Northwest Energy Company

Annual Report 1978

The Company:

Northwest Energy Company is committed to developing and transporting energy resources. Through subsidiaries, the Company supplies natural gas to seven western states, is operating partner for the group which will construct the Alaskan section of the Alaska Highway Pipeline Project, seeks to develop Rocky Mountain natural gas and oil reserves and operates an underground coal mine in Colorado. This report describes these projects and other corporate ventures.

Highlights

"Because we have been successful in laying a firm foundation during the past five years, we expect 1979 to be the best year in the Company's history."

John G. McMillian
Chairman of the Board
and Chief Executive Officer

	Year Ended December 31,				Eleven Months Ended Dec. 31,
	1978	1977	1976	1975	1974
	(Dollars in Thousands, Where Applicable)				
Operating Revenues	**$819,982**	$773,131	$625,982	$482,581	$275,479
Earnings:					
Income before extraordinary items	**$ 23,388**	$ 23,431	$ 22,827	$ 22,502	$ 14,379
Extraordinary items, less applicable income taxes	**15,427**	—	—	—	—
Net income	**$ 38,815**	$ 23,431	$ 22,827	$ 22,502	$ 14,379
Per share of common stock—					
Income before extraordinary items	**$ 5.44**	$ 5.47	$ 5.33	$ 6.41	$ 4.12
Extraordinary items	**3.58**	—	—	—	—
Net income	**$ 9.02**	$ 5.47	$ 5.33	$ 6.41	$ 4.12
Weighted average number of common shares outstanding, in thousands	**4,302**	4,286	4,286	3,510	3,491
Effective income tax rate	**41%**	45%	44%	42%	36%
Stock Data:					
Common shares outstanding (end of year, in thousands)	**4,304**	4,286	4,286	4,286	3,491
Number of stockholders (end of year)*	**20,232**	6,929	6,020	1,827	1,187
Common stockholders' equity (end of year)	**$190,748**	$163,013	$148,796	$135,733	$102,426
Book value per common share (end of year)	**$ 44.32**	$ 38.04	$ 34.72	$ 31.67	$ 29.34
Dividends declared per share of common stock	**$ 2.35**	$ 2.15	$ 2.00	$ 1.80	$ .80
Percentage of common stock dividends to net income (before extraordinary items in 1978)	**43%**	39%	38%	28%	19%
Capital Expenditures	**$105,083**	$ 75,979	$ 36,133	$ 30,510	$ 29,208
Current Ratio (end of year)	**1.2**	.9	1.3	1.0	1.0
Total Assets (end of year)	**$732,263**	$648,775	$575,037	$488,542	$405,989
Capitalization Ratios (end of year)					
Long-term debt	**51.6%**	55.1%	59.6%	62.1%	67.0%
Preferred stock issues of Northwest Pipeline	**10.8**	4.9	4.8	—	—
Common stockholders' equity	**37.6**	40.0	35.6	37.9	33.0
Total	**100.0%**	100.0%	100.0%	100.0%	100.0%
Return on Total Capitalization	**10%**	11%	11%	13%	10%
Gas Sales Volumes (billions of cubic feet)	**370.0**	399.7	392.5	396.9	382.9
Number of Employees (end of year)	**1,536**	1,313	1,122	1,191	1,024

*Excludes participation certificate holders under the Voting Trust because their certificates were converted to common stock by February 28, 1979, or the common stock underlying their certificates was sold in March 1979.

To Our Shareholders:

For Northwest Energy Company, 1978 was a year of significant progress in several areas. Northwest Pipeline, the Company's principal subsidiary, continued to pursue every opportunity to purchase or transport new gas supplies discovered in the Rocky Mountain area near its transmission system. Northwest Pipeline has recently signed agreements that will increase the pipeline system's average daily throughput of natural gas by nearly 20 percent before 1982. Our new gathering system to transport these supplies will drive straight into the heart of the Overthrust Belt, one of the most promising areas for new oil and gas discoveries in the United States.

New Rocky Mountain supplies, plus increased gas volumes from Canada, expanded underground gas storage facilities and major technical improvements in the transmission system enabled Northwest Pipeline to deliver record volumes of natural gas in December 1978 and January 1979. A rate increase, which became effective October 1, 1978, coupled with increased sales volumes, was responsible for a strong fourth quarter performance that enabled the Company to recover from lower earnings through the first nine months of 1978 and record consolidated net income of $23.4 million, or $5.44 per share of common stock, based on revenues of $820 million. Comparable 1977 earnings were also $23.4 million, and earnings per common share were $5.47, based on a lesser average number of shares outstanding and operating revenues of $773 million.

Operational earnings were augmented by an extraordinary gain of $18.6 million (net of income taxes) as part of the liquidation of Apco Oil Corporation. This extraordinary gain was partially offset by an extraordinary charge of $3.2 million (net of income tax benefits) as a result of the government of Ecuador rejecting the only currently feasible plan for economic utilization of gas reserves off the coast of Ecuador, thereby effectively forcing the Company's abandonment of a project to develop those gas reserves. The 1978 net extraordinary income of $15.4 million amounted to $3.58 per share of common stock, resulting in consolidated net income of $38.8 million, or $9.02 per common share.

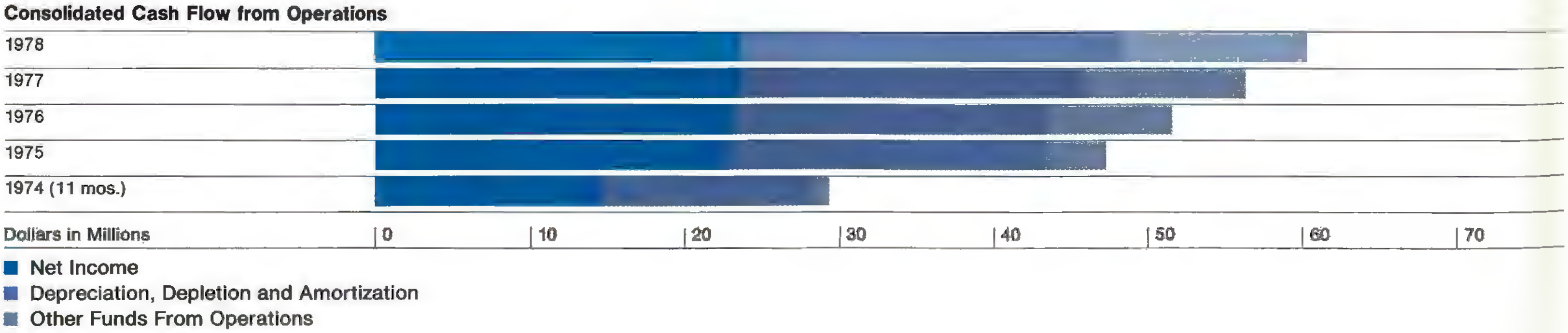
Dividend

For the fourth quarter of 1978, the Board of Directors declared a quarterly cash dividend on the Company's common stock of $.60 per share, payable March 23, 1979 to stockholders of record at the close of business on March 2, 1979. The quarterly dividend was increased from $.55 per share to $.60 per share in May, 1978. This was the fourth dividend increase since the initial dividend of $.40 per share in 1974.

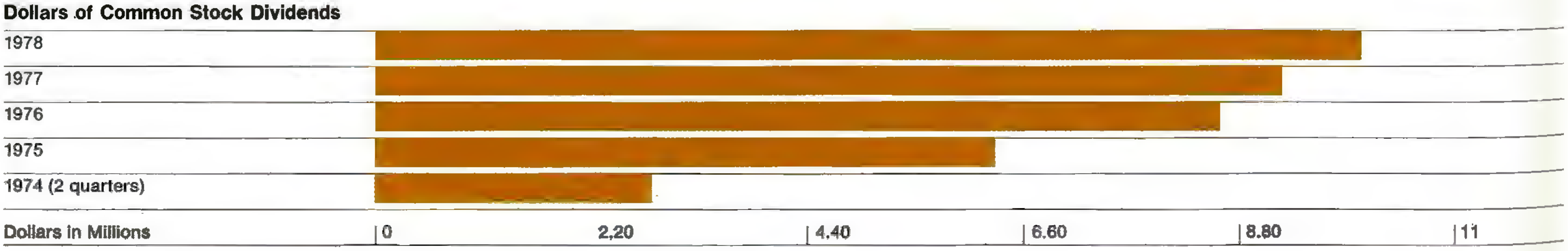
A Challenging Year

The Alaska Highway Pipeline Project for transporting Alaskan gas to the lower 48 states undoubtedly represents one of the greatest challenges that this Company, or any other company, has ever faced. The Alaskan project, however, is worth the challenge both to the Company and the nation. The North Slope of Alaska has more than 10 percent of the total proved gas reserves in the United States. Deliveries of substantial volumes of this gas through the Alaska Highway Pipeline Project could help the nation lessen its dependence on imported oil.

Consolidated Cash Flow from Operations



Dollars of Common Stock Dividends



Although delays in passage of the Natural Gas Policy Act of 1978 and delays in regulatory hearings have forced us to move the targeted completion date from 1983 to 1984, we pressed forward during 1978 and made progress in many areas, including scientific and technical aspects of the project. The Natural Gas Policy Act of 1978 set the price of North Slope natural gas at an initial ceiling of $1.45 per thousand cubic feet and provided for a "rolled-in" pricing mechanism, which permits averaging the cost of Alaskan gas with other domestic gas. This legislation alone has been a great step toward ultimate success of the project. Northwest Alaskan and the five other U.S. companies involved in the project, who established a partnership to advance the project, are hopeful that regulatory delays can be overcome in 1979. The Board of Partners has approved a $22 million budget for the first half of 1979 and is prepared to increase that amount as soon as appropriate regulatory decisions permit.

The year 1978 had other challenges as well. In particular, I would like to point out the distressing conditions in Northwest Pipeline's marketing area. Residual fuel oil, refined from Alaskan crude oil delivered to the West Coast, has flooded the Pacific Northwest marketing area. Many industries, which formerly used natural gas, have switched to this residual fuel oil, which is priced lower than natural gas as a result of market oversaturation that keeps the price of the fuel oil at an artificially low level. The effect on Northwest Pipeline has been to reduce industrial demand of natural gas, particularly in the summer months, and to make earnings more cyclical. This situation adversely affected earnings in 1978. We're hopeful that Alaskan crude oil can soon be transported to other market areas where it can be better utilized.

The Future

In 1979, we look forward to a marked improvement in operational earnings as the increased rates, adequate gas supplies, the expanded gas storage and a major capital improvement program by Northwest Pipeline contribute to overall earnings. We look for both our coal and exploration subsidiaries to improve their operating results. In short, we expect that in 1979 the Company will have the highest operational earnings in its history.

Before closing, a special word is in order concerning the expired Voting Trust Participation Certificates. After the U.S. District Court ruled in October that the stock in the Voting Trust had to be sold within 90 days after February 7, 1979, we made plans to sell all of the stock as expeditiously as possible. All stock in the Voting Trust is being sold through an underwritten public offering or purchased by a new Bonus Employee Stock Ownership Plan, and the Voting Trust will terminate when these transactions are completed.

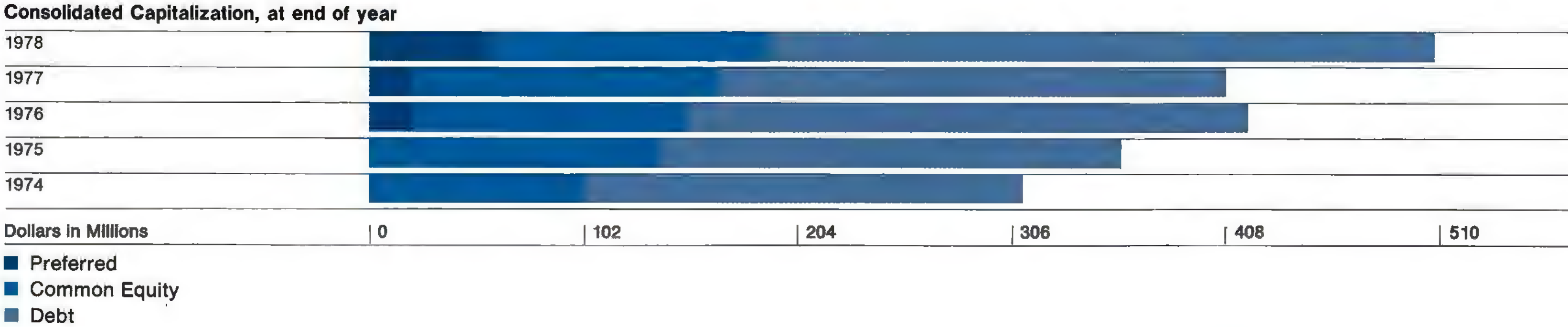
The remainder of this report summarizes key statistical information reflecting the Company's progress since its inception and describes the Company's subsidiaries and their operations. We've established a solid foundation and believe all of these operations will contribute to a prosperous future. Your Company's management looks forward eagerly to the prospects for the years ahead. We're most grateful for your continued support.

