

Moderate oil prices decrease aviation credit risk



Currently moderate oil prices are decreasing credit risk in aircraft financing transactions. Higher oil prices will put a strain on aircraft industry profitability, but a natural cap resulting from high supply will prevent prices reaching 2008's record levels. More airline bankruptcies and lower values for older generation aircraft should be expected if oil prices increase further.

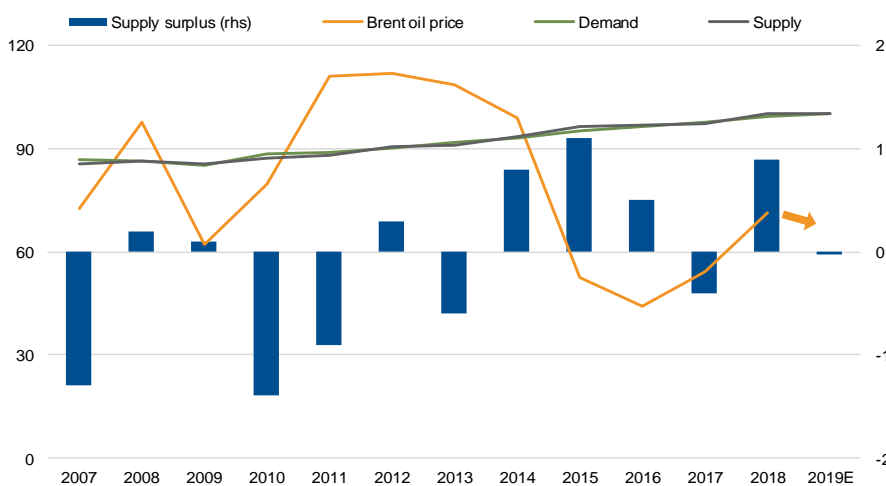
Scope expects moderate oil prices for 2019

Scope reiterates its oil price forecast from December 2018 (see [Scope's Integrated Oil & Gas Outlook 2019](#)) and expects Brent crude prices to average between USD 60 and USD 70 per barrel for the second half and for full-year 2019. Prices continue to be subject to high volatility with strong exposure to events such as tensions in the Persian Gulf, the trade dispute between the US and China, and oil production levels by OPEC+ countries. These difficult-to-predict factors will materially impact the supply-demand balance in the oil market and oil prices in the medium term.

The International Energy Agency estimates that growth in global oil demand will slow to 1.2 mb/d in 2019, with growth in non-OECD countries partly offset by a decline in the OECD. This is mainly driven by the global economic slowdown, lower growth in the petrochemical industry and warmer-than-normal weather in the northern hemisphere.

Global oil supplies are expected to grow only modestly, with strong output from non-OPEC countries (mainly US and Brazil) balanced by a decline from OPEC+ countries (voluntary in the case of Saudi Arabia and Russia; involuntary or as a result of sanctions in the case of Iran and Venezuela). The oil market is therefore projected to be well balanced, assuming OPEC+ countries stick to the recently-extended oil supply cuts.

Figure 1: Global oil demand-supply balance (million barrels per day) and Brent oil price (USD per barrel)



Source: International Energy Agency, Bloomberg, Scope

Supply will naturally increase if oil prices increase. Many shale oil producers suspend new wells when oil prices are low and ramp up production when oil prices are high. Increased oil supply puts pressure on oil prices, which provides a natural cap. It does, however, also contribute towards volatility and can lead to high oil prices over shorter time periods.

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Current oil prices should be manageable for airlines

Increasing oil prices have been blamed for many of the airline bankruptcies in Europe in the past few years. But while higher prices were a trigger, they were not the main reason. Oil prices are well below the record high levels of July 2008 when crude reached an all-time high of USD 145/barrel. The oil price increases of the past two years should be manageable for airlines that have good control of their operating costs.

A fuel-efficient aircraft fleet is important for airlines in a rising oil-price environment. Older-technology aircraft are less fuel efficient but are often more reliable than new-technology aircraft. The higher fuel consumption of older-generation aircraft is partially balanced out, therefore, by their higher reliability so in today's market, the value depreciation of older aircraft is stable. The lower reliability of new technology translates into a value disadvantage in today's market (see [Scope's Aviation Finance Outlook 2019](#)).

The higher the oil price, the higher the present value of fuel-efficient new-technology aircraft compared to less fuel-efficient older-technology models. Increasing oil prices therefore provide less of a credit risk for investors invested in new-technology aircraft compared to older-technology aircraft. And the reliability of new-technology aircraft improves as time goes by. Aircraft and engine manufacturers are working on solving the teething issues related to new-technology aircraft.

Moderate oil prices support the aviation industry

A strong rise in oil prices will increase airline bankruptcies. This will increase the credit risk of aircraft financing transactions. The impact of higher oil prices depends on the timing of the increase. Airlines will be better positioned if a sharp increase in oil prices happens when they can fully utilise the increased efficiency of both the B737MAX and A320neo.

Moderate oil prices are vital for airlines currently operating these two models. The current issues with the engine reliability of the A320neo and the grounding of the B737MAX for safety reasons have high cost implications for airlines. The issues with the two aircraft models cannot be compared, but both impact the operating costs of airlines. Moderate oil prices are critical since newer more fuel-efficient aircraft cannot be fully utilised. The reliability of older-generation aircraft at current oil price levels continues to support the higher fuel consumption compared to the less reliable new-technology aircraft.

Higher oil prices will accelerate the value depreciation of older-technology aircraft. The level of this higher depreciation will depend on the status of the B737MAX and A320neo at the time of the oil price increase. If there are no reliable alternatives to the older-generation aircraft, the value depreciation of older aircraft will be moderate. The value depreciation of older-generation aircraft is likely to be substantial if new-technology aircraft are available and reliable at the time of the oil price increase. Investors will lose money if a steep value depreciation occurs simultaneously with the operator defaulting.



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