Business and Other Risks

The Cosmo Energy Group's business performance and financial condition are subject to a number of factors that in the future could have a significant impact.

The following is a summary of major risk factors that the Group incurs in the course of business development. The Group proactively discloses all risks that are considered to be important to investors, including external factors over which the Group has no control, and which have little probability of occurring. Note that the following does not refer to all risk factors associated with investment in Cosmo Energy Holdings stock.

Forward-looking statements were determined as of the end of the consolidated fiscal year under review.

(1) Risks Unique to Specific Segments

(Petroleum business and petrochemical business)

(i) Crude Oil Price and Crude Oil Procurement

The Group valuates its crude oil inventory using the periodic average method. When the oil price falls, the inventory unit price at the beginning of the period and the declining unit price of stock purchased during the period are averaged. That raises the cost of goods sold. In addition to risk factors in the oil exploration business, this may have an effect on the Group's operating results and financial position.

Any rapid changes in crude oil prices due to increasing tensions in Ukraine and conflict and political instability, terrorism, and other contingencies in the areas surrounding Middle Eastern oil-producing countries may influence oil procurement and have a material impact on the Group's business performance and financial condition.

The Group monitors the sensitivity of its consolidated business performance forecasts for the next fiscal year to changes in crude oil prices. A one U.S. dollar per barrel change in the Dubai crude oil price may result in a 1,700 million yen change in the profits of the Petroleum Business over a year.

(ii) Prices of Petroleum Products and Petrochemical Products

The cost of the Group's major oil products is determined by international market prices of crude oil and foreign exchange rates. On the other hand, the Group's marketing activities are mainly conducted within Japan and selling prices are determined by domestic market conditions. Any gap or time lag between international and domestic market conditions could materially impact the Group's business performance and financial condition.

(iii) Demand for Petroleum Products and Petrochemical Products

Sales of gasoline, kerosene, and diesel fuel that comprise a major portion of the Group's total sales are strongly affected by general trends in personal consumption. Meanwhile, demand for naphtha reflects demand trends in the petrochemical industry, demand for aviation fuel reflects those in the airline industry, demand for diesel fuel reflects those in the transportation industry, and demand for heavy oil primarily reflects trends in the electric power, maritime transportation and other industries. Domestic demand for fuel oil is expected to continue to decrease due to the aging population, the declining birth rate, the shrinking population, the improvement of fuel efficiency, a shift in fuels and other structural reasons. In addition, there may be an oversupply of petrochemical products depending on the construction of new petrochemical plants overseas. Although the Group is working to build a structure for securing domestic sales channels and focusing production on profitable products in preparation for the reduction of demand, changes in both domestic and overseas economic trends, weather conditions, and other factors may cause demand to fluctuate, and this may materially impact the Group's business performance and financial condition.

(iv) Book Value Devaluation of Inventories Due to a Decline in Profitability

If the net realizable value of inventories at the end of the fiscal year falls below the book value as a result of a decline in crude oil prices, the Group may determine that profitability of inventories has decreased. In this case, the loss on valuation posted to reflect the decreased profitability of inventories may materially impact the Group's business performance and financial condition.

The Group uses derivative transactions to hedge the risks of price changes in the export and import of crude oil and oil products. For the specific actions the Group takes, please see Part 5: Accounting Status - 1. Consolidated Financial Statements and Others - (1) Consolidated Financial Statements - Note: Financial Instruments.

(Oil exploitation and production business)

(i) Crude Oil Prices

Crude oil prices are highly susceptible to supply and demand trends. Crude oil demand is subject to global economic trends and demand for oil products. It is particularly influenced by trends in the United States, which is a large consumer nation, and in the fast-growing Asia region, particularly in China. Other factors that impact crude oil prices include changes in the amount produced by OPEC member states and other oil-producing nations, changes in the amount of shale oil produced, wars and political unrest in areas surrounding oil producing states in the Middle East, terrorist attacks and other unexpected events. Crude oil prices are rising sharply, because of the Russian invasion of Ukraine in particular, and there may be rapid changes in crude oil prices depending on developments in Ukraine. The Group is closely watching crude oil price trends in its every day operations. Significant fluctuations in crude oil prices may materially impact the Group's business performance and financial condition.