Sincerely,

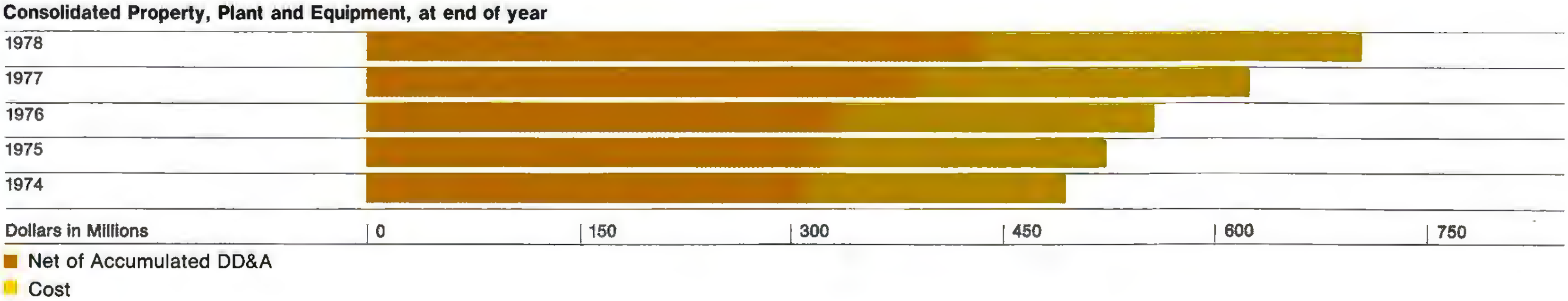
John G. McMillian

John G. McMillian
Chairman of the Board
and Chief Executive Officer

Consolidated Capitalization, at end of year



Consolidated Property, Plant and Equipment, at end of year



Update '78

Pipeline

Northwest Pipeline Corporation continues to have one of the best reserve positions of any natural gas transmission company in America. Northwest Pipeline's proved reserves at the end of 1978 totaled 7.1 trillion cubic feet, including 2.95 trillion cubic feet under contracts for natural gas from Canada. This total is equivalent to approximately 17.7 times the preceding twelve months' production into its system, or approximately double the natural gas industry average.

To remain a leader in the industry, Northwest Pipeline has emphasized (1) development of new sources of gas supply; (2) expansion of gathering facilities throughout the Rocky Mountain area; (3) improved natural gas storage capabilities; and (4) a more efficient pipeline transmission system.

Northwest Pipeline has been so successful in accomplishing its objectives in these areas that in December 1978, when extremely cold weather gripped the Pacific Northwest and Intermountain areas, Northwest Pipeline broke all of its previous records for transmission of natural gas and did not curtail deliveries to any of its customers for their firm contract demand.

Even more important, Northwest Pipeline demonstrated its ability to sustain deliveries when it again broke all of its peak day and month records during January 1979. On January 1, Northwest Pipeline established a peak day delivery record of 1.846 billion cubic feet. For the month of January 1979, deliveries were higher than in any other single month in the system's history, averaging 1.553 billion cubic feet.

Northwest Pipeline delivers natural gas to 22 customers in Colorado, Utah, Nevada, Wyoming, Idaho, Oregon and Washington. The 22 customers include 19 utility and municipal distribution systems and three industrial customers. The system is composed of 3,101 miles of main and branch transmission lines and 1,823 miles of field gathering and supply lines.

The company also owns and operates natural gas processing plants at Ignacio, Colorado and Opal, Wyoming. Natural gas liquids (primarily gasoline, butane and propane) are extracted from the natural gas and sold to suppliers or resellers. In 1978, recovery of natural gas liquids at the two extraction plants was approximately 114.8 million gallons, about the same volume as in 1977.

Process repairman works on equipment at Northwest Pipeline's extraction plant at Ignacio, Colorado. (Shown as location 1 on adjacent map)

Having natural gas available to meet demand on its transmission system and having the ability to transport supplies wherever they may be needed were early objectives of Northwest Pipeline's management. The company is now effectively meeting these objectives, but is continually striving to acquire new long-term gas supplies for its customers and to operate the transmission system in the most efficient manner possible.

Northwest Pipeline has negotiated contracts that have added substantially to the pipeline's gas supply. In December of 1978, Northwest Pipeline completed a gas purchase agreement with Chevron U.S.A. Inc., covering Chevron's 50-percent interest in the Ryckman Creek Field in southwestern Wyoming. Total gas reserves in the field are estimated at 100 billion cubic feet and the purchase agreement includes up to 17 million cubic feet of gas per day. The company is currently negotiating with other producers in the region in expectation of signing additional gas purchase contracts.

Northwest Pipeline also signed a gas gathering and transportation agreement with Cities Service Gas Company for supplies controlled by Cities Service in southwestern Wyoming. By the end of 1979, Northwest Pipeline expects to be transporting up to 50 million cubic feet of natural gas daily as part of this agreement. The total amount gathered and transported will increase to 100 million cubic feet daily by 1982.

Additionally, Northwest Pipeline signed an agreement in December 1978 with Northern Natural Gas Company to transport up to 35 million cubic feet daily from the Painter Reservoir Field, which is near the Ryckman Creek Field. These projects will enable the company to extend its pipeline system into the Overthrust Belt, one of the most active prospective areas for new natural gas and oil discoveries in the continental United States.

Another project, planned jointly with Michigan Wisconsin Pipeline Company, will extend Northwest Pipeline's transmission system into central Wyoming to connect new gas reserves in the Wind River Basin. This pipeline will be designed to transport up to 120 million cubic feet daily and can be expanded to transport up to 220 million cubic feet daily. Hearings are expected to be held later this year before the Federal Energy Regulatory Commission (FERC) on this matter.

Crews prepare pipe for new gathering system in Rocky Mountains near Rangely, Colorado. (Location **2**)

During 1978, Northwest Pipeline also negotiated several other important agreements for new natural gas supplies. These agreements added approximately 173 billion cubic feet of proved reserves in 1978. From February 1, 1974 through December 31, 1978, approximately 555 billion cubic feet of proved reserves were added through gas purchase agreements. The company's objective is to increase its domestic gas supply significantly in the next few years.

Northwest Pipeline also receives natural gas from the San Juan Basin of northwestern New Mexico and southwestern Colorado, the Big Piney Field in Wyoming and from various other fields in the Rocky Mountain area. In 1978, approximately 62 percent of its total gas supply was imported from Canada under two contracts with Westcoast Transmission Company Limited of British Columbia. The contract for deliveries at Sumas, Washington calls for maximum daily volumes of 809 million cubic feet. The other Westcoast contract, for deliveries at Kingsgate, B. C., calls for a maximum of 152 million cubic feet daily. Substantial curtailments under the Sumas contract through the 1976-1977 winter heating season were reduced to only 38 million cubic feet daily during 1977-1978. Curtailments during the 1978-1979 season are expected to average about 42 million cubic feet daily. Northwest Pipeline, however, has been able to eliminate curtailments to its customers, for their firm contract demand requirements, since mid-November of 1977 as a result of substantial improvements in its gas storage capabilities and domestic gas supply.

Northwest Pipeline has invested heavily in gas storage facilities in an effort to have more gas available during winter months when demand is at a peak. These facilities were a significant factor in the company's ability to deliver record volumes in December 1978 and January 1979.

In 1978, Northwest Pipeline doubled its gas volumes in the Clay Basin underground storage reservoir in Daggett County, Utah and doubled its ability to withdraw gas from the reservoir. At the start of the 1978-1979 heating season, Northwest Pipeline had 20 billion cubic feet of natural gas in the reservoir. Withdrawal capability was increased from 75

Welders prepare floor of new LNG tank near Plymouth, Washington. Engineer checks readings in LNG plant central control facility. (Location **3**)

million cubic feet to 150 million cubic feet daily for the current winter heating season. Northwest Pipeline also has a one-third interest in gas stored at the Jackson Prairie underground storage reservoir in the state of Washington. Authorized storage capacity of that reservoir is 10.8 billion cubic feet. Withdrawals are certificated at 300 million cubic feet daily on a firm basis, with an additional 72 million cubic feet daily authorized on a best-efforts basis.

The company is presently doubling the size of its liquefied natural gas (LNG) plant near Plymouth, Washington. The storage tank now in operation has a capacity of 1.2 billion cubic feet of LNG. Another storage tank is currently being completed. The tank and associated liquefaction and vaporization facilities are expected to be operational in 1979. These new facilities will permit Northwest Pipeline to have a total LNG storage capacity of 2.4 billion cubic feet of gas for the 1979-1980 heating season. The cost of the new tank and other facilities is estimated at approximately $26.4 million. Withdrawal capacity is presently 225 million cubic feet daily and will be increased to 300 million cubic feet daily for the 1979-1980 heating season.

In connection with the development of the Clay Basin underground storage reservoir, Northwest Pipeline installed new compressors at four locations in order to deliver Clay Basin volumes to customers in the Pacific Northwest. New compressor stations were added during 1978 at Lava Hot Springs and Pegram, Idaho and at Muddy Creek, Wyoming. An additional compressor was also installed at the existing Green River, Wyoming compressor station.

In addition, the company will complete the automation of all main line compressor stations in the near future. This improvement involves more sophisticated control of the transmission system and has contributed substantially to Northwest Pipeline's ability to handle the record volumes of natural gas delivered this heating season.

Other improvements to the pipeline system have included extensive reconditioning of portions of the main line and hundreds of miles of new pipeline added to the gathering system. On February 1, 1974, the company had 1,163 miles of field gathering lines. This total had reached 1,785 by the end of 1978, a 53% increase. This figure will be much larger at the end of

Construction worker places insulation in walls of new compressor building at Green River, Wyoming, while workman checks support for compressor building. (Location **4**)

1979 as the company adds new pipeline to transport supplies under gas purchase agreements signed last year. Northwest Pipeline connected 270 new wells to the gathering system in 1978, and the number of wells connected will probably reach 340 in 1979. These figures compare with 129 wells connected in 1975, the company's first full year of operations.

