Management's Analysis of Financial Position and Operating Results

The Japan's Economy and the Operating Environment

Although the pace of growth of consumer spending in Japan slowed down in the latter half of 2006, corporate earnings continued to improve and private-sector capital investment continued to expand. In view of these factors, the economy can be judged to have maintained its recovery trend.

Crude oil prices started off the year at a historically high level, with Dubai crude selling at around $55 dollars per barrel, and the price subsequently went even higher due to the twin factors of increased demand, particularly in the United States and the principal oil-consuming nations of Asia, and the perception of rising geopolitical risks in the Middle East. By mid-summer, the price of crude oil had topped $70 per barrel for a short while, setting an all-time high. Thereafter, however, the geopolitical risk factors appeared to recede, and with futures prices declining and the balance of supply and demand becoming easier, the price of Dubai crude finally ended the year back around the $55 level.

On the foreign exchange markets, meanwhile, the Japanese currency started off the year at nearly ¥116 to the dollar and fluctuated in the fairly narrow range of 113-119 to the dollar up to mid-April, against the backdrop of the market's inability to confidently forecast the fiscal policies of the U.S. and Japanese financial authorities. Subsequently, the yen began to climb at a sharp pace, reaching ¥109-110 by the middle of May. In the latter half of the year, however, the yen gradually weakened against the dollar as a result of the U.S.-Japan interest rate disparity, sinking back to around ¥119/$1 by the year-end.

Amid this business environment, the Showa Shell Group decided to take to the next level its efforts—which it has been pursuing for a number of years—to strengthen its cost competitiveness and build a strong financial position. Under the banner of "New Foundation," the management decided to pursue a new growth strategy in the Group's core business of the refining and sale of petroleum products, by expanding its network of filling stations and introducing new items to its product lineup that would clearly set the Group apart from its rivals. At the same time, the Group will continue to invest management resources in the development of peripheral businesses, as well as completely new business lines unconnected with its oil operations.

Operating Results

Sales for 2006 on a consolidated basis came to ¥2,921.2 billion, an increase of 28.8% over the preceding business year. This is attributable to the record-high levels attained by crude oil prices.

At the profit level, the surge in crude oil prices cut back the Group's gross profit on sales to ¥193.1 billion, for a year-on-year decline of ¥19.3 billion. Turning to operating income on a consolidated basis, despite our efforts to cut costs, as evidenced by the 0.9 percentage point year-on-year decline in the ratio of SG&A expenses to sales, the fall in crude oil prices from the latter half of the third quarter led to a much smaller decline in the cost of sales than in the previous year, in line with a decrease in the book value of crude oil inventory. As a result, operating income registered a year-on-year fall of ¥24 billion to ¥74.3 billion.

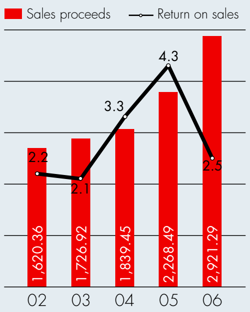
In non-operating profits and expenses, gains/losses on foreign exchange translation improved by ¥4.1 billion over the previous year, but ordinary profit registered a year-on-year decline of ¥22.8 billion to ¥77.6 billion.

For the reporting term, the Showa Shell Group recognized net special losses amounting to ¥400 million (an improvement of ¥800 million year-on-year) in the form of losses on disposal of fixed assets (involving the selloff of idle assets and the scrapping of superannuated facilities to enable replacement with up-to-date facilities), as well as losses resulting from a fire at the Keihin Refinery operated by consolidated subsidiary Toa Oil Co., Ltd.

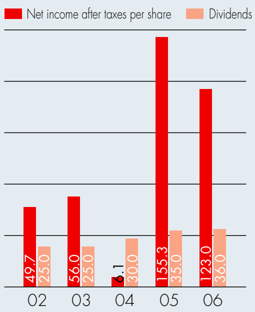
As a result of the above, net income on a consolidated basis for the reporting term came to ¥46.2 billion, down by ¥12.1 billion from the previous year.

