

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

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 the JNR Settlement Headquarters of Japan Railway Construction Public Corporation (JRCC). Based on a Cabinet resolution regarding the Japanese National Railways (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 including the Company. Consequently, approval of the Minister 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; annual 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." In February 2000, the government stated at the Committee on Transport of Japan's House of Representatives that it "wants to achieve complete private-sector ownership as soon as possible."

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.

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

When JNR 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 Japanese National Railways Settlement Corporation (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.

In October 1998, the Law for Disposal of Debts and Liabilities of the Japanese National Railways Settlement Corporation was passed and enforced. It included the following provisions concerning the disposal of JNRSC's liabilities:

- 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 JRCC, 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 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."

Discussing the possibility of imposing further additional liabilities on the JR Companies, the Prime Minister stated during the debate in the Diet prior to passage of this law: "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."

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

To make up for a shortfall in annuity payment obligations of the Association, the JR Companies have made special annual payments of ¥22.0 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. The shortage of the assets to be transferred to the Welfare Pension from the Association was shared by JNRSC and JR Companies on the basis that JNRSC, as successor to the employer's position in the former JNR, would be liable for the period each member of the Association was employed by JNR and the JR Companies for the period the member of the Association was in their employment. The portion shared by the Company amounting to ¥77.6 billion was paid in a lump sum in September 1997. This has been charged to income for the five years since the year ended March 31, 1998 on a straight-line basis.

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, including the interest portion. It was paid in a lump sum in March, 1999 and listed on the income statement as "cash charges for additional obligation related to transfer to Welfare Pension" included in other expenses.

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 consolidated subsidiaries, 25 have a corporate annuity fund.

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, 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 on the Hokuriku Shinkansen, commenced in October 1997. Construction on the Morioka–Hachinohe sector of the Tohoku Shinkansen began in August 1991. 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.

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 passed in May 1999 and enforced in March 2000.

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 and charges

The amended law clearly states that approval is required for upper limits on ordinary fares and Shinkansen charges, a level below which companies can set and revise fares on their own after submitting prior notification of such action. Further, the amended law requires prior notification for revisions to limited express charges, which previously required approval for revisions, making revisions the same as those for Green Car and Sleeper Car charges.

- 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 has 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.

Revisions of fares and charges: Regarding the approval of the Minister of Transport for upper limits on fares and charges, examinations must be conducted to ensure fares and charges do not exceed the sum of reasonable costs and profits following submission of an application for the approval of a fare and charge increase by a railway company. This 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 and charges, 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.

Changes in Accounting Standards

The accounting standards were significantly revised beginning with the fiscal year that ended March 31, 2000 (fiscal 2000). These revisions were 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 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" is applied to determine consolidated subsidiaries. JR East reviewed its consolidated subsidiaries in line with the new standards. As a result, the number of consolidated subsidiaries has increased from 81 to 97, representing 12 companies that meet the standard for effective control and 4 companies in which JR East increased or gained ownership. The scope of companies accounted for using the equity method increased from one to four. In addition to JAPAN TELECOM CO., LTD., there are two companies that meet the standard for having an effective influence on results and one company whose importance has increased (see pages 56, 57 and 58).

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. Consolidated statements of cash flows under new Japanese disclosure standards use presentation methods different to those of previous years. The major differences are as follows:

Amortization of long-term prepaid expense is listed under Cash Flows From Operating Activities. Previously, it was included in Cash Flows From Investing Activities.

Payments of interest and income taxes are listed under Cash Flows From Operating Activities. Previously, it was listed under Supplemental Disclosures of Cash Flow Information.

Proceeds from sales of fixed assets and proceeds from construction grants are listed under Cash Flows From Investing Activities. Previously, it was included in Cash Flows From Operating Activities.

Presentation of interim consolidated financial statements

Interim consolidated financial statements, which were previously voluntary, are mandatory beginning with the six-month period that ends September 30, 2000. Prior to this development, JR East released a set of consolidated financial information including segment information for the interim period ended September 30, 1999.

Adoption of Tax effect accounting

Tax effect accounting, which had been previously applied on a voluntary basis, became mandatory in all cases in fiscal 2000. As JR East did not use tax effect accounting until fiscal 1999, income taxes had not been deferred. Due to this revision, JR East recorded short-term deferred income taxes of ¥22.0 billion (\$207 million) and long-term deferred income taxes of ¥29.4 billion (\$277 million). The major components of these items are reserves for bonuses with regard to short-term deferred income taxes and reserves for retirement benefits with regard to long-term deferred income taxes.

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, 25 of its consolidated subsidiaries have a non-contributory funded pension plan, in the case of most of the 25 subsidiaries, in addition to an unfunded 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 fiscal 2000, companies are allowed to accrue up to 33% of such obligations for tax purposes, and up to 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 33% 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 to be accounted for as an expense and companies are to be permitted to amortize this expense over a period of up to 15 years. This shortfall for JR East could be ¥507.0 billion on a consolidated basis in accordance with the present retirement system. This is calculated based on a discount rate of 3.0%. The Company will charge this shortfall to income over a period of 10 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.