 15, 2014	
A6	A-/Stable	£396.373	5.850	Nov. 27, 2013	Nov. 27, 2015	
A7	A-/Stable	€749.899	4.600	Sept. 30, 2014	Sept. 30, 2016	
A8	A-/Stable	€749.970	4.600	Feb. 15, 2018	Feb. 15, 2020	
A9	A-/Stable	£749.600	5.225	Feb. 15, 2023	Feb. 15, 2025	
A-10	A-/Stable	£700.000	6.750	Dec.3, 2026	Dec.3, 2028	
A-11	A-/Stable	£235.000	Formula that accounts for relevant index-linked UKTi and 3.334%		Dec. 9 2039 Dec. 9 2041	

*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 two-year period, or 50% of RAB (at issuance) within any five-year period.

Borrower Group						
Refinancing facility						
Tranches	Current ratings*	Final amount (Mil. £)	Current amount	Margin† (%)	Final maturity\$	
Heathrow Airport Ltd.						
Tranche A1	NR	150	0.0	1.50	March 31, 2010	
Tranche A2	A-/Stable	250	109.4	1.50	March 31, 2011	
Tranche A3	A-/Stable	750	750.0	1.50	March 31, 2012	
Tranche A4	A-/Stable	1,100	764.6	1.50	March 31, 2013	
Tranche B2	BBB/Stable	250	109.4	2.50	March 31, 2011	
Tranche B3	BBB/Stable	250	250.0	2.50	March 31, 2012	
Tranche B4	BBB/Stable	0.0	300.0	2.50	March 31, 2013	
Stansted Airport Ltd.						
Tranche A2	NR	500	0.0	1.75	March 31, 2011	
Tranche B1	NR	100	0.0	2.25	March 31, 2010	

*Standard & Poor's ratings address timely payment of interest and payment of principal not later than the legal final maturity. †The margins on tranches A and B's refinancing facility vary according to the principal amount outstanding. The cost of this facility decreases as the amount is refinanced. \$Debt totaling no more than 30% of RAB (at issuance) matures during any two-year period, or 50% of RAB (at issuance) within any five-year period.

Transaction Participants	
Borrowers	Heathrow Airport Ltd. and Stansted Airport Ltd.
Co-arrangers	The Royal Bank of Scotland PLC and Citigroup Global Markets Ltd.
Borrowers and issuer cash manager	BAA Airports Ltd.
Borrowers' agent	BAA Airports Ltd.
Paying agent and agent bank	Deutsche Bank AG
Facility agent	The Royal Bank of Scotland PLC
Borrowers and issuer security trustee	Deutsche Trustee Co. Ltd.
Borrower liquidity reserve account trustee	Royal Bank of Scotland PLC
Principal paying agent and agent bank	Deutsche Bank AG
Issuer's initial hedge counterparty	Banco Bilbao Vizcaya Argentaria S.A.; Banco Santander S.A.; Barclays Bank PLC; BNP Paribas; Caja De Ahorros Y Monte De Piedad De Madrid; Calyon; Citibank, N.A. New York, NY, London branch; HSBC Bank PLC; Morgan Stanley & Co. International PLC; and The Royal Bank of Scotland PLC
Borrowers' initial hedge counterparty	Banco Bilbao Vizcaya Argentaria S.A.; Banco Santander S.A.; BNP Paribas; Caja De Ahorros Y Monte; De Piedad De Madrid; Calyon; Citibank, N.A. New York, NY, London branch; HSBC Bank PLC; Morgan Stanley & Co. International PLC; and The Royal Bank of Scotland PLC
Issuer and borrowers liquidity facility providers	Lloyds TSB Bank PLC
Issuer's and borrowers' account bank provider	The Royal Bank of Scotland PLC
Shared services provider	BAA Airports Ltd.

Supporting Ratings	
Institution/role	Ratings
Caja de Ahorros y Monte de Piedad de Madrid as hedge provider	A/Negative/A-1
Banco Bilbao Vizcaya Argentaria S.A. as hedge provider	AA/Negative/A-1+
Barclays Bank PLC as hedge provider	AA/Negative/A-1+
Citibank N.A. New York, NY as hedge provider	A+/Stable/A-1
Banco Santander S.A. as hedge provider	AA/Negative/A-1+
BNP Paribas as hedge provider	AA/Negative/A-1+
Calyon as hedge provider	AA-/Negative/A-1+
HSBC Bank PLC as hedge provider	AA/Negative/A-1+
The Royal Bank of Scotland PLC as hedge provider and bank account provider	A+/Stable/A-1
Morgan Stanley & Co. International PLC as hedge provider	A+/Stable/A-1
Lloyds TSB Bank PLC as liquidity facility provider	A/Negative/A-1

Transaction Key Features	
Closing date	Aug. 18, 2008
Collateral	Security in the form of first fixed and floating charges over the securitized assets that include Heathrow and Stansted airports*, legal mortgages over all real estate, and pledges of shares provided by each entity within the "ringfence."
Country of origination	U.K.
Borrower and issuer combined liquidity facility initial commitment (Mil. £)	600

*The sale of Gatwick airport, previously included in the securitized assets, was completed on Dec. 3, 2009.

Transaction Summary

On Feb. 22, 2010, BAA announced its full-year results for the securitization group and, as a result, Standard & Poor's Ratings Services reviewed its credit ratings on the £50 billion multicurrency program by BAA Funding Ltd. (the issuer), a limited liability company incorporated in Jersey. We also reviewed our ratings on the tranche A and B refinancing facility lent to Heathrow Airport Ltd. (HAL). HAL and Stansted Airport Ltd. (STAL) are all non-bankruptcy-remote operating entities and together form part of the borrower group. Following the completion of the sale of Gatwick airport on Dec. 3, 2009, Gatwick Airport Ltd. (GAL) is no longer part of the transaction and the ratings on the GAL tranches of the refinancing facility have been withdrawn following the repayment of the facility.

As a result of today's review, the ratings on all classes of notes issued by BAA Funding and on all tranches of the refinancing facilities lent to HAL remain unaffected. The outlooks are stable on all ratings. In November 2009, the outlook was revised to stable mainly reflecting the U.K. government's decision not to proceed with proposals to introduce a special administration regime for U.K. regulated airports (including BAA London airports).

The review of the transaction in November 2009 followed the Department for Transport's (DfT) announcement on Oct. 13, 2009, regarding the measures it intends to introduce to strengthen the financial resilience of major U.K. airports and BAA's announcement on Oct. 21, 2009 regarding the sale of Gatwick airport to Global Infrastructure Partners consortium for £1.51 billion.

As expected, the DfT issued its full new regulatory proposals at the end of 2009 (on Dec. 10, 2009). Implementation of the final proposals will require changes in law that we believe are unlikely to occur before mid-2010. We understand that the measures will include:

- A new duty on the Civil Aviation Authority ('CAA') to ensure that airports can finance their licensed activities;
- License conditions to introduce financial ring-fencing;
- An exemption from financial ring-fencing provisions, including those affecting creditor securities, where these would cut across BAA's existing financing arrangements; and
- A requirement that airport operators maintain a minimum level of creditworthiness.