Earnings per share for fiscal 2006 stood at ¥122.88 and net assets per share came to ¥822.20.

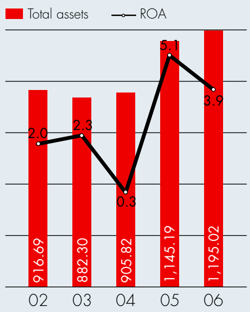
Sales Proceeds/
Return on Sales (operating profit basis)
(¥ billion/%)



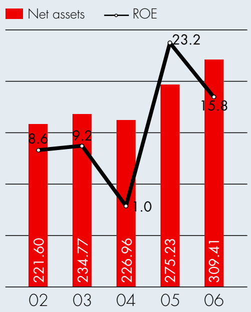
Net Income after Taxes per Share/
Dividends
(¥)



Total Assets/ROA
(¥ billion/%)



Net Assets/ROE
(¥ billion/%)



Twelve-Year Summary of Selected Financial Data

Showa Shell Sekiyu K.K. and Consolidated Subsidiaries
Years ended December 31

	2006	2005	2004	2003	2002
Sales proceeds	**¥2,921,287**	**¥2,268,488**	¥1,839,445	¥1,726,917	¥1,620,359
Cost of sales	**2,728,137**	**2,056,023**	1,665,978	1,570,155	1,460,458
Gross profit	**193,149**	**212,465**	173,466	156,761	159,901
Sales and administrative expenses	**118,847**	**114,084**	113,280	120,787	123,500
Operating profit	**74,301**	**98,381**	60,185	35,974	36,400
Ordinary profit	**77,675**	**100,497**	61,927	38,188	40,101
Net income after taxes	**46,249**	**58,370**	2,362	21,000	18,665
Total assets	**1,195,015**	**1,145,191**	905,823	882,299	916,690
Total shareholders' equity*1	**309,411**	**275,232**	226,955	234,773	221,604
Net income after taxes per share (yen)	**¥122.95**	**¥155.31**	¥6.14	¥55.96	¥49.69
Shareholders' equity per share (yen)	**822.20**	**732.08**	605.25	627.07	592.18
Return on sales (operating profit basis) (%)	**2.5**	**4.3**	3.3	2.1	2.2
Return on sales (net income basis) (%)	**1.6**	**2.6**	0.1	1.2	1.2
Return on assets (%)	**3.9**	**5.1**	0.3	2.3	2.0
Return on equity (%)*1	**15.8**	**23.2**	1.0	9.2	8.6
Equity ratio (%)*1	**25.9**	**24.0**	25.1	26.6	24.2
Number of shares outstanding at end of term (thousand shares) *2,3	**376,323**	**375,863**	374,868	374,303	374,125

*1 The definition of "shareholders' equity" was revised under the new Corporation Law in 2006, and "shareholders' equity" under the new law excludes minority interests. Please note referred numbers above are based on new definition of "shareholders' equity," NOT including minority interests. "Return on equity" and "equity ratio" are also calculated quoting these numbers.
*2 Treasury stock is excluded.
*3 The amount of treasury stock includes Showa Shell Sekiyu stock held by affiliates accounted for by the equity method.

On a current cost of supply basis (i.e., excluding the effects of inventory appraisal), ordinary profit on a consolidated basis would have come to ¥58 billion, for a ¥4.7 billion increase over the previous year.

Regarding the term-end dividend, the management of Showa Shell has recognized steady improvements in its cost competitiveness and financial position. Consequently, we decided to pay a term-end dividend of ¥18 per share. Combined with the ¥18 per share interim dividend, this brings the annual dividend per share to ¥36.

Segment Information

Oil Business

Demand for oil and its derivatives in the Japanese market weakened in 2006 against the background of rising oil prices and the effects of the growing energy conservation movement, as a result of which the gasoline sales volume fell below the previous year's level for the first time in 36 years. In spite of this, the total volume of Showa Shell's sales of petroleum fuels such as gasoline and diesel oil (excluding kerosene, sales of which fell below the previous year's level owing to the relatively warm winter) posted a 5.6% year-on-year growth.