The Group monitors the sensitivity of its consolidated business performance forecasts for the next fiscal year to changes in crude oil prices. A one U.S. dollar per barrel change in the Dubai crude oil price may result in a 1,200 million yen change in the profits of the Oil E&P Business over a year.

(ii) Crude Oil Production

The Group engages in crude oil production in the Emirate of Abu Dhabi, United Arab Emirates (UAE) and in Qatar. The Group accumulates oil field technologies and expertise through its operations to ensure the long-term stability of oil production. If the conditions of the oil reservoir differ from assumptions, there is a risk that we may fail to secure the expected production volume. The Hail Oil Field operated by the Group has shown that its oil reservoir pressure is declining. The Group will implement measures to increase the pressure of the oil reservoir to lower the risk. The suspension of operations or an equivalent event at any of the Group's production sites following an outbreak of war or political unrest in the areas surrounding the oil producing states in the Middle East, a terrorist attack or other unexpected event may materially impact the Group's business performance and financial condition.

(iii) Crude Oil Exploration and Development

The Group was awarded Offshore Block 4 in Abu Dhabi's second Block Bid Round in the UAE in the previous fiscal year. The Group will conduct exploration and investigate the viability of the commercial production of crude oil and natural gas. If the exploration process fails to discover resources at a commercially viable scale and the Group is unable to recover its investment, there may be a material impact on the Group's business performance and financial condition.

(Renewable energy business)

(i) Policies, Laws and Ordinances

The development of offshore wind power generation projects is being executed in general sea areas in accordance with the Act on Promoting the Utilization of Sea Areas for the Development of Marine Renewable Energy Power Generation Facilities. The Ministry of Economy, Trade and Industry and the Ministry of Land, Infrastructure, Transport and Tourism have jurisdiction over their specific procedures and schedules. The Group conduct feasibility studies at provisional project sites. If the sites are not designated as promotion zones at the times anticipated by the Group or if a planned project is delayed or cancelled, there may be a material impact on the Group's business performance, financial condition and future growth potential.

(ii) Development

The wind power generation business must obtain a variety of permissions and approvals at the development stage, observe wind conditions and assess environmental impact. This requires an upfront investment prior to the start of construction. If the Company must give up on the commercialization of a project in the development stage and it cannot recover its investment, that may be a material impact on the Group's business performance and financial condition.

(iii) Construction

The lead time between a successful bid and the start of the construction of an offshore wind power generation facility is several years. If steel material, labor or other costs rise during the period, construction expenses may soar. In addition, the COVID-19 pandemic may delay the transportation of materials and equipment from overseas and restrict engineers' entry into Japan. This may cause construction to be delayed. While the Group will endeavor to reduce these risks through alliances with partners and other means, a rise in construction expenses and a delay in construction may materially impact the Group's business performance and financial condition.

(iv) Investment

Offshore wind power generation projects are carried out through special purpose companies (SPCs) that the Group invests in. Events could occur that force the Group to abandon the commercialization of any of these projects if the Group fails to receive orders as a result of bidding. If this occurs, the Company may determine that its investment is not recoverable and post an impairment loss. This may materially impact the Group's business performance and financial condition. Many companies participate in offshore wind power generation, and competition is intensifying. As a result, the profitability of investments may decline.