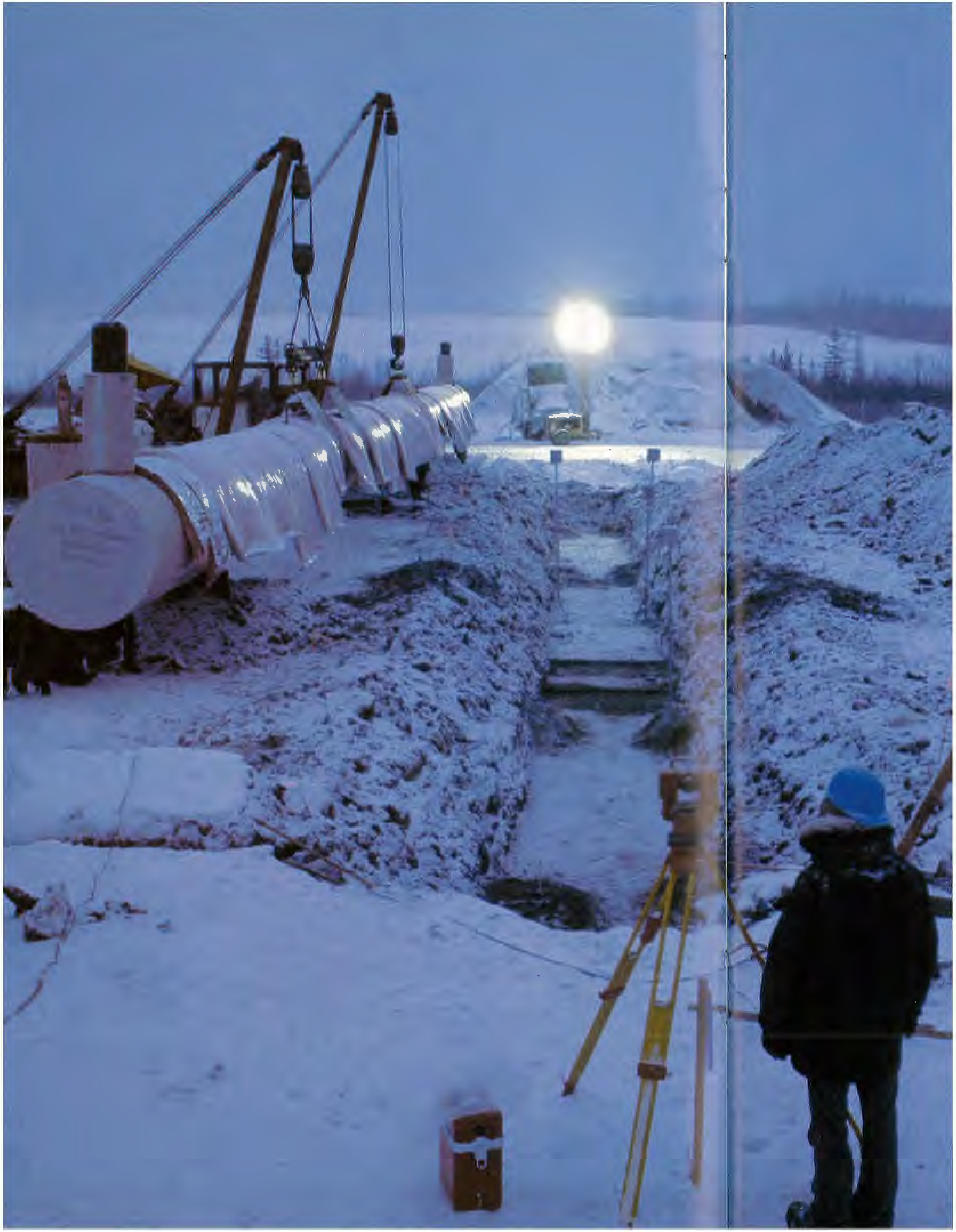
Northwest Pipeline contemplates a further expansion of its pipeline facilities in 1980 to transport Canadian natural gas from the Province of Alberta to southern California.

Northwest Alaskan Pipeline Company, a wholly owned subsidiary of the Company, earlier signed purchase agreements with Pan-Alberta Gas Ltd. for 1.04 billion cubic feet of natural gas daily, of which 240 million cubic feet daily is intended for use in southern California. (For further information on the Canadian gas volumes, see page 14 describing the Alaska Highway Pipeline Project.)

Transportation of the gas to southern California will involve expansion of the existing pipeline facilities of Northwest Pipeline, Pacific Gas Transmission Company and El Paso Natural Gas Company. Northwest Pipeline will loop approximately 351 miles of its main transmission line in Oregon and Idaho to accommodate the new volumes. Northwest Pipeline will have a 70-percent interest in the new facilities and Pacific Interstate will have the remaining 30-percent interest. Total expenditures for this project by Northwest Pipeline will be approximately $103 million, substantially all of which is expected to be spent in 1980 if timely approvals are received from the FERC and the National Energy Board of Canada.

During 1978, Northwest Pipeline sold Pacific Interstate 17.3 billion cubic feet of Canadian gas not required by Northwest Pipeline's customers. These sales accounted for less than 5 percent of the 370 billion cubic feet of natural gas sold by Northwest Pipeline in 1978.

Coordinator logs gas volumes in Salt Lake City gas control center. Above, technician places measurement charts in the electroscanner. (Location **5**)



Alaska

Substantial progress was made in 1978 toward construction of the Alaska Highway Pipeline Project, despite governmental delays that have affected the project's schedule. In early 1978, Northwest Alaskan Pipeline Company formed Alaskan Northwest Natural Gas Transportation Company, in partnership with subsidiaries of five other major United States natural gas transmission companies, to design, construct and operate the Alaskan section of the Alaska Highway Pipeline Project. Canadian companies will construct and operate the portion of the line within Canada. The overall project contemplates a new Eastern Leg pipeline, to be constructed by Northern Border Pipeline Company to transport the Alaskan gas from Monchy, Saskatchewan to midwestern and eastern parts of the nation. A Western Leg segment will transport volumes from Kingsgate, British Columbia to California and other parts of the western United States.

To expedite the construction of parts of the Eastern and Western Leg segments, Northwest Alaskan signed two contracts for terms of 12 years with Pan-Alberta Gas Ltd. to purchase up to 1.04 billion cubic feet of Alberta gas per day. Northwest Alaskan, in turn, signed contracts with four other United States' pipeline companies for the sale of all of the Canadian volumes. Pacific Interstate Transmission Company, a unit of Pacific Lighting Corporation, Los Angeles, will take 240 million cubic feet of the Alberta gas at Kingsgate, British Columbia for delivery to southern California. The remainder will be delivered at Monchy, Saskatchewan for transportation through a portion of the Eastern Leg for ultimate delivery to subsidiaries of Northern Natural Gas Company, Panhandle Eastern Pipeline Company and United Gas Pipeline Company. (See page 12 for a more complete discussion of the Western Leg and Northwest Pipeline's involvement.)

In preparation for building the Alaskan section of the project, Northwest Alaskan has constructed a frost heave test facility at Fox, Alaska, near Fairbanks, to prove methods for mitigating damage to buried, chilled pipelines in Arctic areas.

During 1978, Northwest Alaskan also carried out extensive soil resistivity studies and a program for identifying seismic zones along the pipeline route. Material site reconnaissance work was carried out as well as hydrology studies to determine the

Insulated pipe is lowered into trench at the frost heave test facility near Fairbanks. (Location **6**)
Surveyor checks elevations along route of Alaska Highway Pipeline Project near Tok, Alaska. (Location **7**)

most efficient and environmentally acceptable methods for crossing streams and rivers. Archaeological and cultural studies have also been undertaken as required by state and federal law. Alaskan headquarters for the project have recently been established in Fairbanks.

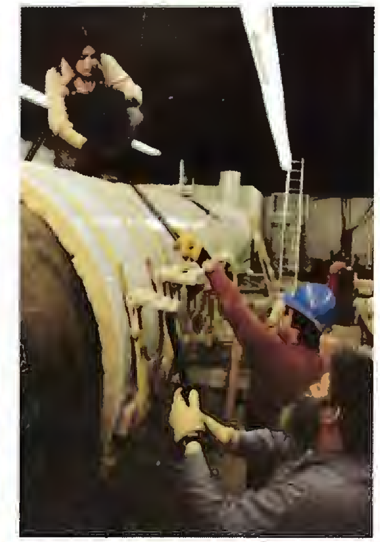
During 1978, Northwest Alaskan worked extensively with the State of Alaska to ascertain ways in which that state could participate in financing the project. The State is being asked to support the project through a $1 billion investment in project debt and a $500 million investment in equity-related securities.

Perhaps the most important achievement during the year was Congressional passage of the Natural Gas Policy Act of 1978, which set the price for Alaskan North Slope natural gas at an initial ceiling price of $1.45 per thousand cubic feet and provided for a "rolled-in" pricing mechanism, which will permit averaging the cost of Alaskan gas with other domestic gas. However, delay in passage of the Act, plus the failure of federal agencies to resolve several critical issues, has resulted in slippage of the project completion date to 1984.

Many unresolved yet critical regulatory issues are holding up final pipeline design and completion of financing arrangements for the project. One of the most important unresolved issues is the "incentive rate of return" mechanism, designed to provide an incentive for project sponsors to control costs. A higher rate of return would be granted if the project is completed at or near final cost estimates. The higher the cost overrun, the lower the return. The responsibility for resolving the "incentive rate of return" matter rests with the FERC. According to the federal agency's own draft plan, the FERC was to commence proceedings on this issue in March 1978 and conclude them in June 1978. However, the issue remains unresolved.

In addition, the FERC has been unable to decide on basic system design, such as pipe diameter and line pressure, or on issues relating to gathering, processing and treating Prudhoe Bay gas. All of these uncertainties have major cost, design and scheduling ramifications.

Northwest Alaskan is convinced, however, that many of the critical issues will be resolved in the months ahead. Energy Secretary James Schlesinger has said that the Administration places a very high priority on timely completion of the Alaska Highway Pipeline Project. He recently said that "Alaskan gas will be a valuable offset to foreign oil imports as well as competitively superior to other supplemental sources of supply."



Technicians scribe contours on aerial survey map showing a portion of the route paralleling the Alaska Highway between Delta Junction and the Alaska/Yukon border. (Location **8**) Above, insulation is applied to pipe at the frost heave test facility.

Coal

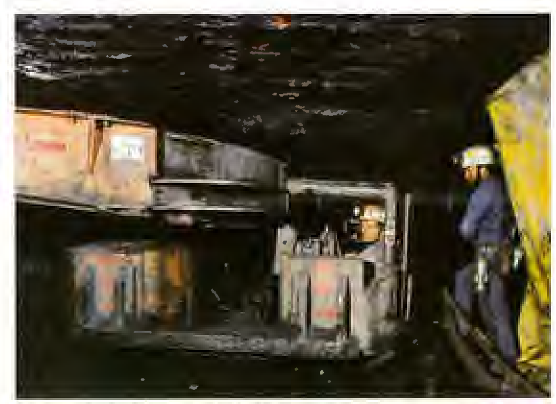
Production from Northwest Coal Corporation's Hawk's Nest mine in western Colorado totaled 331,000 tons during 1978, even though a nationwide coal strike closed the mine for 88 days during the first quarter of the year. The 1978 tonnage figure—had the mine been operational throughout the entire year—would have been more than double production for any other single year in the mine's history.

Even more important, most of this increased productivity was due to better utilization of equipment and manpower. Productivity per man-shift jumped from 7.3 tons in 1977 to 12.6 tons in 1978, for an increase of 73 percent.

Construction began in the fall of 1978 on a unit-train loadout facility capable of loading more than 1,000,000 tons of coal yearly. This facility will load train cars at the rate of 10,000 tons per hour and will permit unit-train shipments of coal to midwestern markets at a considerable reduction in freight rates. These lower costs for freight will allow coal from the Hawk's Nest mine to be competitive in the steam-coal market. Adverse winter weather conditions have hampered construction progress, but the loadout facility is expected to be operational in mid-1979.

The mine consists of five seams, but only the upper seam is currently being mined. Estimated recoverable coal reserves in the upper seam at the end of 1978 were approximately 5.8 million tons. The other seams contain the same type of coal and have been tested by core drilling. The thickness of the remaining seams varies and economic recovery of the coal in these seams would require a coal preparation plant, which would reduce the amount of ash in the coal shipped and thereby increase its BTU content and improve its marketability. Funds have been budgeted for 1979—subject to obtaining long-term sales contracts—to develop two of the lower seams and to construct a coal preparation plant.

Approximately 120 miners, represented by the United Mine Workers of America (UMW), are employed at the mine. The contract negotiated with the UMW extends to 1981.



Mine foreman checks air quality at Hawk's Nest Mine in western Colorado. Continuous mining machine removes coal. (Location **9**)

Exploration

The year 1978 was especially significant for Northwest Exploration Company because of the discovery of the Great Divide Gas Field in Colorado and further development and expansion of the excellent leasehold position developed during the company's initial years of operations. Northwest Exploration began operations on January 1, 1975 to explore for oil and gas in the Rocky Mountain region near the Northwest Pipeline transmission system. Its gas discoveries are committed by contract to Northwest Pipeline Corporation.

At the end of 1978, Northwest Exploration had approximately 828,000 gross acres, or approximately 556,000 net acres, under gas and oil leases. (See pages 22 and 23 for more information on leasehold acreage.)