Turning to petroleum product prices, these climbed sharply from the start of the year up to the summer, owing to the steep rise in the price of crude oil. However, as demand was following a downward trend, we were not able to adjust our selling prices at our filling stations or for fuel sold to industrial customers by a margin sufficient to match the rise in crude oil procurement costs.

As a result of the foregoing factors, the Company's petroleum segment recorded increases both in selling prices and in the volume of gasoline and diesel oil sold in the Japanese market, and the segment's sales on a consolidated basis thus rose 28.1% over the previous year, to ¥2,883.4 billion. Earnings, however, were lower than the previous term's level. This was due to the fact that the price of crude oil entered a downward phase in the latter half of the third quarter, leading to a rise in the cost of sales, and the Company was unable to pass on the increase in costs to its customers to a sufficient extent. Consequently, operating income for the petroleum segment on a consolidated basis amounted to ¥69.9 billion, a decline of ¥24.8 billion from the previous year.

Property Business

In the office building rental business, despite a geographical expansion in the growth trend of demand—against the backdrop of a fullscale recovery in corporate earnings—revenues from the real estate segment of the Showa Shell Group stayed flat on a year-on-year comparison, at ¥4.2 billion. On the bright side, operating income rose 2.6% over the previous term, to ¥2.7 billion, thanks to our various measures to reduce expenses involved in outsourcing our building management services, among other cost reductions.

Other Businesses

In the Group's leasing business, the start-up of a back-office transaction computer system leasing business from the previous term contributed to an increase in total revenues. In the Group's construction and engineering business, revenues were pushed up by an increase in orders for soil purification work and a number of contract completions in the field of work related to our TES (Total Energy System) cogeneration system.

In new businesses, the Group's gas utility business, commenced in 2005, was joined by an IPP (independent power producer) business and a dispersed power source business. Sales on a consolidated basis for the Miscellaneous Business Segment amounted to ¥33.5 billion, a sharp increase of 137.4% over the previous year, while the segment's operating income came to ¥1.6 billion for a year-on-year increase of ¥700 million.

Financial Position

Assets, Liabilities, and Owners' Equity

Total assets on a consolidated basis for the end of the term under

Millions of yen						
2001	2000	1999	1998	1997	1996	1995
¥1,664,954	¥1,639,475	¥1,365,478	¥1,324,752	¥1,588,067	¥1,600,067	¥1,441,176
1,513,626	1,477,361	1,218,732	1,171,788	1,408,789	1,404,723	1,225,954
151,328	162,113	146,746	152,964	179,278	195,344	215,222
123,274	124,442	133,692	144,446	164,434	174,646	186,383
28,053	37,670	13,054	8,518	14,844	20,698	28,839
29,052	38,913	12,191	7,223	12,901	15,225	21,993
2,610	12,499	1,828	1,999	6,387	6,054	13,802
909,902	1,002,146	974,916	992,282	1,049,931	1,071,464	1,001,676
212,168	216,349	197,562	199,711	201,479	198,536	195,926
¥6.95	¥33.19	¥4.85	¥5.31	¥16.95	¥16.06	¥39.94
565.36	574.77	524.25	529.95	534.64	526.84	519.93
1.7	2.3	1.0	0.6	0.9	1.3	2.0
0.2	0.8	0.1	0.2	0.4	0.4	1.0
0.3	1.2	0.2	0.2	0.6	0.6	1.5
1.2	6.0	0.9	1.0	3.2	3.1	7.3
23.3	21.6	20.3	20.1	19.2	18.5	19.6
375,281	376,409	376,850	376,850	376,850	376,850	376,850

review stood at ¥1,195 billion, for an increase of ¥49.8 billion compared with the previous term-end. This increase is primarily attributable to growth in the value of current assets. Crude oil prices followed a consistent upward trend from the end of the previous year, pushing up the value of inventory assets by a large margin. In addition, in line with the growth in sales, an increase in trade notes and accounts receivable (trade receivables) led to an increase in accounts receivable. The increase in fixed assets is largely attributable to: a) the upgrading (scrapping and replacement) of the Group's oil refining facilities; b) investments in the construction of a manufacturing plant for solar cells (photovoltaic modules), one of our new business lines; c) investment in the construction of additional filling stations; and d) the expansion of the scope of consolidation.

