Reshaping Japan's Oil Industry

By Izumi Kubota

After two oil crises and a serious slump in local demand for oil by-products, Japanese oil refineries are not in good shape. To survive, they have begun to seriously study the need for integration and reorganization.

Last October, Maruzen Oil Co., with the fourth largest share of the Japanese market, and eighth-ranking Daikyo Oil Co. announced they would merge their refining operations to create a joint refining division. This triggered a rash of similar moves throughout the industry. In May number six Shell Oil Co. and tenth-ranked Showa Oil Co. decided to merge in January 1985, and industry leader Nippon Oil Co. has agreed to a tie-up with fifth-ranked Mitsubishi Oil Co. Altogether, Japan's 13 refiners will be restructured into seven groups (See Fig. 1).

Even the Oil Sub-Committee of the Petroleum Council, an advisory committee to the Minister of International Trade and Industry, in a report completed on June 4 this year, called for reorganizing the industry, including structural improvements in gasoline distribution networks.

Compared with Europe and the United States, Japan's oil industry suffers structurally from excessive competition—as can be seen, for example, in the very low ratio of gas stations operated directly by refiners. Heavy reliance on imports leaves the industry susceptible to foreign exchange fluctuations, and business management is intrinsically risky and precarious. In short, there are many obstacles to be overcome before the industry can return to economic viability.

The proportion of gas stations operated directly by refiners is very low in Japan.

Changing circumstances and structural weak-points

The changing supply and demand picture after the oil crises motivated the reorganization and centralization of the Japanese oil industry. The large and constant increase in demand for oil products which had supported the expansion of the industry since the end of World War II stagnated (See Fig. 2).

From fiscal 1963 to 1973, the year immediately preceding the first oil crisis, overall domestic demand for fuel oil expanded some 4.4 times. But after fiscal 1979, demand slipped back to 1970 levels, resulting in over-supply. The decreased demand was partly due to the stagnation in the Japanese economy brought on by the world-wide depression following the oil crises, but the main reason was a shift by energy-intensive industries like steel and electric power generation from oil to coal, natural gas and nuclear power. Moreover, demand for crude oil has fallen, and demand for gasoline has increased steadily, significantly altering the demand pattern for oil by-products. As a result, Japanese refineries, designed specifically to handle heavy oil, have become relatively less efficient, and less profitable as well.

Another vulnerability of the Japanese oil industry is its heavy reliance on imported oil, especially from the Middle East. Any worsening of tensions in the Persian Gulf because of an escalation in

Izumi Kubota is an economic correspondent of the Asahi Shimbun which he joined in 1973.

the Iran-Iraq war has immediate effects on the Japanese oil industry.

Nor are unstable supplies the only problem. The Middle East crisis has helped strengthen the U.S. dollar against the yen, and the Japanese oil industry is accordingly liable to substantial exchange loss. The aggregate operating loss during fiscal 1981 amounted to $1.6 billion.

This is very different from the situation in the U.S., where refiners have their own domestic oil-fields, or Europe, where they can rely on the oil resources in the North Sea.

The Japanese oil industry in itself has several serious structural vulnerabilities. There are comparatively too many enterprises, from wholesalers to gas stations in the downstream distibution system, while price is the predominant factor in sales because there are no significant differences in the quality of oil products. Along with the fact that oil supplies are more or less determined by factors beyond the control of Japanese companies, and fluctuations relatively large, these structural factors have helped hobble the industry at a time when the Japanese economy overall has been showing signs of recovery.

Report by the Petroleum Council

The Petroleum Council, after nearly three years of study, completed a report this June suggesting directions for the structural improvement of Japan's oil industry and recommending mid- and long-term policies. The study's scenario makes the following three major points:

1) Japanese oil companies should themselves promote aggressive measures for structural improvement, autonomously establishing a new order within the industry.

2) The industry should make more effective use of market machanisms, gradually reducing administrative intervention by the Ministry of International Trade and Industry (MITI). Use of the Petroleum Industry Law relating to coordination among oil firms should be soft-pedaled in the future.