In 1978, Northwest Exploration drilled or participated in drilling 11 exploratory wells and 31 development wells, the results of which are detailed below:

Wells Drilled in 1978

	Exploratory	Development
Gas	1	18
Oil	—	2
Testing	3	10
Dry	7	1
	11	31

The Great Divide discovery well, Alice Weaver No. 1, is located in Moffat County, Colorado, in the southeastern portion of the Greater Green River Basin. The Alice Weaver was completed from a thick section of the Lewis sandstone at a depth of 7,500 feet. The well has now been connected to Northwest Pipeline's system and is delivering one million cubic feet of gas per day. Five development wells have been drilled on a 320-acre spacing pattern as stepouts from the Alice Weaver. Two of these wells are connected to the pipeline system and are capable of delivering an additional three million cubic feet of gas per day. Two wells are testing and one well is awaiting completion. Additional development drilling is planned for 1979. Northwest Exploration has a 50-percent working interest in all of these wells and in 7,400 acres surrounding the discovery.

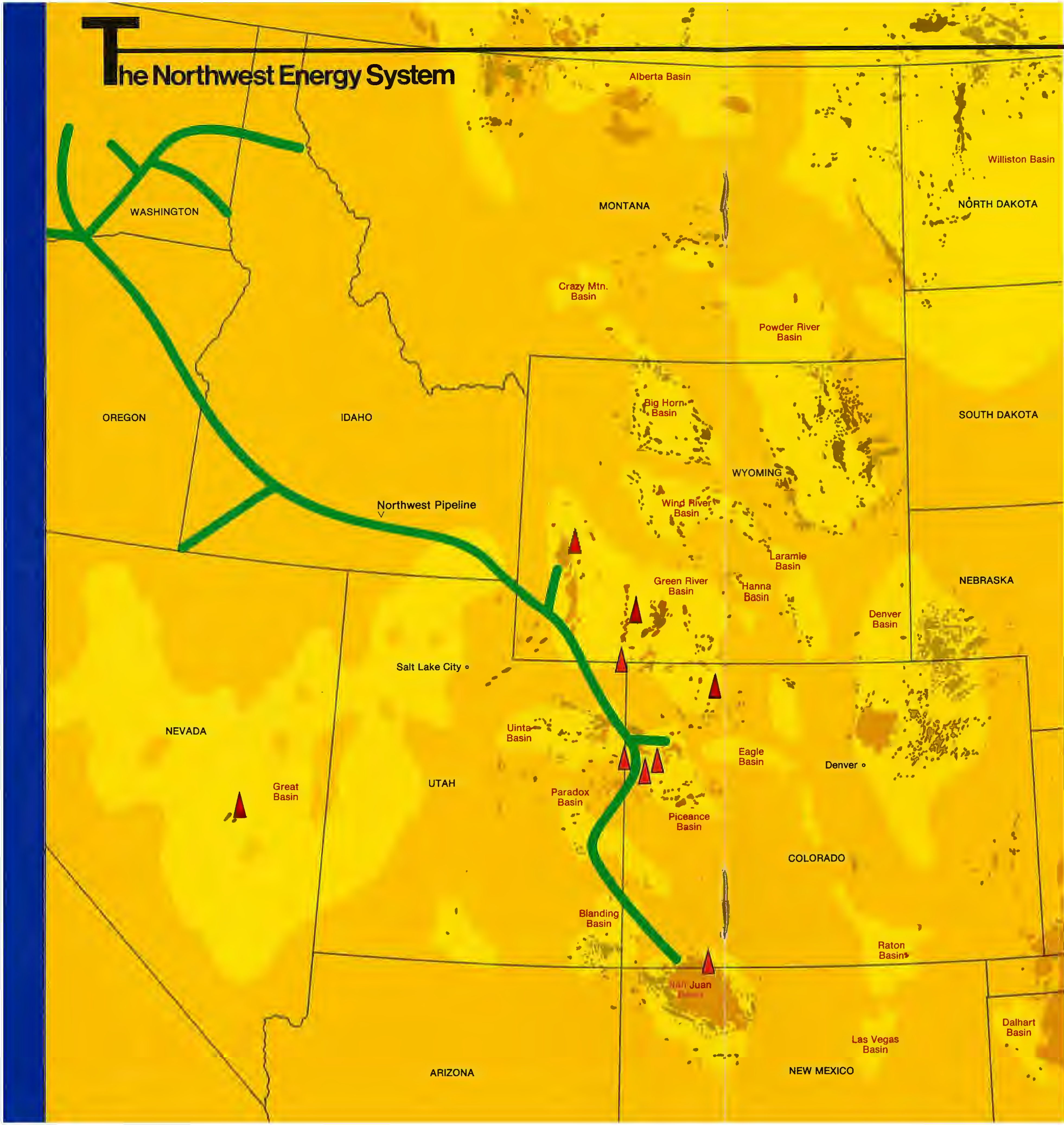
Exploratory wells being evaluated are potential discoveries. Production equipment has been installed for further tests at a well in Nye County, Nevada, near the company's Trap Spring Field discovery. A well in Rio Blanco County, Colorado, is a potential triple-zone gas discovery.

The successful gas development wells were drilled in the Philadelphia Creek area of Rio Blanco County, Colorado, the Great Divide Field and in the San Juan Basin of northwestern New Mexico. The oil development wells were drilled in the Trap Spring Field of Nye County, Nevada. This field was producing approximately 3,200 barrels of oil per day at year-end, of which Northwest Exploration's net share was 658 barrels. The Company's net share of gas production at year-end was approximately 2 million cubic feet daily.

In 1979, Northwest Exploration plans to drill 21 wildcat wells and to expand its development drilling program, thus capitalizing on its excellent leasehold position.

Rig drills gas well in San Juan Basin of northwestern New Mexico. (Location **10**)

The Northwest Energy System



This map illustrates the strategic location of Northwest Pipeline Corporation's transmission system in the Rocky Mountain region, which has tremendous potential for new natural gas and oil discoveries. In addition, it shows the sedimentary basins where Northwest Exploration Company has had several oil and gas discoveries in the past four years and where the company now has approximately 556,000 net acres under gas and oil leases. The following table shows Northwest Exploration's leasehold acreage in major geological areas:

Geological Basin	Gross Acres	NWE Net Acres
Big Horn	24,600	15,300
Denver	1,120	1,120
Great Basin	352,800	156,440
Green River	166,380	137,140
Paradox	14,600	12,000
Piceance	95,460	92,000
Powder River	11,500	9,100
San Juan	22,300	18,000
Uinta	8,115	5,987
Uinta Uplift	9,980	9,000
Wasatch Uplift	783	783
Western Columbia	18,800	18,000
Williston	72,000	50,200
Wind River	26,700	26,700

Gas Deposits

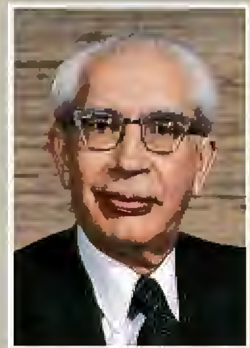
Oil Deposits

Sedimentary Basins

Successful Well Completions Through 1978 for Northwest Exploration

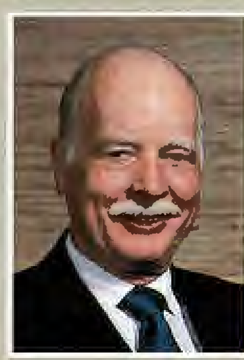
Directors

John G. McMillian, 52
Chairman of the Board, President and chief executive officer of the Company, is also Chairman, President and chief executive officer of Northwest Pipeline Corporation and Chairman of the Executive Committee of the Company.



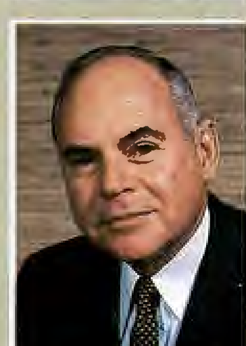
F. Arnold Daum, 68
is a senior partner of the New York law firm of Cahill Gordon & Reindel. He is a member of the Executive and Compensation Committees of the Company.

Thomas W. diZerega, 51
is Vice President and Secretary of Northwest Energy Company and a member of the Executive Committee of the Company. He is also Vice President—Law and Secretary of Northwest Pipeline Corporation.

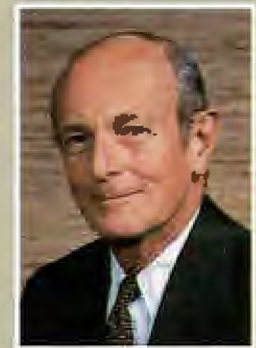


L. P. Himmelman, 66
is Chairman of the Executive Committee of Western International Hotels, Seattle, Washington. He is a member of the Audit Committee of the Company.

Allan D. Insley, 68
is an independent financial consultant headquartered in Calgary, Alberta, Canada. He is Chairman of the Audit Committee of the Company.



S. Lee Kling, 50
is Chairman and President of Landmark Bancshares Corporation (bank holding company), St. Louis. He is also Chairman of Reed Shaw Stenhouse, Inc. (insurance brokerage). He is a member of the Executive and Audit Committees of the Company.



Marne Obernauer, 60
is Chairman and Chief Executive Officer of Devon Group, Inc. (graphic arts; wine and spirits distribution), Los Angeles. He is a member of the Compensation and Audit Committees of the Company.

George S. Patterson, 69
is an independent petroleum consultant headquartered in New York City. He is Chairman of the Company's Compensation Committee.

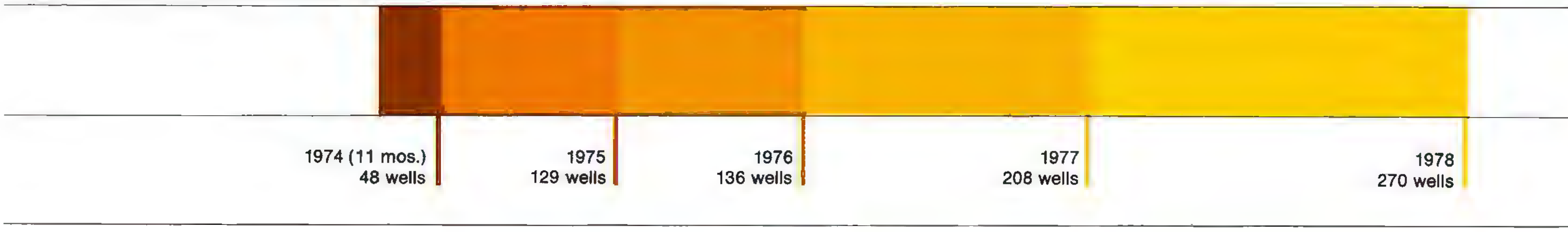
Louis B. Perry, 61
is President of Standard Insurance Company (life insurance), Portland, Oregon and a member of the Company's Compensation Committee.

David K. Watkiss, 54
is a partner in the Salt Lake City law firm of Watkiss & Campbell and is a member of the Company's Executive Committee.

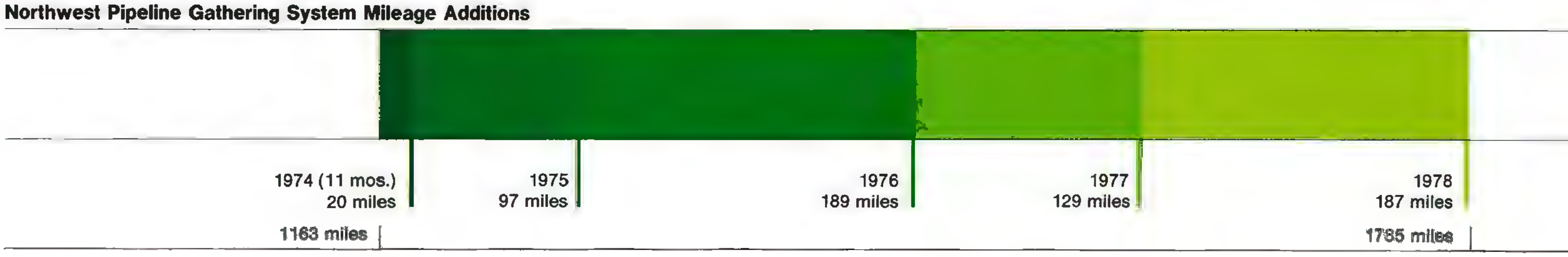
Special Consultant
Mark J. Millard, 71
is Senior Managing Director, Loeb Rhoades, Hornblower & Co. (investment bankers), New York City. He is a special consultant to the Board of Directors of the Company.