The government has also consulted on proposals to require airport operators to maintain a continuity of service plan and to allow the CAA to switch ring-fencing provisions on or off if circumstances were to change. The outcome of the consultation is due in the coming weeks.

We view the proposed changes positively, primarily because they remove the possibility of special administration and hence a potential restructuring event (see "BAA Funding Ltd. Debt Issues Assigned Negative Outlook On Dept. for Transport Consultation Paper; All Ratings Affirmed" published on March 12, 2009). We also believe the future regulation would give airport operators an incentive to improve performance and retain their investment-grade ratings.

With respect to the successful sale of GAL, we had previously indicated that we believed the sale of Gatwick, or of both Gatwick and Stansted, would weaken the overall business risk profile of the borrower group to "strong" ('A' rating category) from "excellent" ('AA' rating category). Based on the proposed regulatory changes, and considering Standard & Poor's expanded business risk/financial risk matrix (see "Criteria Methodology: Business Risk/Financial

Risk Matrix Expanded" published on May 27, 2009), we now expect the business risk to remain unaffected by asset sales.

We still believe that the Gatwick divestiture has reduced the BAA Funding's portfolio diversification, and could lead to increased competition in the medium term. In addition, Heathrow has the most considerable capital program among the three airports. Heathrow has also so far been the most resilient of the three London regulated airports, with 1.5% traffic reduction in 2009 compared with the same period of 2008, versus 10.7% at Stansted. Over the same period, Heathrow has outperformed its main European peers and we would expect Heathrow to retain its dominant European hub position for the foreseeable future.

The net proceeds from the Gatwick sale were about £1.20 billion after transaction derivative-related costs and payments into the defined-benefit pension scheme; the gross price was announced as £1.51 billion. As the refinancing facilities are still outstanding, all disposal proceeds were applied to: (i) pay debt maturing in the next six months, (ii) make sure that at least 12 months' funds are available for capex (or 18 months after 50% of the drawn amount at closing has been repaid), and (iii) pay the refinancing facility.

Ratings remain unchanged following BAA group's announcement of a £500 million equity injection on Nov. 12, 2009. The injection consists of about £130 million of new equity from shareholders and about £370 million from BAA Airports Ltd. and FGP Topco Ltd., the ultimate holding company of BAA group. We believe this equity injection will marginally strengthen the borrowing group's liquidity position and its headroom under its financing structure covenants, and also partially offset the impact of the expected weaker recovery in passenger traffic compared with our original expectations. We do not think that the potential benefits of this injection affect the structure enough to alter the rating or outlook. In our view, however, the injection indicates that BAA group's financial policy is conservative and that it has support from its shareholders.

In December 2009, BAA Funding issued the class A-10 and A-11 notes for a total amount of £935 million. The proceeds from issuing these notes and the sale of Gatwick were used to partly repay the refinancing facility. At year-end 2009, the total amount of the refinancing facility outstanding was only £2,283.4 million lent to HAL, versus £4.4 billion at closing. Combined with the application of net proceeds of the Gatwick sale, this means that the borrower group has limited debt maturities in the next 24 months (to March 31, 2012).

Surveillance Analysis

In March 2009, we assigned a negative outlook to reflect the possibility that changes to the administration regime, if carried on the basis of the consultation paper DfT had put out on March 9, 2009, could lead to a different rating approach. This could have led us to lowering the ratings. The negative outlook also reflected:

- The uncertainties related to the ongoing sale of Gatwick airport and the liquidity situation following the March 2010 repayment; and
- The uncertainty regarding the degree and timing of the recovery in passenger traffic and in financial performance.

In November, we affirmed the ratings on all classes of notes and all tranches of the refinancing facilities and assigned stable outlooks, reflecting the development on the regulatory side, the sale of Gatwick, and the impact of these events on our view of the underlying business risk profile of the securitized group.

The stable outlook reflects our view that, although recent decline in passenger traffic remains a concern, we believe

that the downturn in passenger traffic has started to revert in the course of 2009. Full recovery in passenger traffic is, however, expected to take longer than we initially expected and longer than observed in previous similar downturns. As a result, aviation and airport industries have revised down their volume expectations for 2010 and beyond.

As a result, we expect BAA Funding to fall short of the EBITDA and cash flow assumptions used for regulatory settlement, as well as those prevailing at financial closing in August 2008. However, we believe the financial projections remain commensurate with the ratings. The degree and timing of the recovery in passenger traffic and in financial performance will be a key determinant of the future evolution of the ratings. We will continue to look closely at the ability of the borrower group to maintain strong liquidity and cover future funding needs.

As a result of our analysis, in November, we affirmed the business risk score to excellent. This is now considered independent from any further asset sale. Our business risk score is mainly driven by the competitive position of Heathrow as one of the biggest hubs in the world by both traffic and retail revenue. Revenues have proved relatively resilient in the midst of a major period of stress. Heathrow also demonstrates high and increasing EBITDA margin and solid, tested and improving regulation.

In 2009, BAA increased its EBITDA (before exceptional items) by 17.1%, well above the rate of revenue growth (up 8.3%). We expect it to maintain this for the rest of the regulatory period because the cost base is expected to be much more stable while revenues are expected to grow. We expect expenses to remain under control as BAA maintains its grip on operating expenses, undertakes further cost cutting initiatives (externalization of IT, improved contractual terms with London Heathrow car parking suppliers, etc.) and improves operations. Revenues are likely to continue rising as a result of recovery in traffic volumes and continuous fee increases as agreed under the five-year regulatory settlements for HAL and STAL. The 2009 EBITDA of £885.2 million was consistent with the guidance given in the December 2008 investor report (£895 million), despite actual traffic falling short of expectations.

We have also revised our sensitivities analysis to better capture the downside in passenger traffic and to enable us to assess the resilience of the proposed financial structure. As a result, the ratings continue to reflect the assets' underlying business risk and the structural enhancements aimed at mitigating financial and other risks.

In particular, these enhancements include:

- Liquidity facilities provided by a suitably rated counterparty (Lloyds TSB Bank PLC; A+/Stable/A-1). The issuer can access amounts equal to 12 months' class A notes interest, the senior expenses, and six months' class B notes interest; the borrowing group can access amounts equal to the tranche A interest (that includes hedges, the European Investment Bank loan and the refinancing facility), the senior expenses, and tranche B refinancing facility interest. The liquidity facilities remain undrawn, and the amount available to be drawn is unchanged;
- An adequate hedging structure provided by appropriately rated counterparties, which allows the issuer to cover its interest rate, inflation rate, and currency exposure; the borrowing group may enter into currency swap agreements to hedge nonsterling revenues in the normal course of business; and
- A package of dividend restriction and financial covenants to moderate the cash that can be paid outside the securitized group.

Operating liquidity

Liquidity at Dec. 31, 2009, was, in our view, strong. We understand that the borrower group had cash and cash equivalents of £238.5 million, excluding £143.0 million in restricted cash held in escrow from the Gatwick disposal

to meet potential pension commutation payments and about £2.05 billion of undrawn capex and revolver committed and long-term credit facilities, which should allow the group to cover its negative free cash flow forecast of about £0.5 to £0.6 billion in 2010. This does not include the borrower and issuer liquidity facilities (total £600 million at year-end 2009), which can only be drawn in certain circumstances to fund interest payments to secured creditors.

