

## FACTS ABOUT KEY ISSUES

### **Merger of Japan Railways Group Mutual Aid Association (the Association) into the Welfare Pension (national pension)**

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To make up for a shortfall in annuity payment obligations of the Association, the JR Companies have made special annual payments of ¥22 billion to it during the seven-year period through the end of March 1997. JR East made ¥9.9 billion in special annuity payments annually. These payments were made in addition to the standard annuity payments prescribed by law in which employers match the annuity payments deducted from employees' wages.

In June 1996, legislation was passed to merge the Association and the annuity systems of two other companies (Nippon Telegraph and Telephone Co. (NTT) and Japan Tobacco Inc. (JT)) that were formerly fully owned by the government into the Welfare Pension. In accordance with this legislation, the merger was carried out in April 1997.

The law mandated that the Association transfer all reserves to the Welfare Pension when the merger took place. However, of the total about ¥1,210 billion to be transferred there was a shortfall of about ¥940 billion. Responsibility for this shortfall was divided between Japanese National Railways Settlement Corporation (JNRSC) and the JR Companies. As a result, JNRSC became responsible for about ¥770 billion and the JR Companies for about ¥170 billion. JNRSC would be liable for the period each member was employed by JNR, and the JR Companies for the period the member was in their employ. After Diet deliberation, the law and related regulations were enacted to mandate these payments.

In September 1997 JR East made a payment of ¥77.6 billion to meet this obligation in a lump sum. On its income statements, the Company is amortizing this amount as personnel expenses over a period of five years beginning with the fiscal year that ended on March 31, 1998 (see page 45).

The "Law for Disposal of Debts and Liabilities of the Japanese National Railways Settlement Corporation" (the "Law") was enforced in October 1998. In accordance with the Law, of the amount designated as JNRSC liabilities under the 1996 Law, half of the amount relating to employees of the JR Companies as of April 1, 1987 was mandated to become an additional obligation to be paid by the JR Companies.

JR East's share of this additional obligation was ¥70.5 billion (\$582 million), including the interest portion. It was paid in a lump sum on March 3, 1999 and listed on the income statement as "cash charges for additional obligation related to transfer to Welfare Pension" included in other expense. Please refer to the section entitled "Disposition of Long-Term Liabilities of former Japanese National Railways (JNR)."

It should be noted that JR East does not maintain a corporate annuity fund such as a Qualified Pension Plan or an Employees Pension Fund, which are both annuity systems under which payments by the Company can be recorded as expenses under Japan's Corporate Tax Law. Of the Company's 81 consolidated subsidiaries, 17 have a corporate annuity fund. A revision in the scope of consolidation in the fiscal year ending March 31, 2000 is expected to increase the number of consolidated subsidiaries with a corporate annuity fund.

### **Disposition of Long-Term Liabilities of former Japanese National Railways (JNR)**

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When Japanese National Railways was restructured in April 1987, responsibility for its long-term liabilities was clearly divided between the national government and the JR Companies. The process leading to this division included debate in the Diet. At the time of the restructuring, JNR's liabilities totaled ¥37.1 trillion, including costs that will be incurred in the future. The JR Companies were allocated ¥14.5 trillion of this amount, and JNRSC assumed responsibility for the remaining ¥22.7 trillion. It was decided at this time that JNRSC would repay as much of this amount as possible using funds generated by the sale of land left by JNR and JR Company stock held by JNRSC. Any remaining liabilities were to be assumed and disposed of by the national government.

However, sales of land by JNRSC were temporarily halted by the October 1987 Guidelines for Urgent Measures to Deal with Land that were determined by the Cabinet. Japan's economy subsequently fell into a recession in the early 1990s, further preventing JNRSC from selling land. Furthermore, a delay in the sale of stock in JR companies and other factors meant that liabilities could not be decreased; on the contrary, interest payments caused them to increase.