Financial Review

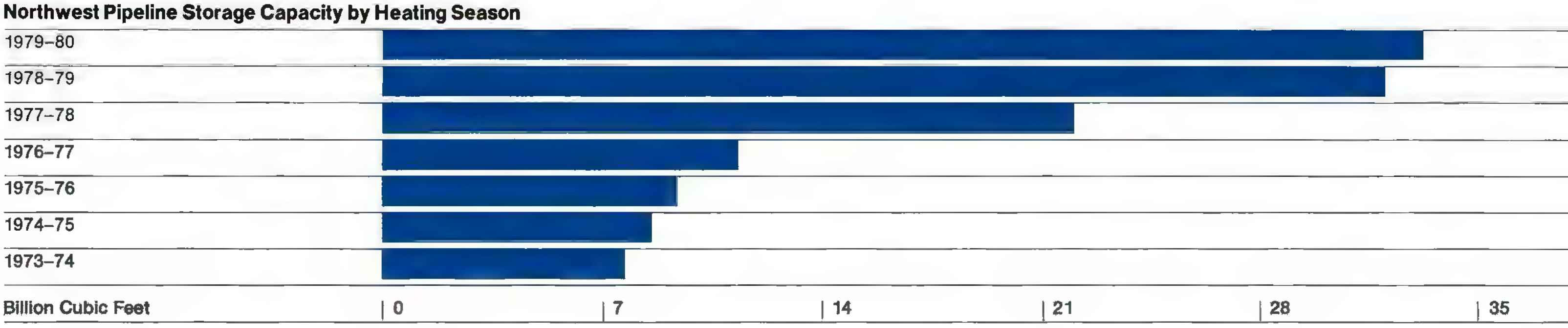
New Wells Connected to Northwest Pipeline System



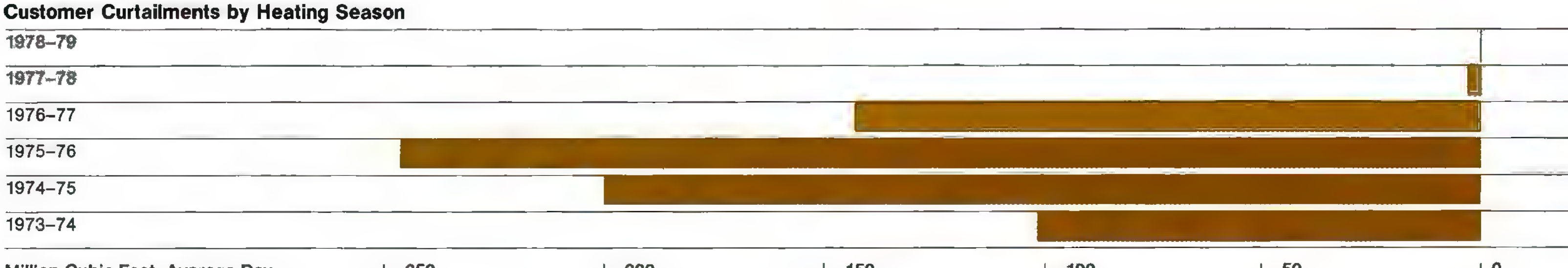
Northwest Pipeline Gathering System Mileage Additions



Northwest Pipeline Storage Capacity by Heating Season



Customer Curtailments by Heating Season



Summary of Operations

The following summary of operations for Northwest Energy Company and subsidiaries (the "Company") summarizes the consolidated statements of income of the Company for the four years ended December 31, 1978, and the eleven months ended December 31, 1974. Such periods constitute the entire time the Company has been in operation.

Although the accompanying summary is not reported upon herein by independent public accountants, it was prepared by the Company from consolidated statements of income (all of which were audited) included in this report or in reports previously published. In the opinion of the Company, all adjustments, which include only normal recurring adjustments, have been made to summarize fairly the results of operations for the periods presented.

Reference is made to the accompanying notes and to the Notes to Consolidated Financial Statements included elsewhere herein, both of which should be read in conjunction with this summary.

	Year Ended December 31,				Eleven Months Ended Dec. 31,
	1978	1977	1976	1975	1974
	(Dollars in Thousands, Except Per Share Amounts)				
Operating Revenues	**$819,982**	$773,131	$625,982	$482,581	$275,479
Operating Expenses	**761,031**	711,124	567,933	430,781	242,405
Income Taxes	**16,026**	19,443	17,452	15,293	7,427
	777,057	730,567	585,385	446,074	249,832
	42,925	42,564	40,597	36,507	25,647
Other Income, Net	**3,105**	2,233	3,185	3,456	2,888
	46,030	44,797	43,782	39,963	28,535
Interest Charges	**22,642**	21,366	20,955	17,461	14,156
Income Before Extraordinary Items	**23,388**	23,431	22,827	22,502	14,379
Extraordinary Items, less applicable income taxes	**15,427**	—	—	—	—
Net Income	**$ 38,815**	$ 23,431	$ 22,827	$ 22,502	$ 14,379
Per Share of Common Stock:					
Income before extraordinary items	**$ 5.44**	$ 5.47	$ 5.33	$ 6.41	$ 4.12
Extraordinary items	**3.58**	—	—	—	—
Net income	**$ 9.02**	$ 5.47	$ 5.33	$ 6.41	$ 4.12
Weighted Average Number of Common Shares Outstanding, in thousands	**4,302**	4,286	4,286	3,510	3,491
Dividends Declared Per Share of Common Stock	**$ 2.35**	$ 2.15	$ 2.00	$ 1.80	$ .80

(a) Reference is made to Note 2 of Notes to Consolidated Financial Statements, appearing elsewhere herein, for a discussion of the settlement agreements and related payments made by Northwest Pipeline Corporation ("Pipeline") to certain special overriding royalty interest holders, subject to a determination as to the jurisdiction of the Federal Energy Regulatory Commission ("FERC") over such payments. In addition, Note 2 discusses the general rate increase placed into effect by Pipeline on October 1, 1978.

(b) The extraordinary items for the year ended December 31, 1978 were comprised of the following items (see Note 5 of Notes to Consolidated Financial Statements):

	(Thousands of Dollars)
Gain on liquidation of Apco Oil Corporation, net of income tax effect of $8.1 million	$18,626
Loss on forced abandonment of Ecuadorian gas exploration and development project, net of income tax benefits of $3 million	(3,199)
	$15,427

(c) A subsidiary of Northwest Energy Company ("Energy") is the operating partner in the Alaskan Northwest Natural Gas Transportation Company partnership (the "Partnership"), which was formed to design, construct and operate the Alaskan portion of a natural gas pipeline to transport natural gas from Prudhoe Bay, Alaska to the lower 48 states. The Partnership includes subsidiaries of five other U.S. natural gas transmission companies. Energy's investment in the Partnership was approximately $27.9 million at December 31, 1978. Energy has recognized its pro rata share of the Partnership's allowance for equity funds capitalized during engineering, design and preliminary construction, computed at a rate of 15%. (See Note 3 of Notes to Consolidated Financial Statements.)

Management's Discussion and Analysis of Summary of Operations

Significance of Gas Sales and Gas Purchases and Royalties
The following tabulation indicates gas sales volumes, the significance of gas sales revenues to consolidated operating revenues and the significance of the total gas purchases and gas royalties to consolidated operating expenses for the periods indicated:

Year Ended December 31,	1976	1977	1978
	(Dollars in Thousands)		
Gas sales volumes (BCF)*	392.5	399.7	370.0
Consolidated operating revenues	$625,982	$773,131	$819,982
Gas sales revenues, included above	$591,643	$730,819	$776,043
Consolidated operating expenses	$567,933	$711,124	$761,031
Gas purchases, included above	$490,583	$599,866	$602,498
Gas royalties, included above	$ 6,477	$ 29,506	$ 62,275

*"BCF" means one billion cubic feet, "MMCF" means one million cubic feet and "MCF" means one thousand cubic feet.

The relationship between gas sales revenues and the total of gas purchases and royalties has remained reasonably constant because increases in those costs have been reflected in gas sales rates concurrently, or else deferred and matched with revenues in a later period when billed to customers through a surcharge.

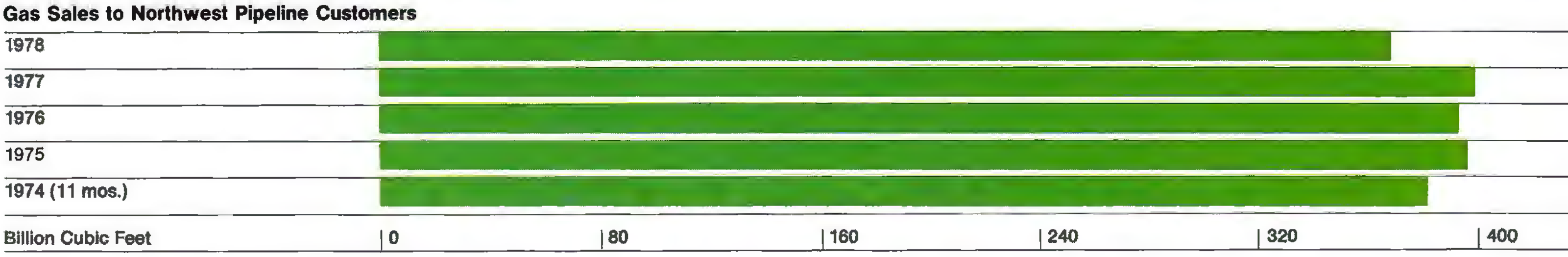
Operating Revenues
Gas sales revenues accounted for more than 94% of consolidated operating revenues for the periods shown above. The increases in gas sales revenues over the prior year, for both 1977 and 1978, also represented more than 94% of the increases in consolidated operating revenues between those same years, as detailed in the price/volume comparisons of gas sales, below:

Increase (Decrease) Between	1977 and 1976		1978 and 1977	
	Amount	Percent	Amount	Percent
	(Dollars in Thousands)			
Average gas sales price per MCF	32.10¢	21%	26.94¢	15%
Approximate related dollar amount	$128,293		$ 99,674	
Gas sales volumes, in MMCF	7,220	2%	(29,783)	(7)%
Approximate related dollar amount	$ 10,883		$ (54,450)	
Gas sales revenues	$139,176	24%	$ 45,224	6%
Consolidated operating revenues	$147,149	24%	$ 46,851	6%

The increase in average sales price per MCF for 1977 over 1976 and for 1978 over 1977 was primarily the result of major price increases on imports of Canadian natural gas by Pipeline, for which FERC permitted concurrent recovery through increased gas sales rates. The cost of Canadian gas (adjusted for heating value and stated in Canadian dollars) increased from $1.60 per MCF to $1.80 per MCF effective September 10, 1976; to $1.94 per MCF on January 1, 1977; and (adjusted for heating value and stated in U.S. dollars) to $2.16 per MCF, effective September 21, 1977. In addition, gas sales rates were increased effective October 2, 1977, in the amount of approximately $46 million annually, to recover certain increased special overriding royalty costs, as further discussed in Note 2 of Notes to Consolidated Financial Statements. Pipeline's gas sales rates were increased again on October 1, 1978, by approximately $28.7 million annually, subject to refund, as a result of Pipeline's March 1978 general rate filing, which was designed to recover additional costs primarily resulting from expanded gathering and storage facilities for the pipeline system (see Note 2 of Notes to Consolidated Financial Statements).

Availability of gas supplies for Pipeline increased, beginning in late 1977, as a result of virtual elimination of curtailments from Westcoast Transmission Company Limited ("West-

Gas Sales to Northwest Pipeline Customers



coast"), resulting from additional supplies becoming available at that time to Westcoast under long-term gas purchase contracts with Pan-Alberta Gas Ltd., plus the cumulative effect of securing additional domestic gas purchase contracts and the continuing development of Pipeline's gas leaseholds in the San Juan Basin. These factors, combined with increased storage gas availability from the expanded Clay Basin and Jackson Prairie underground storage facilities, have permitted Pipeline to satisfy all firm sales contracts to its customers since November 1977.

The gas sales volume decrease between 1978 and 1977 was principally caused by continuing decreases in the industrial customer base of Pipeline's customers, which formerly balanced their more temperature-sensitive residential and commercial loads. The decrease in industrial customers was due to (i) customer reaction to the high Canadian gas costs; (ii) the overabundance of fuel oil refined from Alaskan crude oil on the West Coast, which has been dumped at prices below the equivalent price for gas because no other competitive market for such fuel oil presently exists; and (iii) governmental policies discouraging use of natural gas and encouraging the use of alternate fuels. While Pipeline's customers have implemented a program designed to increase residential consumption to alleviate the loss of industrial users, this also adds to the seasonality of Pipeline's business. The seasonal nature of Pipeline's earnings will be accentuated also by a recent FERC policy requiring Pipeline to change its rate structure to one which allows recovery of fixed costs as gas volumes are delivered, rather than normalized over the entire year. (See Note 16 of Notes to Consolidated Financial Statements).