We believe the liquidity situation has improved following the sale of Gatwick, which completed on Dec. 3, 2009, and the recent £935 million of fresh bond issuance:

- The March 2010 £1 billion coming and most of the March 2011 £1 billion due of the refinancing facility were redeemed in advance through the cash net proceeds, in line with the structure's documentation.
- This will leave capital expenditure and revolver facilities largely untouched and available to meet future business needs.

We note, however, that although none of the refinancing, liquidity, capital expenditures, or revolver facilities at borrowing-group level 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;
- 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.

Updated Strengths, Concerns, And Mitigating Factors

Strengths

- BAA has strong competitive position as the dominant U.K. airport operator and the key hub in Europe.
- We expect continued supportive regulatory environment and government policies.
- The passenger traffic activity has proven to be relatively resilient at Heathrow, especially in a European context.
- About half of revenues are regulated and subject to a five-year price-cap mechanism, which supports visibility on future revenues.
- The borrower group is ring-fenced from the ultimate parent, BAA, and from the ultimate owners.
- Financial forecasts continue to sustain stress-testing.
- The recent DfT announcement and its proposed changes primarily remove the possibility of special administration and hence a potential restructuring event for BAA Funding.

Concerns

- In our opinion, the capital structure is considered to be aggressive, with class A and B debt-to-RAB likely to average close to 83% over most of the life of the transaction, resulting in weak credit ratios. However, the company has indicated it will keep a buffer on the 85% debt-to-RAB trigger.
- There is negative free cash flow due to a lumpy capital plan for the foreseeable future, and a consequent need to access the debt markets for additional financing.

- There is a significant and recurrent refinancing risk.
- Under the structure, BAA has limited incentive to aim for debt-protection measures that are materially better than covenant levels, and cash is expected to be returned to shareholders to the maximum extent possible.
- No obligor may make any restricted payments except, subject to compliance with the restricted payment condition, payments of interest or scheduled principal under or in respect of the subordinated facility agreement outside the BAA Funding ring-fence (£1.56 billion outstanding at year-end 2009 and coming due in April 2011), even if the principal amount outstanding under the refinancing facility agreement exceeds £1.3 billion.
- The borrower covenants are more flexible than has traditionally been seen in corporate securitization transactions in the U.K., where ratings rely on the appointment of an administrative receiver if the borrower group becomes insolvent.
- The lenders to the security group may include several different lenders in addition to the capital markets debt. At closing, the noncapital market debt included a capex facility, a working capital facility, an EIB facility, and refinancing facilities. The coexistence of bank debt and capital market issuance presents additional risks compared with other corporate securitizations because, for example, an appointment of an administrative receiver over the borrower group might be challenged. It also causes an increase in tax risks above those generally seen in corporate securitization transactions with a limited-purpose entity and no third-party debt
- Tax amounts in relation to group relief are provided by BAA's self-certification. We understand that these amounts will be self-certified.
- Under the share service agreement (SSA), there is a potential risk on transfer pricing taxes being payable by the borrower group, the amount of which is difficult to quantify.

Mitigating factors

A strong covenant package to protect secured debt holders, including limitations on additional debt and business activities, such as a rating confirmation requirement for acquisitions above certain thresholds (the latter creating certainty that the revenue profile will not change dramatically), a post-enforcement cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on upstream distributions outside the ring-fence.

The overall debt profile has certain maturity limitations.

No payments permitted to shareholders until the refinancing facility has been repaid down to £1.3 billion. Payments to service the subordinated debt will continue to be permitted subject to compliance with the restricted payments test of the securitization. This is an incentive for shareholders to refinance the refinancing facility as soon as possible.

The additional indebtedness levels are 72.5% for the class A debt (including any additional authorized credit facilities of the borrower group ranking pari passu with class A) and 85.0% for the class B debt (including any additional authorized credit facilities of the borrower group ranking pari passu with class B) increasing to 90.0% once the refinancing facility is fully refinanced.

Two levels of financial covenants (distribution lock-up/trigger events, and events of default) provide creditors with significant control over the borrower group at the earliest stage of financial and/or operational difficulty, or of material changes in business circumstances. These covenants are aimed at preventing administration and minimize the borrower probability of default, which creates an additional credit cushion.

Liquidity facilities cover 12 months of senior interest and six months of junior interest.

Capital expenditures and revolver facilities are designed to cover about 40% of the capital plan at the beginning of each regulatory period (with £2.7 billion capital expenditure and £50 million revolver facilities at year-end 2009). Until the end of the current regulatory period, this ratio is close to 60%.

Secured lenders to the borrower group acceded to a common terms agreement and a security trust intercreditor deed that pool security and seek to regulate enforcement.

Although there is no absolute limit on development, significantly increased asset development expenditures would probably result in the borrower operating under increasingly tighter loan covenants.

There is a tax deed of covenant that seeks to mitigate risks on secondary tax liabilities.

The self certification for group tax relief by BAA is limited to up to 0.5% of total RAB. Any amount in excess of this limit will be certified by an independent advisor.

The risk of transfer pricing taxes being payable under the SSA has been mitigated by the fact that, firstly, the regulator has historically accepted the mark-up applied to the borrower group by BAA and, secondly, BAA has operated this practice since privatization and HM Revenue & Customs has never challenged the basis, which should mean that HM Revenue & Customs is less likely to challenge this position now.

The transaction opinions confirmed that the transaction benefits from a capital markets exemption and, notwithstanding the inclusion of bank debt in the transaction, an administrative receiver could be validly appointed in the event of the enforcement of loan security for the companies included in the borrower group.

Updated Business Profile: Excellent, Even After Sale Of Gatwick And/Or Potential Sale Of Stansted

We consider that BAA's business profile remains "excellent" (commensurate with the 'AA' category). In our opinion, the business profile could remain stable if BAA were to sell Stansted, with Heathrow remaining the only securitized asset in the transaction.

Our view reflects the fact that BAA would retain the best of the three London airports included in the transaction. Heathrow benefits from an unrivalled competitive position as the biggest hub in the world. It will continue to attract high traffic levels and has demonstrated traffic and retail revenue resilience in the midst of a major period of stress. Heathrow also benefits from a strong catchment area with good public transportation.

Elements supporting the business risk profile include:

- London being a major business and tourist destination;
- Heathrow being the key U.K. hub operations for the three global airline alliances;
- A solid, tested, and improving regulation;
- A solid management team with a track record of operational improvement after a difficult start and cost cutting plan, and
- High and increasing EBITDA margin.

The BAA group is the largest airport operator in the world, handling around 85.9 million passengers at Heathrow and Stansted, a level marginally higher than that of Aéroports de Paris (83 million passengers in 2009) which

operates Paris-Charles de Gaulle (CDG) and Paris-Orly (dedicated to regular short-to-medium haul, low-cost, and charter flights).

The BAA group continues to benefit from good traffic growth prospects and from the ownership and operation of a portfolio of two of the three key London airports, catering for a diverse mix of airlines, traffic, destinations, and passengers; and from generally supportive regulation and government policies. In addition, the key strategic position of its main asset, Heathrow, as a hub airport, supports the BAA group's competitive position.