3) The industry should first move to integrate wholesalers, the central pillar of the oil industry, thereby ameliorating the structural difficulties of the gasoline wholesaling and refining system.

Furthermore, the Petroleum Council made several recommendations:

1) As there are 13 refineries in Japan, few with even a 10% share of the market, they should be reorganized into groups each having a 10% or larger market share.

2) Preferably, one or two "leading" companies should have a 25% share in order to facilitate rationalization and stabilization of supplies, thereby establishing an autonomous order in the industry.

3) To attain this objective, either

Fig. 1 Reorganization of Japanese Refineries ( ) shows market share as of 1983

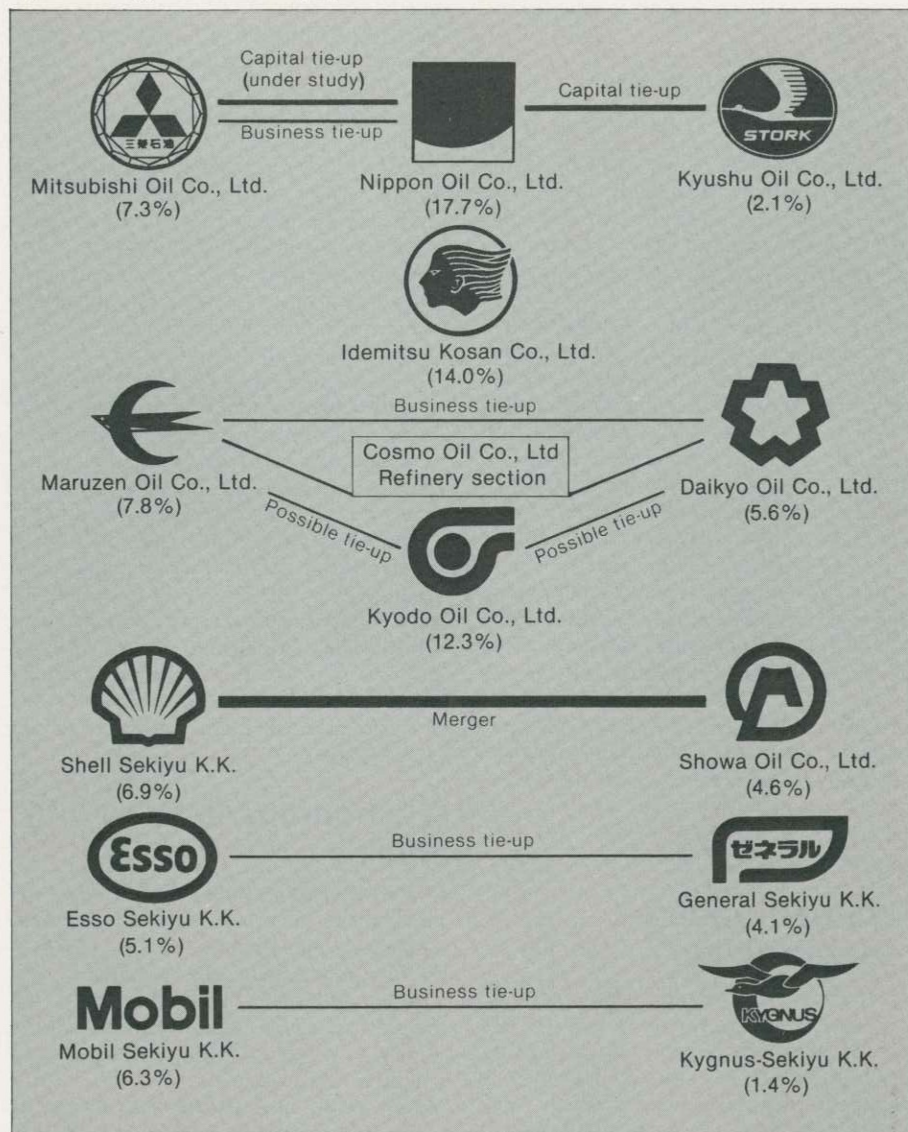
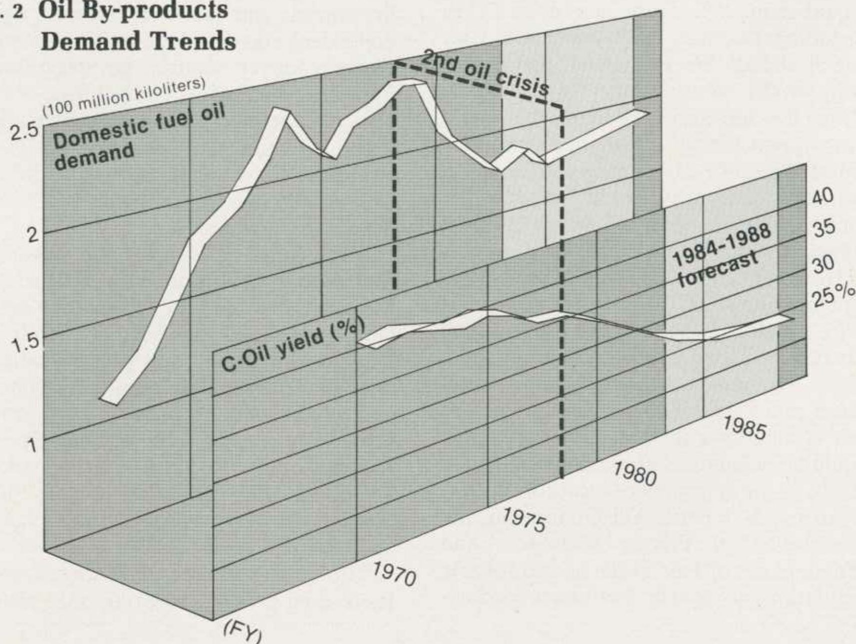