(2) Other risks

(i) Foreign Exchange Rates

The Group imports crude oil and exports and imports oil products. Payment for oil and products is usually made in U.S. dollars. Gains or losses occur depending on foreign exchange rate fluctuations. The Group makes foreign exchange hedge transactions to minimize the adverse impact of fluctuations in foreign exchange rates. A weaker yen increases procurement costs. Fluctuations in foreign exchange rates also affects the conversion of figures in financial statements of any consolidated subsidiary or equity-method affiliate based overseas into the Japanese currency. This may materially impact the Group's business performance and financial condition.

The Group monitors the sensitivity of its consolidated business performance forecasts for the next fiscal year to changes in foreign exchange rates. A change in the exchange rate of the U.S. dollar against the yen by one yen may lead to a 2,600 million yen change in the profits of the Petroleum Business and the Oil E&P Business within a year.

As mentioned above, the Group uses derivative transactions to hedge the risk of exchange rate fluctuations. For specific actions, please see Part 5: Accounting Status - 1. Consolidated Financial Statements and Others - (1) Consolidated Financial Statements - Note: Financial Instruments.

(ii) Interest Rates

In the case where interest rate fluctuations lead to higher borrowing rates and higher finance costs, they may materially affect the Group’s business performance and financial condition.

Some of the Group's borrowings are exposed to interest rate fluctuation risks since variable interest rates apply. For the purpose of hedging these risks, the Group uses derivative transactions. For specific actions, please see Part 5: Accounting Status - 1. Consolidated Financial Statements and Others - (1) Consolidated Financial Statements - Note: Financial Instruments.

(iii) Asset Value

A drop in crude oil prices and changes in market conditions may result in the reduction of asset profitability or value. The Group may judge that its investments will not be recovered in whole or in part. In this event, a loss of impairment or valuation posted reflecting the recoverability of investments in non-current assets and loans may have a material impact on the business performance and financial condition of the Group.

(iv) Reversal of Deferred Tax Assets

The Group’s calculation of deferred tax assets is based on forecasts, including its estimation of future taxable income, and actual results may differ. When the Group determines that its tax burdens will not be reduced based on its estimation of future taxable income, the deferred tax assets will be reversed. This may have a material impact on the Group’s business performance and financial condition.

(v) Infectious Diseases

In response to the COVID-19 pandemic, the Group held joint crisis response meetings (17 Crisis Countermeasures Headquarters meetings and 3 crisis countermeasures meetings in FY2021) to take strong measures to address the pandemic. To minimize the impact of the pandemic, the Group has taken measures, including thorough measures to prevent infection, the promotion of office workers working from home, establishing procedures for when someone becomes infected or is suspected of being infected, providing vaccination opportunities at workplaces, securing and distributing test kits, and developing and providing a health observation app for home care patients. In addition, the Group revised its business continuity plan (BCP) manual for a novel influenza virus or other virus pandemic and has established a system for maintaining the stable supply of petroleum products. Before the COVID-19 pandemic, the Group had established a system enabling employees to work from home in the context of work style reforms. The Group used this system as a measure to prevent COVID-19 infections, combined with employees commuting outside of peak hours and other measures seeking the establishment of new work styles that enhance productivity and improve employee safety and health. However, if infections occur within the Group that affect the operations of its businesses, they may materially impact the Group's business performance and financial condition.

(vi) Climate Change

Japan had previously set a target of reducing CO_2 emissions by 26% from the FY2013 level by FY2030 in accordance with the Paris Agreement. In April 2021, the Japanese government announced that it had revised its target upward to a 46% reduction of greenhouse gas emissions from the FY2013 level by FY2030 and would aim to achieve carbon neutrality, or net zero greenhouse gas emissions, by FY2050.

The Group has also set a target of achieving net zero greenhouse gas (GHG) emissions in the Group's business by 2050. The acceleration of the global shift from fossil fuels to address these reduction targets involves the expansion of electric vehicles and sharing economies. While demand for gasoline will continue to exist, demand for fossil fuels is expected to decline gradually. In consideration of these circumstances, the Group will accelerate the changes to its business portfolio and aim to evolve into an environmentally friendly company. However, if Japan and other countries strengthen their policies for tackling climate change or amend or introduce environment-related legislation, demand for oil products may drop faster than predicted. That could have a material impact on the Group's business performance and financial condition, mainly in the petroleum-related business.