Liabilities at term-end increased by ¥12.9 billion to ¥864 billion. This is principally attributable to the fact that the increase in trade payables—stemming from the rise in crude oil prices—greatly exceeded the decrease (combined total of income taxes paid and reversal of allowance for the regularly-scheduled refurbishment of refining facilities). In addition, interest-bearing liabilities fell only slightly, to stand at ¥190.5 billion. However, the gearing ratio fell by 2.9 percentage points from the previous term, to 38.5%.

Owners' equity on a consolidated basis came to ¥303.9 billion, an increase of ¥34.1 billion over the previous year. This was principally due to an increase in retained earnings made possible by the posting of net income. As a result of the foregoing, the term-end equity ratio stood at 25.9% and the ROE was 15.8%.

Cash Flows

Net cash provided by operating activities amounted to ¥29.3 billion, due to the fact that the combined amount of increases in income before income taxes and in depreciation expenses exceeded the amount of income taxes paid.

Net cash used in investing activities amounted to ¥28.8 billion. The main factor behind this was the acquisition of new fixed assets as part of the regularly scheduled refurbishment of the Group's oil refining facilities.

Net cash used in financing activities came to ¥13.7 billion. This is largely attributable to the fact that, despite fund procurement through the issuance of corporate bonds in the amount of ¥15 billion, this amount was exceeded by the combined total of ¥5.6 billion in payments of term-end dividends for the previous business year, ¥6.7 billion in interim dividend payments for the reporting term, and ¥16.3 billion in repayments of long-term debt and short-term bank borrowings.

As a result of the above, cash and cash equivalents at term-end came to ¥16.5 billion, representing a decrease of ¥12.8 billion from the previous term-end, despite an increase due to the wider scope of consolidation. The free cash flow (cash flow provided by operating activities minus cash flow used in investment activities) came to ¥400 million.

Outlook for 2007

For the fiscal year ending December 2007, as crude oil prices are virtually certain to remain high, we project business performance as follows: sales at ¥2,860 billion on a consolidated basis and ¥2,750 on a non-consolidated basis; ordinary profit at ¥60 billion (consolidated) and ¥53 billion (non-consolidated); and net income at ¥35 billion (consolidated) and ¥31 billion (non-consolidated).

On a current cost of supply basis, ordinary profit (consolidated) is forecast at ¥60 billion.

These forecasts are based on the assumption of an average crude oil price for the entire term of $55 per barrel ($53.5/barrel for the first half; $56.5/barrel for the second half), and on an assumed average exchange rate of ¥120 to the dollar.

Operational Risks

The Showa Shell Group has created a system to monitor and manage business risk, and endeavors to mitigate the risks associated with its business operations. Among such risks, the following are considered important categories related to the businesses of the Showa Shell Group and its financial and accounting position that could have a material effect on the decisions of investors.

The risks described below are those risks evaluated to be material by the Showa Shell Group (on a consolidated basis) at the end of the fiscal year under review. This list is not meant to be, and should be not construed as, a comprehensive list of every risk affecting the Group. Furthermore, the matters discussed here concerning future circumstances are those matters evaluated by the Showa Shell Group at the end of the fiscal year under review.

1. The effects of energy demand and market conditions for petroleum products

Domestic demand for petroleum products is affected by, and changes with, factors such as the economic situation in Japan and domestic energy supply and demand.

Moreover, Japan's domestic petroleum products market is affected by factors such as fluctuations in demand, price competition with other companies in the industry, overseas prices for petroleum products, and price competition with other forms of energy. These fluctuating factors also exert an influence on the quantities and prices of petroleum products that the Showa Shell Group sells, and cause changes to the Group's earnings.

