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The 2003 Year-End Business Environment and Showa Shell's Performance

4 The business environment for the oil industry in the fiscal year ended December 31, 2003 offered plenty of potential justifications for flat business results: soaring crude oil prices, fears of an oil shortage with the war in Iraq, concerns about fuel oil supply for power generation, and weak demand due to the outbreak of severe acute respiratory syndrome (SARS) and the unusually cool summer. The Showa Shell Group, however, did not have to avail itself of such rationalizations. Showa Shell not only exceeded the ¥30 billion in profit promised to shareholders at the beginning of the year, but also surpassed the ¥35 billion revised forecast given in the interim results report, delivering consolidated ordinary income for the year of ¥38.1 billion. Consolidated ordinary income was strong even after factoring in current cost of supply (CCS), an index of actual procurement costs that excludes the effects of fluctuations in crude oil prices on inventory value which is used by Showa Shell and the Royal Dutch/Shell Group to forecast future earnings and evaluate performance. At ¥36.3 billion, consolidated ordinary income on a CCS basis made solid gains in fiscal 2003, topping last year's figure of ¥29.3 billion by 24 percent.

Although proud of these successes for Showa Shell, we remain sober about changes in the market. In fiscal 2003, our rivals began to close the significant gap in cost competitiveness that we have long enjoyed. In 2004, reestablishing and maintaining Showa Shell's undisputed edge over the competition is a key priority. We are committed to pursuing dramatic cost reductions and improving profitability—surpassing all our competitors in both the speed and scale of these efforts.

Showa Shell's Medium-Term Management Plan (2003–2005)

■ Pursuing Sustainable Growth-Progress in Fiscal 2003

In fiscal 2002, the Showa Shell Group moved decisively into the second stage of its corporate reform program. During the

first stage, we significantly improved the Group's financial position and generated strong cash flows. In the second stage, we are focused on reinvesting these funds in growth sectors and converting these investments into sustainable corporate growth. In fiscal 2003, the initial year of the Medium-Term Management Plan (2003–2005), Showa Shell took specific steps to address the following three priorities.

1. Growth in Core Businesses That Are Primary Revenue Sources

Over the three years covered by the Medium-Term Management Plan, we are enhancing sales strength and profitability by concentrating management resources in our core downstream oil business (refining and sales of oil products). Specifically, we are working to increase sales of Shell Pura, our new high-octane gasoline, which has been very popular with customers since its release in fiscal 2002. We are also offering various value-added services to customers through the Shell Starlex Card. In September 2003, we reached agreement on equity participation in Marubeni Energy Corporation, a move that has strengthened our sales network by giving us access to Marubeni's vast customer base.

Powered by these and other initiatives, Showa Shell achieved a 14.1 percent share (including Seibu Oil Co., Ltd.) of total 2003 gasoline sales in Japan, reaching third place in terms of market share for this high-value-added product that gives us a direct connection with the end-consumer. (Showa Shell had a 14.7 percent share of the high-octane gasoline market.)

2. Enhanced Competitiveness through Further Structural Cost Reductions

Beginning in fiscal 2003, the Showa Shell Group set out to cut structural costs by at least ¥5 billion each year, for a total three-year reduction of ¥15 billion. We went ahead of plan in fiscal 2003 by scaling back ¥6.5 billion of structural costs, a significant figure when viewed in the context of 1995 total costs of ¥117.7 billion.

Our new Core Business Integration System (new SAP R/3), a program designed to provide the infrastructure for our business process reengineering (BPR) efforts, became fully operational in October 2003. We have also speeded implementation of our target strategies for growth by further raising operational efficiency and ensuring that information and knowledge is shared and practically applied at every level of the Company to accelerate decision-making processes.

3. Laying the Foundation for the New Businesses of the Future

In tandem with the comprehensive measures taken to bolster profitability in Showa Shell's core downstream oil business (refining and sales of oil products), we are also working to lay the foundation for enterprises in new fields with strong potential for future growth. One example is K.K. Ogishima Power, a firm jointly established in August 2003 by Tokyo Gas Co., Ltd. and the Royal Dutch/Shell Group. Beginning in fiscal 2009, Ogishima Power will generate 1.2 million kW of electricity using liquefied natural gas (LNG). The firm has already begun environmental assessments and other preparations for the launch of operations.