As an operating business, the BAA group will continue to face challenges, including the execution of a lumpy capital expenditure program; in our opinion, this is likely to result in negative free cash flow generation, and therefore rising absolute level of debt over the next 10 years. We therefore need to rely on the management of the BAA group to perform to maintain its excellent business risk profile. The successful execution of the capital expenditure program at Heathrow is a key challenge, as will be managing the competitive position as the aviation market changes now that Gatwick has been sold; other medium- to long-term competitive threats stem from other airports pursuing an expansion and hub strategy in Europe or in the Middle East.

Competitive position: potentially rising pressure upon sale of Gatwick

The strengthening transfer contribution to Heathrow traffic (2009: 37.4%; 2008: 35.9%) and above-average traffic performance at Heathrow illustrate its hub status and contributes to its competitive position as largest European and third global airport. In times of stress, airlines retrench from the regional and second-tier operators and preserve their operations in key hubs. This is due to the value of slots and to retain a critical mass, which is the rationale of hubs' operations. Hubs offer high number of routes, optimize aircraft turnaround and occupancy, and typically maximize airlines' yields.

We do not see the change of ownership of Gatwick (and possibly in the future, of Stansted) as a material threat to BAA Funding's competitive position. If BAA Funding retains Stansted, it may be marginally affected as Gatwick and Stansted are, in our opinion, direct competitors and operate on a comparable fee basis, while public transportation and catchment area are better for Gatwick. If BAA Funding sells Stansted, we believe that Gatwick and Stansted will not compete with Heathrow because:

- Heathrow is a hub airport, while Gatwick and Stansted are point-to-point airports
- These airport types are very different: i) they serve airlines with fundamentally different business models; and ii) they serve different markets.

We also believe that the disposal of Gatwick and potentially of Stansted will not dramatically change the competitive landscape in the short-to-medium term. Reasons for our belief include:

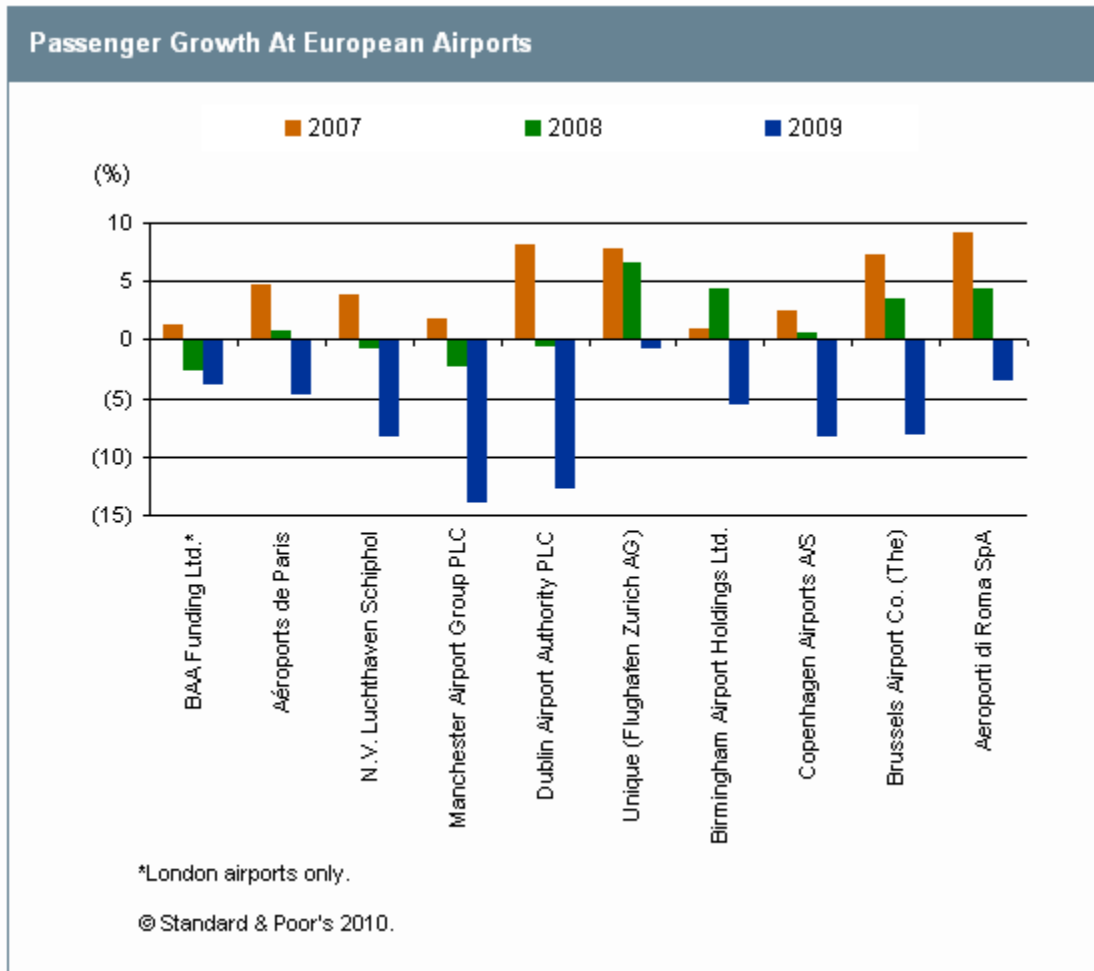
- In our opinion, airlines generally obtain higher yields in hub airports such as Heathrow;
- The Open Skies agreement (which has allowed airlines to fly from anywhere within the 27 member states of the EU to any point in the U.S. and vice versa since the end of March 2008) has confirmed airlines' preference for long-haul services at Heathrow; and
- Airlines rarely move from Heathrow to Stansted, despite Stansted's spare capacity.

In addition, we note that Gatwick is evolving away from Heathrow's strongest markets. Airlines operating through Heathrow also gain mutual benefits from transfer traffic.

BAA's Heathrow competes mainly with Europe's other major international hub airports for connecting passengers

only, most notably Frankfurt, Amsterdam Airport Schiphol, and CDG (see chart 1). Capacity constraints at Heathrow have somewhat affected its competitive position. In addition, the number of destinations served by Heathrow lags behind that of CDG, Frankfurt, and Schiphol. BAA, however, has higher frequency service to major destinations, which is an important factor for both travelers and airlines because it gives a choice of connections. In addition, Heathrow is less exposed than its peers to competition for transfer passengers.

Chart 1



Heathrow delivered the most resilient performance of the major European airports, with passenger numbers declining only 1.5% to 65.9 million (2008: 66.9 million) against an average decline of 5.6% amongst the next four largest airports in Europe. Heathrow benefited particularly from its position as a major global hub airport for long-haul traffic, which has been the best performing segment of the aviation industry in 2009. Traffic with markets such as India and the Middle East grew strongly, at 10.0% and 10.4%, respectively. As a result, 52.9% (2008: 52.2%) of Heathrow's traffic is now on long-haul routes.

Generally, the impact, if any, of the EU-U.S. Open Skies Agreement (in place since March 2008) has been hardly noticeable, although it may have benefited some hub airports. That said, we believe Heathrow benefited from the relocation of some transatlantic flights from Gatwick airport. Generally, the positive impact could increase, if and

when market demand returns.

