PILARSKI SAYS…

Has the Pilarski prophecy come true yet?

The lower oil prices predicted by Adam Pilarski, senior vice-president at Avitas, are starting to happen, but his forecasts are still some way from being realized.

I get a lot of messages related to the recent oil price declines, all congratulating me on my predictions. My friend Mark Streeter from JP Morgan even facetiously suggests he wants to copyright the term "Pilarski Prophecy" regarding my forecast. How correct was the prophecy and what does it mean for aviation?

Some time ago, when oil prices were more than \$140 a barrel, I predicted that they would reach \$40 by October 16 2018. That prediction is easy for me to remember because that date is my big birthday. The specific date and amount are less relevant than the fact that I believe supply and demand realities do not support the high oil prices we have been experiencing for a number of years.

The fact that the prices stayed high that long caused, in my opinion, serious distortions to the aviation market but also caused the almost universally accepted belief that such high prices will stay forever. I want the aviation community to realize that such an eventuality is not very probable because market realities do not support oil prices at above \$100/barrel.

My analysis of supply/demand factors led me to believe oil prices that much above equilibrium levels will cause demand to fall and supply to increase, in line with standard economic theory. The longer prices stayed high, the higher the probability that a dramatic and permanent price reduction was on the cards.

This is exactly what happened in the first period oil prices being above market realities in the early 1980s. At that time Opec, mainly Saudi Arabia, cut its production levels to maintain high oil prices. Demand decreased, non-Opec producers increased their production but prices stayed high. By 1985 it was obvious that with such high oil prices Opec would have to cut production even more significantly and would eventually disappear as a producer. Hence, after six years of unreasonably high prices, the Saudis increased production dramatically, causing prices to crash, marginal non-Opec producers to get eliminated and demand to rise again. They avoided a permanent structural change in oil market realities.

This time the realities were a little different. Because of political considerations, Saudi Arabia did not upset Russia and Iran, among others, and resisted increasing production. This kept oil prices at levels not justified by demand/supply conditions for more than eight years, or longer than the six-year run-up in the 1979-85 period.

Market realities, of course, have caught up eventually with the situation, and demand has become stagnant for the past few years.

In terms of supply, fracking caused huge increases in shale oil production, leading to increased worldwide supplies. Opec was again faced with the situation of the early 1980s: cut production, which maintains high oil prices but leads to oblivion, or maintain production levels, which causes prices to fall and eliminates some of the marginal high-cost competitors. The inevitable outcome was that Opec moved as it did before.This does not jibe with my base forecast, which predicts a structural change in the oil industry which may delay the inevitable, but more fundamental and dramatic, decline in oil prices.

How does all this affect aviation? The unreasonably high oil prices caused various changes in the industry. They explain in part the bubble of orders we are experiencing. Because oil is traded in a non-competitive market, prices stayed higher than could have been expected had we not had a cartel-type organization influencing them. That led many airline executives to start believing that high oil prices were here to stay, hence buying new highly fuel-efficient aircraft was seen as a prudent strategy, minimizing risk. The current oil price reductions will be seen as possibly a temporary aberration, and longer-term decision-making will not be immediately commenced.

On the other hand, on the margin, we can expect some more aircraft order cancellations, some more aircraft coming back to active service from the desert and fewer retirements.

On a more global scale, lower oil prices shift the distribution of wealth from some regions to others, which may affect some of the large widebody orders from the Middle East or from Russia. Lower oil prices will on a macroscale increase world gross domestic product, increasing travel. Airlines and the International Air Transport Association are naïve in assuming airline profits will skyrocket but traffic will rise. Also, since costs will go down we will have lower fares, again increasing worldwide travel. It will make consumers richer but at the same time reduce the sovereign wealth funds, which may reduce the amount of finance being available to buy aircraft funds.

Overall, more flying will increase demand for seats, which can be supplied by a combination of new aircraft and fewer retirements. Airlines will make more money but there may be fewer sovereign funds for investment. New aircraft design and new engines will not go away but the rate of new technology introduction may slow.

We are entering a new period of change, when new approaches should be tried.