2. Changes in crude oil prices and exchange rate market prices

a. Effect on sales margin

Because the cost of sales of the petroleum products sold by the Showa Shell Group is affected by changes in crude oil prices and the foreign exchange market, the Company's basic policy is to reflect these influences in its sales prices. When it is difficult to reflect the changes in cost of sales, which result from factors such as the domestic market environment, in the Company's sales prices, however, these changes will cause fluctuations in the Group's earnings.

In addition, there is a possibility that the amount of working capital the Group requires will increase because of a rise in crude oil prices or a rapid depreciation of the yen.

b. Effect of inventory valuation

The Showa Shell Group uses the weighted-average method to value crude oil inventory. When crude oil prices have declined, the Group's cost of sales will be increased by the effect of inventory that is relatively expensive at the beginning of the period, which will be a negative factor for earnings. When crude oil prices have risen, on the other hand, the Group's cost of sales will be reduced by the effect of inventory that is relatively inexpensive at the beginning of the period, which will be a positive factor for earnings. As this illustrates, there is a possibility that changes in crude oil prices will affect the Group's operating results.

3. Risks related to sources of crude oil procurement

The Showa Shell Group procures all of its crude oil from countries in the Middle East. There is a possibility that the financial position and operating results of the Showa Shell Group would be seriously affected in the event that obstacles arose to its procurement of crude oil, for reasons such as changes in the political climate in oil-producing countries, and assuming that an appropriate alternative supply source could not be found.

4. Environmental regulations and introduction of environmental taxes on the Group's business operations

Stricter regulations have been introduced limiting the sulfur content of gas oil to 10 ppm or less (de facto sulfur-free), and these restrictions will be extended to gasoline from the start of 2008. The Showa Shell Group is making investments to respond to this change. There is a possibility that the Group's additional capital investment or expense burden will increase if environmental taxes or quantity restrictions on parties that emit carbon dioxide, or on consumption of fossil fuels or other new environmental regulations, are introduced in Japan in the future, which would affect the Group's financial position and operating results.

5. Termination or restriction of active conduct of business as the result of a disaster, accident, etc.

The Showa Shell Group has enacted a basic policy concerning health, safety, security and the environment (HSSE) based on its own management rules, and strives to ensure safe operations and minimize disaster risk through the use of appropriate insurance, including property and casualty insurance. There is a possibility, however, that each office and facility of the Showa Shell Group, including its refineries, could face obstacles to its operations if struck by a natural disaster such as a large typhoon or earthquake, or if the area of business operations of the Company was hit by a large-scale epidemic of a serious infectious disease such as avian influenza, either of which would affect the Group's financial position and operating results. There is also a possibility of being similarly affected by the termination or restriction of active conduct of its business as the result of an occurrence such as a serious industrial injury or equipment accident.

6. Risks related to intellectual property rights

In addition to competition for technological development, as intellectual property rights strategies become more important, there is a risk that disputes will occur over issues such as the violation of intellectual property rights if the Group's steps to strengthen its intellectual property rights management system or defensive measures are inadequate.

7. Control of personal data

The Showa Shell Group obtains and uses personal data, including information on its customers, in relation to its businesses such as oil sales, and has created in-house management systems for the administration of this data.

The Group strives to protect such information with great care, but there is a possibility the Showa Shell Group brand image will be damaged, and the business performance of the Group negatively affected, if for some reason such data is disclosed outside the group and misused.

8. Risk concerning retirement benefits

The Showa Shell Group's estimated pension benefit obligations and costs are calculated according to mathematical valuation principles, and basic rates such as the discount rate and the expected rate of return on pension plan assets have been set as calculation assumptions. In the event the actual numerical values concerning the basic rate differ from these assumptions, or in the event the assumptions are revised, these changes would affect the amount of the pension benefit obligation and the costs recognized in the future because the effects would be cumulative and would be recognized regularly in future periods.