Aeronautical activity: good resilience overall with positive trend since summer at Heathrow

The reduction in passenger traffic in 2009 relative to 2008 reflects a difficult macroeconomic environment, but the rate of decline has moderated as the year has progressed. It was 8.3% in the first quarter, 4.8% in the second, 2.0% in the third, and 0.5% in the last quarter. This represents a 3.8% drop in 2009.

At Heathrow, traffic performance improved in the course of the year and turned positive from July 2009 with a year-on-year growth of 0.3% and 1.1% in the third and fourth quarter, respectively. The rate of decline in first-half 2009 and gradual recovery since July in passenger numbers across the BAA group's airports has been driven by non-North Atlantic long-haul routes, as well as partly by European scheduled traffic. Compared to major European airports, Heathrow posted the most resilient performance as the average decline in passenger traffic in Europe's biggest airports was around 5.6%. For instance, CDG and Schiphol were down 4.9% and 8.1%, respectively, in 2009.

BAA management forecasts passenger traffic of 86.8 million for 2010, an increase of 1%. This is in line with Standard & Poor's outlook for European airports: we expect that the sector will post almost no growth in 2010, with most airports' traffic evolution ranging between negative 2% and 2%.

Recent performance has also been characterized by significantly higher capacity utilization, with the number of passengers per air transport movement up in the third and fourth quarters compared to 2008 (see table). This suggests underlying demand resilience in both leisure and business markets.

BAA Funding Ltd. Traffic Summary

Terminal passengers (Mil.)	Year to Dec. 31, 2009	Year to Dec. 31, 2008	Year to Dec. 31, 2007
Heathrow	65.9	66.9	67.9
Stansted	20.0	22.3	23.8

BAA's London U.K. airports handled a total of 6.0 million passengers in January 2010. Poor weather in January adversely affected passenger numbers: At Heathrow there was a drop of 0.5% in passenger numbers compared to last January and at Stansted the drop was 5.6%. The figures also reveal an encouraging improvement in the overall trend, once the disruption has been taken into account: without the bad weather causing the loss of around 145,000 passengers at Heathrow, traffic would have grown by an estimated 2.5%.

In February 2010, Heathrow passenger traffic was 4.6 million, an increase of 5.3% from February 2009, when traffic was disrupted by adverse weather. Adjusting for that, the increase is estimated at 2.7%. For January and February combined, Heathrow traffic was 9.43 million, up 2.3% from 2009. At Stansted, traffic in February was 1.24 million, down 4.5% from 2009. January and February combined show traffic of 2.45 million, down 5.0% from 2009. The two airports combined reported traffic is up 0.7% for first two months of 2010, compared with 2009.

Cargo traffic continued the recovery first seen in October 2009, rising in January 2010 by a robust 14.7%.

Regulation

On Feb. 25, 2010, the U.K.'s Competition Appeal Tribunal rejected an application from the Competition Commission to appeal against a December decision that halted more sales following the disposal of London Gatwick and instead ordered the commission to reconsider its original ruling against BAA. However, the

Competition Commission said in reaction that it would continue its fight to force the operator to go ahead with more sales. We do not expect any definitive decision by the U.K. competition authorities on whether BAA has to sell more airports (of which only the sale of Stansted would affect the BAA Funding transaction) until the end of 2011. BAA's management reiterated its desire that, in the worst-case scenario, the group would control the timing of the required sale.

Operations: Improved Operational Standards

The company has made substantial progress in improving and delivering consistent high service, beyond the regulator's request, which:

- Drives more revenues;
- Drives cost efficiencies; and
- Improves competitive position.

Operational performance improved significantly in 2009. At Heathrow, the proportion of aircraft departing within 15 minutes of schedule increased to 77% (2008: 69%) and at Stansted it increased to 82% (2008: 79%). This was despite the significant impact on performance during December from adverse winter weather across much of the northern hemisphere and new security requirements implemented on flights to the U.S. following the Delta Air Lines terrorist incident on Dec. 25, 2009.

Other key operational and service standards improved. At Heathrow, the proportion of baggage not accompanying passengers on their journeys almost halved, while 97.9% of passengers (2008: 95.5%) passed through security in less than five minutes. These improvements in service standards are reflected in recent results in the independent Airport Service Quality surveys produced by Airports Council International. Heathrow has improved its ranking amongst the five largest airports in Europe over the last two years and now ranks second.

The ongoing improvements in service standards at Heathrow are also illustrated by performance under their service quality rebate schemes. In 2009, £3.3 million in service quality rebates were incurred at Heathrow (£7.2 million in 2008). At Stansted, £0.5 million in service quality rebates have been incurred since the scheme was introduced on April 1, 2009.

Capital investment plan

BAA has a lumpy capex plan ahead of it, almost exclusively at HAL.

An updated capital investment plan for Heathrow for the five-year period to March 31, 2013, was published in the Nov. 20, 2009, base prospectus. This amounts to £4.8 billion (at 2008/2009 prices) over the five-year period, consistent on an inflation-adjusted basis with the £4.5 billion (in 2007/2008 prices) contained in the CAA settlement for this period.

The overall program spend remains in line with that published in May 2009, but over £250 million of spending has been deferred from the current regulatory year, mainly into the year ending March 31, 2012. There are also changes to the balance of spending in the main project groupings. These are evident from comparing the spending profiles in the May 2009 capital investment plan document with that in the Nov. 20, 2009, base prospectus.

The main investment over this period will be the construction of the new Terminal 2, which will provide facilities of

equivalent standard to Terminal 5 and is expected to become operational from early 2014. In addition, significant sums are being invested in developing what will be the largest integrated baggage handling system in the world.

Over the five years to March 31, 2014, Stansted's capital plan is forecast at £135 million (in 2009/2010 prices), comprising £92 million on existing facilities (primarily upgrading the baggage system and construction of additional aircraft stands), as the CAA-delayed decision on Stansted's Terminal 2 and £43 million on activities related to the potential development of a second runway.

The management forecasts 2010 capex at about £1 billion.

In 2009, the main focus of the group's investment program continued to be at Heathrow. The group invested £1,002.8 million in capital expenditure (2008: £1,031.7 million) with £817.8 million at Heathrow, £127.1 million at Gatwick, and £57.9 million at Stansted. The major projects at Heathrow included construction of a tunnel between Terminals 3 and 5 for an integrated baggage system. Work also continued on constructing Terminal 5C, the second satellite for Terminal 5, while the first phase of Terminal 2B, the satellite building for the new Terminal 2 was completed and became operational. There were various other projects across the rest of the Heathrow campus, such as the Terminal 4 refurbishment and improvement of check-in capacity associated with airline relocations.

Stansted's capital expenditure comprised £35.1 million on modernizing existing infrastructure and £22.8 million under blight compensation schemes related to the proposed development of a second runway.

Heathrow's third runway

On Jan. 15, 2009, the Secretary of State for Transport confirmed the U.K. government's support for the addition of a third runway at Heathrow with additional terminal facilities. It is expected that this will allow maximum air transport movements to increase from 480,000 to 605,000 by around 2020, subject to achieving noise and air quality standards.

