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**JR EAST BACKGROUND—FROM COMPANY ESTABLISHMENT TO ACHIEVEMENT OF FULL PRIVATIZATION**

JR East was incorporated as a joint stock corporation under the laws of Japan on April 1, 1987 as one of several successors to the railway operations of the Japanese National Railways (JNR). JNR was established as an independent public entity to own and operate the nationwide railway network in 1949 as part of the post-war reorganization of Japan's national passenger and freight railway. Despite Japan's economic growth following JNR's establishment, JNR experienced financial difficulties and an increasing debt burden, which rendered it effectively insolvent. In 1986, legislation was passed to restructure and eventually privatize JNR and which involved transferring its railway operations and certain related assets and liabilities to the JR Companies\*.

Other than the Tokaido and Sanyo Shinkansen lines, which involve the operation of railway facilities in the service areas of other JR Passenger Companies\*\*, the JR Passenger Companies assumed the passenger railway operations of JNR in their respective geographic areas. JR Freight assumed JNR's cargo operations nationwide. Because JR Freight doesn't own railway lines other than facilities used exclusively for freight operations, it pays track access charges to the JR Passenger Companies, including JR East. Certain other businesses and related assets and liabilities were transferred to other JNR Successor Entities\*\*\*, including the Shinkansen Holding Corporation, as discussed below. After such transfer and assumption, the remaining assets and obligations of JNR became assets and liabilities of JNR Settlement Corporation (JNRSC). JNRSC was in turn dissolved in October 1998. Most of JNRSC's liabilities were assumed by the Government or canceled, and its assets (including all shares of JR East then held by JNRSC) and certain liabilities were transferred to the Japan Railway Construction Public Corporation (JRCC). In connection with the dissolution of JNRSC, legislation was passed which required that certain pension-related liabilities of JNRSC be transferred to the JNR Successor Entities, including JR East. (See page 46.)

In addition to the JR Companies, the restructuring of JNR also resulted in the creation of the Shinkansen Holding Corporation to own and lease the facilities comprising JNR's four then-existing Shinkansen lines to JR East, JR Central and JR West. Although JR East initially leased the Tohoku and Joetsu Shinkansen lines from the Shinkansen Holding Corporation, on October 1, 1991, it purchased both lines pursuant to a long-term purchase arrangement. Subsequent to this purchase, the Shinkansen Holding Corporation was dissolved, and payments to be made by JR East in respect of its Shinkansen purchase liabilities are now made to the Government-owned Corporation for Advanced Transport & Technology, the ultimate successor entity to the Shinkansen Holding Corporation.

Prior to December 1, 2001, all JR Companies were subject to the Law Concerning the Passenger Railway Companies and the Japan Freight Railway Company (JR Law), and their business and management were under the supervision of the Minister of Land, Infrastructure and Transport. Beginning December 1, 2001, JR East, JR Central and JR West are, in general, no longer subject to the provisions of the law. (See page 45.)

Initially, all capital stock of each of the JR Companies, including JR East, was owned by JNRSC. In October 1993, JR East's common stock was listed on the Tokyo, Osaka and Nagoya stock exchanges in conjunction with the sale by JNRSC of 2,500,000 shares, or 62.5%, of JR East's total outstanding common stock to the public in

Japan. The proceeds from the sale of such shares were used by JNRSC to repay its long-term indebtedness. Upon the dissolution of JNRSC in October 1998, its assets and liabilities, including 1,500,000 shares of JR East's common stock, were assumed by JRCC. JRCC sold 1,000,000 shares, or 25.0%, of JR East's common stock in August 1999, and all 500,000 remaining shares, or 12.5%, in June 2002, both through the global offering of such shares. JR East finally achieved full privatization to become an entirely private-sector enterprise 15 years after its establishment.

\* "JR Companies" means, collectively, JR East, Hokkaido Railway Company (JR Hokkaido), Central Japan Railway Company (JR Central), West Japan Railway Company (JR West), Shikoku Railway Company (JR Shikoku), Kyushu Railway Company (JR Kyushu), and Japan Freight Railway Company (JR Freight).

\*\* "JR Passenger Companies" means JR Companies other than JR Freight.

\*\*\* "JNR Successor Entities" means the entities which succeeded to JNR's railway and other operations on April 1, 1987, consisting of the JR Companies, the Shinkansen Holding Corporation, Railway Telecommunication Co., Ltd., Railway Information Systems Co., Ltd. and the Railway Technical Research Institute.

## A BRIEF HISTORY OF JR EAST

			Number of JR East shares held by government agency
<b>April</b>	<b>1987</b>	JR East was established upon the division and privatization of JNR.	<b>4,000,000</b> (100.0%)
<b>October</b>	<b>1993</b>	The first public sale of shares held by JNRSC.  Listed on the First Section of the Tokyo Stock Exchange and other exchanges in Japan.	<b>1,500,000</b> (37.5%)
<b>August</b>	<b>1999</b>	The second public sale of shares held by JRCC, a successor of JNRSC.	<b>500,000</b> (12.5%)
<b>November</b>	<b>2000</b>	JR East announced Medium-Term Business Plan— <i>New Frontier 21</i> .	
<b>December</b>	<b>2001</b>	The amendment to the JR Law took effect.	
<b>June</b>	<b>2002</b>	The third public sale of shares held by JRCC, and full privatization achieved.	<b>0</b> (0.0%)

## EXCLUSION FROM THE ADOPTION OF THE JR LAW

Prior to achievement of full privatization, the amendment law, which generally excluded the three JR Passenger Companies in Honshu, Japan's mainland, (JR East, JR Central and JR West) from the JR Law, took effect in December 2001. Previously, under the JR Law, approval of the Minister of Land, Infrastructure and Transport was required for a number of actions. Among them were issuing new stocks 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. JR East is no longer subject to these approvals.