As of April 1987, liabilities held by JNRSC were ¥25.5 trillion, the combination of the above-mentioned ¥22.7 trillion and ¥2.9 trillion. The ¥2.9 trillion was one portion of the Shinkansen usage fees paid by the three Honshu-based JR passenger

railway companies, and was to be used to repay JNRSC's debt. Due to the above factors, these liabilities had grown to ¥28.3 trillion by the dissolution of JNRSC in October 1998.

The government in December 1997 decided on a policy for disposing of the debts of JNRSC. In February 1998, a "Bill for Disposal of Debts and Liabilities of the Japanese National Railways Settlement Corporation" was submitted to the Diet.

The bill included the following provisions:

- JNRSC's interest-bearing liabilities would be assumed by the national government's general account and JNRSC would be absolved of its non-interest bearing liabilities to the government.
- The land, JR Company stock and other assets held by JNRSC would be transferred to the Japan Railway Construction Public Corporation, which would pay for pension and other obligations.
- With regard to the amount to be transferred from the Japan Railways Group Mutual Aid Association to the Welfare Pension, a portion of the aforementioned liabilities legally assigned to JNRSC would become additional obligations of the JR Companies. Please refer to the section entitled "Merger of Japan Railways Group Mutual Aid Association into the Welfare Pension."

If this bill had been enacted, it would have resulted in additional obligations on the JR Companies totaling about ¥360 billion, of which approximately ¥140 billion would have been assigned to JR East.

With regard to these pension transfer payments, the division of responsibility for liabilities between the JNRSC and the JR Companies was prescribed by law in 1996. In addition, the issue had been settled by a Cabinet decision stating that the national government would ultimately dispose of the liabilities assigned to JNRSC. Consequently, JR East was opposed to the imposition of additional obligations on the JR Companies.

The proposed bill became law in October 1998 following an amendment that halved the additional obligations of the JR Companies to ¥177 billion (\$1,463 million), ¥69.9 billion (\$578 million) of which was assigned to the Company.

Following the enactment of this legislation, JR East sought a broad range of opinions to determine the best way to respond in a manner that maximizes benefits for the Company and its shareholders. The Company decided to pay the entire additional obligation of ¥70.5 billion (\$582 million), including the interest portion, in a lump sum and to record this amount in other expense on the income statement. The Company further decided not to attempt to overturn this legislation in the courts. This decision was based on the belief that the Company and its shareholders will benefit most if JR East makes a concerted effort to become an independent, self-reliant company by achieving full private-sector ownership as soon as possible, thus gaining the complete freedom to resolutely adhere to a management strategy that prioritizes shareholder value.

Discussing the possibility of imposing further additional liabilities on the JR Companies, Prime Minister Keizo Obuchi stated at the Diet: "Regarding those debts and pension liabilities of Japanese National Railways Settlement Corporation that have not been designated for assumption by JR Companies, the Government is of the view that such obligations must not be imposed on JR Companies in the future."

## ***The Law Concerning Passenger Railway Companies and the Japan Freight Railway Company (the JR Law) and Complete Private-Sector Ownership***

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JR East has 4 million shares of common stock issued and outstanding. When the Company's shares were listed on domestic stock exchanges in October 1993, 2.5 million shares were sold to the public. Subsequently, 1 million shares were sold to the public in August 1999. The remaining 500 thousand shares are held by JRCC's JNR Settlement Headquarters. Based on a Cabinet resolution regarding the JNR restructuring, it was determined that the shares in the JR passenger and freight railway companies "shall, as the companies establish suitable management bases and meet other conditions, be sold to make these companies entirely private-sector enterprises as quickly as possible."

Presently, the JR Law is still applicable to all of the JR passenger and freight railway companies. Consequently, approval of the Ministry of Transport is required for a number of actions. Among them are issuing new stock and bonds; taking out loans with a repayment period of more than one year; appointments and dismissals of representative directors and corporate auditors; business plans; the transfer of major property; and the appropriation of earnings. At the Committee on Transport of Japan's House of Representatives, the government has stated that "revision or abolition of the JR Law will be necessary once the JR companies have been listed and their shares sold, making them fully private-sector companies. We are now studying the specific timing and method to conduct such a revision or abolition."