Fig. 2 Oil By-products Demand Trends



mergers or the establishment of joint sales companies and or business collaborations are in order.

Reorganization in Europe and the U.S.

In preparing the report, the Petroleum Council dispatched two study missions to the U.S., France and the Federal Republic of Germany, and studied oil companies, gas stations, and administrative measures in these countries.

The survey found, for example, that the number of gas stations has substantially decreased or been integrated in recent years. In the F.R.G., the number has fallen from 40,000 to 23,000, and in the U.S. it has been integrated down to 313,000. Average sales volume per gas station has increased by 40% to 60%, enabling dealers to successfully weather the recession. In France, the government is actively pursuing a scrap-and-build policy, and is encouraging self-service gas stations or joint operations with supermarkets or convenience stores to improve efficiency.

Japan has about 60,000 gas stations, proportionally far too many compared with the size of the market, and some are reporting losses because of cut-throat discount sales. The two survey missions concluded that aggressive measures are needed in Japan to improve the situation.

Whither refinery reorganization?

Japanese refineries will be reorganized into seven groups, two of which deserve special attention: Nippon Oil and Mitsubishi Oil, which have already agreed to a complete tie-up; and Shell Sekiyu and Showa Oil, which will merge next January.

If and when the Nippon-Mitsubishi deal comes through, the resulting giant firm would claim 25% of the market or 27.5% including the sales of Kyushu Oil Co., which already has a financial tie-up with Nippon Oil. With number two Idemitsu Kosan Co. having a 14% share, this would put Nippon and Mitsubishi in a very influential position. By utilizing their huge market share, they could stabilize the local wholesale market, which is now subject to wild fluctuations.

However, the Japanese Fair Trade Commission (FTC) is very nervous about price stabilization. There are some districts in Japan where the market share of a Nippon-Mitsubishi group would reach more than 40%. In the absence of fair competition in these districts, prices could be maintained at unrealistically high levels, to the detriment of local consumers.

Although Japan's Act Concerning the Prohibition of Private Monopoly and Maintenance of Fair Trade has no specific regulations to restrict business coordination in connection with sales agreements, the FTC is expected to thoroughly investigate the forthcoming tie-up, and could even rule that it is not just a tie-up but a de facto merger.