Operating Expenses

Gas Purchases and Gas Royalties

The total of gas purchases and gas royalties of Pipeline accounted for more than 87% of consolidated operating expenses in 1976, 1977 and 1978. The total increase in gas purchase and gas royalty costs over each prior year ($132.3 million increase in 1977 and $35.4 million increase in 1978) accounted for over 90% and 70%, respectively, of the $143.2 million and $49.9 million increase in consolidated operating expenses between those same years, as detailed in the price/volume comparisons below:

Increase (Decrease) Between	1977 and 1976		1978 and 1977	
	Amount	Percent	Amount	Percent
	(Dollars in Thousands)			
Average purchase price per MCF	23.06¢	17%	19.55¢	12%
Approximate related dollar amount	$ 97,068		$ 53,397	
Gas purchase volumes, in MMCF	9,147	2%	(31,863)	(8)%
Approximate related dollar amount	$ 12,215		$ (50,765)	
Gas purchases	$109,283	22%	$ 2,632	–%
Gas royalties	$ 23,029	356%	$ 32,769	111%
Consolidated operating expenses	$143,191	25%	$ 49,907	7%

The increase in average purchase price per MCF between the periods compared is principally the result of the Canadian gas purchase price increases referred to under "Operating Revenues". In addition to the major Canadian gas price increases, escalations in domestic gas purchase costs, especially in 1977, resulted from gas price increases under nationwide rates granted by FERC to gas producers.

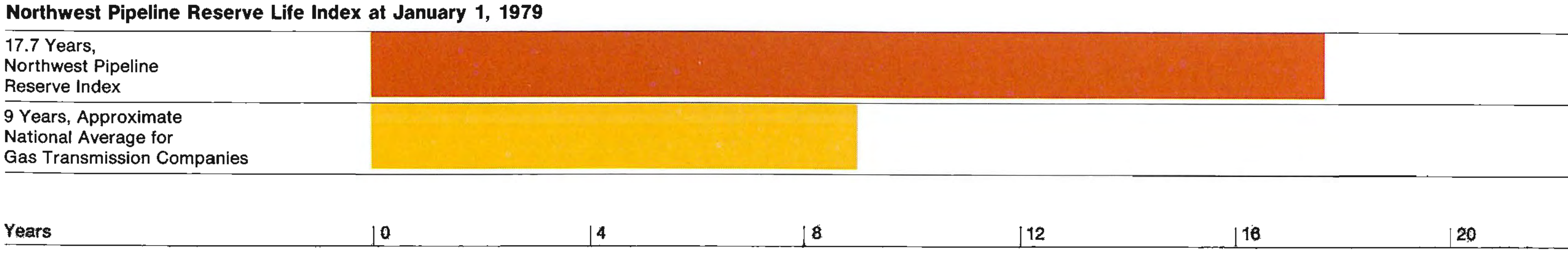
The decrease in gas purchase volumes in 1978 compared to 1977 is primarily due to reduced gas sales volumes, also discussed under "Operating Revenues".

The increases in gas royalty expense are primarily a result of settlements at increased rates for certain special overriding royalties (see Note 2 of Notes to Consolidated Financial Statements) and the increased sales prices granted by FERC for domestic production, as mentioned above. In addition, Pipeline's production increased 675 MMCF, or approximately 2%, in 1978 over 1977.

Operation and Maintenance

Operation and maintenance expenses increased approximately $7 million, or 16%, in 1977 over 1976, largely as a result of operational expenses of the new Clay Basin underground storage project, increased payroll and other employee-related expenses.

Northwest Pipeline Reserve Life Index at January 1, 1979



Operation and maintenance expenses increased approximately $11.9 million, or 23%, in 1978 over 1977, due most significantly to the following items: (1) an increase in payroll, employee expenses and benefit costs, amounting to approximately $3 million, or 14%, resulting from an increase in the number of employees, plus general salary and benefit improvements; (2) an increase of approximately $2.3 million, or 69%, in contractors' services from the extensive use of outside firms for maintenance work; and (3) an increase of almost $2.2 million, or 45%, in operation expenses of the expanded Clay Basin underground storage project due to an increase in Pipeline's percentage level of participation in the usage of the facility.

The increases discussed above reflect, in part, the significant impact of inflation.

Depreciation, Depletion and Amortization
This item increased $1.7 million, or 8%, in 1977 over 1976 and $2.7 million, or 12%, in 1978 over 1977, due principally to an increase in depreciable plant.

Taxes, Other Than Income Taxes
Taxes, other than income taxes, increased approximately $2.1 million, or 33%, in 1977 over 1976, primarily due to higher property and gas production taxes. Washington state property taxes increased due to the construction of a new LNG storage plant, plus an increase in the tax levy from additional bond issues passed by certain counties. Production taxes increased due to an increase in the gas production tax rate in New Mexico, effective September 1, 1976, and due to increased sales prices under nationwide rates granted by FERC to gas producers.

Income Taxes
Income taxes increased almost $2 million, or 11%, in 1977 over 1976 and decreased $3.4 million, or 18%, in 1978 compared to 1977, correlating generally with the change in taxable income between those periods. Investment tax credit recognized currently increased $.7 million, or 29%, in 1977 over 1976 and $2.1 million, or 70%, in 1978 over 1977, primarily due to the recognition of qualified progress expenditures on the construction of the second phase of the LNG storage plant, expenditures relating to the Clay Basin underground storage project, and an increase in overall construction activity.

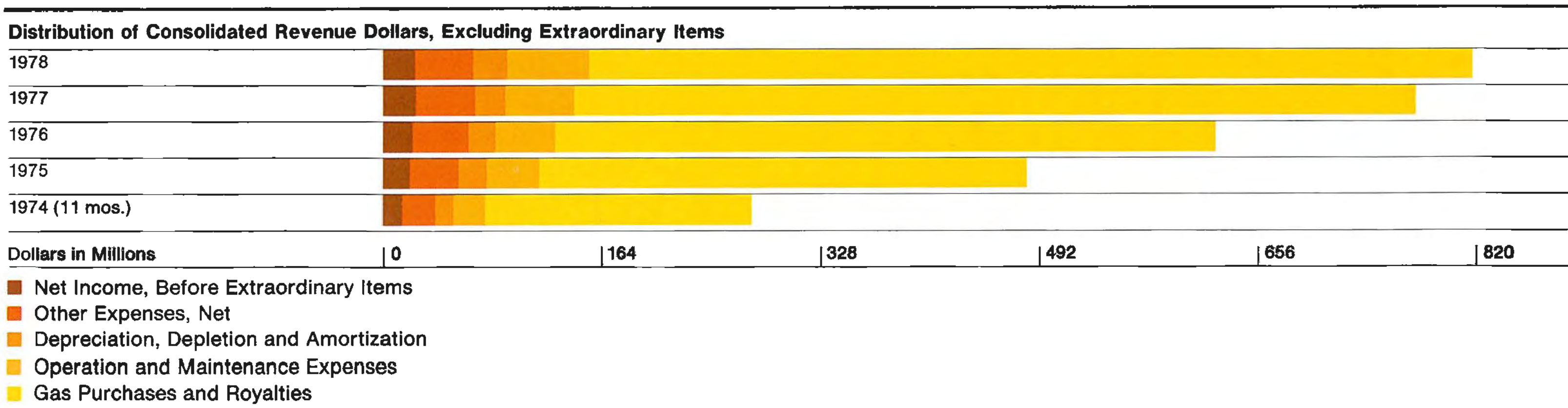
Other Income, Net
Pro Rata Share of Alaskan Northwest's Allowance for Equity Funds Capitalized
Commencing in 1978, the Company is recognizing its pro rata share of allowance for equity funds capitalized during engineering, design and preliminary construction from a newly formed partnership, Alaskan Northwest Natural Gas Transportation Company, established to design, construct and operate the Alaskan portion of the Alaska Highway Pipeline Project (see Notes 1 and 3 of Notes to Consolidated Financial Statements).

Equity in Earnings of Phillips Pacific Chemical Company, net of income taxes
Pipeline's equity in earnings of Phillips Pacific Chemical Company ("Phillips Pacific"), net of income taxes, decreased $1.6 million, or 69%, in 1977 from 1976 and $.4 million, or 63%, in 1978 from 1977, due principally to a decrease in average sales prices and production levels, and an increase in production costs, particularly natural gas.

The decrease in sales prices resulted from overexpansion of domestic supply sources and increasing competition from foreign imports. Major factors contributing to a reduction in production levels to about 87% of capacity in both 1977 and 1978 were mechanical problems at the plant in both 1977 and 1978, drought conditions in Phillips Pacific's marketing area in 1977 and one of Phillips Pacific's largest customers being unable to accept normal deliveries during several months in 1978 because of operating problems in its ammonia conversion facilities.

Dividend Requirements on Preferred Stock Issues of Northwest Pipeline Corporation
Since the $2.50 series cumulative preferred stock of Pipeline was issued in mid-January 1976, dividends on such stock were approximately $1.9 million in 1976 and increased $.1 million for the full year of 1977.

Distribution of Consolidated Revenue Dollars, Excluding Extraordinary Items



In June 1978, Pipeline issued 1,400,000 shares of $2.36 series cumulative preferred stock which increased preferred dividends by approximately $1.9 million in 1978.

Interest Income and Other

Interest income increased approximately $1.1 million during 1977 compared with 1976, primarily as a result of accrued interest on certain unrecovered special overriding royalty costs. Partially offsetting the increase in interest income was a reversal in 1977 of a gain recorded as other income in 1976, resulting from the settlement of a claim on the sale of a fixed asset.

Interest income increased approximately $.6 million during 1978 compared with 1977, primarily due to accrued interest on the unrecovered special overriding royalties, mentioned above, plus accrued interest on unrecovered gas purchase costs, all slightly offset by a reduction in interest income from temporary cash investments.

Interest Charges

Gross interest charges increased approximately $1.5 million in 1977 over 1976. The credit from allowance for borrowed funds used during construction increased by $1.1 million, resulting principally from costs applicable to the Alaska Highway Pipeline Project, which had the effect of reducing the increase in interest charges by a corresponding amount. The increase in gross interest charges was primarily due to the issuance of $50 million of sinking fund debentures by Pipeline in mid-1976. Additional interest was also accrued in the first half of 1977 applicable to the special overriding royalty payments discussed above. Increased interest expense was partially offset by retirement of long-term debt, principally to satisfy Pipeline's sinking fund requirements, installment payments on Energy's secured bank loan and payment of a rate refund to customers in March 1977.

Gross interest charges increased $2.9 million, or 13%, in 1978 over 1977. The credit from allowance for borrowed funds used during construction increased $1.6 million to more than double the 1977 amount, due to increased construction activity, the use of borrowed funds as opposed to equity funds, plus an increase from 8.8% to 12.8% in the overall formula rate. This credit had the effect of reducing the increase in interest charges by a corresponding amount. Gross interest expense increased primarily due to the issuance of $70 million of additional sinking fund debentures by Pipeline in June 1978. In addition, in 1978 higher interest charges were due to increased borrowings on the Company's lines-of-credit, slightly offset by decreased interest charges arising from principal payments on Pipeline's mortgage bonds and sinking fund debentures, plus repayment of Energy's bank loan from proceeds of the liquidation of Apco Oil Corporation, referred to in Note 5 of Notes to Consolidated Financial Statements.

