

Japan's Oil Industry Comprises 3 Poles after Idemitsu-Showa Shell Integration

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On April 1 when “Reiwa” was announced as Japan’s new imperial era name, Idemitsu Kosan Co. and Showa Shell Sekiyu K.K. integrated into a new company that takes over the corporate name of Idemitsu Kosan and carries the trade name of Idemitsu Showa Shell. At the end of March 2018, Idemitsu and Showa Shell owned seven oil refineries with total capacity at 1.09 million barrels per day accounting for 31% of total Japanese capacity and about 6,500 service stations commanding 31% of fuel oil and gasoline sales in Japan as of FY2017. The integrated company ranks as the second largest petroleum product wholesaler in Japan, following industry leader JXTG Holdings Inc. that captures 55% of Japan’s total oil refining capacity, 47% of fuel oil sales in Japan and 51% of gasoline sales in the country. The first and second largest oil firms thus account for more than 80% of oil refining capacity, fuel oil sales and gasoline sales in Japan. Those two and third-ranked Cosmo Energy Holdings Co. (Cosmo Oil Marketing Co.), which captures more than 10% of the Japanese oil market, command 90% of the Japanese market. Japan thus has a tripolar downstream oil market. Particularly, JXTG Holdings and Idemitsu Showa Shell are called the “Big Two,” indicating a dominant presence in the industry.

In Japan, as many as 17 petroleum product wholesalers were competing until the first half of the 1980s. Then, Japan was the world’s second largest oil consumer, with oil demand rising after a drop following the second oil crisis. Fuel oil sales continued moderate growth until FY1999 when they peaked. Since the 1980s, however, the Japanese industry has been reorganized frequently. Now, the three or two groups are dominant players in the industry.

Various factors including company-specific conditions have been at work behind Japan’s large-scale oil industry reorganization over some 30 years. However, only two factors have played the most important or greatest role in the reorganization. The first one is oil market deregulation or liberalization. Exposed to fierce competition in a deregulated market, petroleum product wholesalers chose business integrations and mergers to streamline themselves and enhance profitability for survival. In 1973 when the first oil crisis came, oil was Japan’s dominant energy source, accounting for nearly 80% of primary energy supply. Given that stable oil supply was the key to national security for Japan depending on imports for almost all oil supply, the oil industry was placed under government regulations. However, economic deregulation gained momentum under Reaganomics and Thatcherism from the early 1980s, spilling over to the Japanese oil industry in which deregulation started in the second half of the 1980s.

The first milestone for oil industry deregulation was the five-year action program launched in 1987. The most symbolic and important in the five-year step-by-step deregulation was the repeal of company-wise gasoline production and oil refining quotas. Before the deregulation, gasoline production as the biggest profit source and oil refining for petroleum product production had been controlled by the government. After the five-year action program, petroleum product imports were

liberalized on the abolition of the Act on Interim Measures concerning the Importation of Designated Petroleum Products in 1996. In 2001, Japan repealed the Petroleum Industry Act, completing the oil industry deregulation. Since then, Japan's daily oil industry operations (excluding oil stockpiling) have been left to market forces during peacetime excluding emergency.

The second most important factor behind Japan's oil industry reorganization has been a full-blown decrease in Japan's oil demand as a macroeconomic factor. Japan's fuel oil sales peaked at 246 million kiloliters (4.24 million barrels per day) in FY1999. Those in FY2017 plunged by 29% from the peak to 174 million KL (3 million bpd). Gasoline sales, the largest profit source for petroleum product wholesalers, peaked at 61.48 million KL (1.06 million bpd) in FY2004 and sank to 51.83 million KL (0.89 million bpd). As domestic fuel products sales continued to fall, the oil industry was urgently required to reduce oil refining and sales capacity. Oil wholesalers made their respective maximum efforts to streamline themselves and eventually chose mergers to fundamentally cut surplus capacity and raise capacity utilization rates. As policy measures were required to cut structural surplus capacity, the Act on the Promotion of Use of Non-fossil Energy Sources and Effective Use of Fossil Energy Materials by Energy Suppliers was enacted to force oil companies to increase secondary (advanced) capacity or cut crude oil refining capacity. Companies were required to cooperate in responding to the act, supporting their reorganization. The reorganization pressure produced giant JXTG Energy as the top industry leader before leading to the creation of Idemitsu Showa Shell as the second largest industry player, resulting in the Big Two commanding more than 80% of the Japanese oil market.

Petroleum product wholesalers with powerful financial strength and international competitiveness are very meaningful for Japan's long-standing important challenge to secure stable oil supply. It is significant for the Japanese oil industry and for Japan that the industry's financial strength has been improved through its reorganization into three or two groups. Synergy effects of integrations and mergers have worked to cut costs and improve profitability. The reduction of surplus capacity through the industry reorganization has increased capacity utilization rates and oil refining and downstream profit margins. The reorganization and intensification process taken over decades has allowed Japan's downstream oil industry to enhance its financial strength in response to a severe business environment. Under the improved industry setup, the International Maritime Organization's plan to toughen regulations on the sulfur content in shipping fuel in 2020 is expected to help the industry to maintain or improve oil refining profit margins. At least for the coming few years, the business environment surrounding Japan's oil industry has numerous positive factors.

At the same time, however, there are numerous factors for which no optimism can be warranted. The most important among them is the potential acceleration of an oil demand fall. According to a medium-term outlook released by the Agency for Natural Resources and Energy on March 29, Japan's fuel products demand (excluding heavy fuel oil C for power generation) is projected to decrease at an average annual rate of 1.3% in the coming five years. Over a longer term, the oil demand decline can be expected to accelerate due to aging and declining population, young people's shift away from vehicles, automobiles' electrification and competition from other energy sources.

At a time when business conditions are and are expected to remain relatively favorable under a new oil industry setup following the intensification, Japan is required to develop a long-term vision or strategy for addressing various challenges and uncertainties and consider how the oil industry should be in the future. In developing its long-term vision or strategy, Japan must analyze a

fast-changing uncertain market and business and competition environments at home and abroad as accurately as possible and comprehensively and strategically consider how best to maintain and enhance oil refining and sales as the industry's core business operations, how to diversify business operations, how to expand into new growth areas and how to develop overseas business operations. The oil industry that supplies the most important energy source for Japan is expected to enter a crucial stage in the future. All oil industry stakeholders are required to combine their wisdom to this end.

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