JR East strongly believes that establishing an independent and self-reliant management base that is completely separate from the government will yield significant benefits for the Company. It is thus JR East's fervent wish that JRCC's JNR Settlement Headquarters sell all its remaining JR East shares and that JR East is released from the JR Law as soon as possible.

## **Construction and Operation of Seibi Shinkansen Lines**

The Seibi Shinkansen is a network of proposed Shinkansen lines pursuant to the Nationwide Shinkansen Railway Development Law. The basic plan for these new lines was decided in 1973. Currently, work is under way on eight sectors of three lines which are segmented into “five sectors of three lines” and “sectors of New Shinkansen lines for launching construction.” Within JR East’s service area, the Japan Railway Construction Public Corporation (JRCC) has been involved in building full-scale Shinkansen lines on the Hokuriku Shinkansen Line’s two sectors (Takasaki–Nagano and Nagano–Joetsu) and on the Tohoku Shinkansen Line’s two sectors (Morioka–Hachinohe and Hachinohe–Shin-Aomori). Service on one of these sectors, extending from Takasaki to Nagano (Nagano Shinkansen), commenced in October 1997. The Nagano–Joetsu sector and the Morioka–Shin-Aomori sector are still under construction.

JR East has reached the following agreement with the government regarding the construction of Seibi Shinkansen lines:

- (1) JR East will pay only usage fees after the Company has started operations on the new lines. The usage fees will not exceed the corresponding benefits of the applicable line. JR East will incur no financial burden other than these usage fees.
- (2) JR East will separate itself from conventional lines running parallel to the new Shinkansen lines.

JR East agreed to the construction of the two lines mentioned above in its service area based on its judgment that these new lines would not adversely affect the Company’s results.

In December 1996, the Japanese government and ruling parties agreed that all future decisions regarding the order for starting construction on Seibi Shinkansen lines should be based on the profitability of the lines where construction has not yet begun and the assent of the applicable JR company and local governments. This assent should take into account the method for removing parallel conventional lines from JR operations and other issues. They also agreed that the financial burden of each JR company should be limited to usage fees and advance payments of these fees that do not exceed the corresponding benefits of the applicable line in each company’s service area.

In May 1997, an amendment to the Nationwide Shinkansen Railway Development Law was passed. This amendment clarifies the division of responsibilities for funding new Shinkansen lines between the national and prefectural governments. Under this system, the national government funds two-thirds of construction costs and prefectures fund the remainder. In addition, the government and ruling parties formed an exploratory committee to examine Seibi Shinkansen issues. This committee was responsible for studying the viability of each proposed Shinkansen line as well as agreements with localities and the JR companies regarding the separation from JR of the parallel conventional lines. Based on these studies, the committee examined the order for building the new lines. With regard to the Tohoku Shinkansen sector between Hachinohe and Shin-Aomori and the Hokuriku Shinkansen’s Nagano-Joetsu sector, both of which are within JR East’s service area, JR East has confirmed that the basic principles of the Seibi Shinkansen have been fulfilled. Consequently, JR East has given its approval for the construction of these lines and JRCC began work on both sectors in March 1998.

JR East’s Yamagata and Akita hybrid Shinkansen are not covered by the Nationwide Shinkansen Railway Development Law. JR East is proceeding with these two projects independently, with the cooperation of the national and local governments in the form of interest-free loans and other support. Currently, JR East is carrying out work to extend the Yamagata hybrid Shinkansen (Fukushima-Yamagata) north to Shinjo. Operation on the extended sector is expected to begin in December 1999.

## **Deregulation**

In December 1996, the Ministry of Transport decided on a policy of abolishing most of its restrictions, originally imposed to maintain the supply-demand balance, on the entry of companies in the public transportation sector. After much internal and public debate at the Council for Transport Policy and other organizations, an Amendment Bill to the Railway Business Law was submitted to the Diet in February 1999 and passed in May 1999.