Extraordinary Items

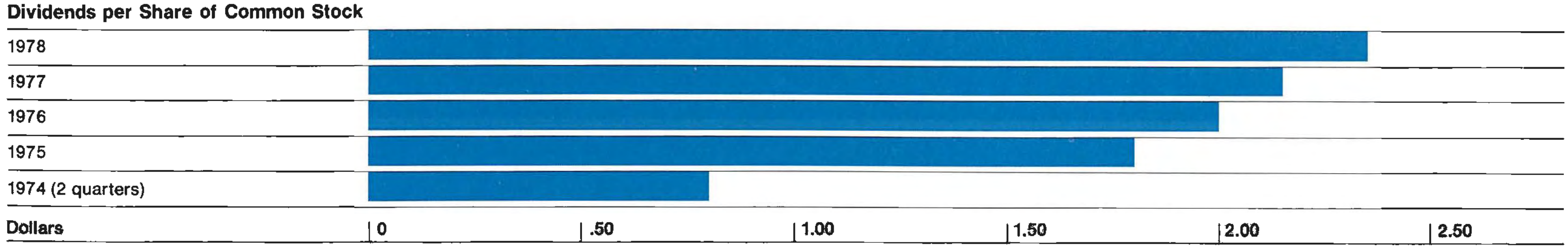
Reference is made to Note 5 of Notes to Consolidated Financial Statements for a discussion of the gain on the liquidation of Apco Oil Corporation and the provision for a loss on the forced abandonment of an Ecuadorian gas exploration and development project, both recognized in 1978 as extraordinary items.

Common Stock Prices and Dividends

Northwest Energy Company's common stock is traded on the New York and Pacific Stock Exchanges. The table below shows the quarterly high and low composite sales prices for such common stock, for the years 1977 and 1978, as reported by *The Wall Street Journal,* and the dividends declared on such stock for each quarter listed:

	High	Low	Dividends Declared Per Share
Quarter of 1977			
First	38	32¾	50¢
Second	42	32⅛	55
Third	43⅞	37¾	55
Fourth	39¾	34¼	55
Quarter of 1978			
First	38⅛	33⅛	55
Second	35⅝	33	60
Third	35⅝	31	60
Fourth	34¼	25⅜	60

Dividends per Share of Common Stock



Consolidated Balance Sheet

December 31,	1978	1977
	(Thousands of Dollars)	
Assets		
Property, Plant and Equipment, at cost	$702,732	$623,192
Less—Accumulated depreciation, depletion and amortization	265,266	240,627
	437,466	382,565
Construction work in progress	36,035	14,632
	473,501	397,197
Investments:		
Alaskan Northwest Natural Gas Transportation Company (Note 3)	27,867	—
Apco Oil Corporation (Note 5)	—	41,012
Phillips Pacific Chemical Company (Note 4)	8,433	8,447
Other	2,113	6,353
	38,413	55,812
Current Assets:		
Cash	9,420	8,579
Accounts receivable	116,191	89,788
Gas stored underground (at average cost)	45,759	28,592
Materials and supplies (at average cost)	10,407	10,848
Costs recoverable through rate adjustments (Note 2)	27,369	28,524
Prepayments and other	3,992	3,965
	213,138	170,296
Deferred Charges:		
Alaska Highway Pipeline Project (Note 3)	—	18,340
Other	7,211	7,130
	7,211	25,470
	$732,263	$648,775

December 31,	1978	1977
	(Thousands of Dollars)	
Liabilities and Stockholders' Equity		
Capitalization:		
Common stockholders' equity—		
Common stock, par value $1 per share, authorized 10,000,000 shares; outstanding 4,304,026 shares and 4,285,768 shares, respectively (Note 6)	**$ 4,304**	$ 4,286
Additional paid-in capital	**104,150**	103,550
Retained earnings (Note 7)	**82,294**	55,177
	190,748	163,013
Preferred stock, issuable in series, par value $1 per share, authorized 1,000,000 shares; none outstanding	**—**	—
Preferred stock issues of Northwest Pipeline Corporation, subject to periodic redemption	**55,000**	20,000
Long-term debt, less current maturities (Note 7)	**261,619**	224,760
	507,367	407,773
Current Liabilities:		
Current maturities of long-term debt (Note 7)	**17,970**	23,853
Notes payable to banks (Note 8)	**9,000**	56,500
Accounts payable	**88,230**	80,927
Accrued taxes	**36,442**	20,208
Accrued interest	**3,984**	4,166
Other	**15,265**	9,938
	170,891	195,592
Accumulated Deferred Income Taxes (Note 9)	**54,005**	45,410
Commitments and Contingent Liabilities (Notes 2, 3, 4 and 13)		
	$732,263	$648,775

The accompanying notes to consolidated financial statements are an integral part of this consolidated balance sheet.

Consolidated Statement of Income

Year Ended December 31,	1978	1977
	(Dollars in Thousands, Except Per Share Amounts)	
Operating Revenues (Notes 2 and 10)	$819,982	$773,131
Operating Expenses:		
Gas purchases	602,498	599,866
Gas royalties	62,275	29,506
Operation and maintenance	62,868	50,929
Depreciation, depletion and amortization	24,745	22,071
Taxes, other than income taxes	8,645	8,752
Income taxes (Note 9)	16,026	19,443
	777,057	730,567
	42,925	42,564
Other (Income) and Income Deductions:		
Interest charges	25,528	22,671
Less—Allowance for borrowed funds used during construction	(2,886)	(1,305)
	22,642	21,366
Pro rata share of Alaskan Northwest's allowance for equity funds capitalized during engineering, design and preliminary construction (Note 3)	(3,144)	—
Equity in earnings of Phillips Pacific Chemical Company, net of income taxes (Note 4)	(261)	(704)
Dividend requirements on preferred stock issues of Northwest Pipeline Corporation	3,927	2,000
Interest income and other	(3,627)	(2,999)
Allowance for equity funds used during construction	—	(530)
	19,537	19,133
Income Before Extraordinary Items	23,388	23,431
Extraordinary Items, less applicable income taxes of $5.1 million (Note 5)	15,427	—
Net Income	$ 38,815	$ 23,431
Per Share of Common Stock:		
Income before extraordinary items	$ 5.44	$ 5.47
Extraordinary items (Note 5)	3.58	—
Net Income	$ 9.02	$ 5.47
Weighted Average Number of Common Shares Outstanding, in thousands	4,302	4,286
Dividends Declared Per Share of Common Stock	$ 2.35	$ 2.15

The accompanying notes to consolidated financial statements are an integral part of this consolidated statement.

Consolidated Statement of Changes in Financial Position

Year Ended December 31,	1978	1977
	(Thousands of Dollars)	
Source of Funds:		
Operations—		
Income before extraordinary items	$ 23,388	$ 23,431
Nonfund income items:		
Depreciation, depletion and amortization	24,745	22,071
Deferred income taxes—noncurrent (Note 9)	11,295	9,215
Pro rata share of Alaskan Northwest's allowance for equity funds capitalized during engineering, design and preliminary construction (Note 3)	(3,144)	—
Equity in earnings of Phillips Pacific Chemical Company (Note 4)	(261)	(704)
Other	4,153	2,088
Total funds from operations	60,176	56,101
Extraordinary items (Note 5)—		
Gain on liquidation of Apco Oil Corporation, net of income taxes	18,626	—
Loss on forced abandonment of Ecuadorian gas exploration and development project, net of income tax benefits	(3,199)	—
Deferred income tax benefits	(2,735)	—
Other sources—		
Recovery of investment in Apco Oil Corporation (Note 5)	40,810	—
Preferred stock issue of Northwest Pipeline Corporation	35,000	—
Dividends received from Phillips Pacific Chemical Company (Note 4)	294	980
Common stock issued	630	—
Long-term borrowings	69,823	—
Other	5,038	—
Decrease in working capital	—	62,047
Total source of funds	$224,463	$119,128
Use of Funds:		
Additions to property, plant and equipment	$105,083	$ 75,979
Investment in Alaskan Northwest, excluding allowance for equity funds capitalized (Note 3)	6,383	8,920
Reduction in long-term debt	32,989	23,820
Cash dividends on common stock	10,114	9,214
Other	2,351	1,195
Increase in working capital	67,543	—
Total use of funds	$224,463	$119,128
Changes in Components of Working Capital:		
Cash and temporary cash investments	$ 841	$ (43,644)
Accounts receivable	26,403	15,554
Gas stored underground	17,167	17,508
Costs recoverable (payable) through rate adjustments	(1,155)	20,331
Current maturities of long-term debt	5,883	(472)
Notes payable to banks	47,500	(56,500)
Accounts payable	(7,303)	(28,427)
Accrued taxes	(16,234)	(4,817)
Rate refund due customers, including interest	—	15,935
Other	(5,559)	2,485
Total increase (decrease) in working capital	$ 67,543	$ (62,047)

The accompanying notes to consolidated financial statements are an integral part of this consolidated statement.

Consolidated Statement of Capitalization

Year Ended December 31,	1978	1977
	(Dollars in Thousands, Except Per Share Amounts)	
Common Stockholders' Equity:		
Common stock, par value $1 per share, authorized 10,000,000 shares; outstanding 4,304,026 shares and 4,285,768 shares, respectively (Note 6)—		
Balance at beginning of period	$ 4,286	$ 4,286
Par value of 18,258 shares issued in 1978	18	—
Balance at end of period	4,304	4,286
Additional paid-in capital—		
Balance at beginning of period	103,550	103,550
Proceeds, in excess of par value, from common stock issued	612	—
Issuance costs of common stock	(12)	—
Balance at end of period	104,150	103,550
Retained earnings (Note 7)—		
Balance at beginning of period	55,177	40,960
Net income for period	38,815	23,431
Cash dividends on common stock	(10,114)	(9,214)
Issuance costs on preferred stock issue of Northwest Pipeline Corporation	(1,584)	—
Balance at end of period	82,294	55,177
Total common stockholders' equity	190,748	163,013
Preferred Stock of Northwest Energy Company:		
Issuable in series, par value $1 per share, authorized 1,000,000 shares; none outstanding	—	—
Preferred Stock Issues of Northwest Pipeline Corporation:		
Issuable in series, par value $1 per share, authorized 10,000,000 shares; outstanding 800,000 shares, cumulative $2.50 series and 1,400,000 shares, cumulative $2.36 series, both subject to periodic redemption—		
Balance at beginning of period	20,000	20,000*
Par value of shares issued	1,400	—
Mandatory redemption price in excess of par value	33,600	—
Balance at end of period	55,000	20,000
Long-Term Debt, less current maturities of $17,970,000 and $23,853,000, respectively (Note 7):		
Northwest Energy Company—		
Secured bank loan	—	15,000
Northwest Pipeline Corporation—		
First Mortgage Pipe Line Bonds, 4.675%-6% series, due 1980-1986	36,566	44,456
Sinking Fund Debentures, 5⅝%-10⅜% series, due 1981-1998	224,255	162,888
Other subsidiary companies, due through 1983	798	2,416
Total long-term debt	261,619	224,760
Total capitalization	$507,367	$407,773

*Par value, $800,000; mandatory redemption price in excess of par value, $19,200,000.

The accompanying notes to consolidated financial statements are an integral part of this consolidated statement.

Notes to Consolidated Financial Statements

(1) Summary of Accounting Policies

Consolidation

The consolidated financial statements include the accounts of Northwest Energy Company ("Energy") and all significant wholly owned subsidiaries (the "Company"). All significant intercompany transactions have been eliminated. Northwest Pipeline Corporation ("Pipeline"), the principal subsidiary of Energy, is an interstate natural gas transmission company which owns and operates a pipeline system for the transmission and sale of natural gas in the northwestern United States. Pipeline's assets approximated 90% of consolidated assets at December 31, 1978, and 95% at December 31, 1977. Pipeline's operations accounted for more than 91% and 98% of consolidated operating revenues and income before extraordinary items for the years ended December 31, 1978 and 1977, respectively.

Alaskan Northwest Natural Gas Transportation Company (the "Partnership") was formed to design, construct and operate a natural gas pipeline and related facilities to transport Alaskan natural gas to the lower 48 states. Energy's investment in the Partnership is held through a subsidiary, Northwest Alaskan Pipeline Company ("Northwest Alaskan"). Such investment is accounted for at cost plus Northwest Alaskan's pro rata share of allowance for equity funds capitalized during engineering, design and preliminary construction from the Partnership. The investment is carried at an amount which is the same as Northwest Alaskan's equity in the Partnership's underlying net assets, except for a reserve recognized by Northwest Alaskan to reduce the effective allowance for equity funds capitalized during engineering, design and preliminary construction to a rate of 15%. (See Note 3.)

Pipeline's investment in Phillips Pacific Chemical Company ("Phillips Pacific"), a manufacturer of chemical fertilizers, is accounted for at Pipeline's cost plus its equity in Phillips Pacific's undistributed earnings. Such investment amount is the same as Pipeline's equity in Phillips Pacific's underlying net assets.