BAA said it will not submit a planning application before the general election and will not sign contracts to "bounce" a future Conservative government into accepting it.

Profitability

BAA is currently underperforming with respect to the CAA operating expenses forecasts; some of the challenges that the CAA factored in its settlement were probably difficult to achieve at the beginning. BAA was confident that over time it could deliver more-significant savings and do better on other areas (such as the retail or the commercial revenue side): so while BAA couldn't be sure it will mimic the CAA operating revenue or expenditures assumptions year by year, the group is targeting the net present value throughout the five-year period.

Full-year 2009 results for BAA (SP) Ltd.--which is the holding company in the financing structure for Heathrow Airport Ltd., Gatwick Airport Ltd., Stansted Airport Ltd., and Heathrow Express Opco Ltd.--demonstrated the resilience of the business.

In its December 2009 investor report, BAA's management forecasts annual revenue of £2,087 million and adjusted EBITDA of £956 million for the year to Dec. 31, 2010, reflecting the following key operational assumptions:

- Passenger traffic of 86.8 million;
- Aeronautical income per passenger: up by 4% at Heathrow and down by 1% at Stansted; net retail income per

passenger: up by 8%; and

- Operating costs (excluding depreciation and exceptional items) up 3% but down 1% once adjusted for central costs being allocated across a smaller business base following the Gatwick sale and increased rates of pension accruals.

In 2009, BAA increased its EBITDA (before exceptional items) by 17.1%, well above the rate of growth in the revenues (up 8.3%). We expect it to maintain this for the rest of the regulatory period because the cost base is expected to be much more stable while revenues are expected to grow. One is the tariff increase. We expect expenses to remain under control as BAA maintains its grip on operating expenses, undertakes further cost cutting initiatives (externalization of IT, improved contractual terms with London Heathrow car parking suppliers, etc.) and improves operations. The 2009 EBITDA of £885.2 million was consistent with the December 2008 investor report, despite actual traffic being weaker than expected.

Revenues from continuing operations--i.e., excluding Gatwick--rose 8.3% to £1.98 billion in 2009. (On a like-for-like basis, turnover increased 5.3% to £1,929.9 million). The 8.3% increase is due to a robust growth in aeronautical income (up 11.5% year-on-year, primarily driven by aeronautical fee increases, as traffic at BAA's two London airports declined 3.8%) and higher net retail income per passenger (up 6.1% year-on-year, a strong performance when considering the economic environment). High retail income is due to a very strong performance by Heathrow, which reaped the benefits of the new Terminal 5 and a pickup in intraterminal transfer passengers, as well as airside and landside shops across all the group's airports. In 2009, Heathrow generated its highest level of retail income since intra-EU duty-free shopping was abolished in 1999. Stansted's retail income declined 3.1%, a resilient performance given passenger trends.

At both Heathrow and Stansted, the strength of in-terminal retail activities was partially offset by lower car parking income due to economic conditions encouraging passengers to use alternative transport to travel to and from the airports, an increase in lower-yielding advance car park booking and, in the case of Heathrow, increased transfer passengers

EBITDA improvement also stemmed from a moderate increase in the group's operating costs (3.9%) below the rate of its turnover growth: this was driven by lower employment costs (fewer senior managers) and lower general expenses (marketing costs). In 2009, EBITDA margin stood at 40.5% versus 37.2% a year earlier. Heathrow contributed 88.4% (84.5% in previous comparable period) of EBITDA and generated 76.75% (75% in previous comparable period) of passengers.

However BAA's performance was severely affected by noncash charges, which amounted to £665.4 million. The group therefore posted a net loss of £684 million against a net loss of £201 million in 2008. The main causes were:

- £277.3 million net loss on the disposal of Gatwick airport stemming mainly from a £225 million impairment charge;
- £217.8 million non-cash charge relating to increased pension scheme deficits;
- A fair-value loss of £117.4 million on financial instruments; and
- £54.6 million of accelerated depreciation on Heathrow Terminals 1 and 2.

Updated Financial Profile: Aggressive Due To High Debt, Weak Credit Ratios, Negative Cash Flow And Significant, Although Reduced, Refinancing Risk

The BAA group's financial profile under the corporate securitization remains aggressive, reflecting the high degree of leverage within the BAA group. It is characterized by low interest coverage ratios. However, the BAA group performs relatively robustly against sensitivities over many of the key variables, such as traffic volumes, capital expenditure execution, and operating costs.

Please refer to the August 2008 new issue report for long-term projections and sensitivities made at the time of the financial closing.

Credit And Cash Flow Evaluation

As of Dec. 31, 2009, the group's reported net debt amounted to £8.6 billion (down 9% year on year). This was primarily driven by i) the sale of Gatwick, whose net proceeds were applied to debt redemption of about £1.2 billion; ii) the equity injection of £282.6 million; and iii) cash flow from operations of £972.6 million.

At Dec. 31, 2009, the group's senior and junior gearing ratios (nominal net debt to RAB) were 0.674x and 0.731x, compared with trigger levels of 0.70x and 0.85x. They had improved over 2008 (0.68x and 0.76x, respectively). Further, the group has the flexibility to manage the senior gearing ratio utilizing the currently undrawn junior debt tranche of the capital expenditure facility up to the lower of £400 million and the level of senior debt drawings.

In the year ended Dec. 31, 2009, the group's senior and junior interest cover ratios (the ratio of cash flow from operations, less tax paid and 2% of RAB to interest paid) were 1.620x and 1.483x compared with trigger levels of 1.40x and 1.20x.

Reported funds from operations fell to £325 million from £768 million a year earlier on the back of higher net interest (£512.9 million versus £100.8 million in 2008). Capex came in at around £1 billion, leading to massive negative free cash flow after interest paid and capital spending. Net interest paid in the year ended Dec. 31, 2009, was £512.9 million (2008: £100.8 million). This consisted of £383.3 million paid primarily in relation to external debt and £129.6 million under the debenture between BAA (SP) and BAA (SH) Ltd. We treat this latter interest as dividend as it is subject to compliance with the restricted payment condition: in case of underperformance and breach of this condition, the interest on the debenture will no longer be paid without leading to the default of BAA Funding.

Total net interest paid for the year ended Dec. 31, 2009, used for calculating interest cover ratios under the group's financing agreements, was £497.5 million, while senior net interest paid was £455.5 million. The variance between £497.5 million and the £512.9 million in the cash flow statement is due to the exclusion of £129.6 million of interest paid on the debenture between BAA (SP) and BAA (SH) and the inclusion of £114.2 million in derivative interest prepayment included in financing flows in the statutory cash flow statement. As a result, BAA Funding achieved senior ICR of 1.62x and junior ICR of 1.483x for the year ended Dec. 31, 2009, well above trigger levels of 1.4x and 1.2x, respectively.

As part of the GAL disposal, the refinancing facility portion of Gatwick has been moved or novated from GAL to Heathrow. Net proceeds from the sale of Gatwick airport, together with the proceeds of the two bonds issued in

December 2009 have been used to prepay amounts due under the refinancing facility in accordance with its terms. The £1 billion due to be paid in March 2010 has been prepaid in full. In addition, approximately £781 million of the £1 billion due to be paid in March 2011 and £335 million of the £1.4 billion due to be paid in March 2013 have been prepaid.