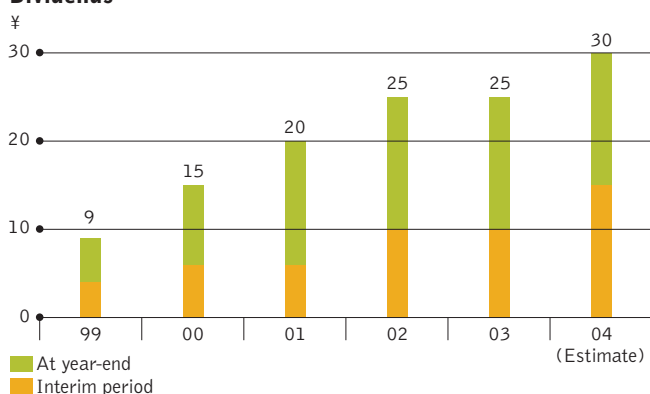
To ensure that Showa Shell is in a strong position when the age of fuel cell vehicles arrives, we have opened the Ariake Hydrogen Station and initiated other hydrogen-supply projects. We are also involved in substantive testing on public roads of Japan's first gas-to-liquid (GTL) fuel (a liquid fuel synthesized from natural gas). The proactive investment of management resources in sectors where we expect higher growth potential and asset efficiency, primarily in environmental businesses and energy-related sectors such as new fuels, is an important component of our strategy for new business development.

Working Together with Stakeholders

■ Safety and Legal Compliance: Our Top Priorities

Operational safety and total compliance with laws and regulations in every aspect of our corporate activities are top priorities for the Showa Shell Group. Sadly, large-scale accidents, disasters, and violations of the law shook the Japanese oil industry in 2003. Although Showa Shell was not directly involved, we do not consider these events to be insignificant for our own operations. We are fully aware of how vital it is that we protect our reputation as a highly respected corporate citizen. We are dedicated to ensuring that the Group strictly complies with all ethical standards, working consistently to raise the bar with regard to health, safety, security, and environmental conservation.

Dividends



■ Human Resource Development and Corporate Governance

The key to realizing the strategies and management plan outlined above clearly lies in our efforts at human resource development. Employees that demonstrate professionalism, leadership skills, and a strong commitment to achieving the goals of the company are vital to our success. We are striving to ensure that personnel and human resource development strategies emphasize and fully utilize the great diversity our employees bring to the Group. We have management programs focused on nurturing the individual abilities of each Group employee, increasing the capacity of our organization as a whole to do this, and encouraging a corporate culture that will help us to meet these goals.

Showa Shell is striving to build a system of corporate governance that enables us to make and carry out appropriate business decisions fast enough to avoid missing opportunities, even in today's uncertain business environment. Another of our key aims is to ensure that our operations are transparent to all stakeholders. In April 2003, we undertook a major overhaul of our management structure, with the primary objective of more clearly defining the roles, responsibilities, and authority of our directors and executive officers. The results have been extremely effective in improving the way we function together as a team. Further investigations scheduled for 2004, however, will be designed to determine the optimum business mechanisms for our specific corporate culture, as well as the Japanese business environment in general, and include the possibility of restructuring Showa Shell into a committee-run corporation.

■ Delivering Sustainable Growth in Total Shareholders' Return

Consistent increases in total shareholders' return are essential to achieving our goal of becoming the leading company in the Japanese oil industry. Raising the stock price and increasing dividends are both keys to meeting our shareholders' expectations of growing returns. We have made steady gains in total annual cash dividends per share since the ¥9 recorded in fiscal 1999. We project an additional ¥5 increase in 2004, which will bring the dividend up from the ¥25 we posted in fiscal 2003 to a total annual cash dividend of ¥30 per share.

On behalf of everyone at the Shell Group, we pledge to move forward as one with the shift to dynamic growth, the primary aim of the second stage of our corporate reforms. We will work as a team to achieve the goals we have set in the Medium-Term Business Plan. We remain committed to delivering consistent increases in revenue, profit, and dividends, and hope that our unceasing efforts will continue to win the trust and support of all the shareholders of the Showa Shell Sekiyu Group.

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John S. Mills
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