

Exclusions of 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 Land, Infrastructure and 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.

As regards this JR Law, the Law of Part Amendment to the Law concerning Passenger Railway Companies and the Japan Freight Railway Corporation (the amendment law), which excludes the three passenger railway companies in Honshu (JR East, JR Central and JR West) from the JR Law passed on June 15, 2001 at the 151st session of the Ordinary Diet, and issued on June 22, 2001 (the Law No. 61 in 2001). This law shall be in force on the date decided by an ordinance within six months from the date on which it is issued.

Following the enforcement of the amendment law, obtaining a permit as regards the matters to be permitted by the Minister of Land, Infrastructure and Transport stated in the above shall not be required. The Company expects that this will enable enhancement of independence of management and more mobile business operation.

The amendment law provides that the Minister of Land, Infrastructure and Transport shall decide guidelines relating to the matters needing consideration for the time being in cases where the three companies in Honshu including the companies which, if any, will be involved in management of the railway business by splitting, etc., (the Three Companies and their successors) carry out business in order to secure passengers' convenience, etc., in consideration of the purpose of the JNR restructuring. The amendment law also provides that the Minister of Land, Infrastructure and Transport may guide and advise the Three Companies and their successors in cases where business operation that takes these guidelines into account is needed to be secured, and warns and directs them further in case where business operation contrary to the guidelines is carried out without any justifiable reason.

Matters provided in the guidelines are as follows:

- Matters relating to security of tie-up and cooperation between the companies such as appropriate set-up of passenger fares and charges between JR companies, smooth use of railway facilities and other factors of the railway businesses.
- Matters relating to appropriate maintenance of the routes currently in operation and security of users' convenience at the time of preparation of the stations and other railway facilities consid-

ering change in the trend of transport demand and other factors after the implementation of the JNR restructuring.

- Matters relating to consideration given to small- and medium-sized companies in order to avoid inappropriate interference in business activities of such companies or inappropriate violation of their benefits.

JR East has been taking note of the matters provided in its guidelines while carrying out its business operations and intends to continue to do so as a matter of course in the future. Therefore, JR East does not think the existence of these guidelines will hinder its management.

As regards sale of the shares of the Three Companies held by the JNR Settlement Headquarters of JRCC, the Minister of Land, Infrastructure and Transport, etc., shows in the Diet the policy that these shares should be sold in order in consideration of the equity market condition after the enforcement of the amendment law.

All bonds issued by JR East are covered by general guarantees under the JR Law. This means that bondholders have preferential rights covering payment of principal and interest. After the amendment law takes effect, JR East will be exempted from this provision. However, the general guarantees will remain in effect as a transitional measure with regard to bonds issued before the date on which the amendment law takes effect.

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.

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 JNRSC 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."

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 six sectors of three lines. Within JR East's service area, JRCC is now involved in building full-scale Shinkansen lines on the Hokuriku Shinkansen line's one sector (Nagano–Joetsu) and on the Tohoku Shinkansen line's two sectors (Morioka–Hachinohe and Hachinohe–Shin-Aomori). Service on the Hokuriku Shinkansen line's sector from Takasaki to Nagano already commenced in October 1997 (operationally named Nagano Shinkansen).

Construction on the Morioka–Hachinohe sector of the Tohoku Shinkansen line began in August 1991. JR East has reached the following agreement with the government.

- (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. The operation of this sector is expected to start at the end of 2002.

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 assent of the local governments and relevant JR company in respect of the profitability of each sector of the lines and management separation of the parallel conventional lines, etc., and that the financial burden of each JR company should be limited to usage fees and advance payments 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. JR East confirmed the basic principles of the Seibi Shinkansen lines in respect of the sectors between Hachinohe and Shin-Aomori of the Tohoku Shinkansen line and between Nagano and Joetsu of the Hokuriku Shinkansen line within the JR East's service area and has agreed to construct them. The construction of these two sectors commenced in March 1998. The construction of these two sectors is estimated to com-

plete 12 years later and a little more than 12 years later, respectively, from the date of amended license of construction dated April 2001.

JR East's Yamagata and Akita hybrid Shinkansen are not covered by the Nationwide Shinkansen Railway Development Law. JR East has constructed these two lines 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 (predecessor of the Ministry of Land, Infrastructure and 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 Transport (predecessor of the Minister of Land, Infrastructure and Transport) 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 (first class 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 Land, Infrastructure and 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, the 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: For the new system for certifying railway companies, JR East obtained certification in December 2000 for the first time as a railway company.

Changes in Accounting Standards

In Japan, the accounting standards are presently being revised significantly in line with the trend of adoption of the international accounting standards, which enable more accurate understanding and analysis of the operating results and the financial position of the whole corporate group.

Following are the revised matters already applicable from the year ended March 31, 2000.

- Shift in emphasis from nonconsolidated to consolidated financial statements
- Scope of consolidation to be decided on the basis of the effective control and influencing standards
- Presentation of statements of cash flows
- Adoption of tax effect accounting

Following are the revised matters applicable from the year ended March 31, 2001.

- Presentation of interim consolidated financial statements (applicable from the interim period ended September 30, 2000).
- Adoption of accounting for retirement benefits (recognition of obligations for severance and retirement benefits, etc.)*
- Adoption of accounting for financial instruments (market values of financial instruments, etc.)*

*For further details, see Notes of Financial Section.