It includes the following provisions:

- Review of regulations on entry and withdrawal

Previously, railway companies needed a license from the Minister of Transportation to operate. The amended law requires only the minister’s permission. Operators wishing to cease providing a service now need to submit notification one year in advance, without having to seek permission as was previously required.

- Revisions of regulations on fares

The amended law clearly states that approval is required for upper limits on fares, a level below which companies can set and revise fares on their own after submitting notification of such action.

- Revision of regulations on technology

Procedures for obtaining approval for construction, a process that was extremely complex, have been simplified for railway companies certified by the national government as having a certain level of technical skills.

JR East had adopted the following positions regarding these changes.

**Entry and withdrawal:** Even though demand and supply restrictions have been lifted, the huge initial investment required by railways and extremely long period needed to recover those investments make it highly unlikely that a new competitor would have any impact on the Company's results. Regarding withdrawal, JR East welcomes the establishment of a clear withdrawal method to replace the previously vague standards. However, the Company has no concrete plan at this time to cease service on any particular line, and regards this as a matter for future consideration.

**Fare revisions:** Regarding the approval of the Minister of Transport for upper limits on fares, examinations must be conducted to ensure fares do not exceed the sum of reasonable costs and profits following submission of an application for the approval of a fare increase by a railway company. This fare calculation method is called the total-cost method. The Company believes that this method has a number of major drawbacks. Among them are (1) higher costs can be translated into higher fares, so there is no incentive for companies to implement effective management practices, and (2) the process of determining applicable expenses entails considerable time and labor expenses; government authorities thus become involved in how railways are managed.

Due to these problems, JR East has strongly urged that the total-cost method be replaced with the price-cap method. Under this method, railway companies would be free to adjust fares by submitting notification within a prescribed range, such as one based on the consumer price index. This method is already being applied to utilities in the United Kingdom, United States and other countries.

The government will continue to study the price-cap method and other ways to improve the system for determining railway fares. Unfortunately, a plan does not exist at the present time for the immediate adoption of the price-cap method. Unless there is a significant change in the operating environment, JR East intends to retain its policy of avoiding fare increases. That means JR East will not be subjected to the total-cost method system for the time being. On the other hand, the decision of whether or not to adopt the price-cap method will not have an immediate effect on JR East's operations, although JR East will continue to strongly urge adoption of this method in order to establish an independent base for the Company's management.

**Technology:** The new system for certifying railway companies reflects almost all of the points the Company had been urging. Details will be determined by ministerial ordinance from the Ministry of Transport. JR East will continue to urge the adoption of a system under which certification standards and application procedures are dramatically simplified.

## **The Year 2000 Issue**

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JR East depends on a large number of computer systems and devices using microcomputers in a broad line of railway, life-style service and other business activities. Year 2000 compliance work is still proceeding on some of these systems. The Company regards this as a priority issue and is taking actions on a company-wide basis as necessary.

In November 1996, a committee headed by a Company executive vice president was formed to draw up a schedule for ensuring Year 2000 compliance. Remedial work has been proceeding since April 1997. As of June 1999, the Company had completed substantially all measures (revisions to programs, replacement of devices and tests) needed to ensure that there will be no Year 2000 problems involving train operations, sales, accounting and other critical systems. Revisions are proceeding on other systems as well with a target of completing the measures by October 1999.

Most JR East systems are self-contained, but the Company is conducting tests to verify the compliance of the computer systems of several companies with which the Company's computers are connected via a network or other means. JR East is also conducting a survey of Year 2000 compliance at other companies with which it does business.

In February 1999, under the supervision of the Company's executive vice president, JR East formed a Headquarters for Year 2000 Issue Contingencies to formulate a contingency plan to deal with unforeseen problems.

## **Changes in Accounting Standards**

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The accounting standards to be used by publicly owned companies and other companies to which the Securities and Exchange Law is applicable are to be significantly revised beginning with the fiscal year ending March 31, 2000 (fiscal 2000). These revisions are being made to conform to the trend toward adoption of International Accounting Standards and to better disclose and facilitate accurate analysis of the operating results and financial positions of corporate groups. The most important revisions are as follows.