(vii) Disasters and Accidents

The Group handles large volumes of hazardous materials and high pressure gas, and implements a variety of safety measures to prevent accidents. However, accidents with or without workers' injuries arising from aging equipment and human error may result in the suspension of operations at oil refineries, logistics bases, oil storage depots and other facilities. To minimize the impact of a potential major earthquake or other natural disaster, the Group has been taking measures, including the installation of emergency power supplies, the renovation of facilities to increase seismic resistance, the revision of the BCP manual and disaster drills. However, if a natural disaster occurs, operations may be suspended. Apart from the suspension of oil refineries, logistics bases or oil storage depots, the disruption of business operation due to an accident involving an oil station, marine tanker or a tanker truck may have a material impact on the Group's business performance and financial condition.

(viii) Laws and Regulations

Various environmental regulations that affect the oil industry have been implemented, and the Group implements measures to comply with these regulations. However, additional environmental regulations and tougher penalties are expected. If new laws or amendments to existing laws result in an additional cost burden, that may have a material impact on the Group's business performance and financial condition.

(ix) Competition

The Group is engaged in stiff competition with domestic and overseas companies mainly in the oil business. While the Group is working to maintain and improve its competitiveness, the inability to maintain efficient business operations relative to competing companies could have a material impact on the Group's business performance and financial condition.

(x) Credit

The Group has established a management system for credit to customers. If any trade receivables owned turn irrecoverable after the customer has its financial condition deteriorated and goes into default, that may have a material impact on the Group's business performance and financial condition.

(xi) Quality of Products and Services

The Group is working to strengthen its product and service quality management system by setting targets and key performance indicators (KPIs) to ensure quality. They are priority management items in its risk management.

However, quality management risks may occur resulting in the loss of customer confidence and a weakened brand image. This may materially impact the Group’s business performance and financial condition.

(xii) Customer Satisfaction

In an effort to improve customer satisfaction, the Group employs the quality inspection of its customer center and the percentage of complaints about its services as KPIs. They are also included in the priority management items in the Group's risk management.

However, failure to meet the customer demand due to the deterioration of services could result in the loss of customer confidence and a weakened brand image. This may materially impact the Group’s business performance and financial condition.

(xiii) Violations of Laws and Ordinances

The Group defines compliance as one of the pillars of its sustainability management and it has developed a system for it. In addition, the Group is working to disseminate the Cosmo Energy Group Code of Conduct, which outlines rules for action that employees must follow, and to improve the morals and knowledge of individual employees through training on corporate ethics and human rights. However, the violation of laws or ordinances due to human error and other factors could lead to administrative sanctions and the possible disruption of business operations, as well as the loss of customer confidence and a weakened brand image. This may materially impact the Group’s business performance and financial condition.

(xiv) Information Management

In terms of information management, malicious software countermeasures and personal information protection measures have been implemented to strengthen the Group’s internal IT system security. In addition, the Group has established internal monitoring procedures and regulations on how to handle confidential information, including customer information, and has contracted external third parties to implement supervision and audits over the management and handling of confidential information within the Group. However, the loss, leakage or falsification of personal information and other confidential information or similar event for any reason could result in the disruption of business operations, the loss of customer confidence and a weakened brand image. This may materially impact the Group’s business performance and financial condition.

(xv) Internal Control

The Group is working to construct, operate and improve an effective internal control system that covers internal control on financial reporting, for the purpose of complying with laws, ordinances and other rules. However, the internal control system established by the Group may not function effectively due to changes in the environment inside and outside the organization and the occurrence of compliance violations. This could lead to a loss of confidence from stakeholders and may materially impact the Group's business performance and financial condition.