The refinancing facility is now backed in full by the two regulated airports. For accounting purposes, the debt was allocated by airport, but the whole debt is securitized by the whole assets.

The group returned to the debt capital markets in late 2009 for the first time since 2006, completing two bond issues that generated proceeds of approximately £925 million. This has resulted in nominal debt outstanding under bond issues at Dec. 31, 2009, of £5,434.3 million (2008: £4,498.9 million).

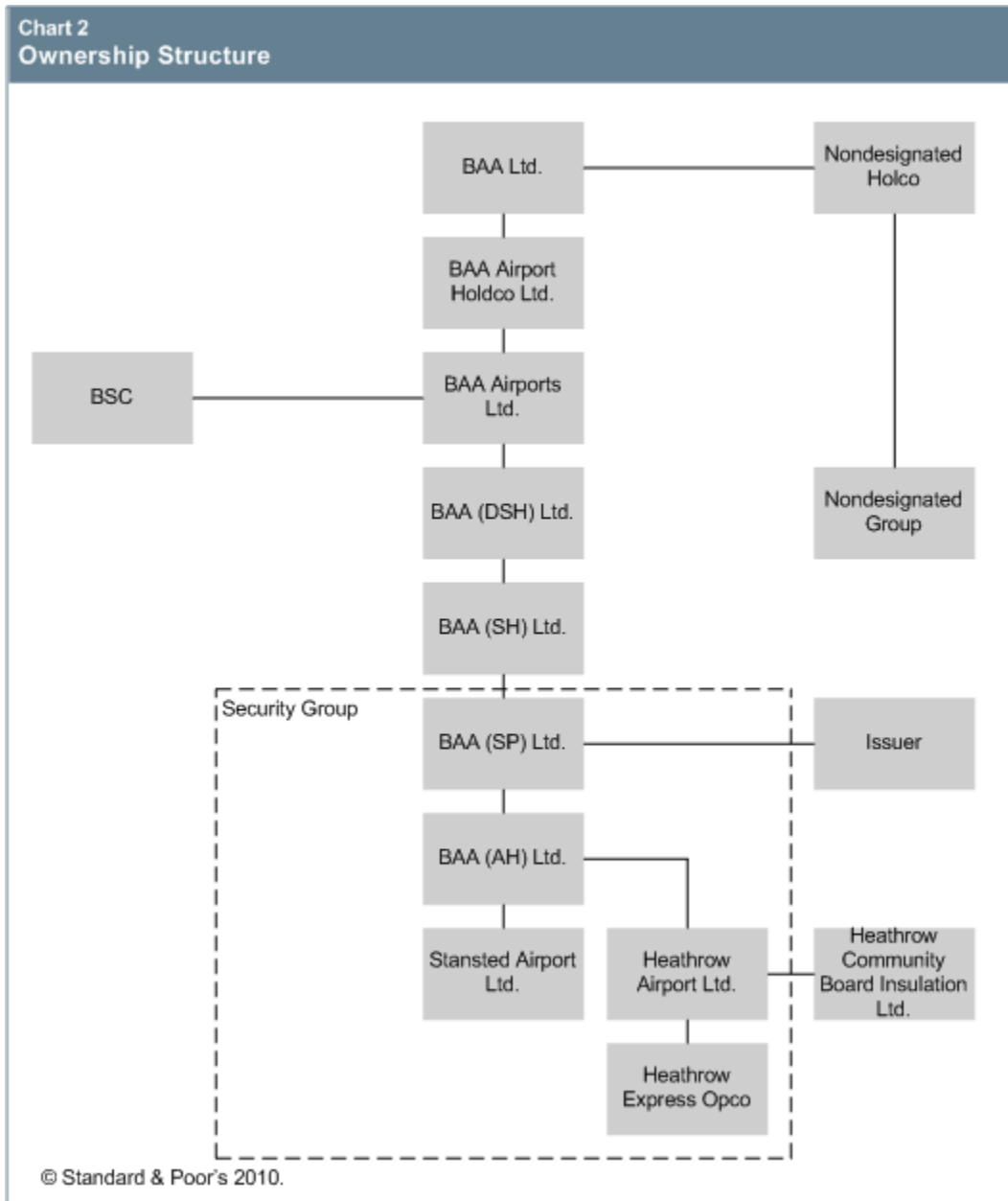
In November 2009, BAA announced a £500 million cash and equity injection into the group. The funds were provided primarily from existing financial resources of FGP Topco, the group's ultimate holding company, jointly owned by BAA's three controlling shareholders, as well as new equity injected into BAA by its shareholders. The proceeds of the cash and equity injection are intended to strengthen the group's long-term financial ratios by paying down debt and restructuring the group's derivative portfolio to reduce interest costs. By Dec. 31, 2009, £282.6 million of this investment had been completed and the remaining funds were injected in January 2010.

The BAA group has updated its long-term projections for the securitized airports. The main changes include the completion of Gatwick sale, a more-cautious view on passenger traffic, a review of EBITDA initiatives, and an update on contribution to the pension deficit.

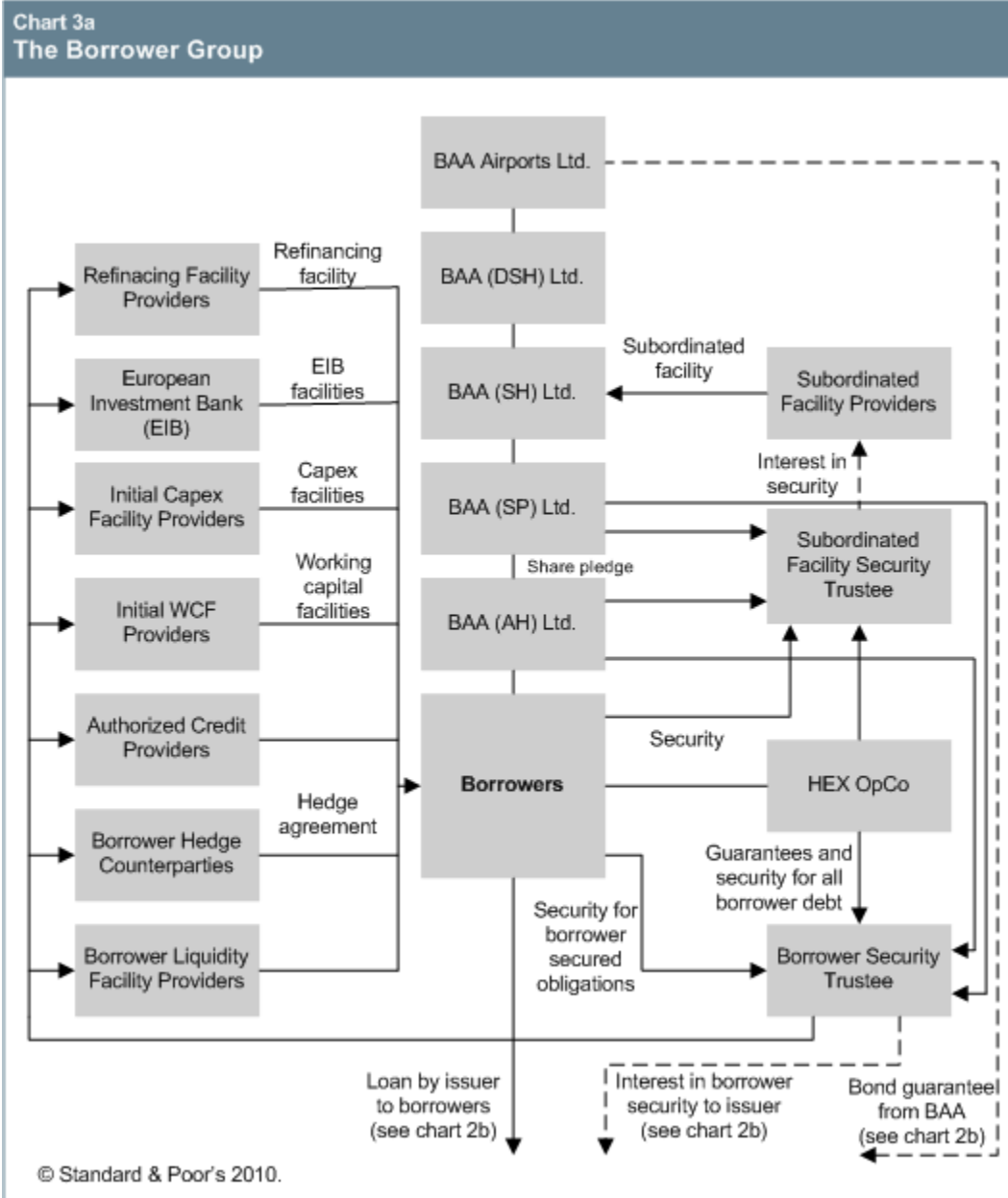
Please refer to the August 2008 new issue report for long-term projections and sensitivities made at the time of the financial closing.