### **Shift in emphasis from nonconsolidated to consolidated financial statements**

In Japan, nonconsolidated financial statements were the predominant means of financial disclosure. Beginning with fiscal 2000, consolidated statements will assume this role.

### **Expansion of scope of consolidation**

Previously, Japan used ownership of more than 50% as the definition for consolidated subsidiaries and ownership of 20% to 50% as the definition of affiliated companies. Beginning with fiscal 2000, the “effective control and influence standard” will be applied to determine consolidated subsidiaries. This is expected to increase the number of consolidated subsidiaries of Japanese companies. JR East is currently reviewing its consolidated subsidiaries in line with the new standards. The number of consolidated subsidiaries is expected to be 95 and that of affiliated companies to be 2 in fiscal 2000.

### **Presentation of statements of cash flows**

Previously, Japanese companies provided a “cash table” as supplementary information to the nonconsolidated financial statements. Beginning with fiscal 2000, companies are required to produce and disclose consolidated statements of cash flows. JR East expects that this will result in changes in the presentation of the consolidated statements of cash flows in its annual report beginning with fiscal 2000 to conform to Japanese disclosure standards.

### **Presentation of interim consolidated financial statements**

Interim consolidated financial statements, which were previously voluntary, are mandatory beginning with the six-month period ending September 30, 2000.

### **Tax effect accounting**

Tax effect accounting, which was previously applied on a voluntary basis, is mandatory in all cases in fiscal 2000. As JR East has not used tax effect accounting, income taxes have not been deferred.

### **Recognition of obligations for severance and retirement benefits**

All employees of JR East and its consolidated subsidiaries are generally entitled to receive lump-sum severance and retirement benefits under an unfunded plan. The amounts of the severance and retirement benefits are generally determined by the length of service and basic salary at the time of severance or retirement of the employees. JR East and most of its consolidated subsidiaries accrue a liability for such benefits equal to 40% of the amount required if eligible employees voluntarily severed employment at the balance sheet date. No severance or retirement benefits have been funded. Although JR East has no funded pension plan, 17 of its consolidated subsidiaries have a non-contributory funded pension plan in addition to an unfunded plan (see page 45). A revision in the scope of consolidation in the fiscal year ending March 31, 2000 is expected to increase the number of consolidated subsidiaries with such a plan.

Because of amendments to the Japanese Tax Law applicable from fiscal 1999, methods for tax accounting for accrued retirement allowances have been revised. The maximum amount that companies are allowed to accrue is being reduced in stages from 40% to 20% of the voluntary retirement obligations mentioned above. For the year ended March 31, 1999, companies are allowed to accrue up to 37% of such obligations for tax purposes, and up to 33%, 30%, 27% and 23% in each subsequent year. The excess of the amount accrued at 40% for financial statement purposes over the maximum amount allowable at 37% for tax purposes is not tax-deductible.

Under Japanese accounting standards, all lump-sum payments upon retirement are treated as mentioned above. With regard to pensions, the portion corresponding to payments of the fund to the pension assets is recognized as an expense. However, beginning with fiscal 2001, both accounting methods will be applied in a consistent manner as follows.

In Japan, companies will be required to accrue a shortfall of the amount of a liability calculated based on the present value of future payment obligations. Such accrual is likely to be accounted for as an expense and companies are likely to be permitted to amortize this expense over a period of up to 15 years. It should be noted that, in the case of an unfunded plan, the shortfall mentioned above will not cause any additional cash outflow.

### **Market values of financial instruments**

In Japan, financial instruments are valued on the basis of their acquisition cost. Beginning in fiscal 2001, market value will be used instead. Securities as well are carried at cost and are revalued only in instances where market value falls significantly below book value. All quoted securities will be valued at market. Revaluations of securities for trading will be reflected as gains and losses on the income statements beginning in fiscal 2001, while revaluations of long-term investments in securities will principally be reflected as additions and deductions to shareholders' equity from fiscal 2002.