Everyone in the oil business is carefully watching the situation. How the present obstacles are surmounted will determine the pattern of future competition.

In Japan, where most large corporations have adopted a lifetime employment system, company loyalty is far stronger than in Europe and the U.S. Conversely, the sense of competition with rival companies is keen and deep-rooted.

This is a serious issue in the proposed tie-up between Shell and Showa, where both firms must encourage harmonious collaboration and friendship among their staff after the merger. The two companies have established "Merger Committees" and are now negotiating the reshuffling of staff positions. One middle-management executive at Shell recently confided his own anxieties: "I see my counterpart at Showa fairly often these days, but I must confess that I can't sleep well at night when I start wondering whether he or I will be given a higher position in the new company!"

Two companies holding back

Two companies have so far shunned the limelight in the present reshuffling drama —the two big Japanese refiners, Idemitsu Kosan and Kyodo Oil Co. These two firms could play a dramatic role if the Persian Gulf crisis worsens or some other drastic change in world affairs should trigger a third oil crisis. And this in turn might result in a further regrouping of Japanese oil refiners.

Independent and proud, Idemitsu maintains imports of oil products should be liberalized, and looks to continue its independent stance—there are even rumors that it is actively scouting gas stations now under the wing of its competitors. Naturally other refiners are apprehensive about such activities as Idemitsu moves to strengthen its competitiveness in the face of possible further realignments among Japanese oil companies.

Meanwhile, there is a good possibility that Kyodo will join with Daikyo and Maruzen, provided the reported tie-up between the latter two becomes reality. A Daikyo-Maruzen-Kyodo group would be almost as powerful as Nippon-Mitsubishi, and would turn the present seven groups into six groups: Mitsubishi/Nippon/Kyushu (27.1%); Maruzen/Daikyo/Kyodo (25.7%); Idemitsu (14%); Shell/Showa (11.5%); Esso/General (9.2%); and Mobil/Kygnus (7.7%).

This series of reorganizations would leave each group, excepting only Mobil/Kygnus, with shares of 10% or more, thereby meeting the target of the current restructuring of the industry. But it is quite a different story when it comes to the core objective—strengthening the performance of each group through centralization.

Reluctance to change

Cut-throat competition among gas stations continues throughout the country. The refiners admit that there are too many gas stations, but most are operated by independent management, and are outside the control of the oil companies. This is a fundamental difference with the situation in the U.S. and Europe. A French-style scrap-and-build policy simply would not work in Japan. Furthermore, companies must respect the right of gas station owners to make a living, while any decrease in the number of gas stations also adversely affects market share. Under the circumstances, it is extremely difficult for gas station owners (and refiners) to end the prevailing cut-throat competition, meaning many operations will continue in the red for a long time to come.

Of course, "business coordination" has its merits. One group estimates that reciprocal use of refineries, streamlining and integration of distribution channels, and joint operation of oil tankers and joint purchases of crude oil could save its members more than $10 million every year.

If every company devotes itself to reorganizing and integrating oil refineries and storage facilities with courage and determination—even at the sacrifice of its own interests—the current reshuffling might yet work. But some groups are still lukewarm to the idea, and have only joined the current rush for fear of missing the bus. They are ready to push rationalization, but only to a point. And they want a free hand to back out in case integration fails, or a changing situation allows them to go ahead independently again.

Oil is a matter of life and death for Japan, which has no significant domestic energy resources of its own. The vulnerability of the companies responsible for the import and distribution of oil in the local market is likewise a matter of life and death for the Japanese economy. MITI will continue to encourage the integration of Japan's oil industry as it endeavors to strengthen the industry itself, and is currently working to produce a realistic recommendation for structural improvements in gasoline sales by the end of this year. This will further heighten expectations for the reorganization and integration of oil refineries. But given the uncertainty in the global oil situation, it will probably be later rather than sooner that the integration of Japan's oil industry finally takes root. ●