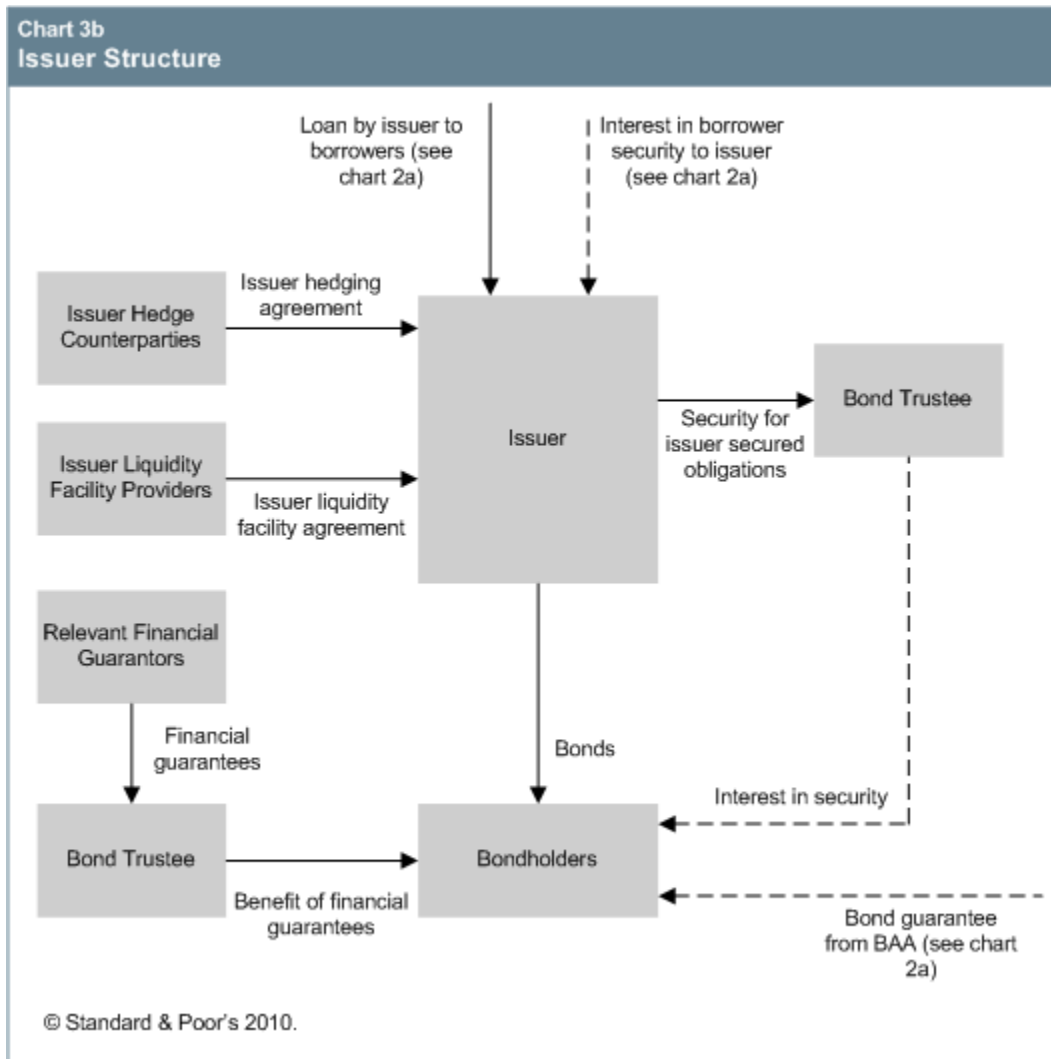
Corporate And Transaction Structure

BAA Funding Ltd. is a wholly-owned subsidiary of BAA Ltd. (formerly Airport Development and Investment Ltd.), which is itself controlled by a Ferrovial-led consortium (Consortium) that acquired BAA in 2006. The principal activity of BAA, its holding companies, and its subsidiaries (the BAA group) is the provision and management of various airport facilities in the U.K., including London's Heathrow and Stansted airports. The BAA group also owns and operates the Heathrow Express, a rail link connecting Heathrow and central London. The designated airports and the rail link are collectively referred to as the securitized assets (see chart 2).



This transaction was made under a secured-loan structure, comprising a borrower group and an issuer, which is bankruptcy-remote to our rating standard. The issuer issues the rated debt and grants a loan to the borrower group. The issuer satisfies our special-purpose entity and bankruptcy remoteness criteria.





Full details of the BAA Funding Ltd. transaction, including a definition of the covenants and details on past performance, are available in the new issue report and previous transaction updates (see "Related Research").

Related Research

- Industry Report Card: A Protracted Return To Growth For European Airports, Feb. 25, 2010
- Industry Report Card: Somber Outlook Persists For Some European Corporate Securitizations To October 2009, Oct. 14, 2009
- BAA Funding Ltd. Debt Issues Assigned Negative Outlook On Dept. for Transport Consultation Paper; All Ratings Affirmed, March 12, 2009
- Methodology For Rating And Surveilling European Corporate Securitizations, Jan. 23, 2008
- Overview Of Legal And Analytical Challenges In Rating U.K. Corporate Securitizations, Jan. 18, 2007

Related articles are available on RatingsDirect. Criteria, presales, servicer evaluations, and ratings information can also be found on Standard & Poor's Web site at www.standardandpoors.com. Alternatively, call one of the

following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.

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