Under the authority of the amended JR Law, the Minister of Land, Infrastructure and Transport has issued guidelines relating to the matters needing consideration for the time being in cases where the three JR Passenger 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 amended JR 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 considering 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.

Although JR East is no longer subject generally to the amended JR Law, all bonds issued by JR East prior to December 1, 2001, the effective date of the amendment to the JR Law, are and will continue to be general mortgage bonds as required under the JR Law which are entitled to a statutory preferential right over the claims of unsecured creditors of JR East. Any bonds issued on or after December 1, 2001 are unsecured bonds without general mortgage preferential rights. Since then, JR East has already issued 10-year, 20-year and 30-year unsecured bonds worth a total of ¥216 billion on the Japanese market as of June 2003.

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## DISPOSITION OF LONG-TERM LIABILITIES OF FORMER 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 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 Companies' stocks 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 reces-

sion in the early 1990s, further preventing JNRSC from selling land. Furthermore, a delay in the sale of shares 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 JR Passenger Companies in Honshu, 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 Companies' stocks 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 then 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."

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## CONSTRUCTION AND OPERATION OF ADDITIONAL SHINKANSEN LINES

The basic plan for a network of proposed new Shinkansen lines was decided in 1973 pursuant to the Nationwide Shinkansen Railway Development Law. Currently, work is under way on five segments 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 Nagano–Joetsu segment and on the Tohoku Shinkansen line's Hachinohe–Shin-Aomori segment.

Services on the Hokuriku Shinkansen line's segment between Takasaki and Nagano (operationally named Nagano Shinkansen) and the Tohoku Shinkansen line's segment between Morioka and Hachinohe already commenced in October 1997 and December 2002, respectively. In both cases, prior agreement was reached between the government and ruling parties on the following principles, and these conditions have been scrupulously observed in actuality.

- (1) JR East will pay only usage fees after it 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.

In December 1996, the national government and ruling parties agreed that all future decisions regarding the order for starting construction on new Shinkansen lines covered by the Nationwide Shinkansen Railway Development Law should be based on the assent of the local governments and relevant JR company in respect of the profitability of each segment 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 new Shinkansen lines covered by the Nationwide Shinkansen Railway Development Law in respect of the segments between Hachinohe and Shin-Aomori of the Tohoku Shinkansen line, and between Nagano and Joetsu of the Hokuriku Shinkansen line within JR East's service area and has agreed to construct them, having concluded that the construction of these lines would not have an adverse impact on the maintenance of a sound financial position. The construction of these two segments commenced in March 1998, and is estimated to be completed 12 years and a little more than 12 years, respectively, from the date of the amended license of construction, dated April 2001.

There are no usage fees on the Tohoku Shinkansen line's Tokyo–Morioka segment and the Joetsu Shinkansen line's Omiya–Niigata segment because JR East purchased these assets in 1991. (See page 44.)

The Yamagata and Akita hybrid Shinkansen lines 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.

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## 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 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 results of JR East.

Regarding withdrawal, JR East welcomes the establishment of a clear withdrawal method to replace the previously vague standards. However, JR East 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.

JR East 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 it is difficult 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 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. However, a plan does not exist at the present time for the immediate adoption of the price-cap method.

**Technology:** For the new system for certifying railway companies, JR East obtained certification in December 2000 for the first time as a railway company.

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## 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 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 Standards for Retirement Benefits (recognition of obligations for severance and retirement benefits, etc.)\*
- Adoption of Accounting Standards for Financial Instruments (market values of financial instruments, etc.)\*

In April 2002, Japan's Business Accounting Council issued draft accounting standards calling for the adoption of asset impairment accounting. Under the proposed accounting standard for long-lived assets, companies would be required to recognize an impairment loss in their income statements if certain indicators of asset impairment exist and the book value of an asset exceeds the undiscounted sum of future cash flows of the asset. The impairment loss would be measured as the excess of the book value over the higher of (1) the fair market value of the asset net of disposition cost and (2) the present value of future cash flows arising from ongoing utilization of the asset and from disposal after asset use. The standards cover land, factories, buildings and other forms of property, plant and equipment. Assets would be grouped at the lowest level for which there are identifiable cash flows that are independent of the cash flows of other groups of assets. Restoration of previously recognized impairment losses would be prohibited. The draft calls for a two-year phase-in period beginning with the year ending March 31, 2004 during which companies may voluntarily adopt the new standards and mandatory adoption of the standards by the year ending March 31, 2006. In the plan of the final set of standards, the Accounting Standards Board of Japan stated in the exposure draft that railway operators should group their assets by line for asset-impairment accounting. Together with other JR companies, we have put forward the counter-argument that railway businesses operate as total networks and that all lines should be treated together as a single asset.

\*For further details, see Notes to consolidated financial statements.