Property, Plant and Equipment

Property, plant and equipment, consisting principally of gas transmission and production plant, is recorded at cost which, for properties of Pipeline, represents original cost.

Expenditures which materially increase values or capacities or extend useful lives of property, plant or equipment are capitalized. Routine maintenance, repairs and renewal costs are charged to income as incurred. Gains or losses from the ordinary sale or retirement of property, plant and equipment are charged or credited to accumulated depreciation, depletion and amortization.

Allowance for Borrowed and Equity Funds Used During Construction

Allowance for funds used during construction ("AFUDC") for Pipeline, included in other income, represents the estimated cost of borrowed and equity funds applicable to utility plant in process of construction. Recognition is made of this item as a cost of utility plant since it constitutes an actual cost of construction and, under established regulatory practices, Pipeline is permitted to recover and earn a return on such costs. The composite rate used by Pipeline to capitalize the cost of funds related to construction was 8.8% for 1977 and 12.8% for 1978. Effective January 1, 1977, the Federal Energy Regulatory Commission ("FERC") prescribed a formula to be used in computing separate allowances for borrowed and equity funds used during construction. In 1978, average short-term debt exceeded average construction work in progress which, pursuant to FERC rules, required Pipeline to use its effective interest rate on short-term borrowings in computing the allowance for borrowed funds used during construction. Such short-term interest rate, in 1978, included the cost related to compensating balance arrangements.

Oil and Gas Exploration and Development Costs

Full-cost accounting is followed for exploration costs incurred by Energy's oil and gas exploration subsidiary. Under such method, all costs pertaining to exploration and development, including the costs of unsuccessful drilling, are capitalized in an amount not in excess of the net realizable value of related reserves discovered. Costs related to successful drilling efforts of Pipeline are capitalized, whereas costs of unsuccessful drilling are charged currently to income.

Depreciation, Depletion and Amortization

Depreciation for Pipeline is provided by the straight-line method for all classes of property, plant and equipment, except producing gas properties. The composite annual depreciation rate for the periods presented was 4.08%.

Depreciation, depletion and amortization of oil and gas properties is determined by the unit-of-production method, based upon equivalent barrels of proved reserves. Undeveloped leasehold costs representing approximately $9 million and $5.5 million at December 31, 1978 and 1977, respectively, are not amortized. However, beginning in 1979, rules adopted by the Securities and Exchange Commission ("SEC") will require amortization of such costs.

Coal leases and mine development costs are amortized or depleted using the unit-of-production method, based upon total estimated tons of proved recoverable coal reserves. Coal mining equipment is depreciated on a straight-line basis over useful lives of from 3 to 20 years.

Federal Income Taxes

Deferred income taxes are provided on substantially all tax timing differences. The tax benefit of the investment tax credit is recognized currently for financial reporting purposes.

(2) Rate Matters

1978 General Rate Increase

Pursuant to a general rate filing, on October 1, 1978 Pipeline was authorized to place increased rates into effect, subject to refund, which are estimated to increase annual revenues by approximately $28.7 million. Pipeline filed a proposed stipulation and agreement with FERC in February 1979, which provided for settlement at filed rates. The proposed settlement agreement provides that refunds will be required based upon any excess of actual total sales volumes during the twelve months ending September 30, 1979 over estimated annual sales volumes specified in the agreement. The actual sales volumes experienced for the three months ended December 31, 1978 exceeded the sales volumes estimated for that period as a component part of the estimated annual sales volumes. Because of the seasonality of gas sales volumes, Pipeline is unable to project whether a refund will ultimately be required and, accordingly, no reserve relative to this issue has been reflected in the accompanying consolidated financial statements. At such time as Pipeline can reasonably project estimated sales volumes through September 30, 1979, a reserve for refund, if necessary, will be established. An accurate projection of sales volumes through September 30, 1979 is dependent principally upon weather conditions and industrial load requirements, and, accordingly, is not subject to reasonable determination at December 31, 1978. In addition, the proposed settlement agreement provides that Pipeline will make refunds to the extent it pays less than the amount allowed in the settlement rates for its costs associated with the Clay Basin storage project due to the level of participation of El Paso Natural Gas Company ("EPNG") in such project. Pipeline has reserved sufficient amounts to cover estimated refunds required pursuant to participation by EPNG.

Special Overriding Royalties

Approximately 75% of Pipeline's San Juan Basin natural gas leasehold production is obtained under leases which include special overriding royalty provisions with escalation formulas which generally require a price redetermination every five years. Pursuant to previously negotiated settlement agreements approved by FERC, such special overriding royalty payments are included in Pipeline's gas sales rates. The settlement agreements are specifically subject to a determination of FERC jurisdiction over such payments. Litigation regarding the issue of jurisdiction is presently pending in the courts and before FERC. At this time, it is impossible to determine the results of such litigation, but if it is ultimately determined that FERC has jurisdiction, refunds may be required from the royalty owners. In the event refunds are required, the royalty owners would be required to repay Pipeline for the difference between the reduced royalty rates and the previously approved royalty rates. Pipeline would then be obligated to refund to its customers amounts applicable to Pipeline's production from wells drilled prior to 1973, but might be permitted, subject to FERC approval, to retain the payments applicable to Pipeline's production from wells drilled thereafter since Pipeline has priced such production at the applicable nationwide rate in lieu of actual cost of service for rate purposes.

The settlements in 1977 resulted in payment of amounts previously deferred. FERC authorized recovery of such costs incurred prior to October 1, 1977 over a two-year period. The net unrecovered special overriding royalties was $15.3 million and $30.5 million at December 31, 1978 and 1977, respectively.

Other

Pipeline's FERC gas tariff includes a purchased gas adjustment clause which provides for semiannual rate adjustments to permit the tracking of changes in gas purchase costs, except that specific FERC authorization is required for increases in the cost of Canadian gas purchases. Such semiannual rate adjustments may be made effective each April 1 and October 1 to reflect changes in purchased gas costs during the previous six-month periods ended December 31 and June 30, respectively. In addition to recovery of domestic gas purchase price increases, FERC will consider exceptions to such filing intervals, permitting Pipeline to file for and commence recovery of significant Canadian gas purchase price increases on the dates such increases become effective for Pipeline. The recovery of all Canadian gas price increases to date has been approved by FERC.

"Costs recoverable through rate adjustments", for which Pipeline is permitted to recover allowed carrying costs, consisted of:

December 31,	1978	1977
	(Thousands of Dollars)	
Unrecovered special overriding royalties, net	$15,306	$30,537
Unrecovered (excess recovery of) gas purchase costs	10,698	(1,925)
Other rate-related items	1,365	(88)
	$27,369	$28,524

(3) Investment in Alaskan Northwest Natural Gas Transportation Company

Northwest Alaskan is the operating partner in the Alaskan Northwest Natural Gas Transportation Company partnership (the "Partnership"), which includes subsidiaries of five other U.S. natural gas transmission companies. The Partnership was formed to design, construct and operate the Alaskan portion of a natural gas pipeline to transport natural gas from Prudhoe Bay, Alaska to the lower 48 states, an undertaking known as the Alaska Highway Pipeline Project (the "Project"). Certain Canadian companies are to transport the natural gas across Canada for delivery at two locations on the U.S.-Canadian border, from which points the gas will be transported to midwestern and western U.S. markets. It is contemplated that a new pipeline will be constructed to transport the Alaskan gas from the Canadian border to the midwestern United States (the "Northern Border segment").

A portion of the Alaskan gas is intended to be transported west from the Canadian border to California and other western states through the expansion of existing pipeline facilities.

The estimated capital costs, based upon the originally planned in-service date in early 1983, were approximately $10 billion. Of this amount, the Alaskan portion was estimated to cost $4 billion. Due to delays in Congressional enactment of energy policy legislation, which, among other things, fixed the pricing policy for Alaskan gas, and also due to delays in the receipt of other governmental decisions, the capital costs of the Project are expected to increase substantially, but definitive cost estimates have not been developed. The Partnership currently estimates that gas deliveries from the Project could commence in 1984, unless there are further delays in the receipt of necessary governmental and regulatory approvals.

Neither Energy nor the Partnership has made commitments on the timing or amount of funds to be invested in the Alaskan portion of the Project. However, management currently expects that the financial commitment of Energy will be between $150 million and $200 million, and will consist primarily of equity investments in the Partnership.

Summary financial information of the Partnership as of December 31, 1978, follows:

	(Thousands of Dollars)
Natural gas transmission plant under construction	$102,334
Working capital	3,448
Partners' equity	$105,782

Natural gas transmission plant under construction, shown above, consists primarily of costs associated with research, design and engineering and filings with regulatory authorities, and AFUDC.

Expenditures incurred on the Project by the Company prior to December 31, 1977 were originally reflected as deferred charges on the accompanying consolidated balance sheet. After formation of the Partnership, on January 31, 1978, the deferred charges accumulated through that date were contributed to the Partnership, through Northwest Alaskan. Energy's investment in the Partnership was approximately $27.9 million as of December 31, 1978. This is represented by $17.9 million of expenditures incurred in connection with FERC application and engineering studies for the Project prior to formation of the Partnership as of January 31, 1978, $5.7 million in capital contributions to the Partnership for further engineering work in 1978, $3.1 million in equity funds capitalized since formation of the Partnership and $1.2 million in AFUDC capitalized prior thereto. The equity funds capitalized, as recognized by Northwest Alaskan, have been based on a rate of 15% since formation of the Partnership. From the formation of the Partnership through December 31, 1978, Pipeline provided services to the Partnership and has been reimbursed at its cost, which aggregated approximately $2 million. It is anticipated that Energy's investment in the Partnership will increase in 1979 by approximately $12 million, of which approximately $7 million is for capital expenditures and approximately $5 million is equity funds capitalized.

The Project was approved by Congress in 1977 pursuant to the Alaskan Natural Gas Transportation Act of 1976, and legislation authorizing the Canadian portion has been enacted in Canada. It has been stipulated that the Project will be open to ownership participation by all persons, without discrimination, except producers of Alaskan natural gas. The President's 1977 decision and report to Congress selecting the Project contemplated that there would be no Federal guarantees of debt for the Project, and that consumers would not be required to bear any portion of the risks prior to completion and commissioning of the line. However, the Partnership considers a prerequisite for private financing of the Project to be that the State of Alaska provide financial support through preferred equity investment and issuance of tax-exempt bonds, the proceeds of which would be loaned to the Project.

FERC has adopted an "incentive rate of return on equity investment" ("IROR") concept as a condition to the issuance of certificates of public convenience and necessity for the Alaskan portion and the Northern Border segment of the Project. This concept, which will apply separately to the Alaskan portion and the Northern Border segment is designed to provide an incentive for minimizing construction costs by establishing variable rates of return on equity, which rates would decrease if construction cost overruns occur. Adjustments for inflation and for additional construction costs for changes in Project design due to factors uncontrollable by the sponsors, as well as the applicable rates of return on equity under the order, will be promulgated by FERC in the future.

Development of a financing plan is dependent upon improvement in the regulatory environment, including FERC's setting of a range for rate of return. FERC has requested the Partnership to submit a financing plan before it sets such a range.

Efforts in 1979 will focus on the financing plan, resolution of IROR issues, preparatory work for submitting the application for certification as previously discussed and other regulatory matters. A filing of definitive cost estimates based on preliminary design is scheduled for mid-1979; this estimate will be used as a basis (with adjustments for scope changes and inflation) for establishing a rate of return within the range ultimately set by FERC.

In February 1979, FERC issued a proposed rulemaking and statement of policy which proposes that the producers be responsible for constructing and operating a gas conditioning plant at Prudhoe Bay. However, ultimate responsibility has not been established.

Northwest Alaskan has submitted filings to FERC for approval of advance delivery of Canadian gas, to be made possible by early construction of portions of the facilities in the lower 48 states. The extent of the Company's financial participation in the early construction of these portions is presently estimated to be approximately $200 million.

Although delays have been encountered and cost estimates are expected to increase, management of Energy, on balance, is encouraged by what has been achieved to date and continues in its belief that the Project is viable. The ultimate success of the Project is dependent upon final governmental and regulatory authorizations, satisfactory gas purchase, sale and transportation contracts, adequate financing, and successful completion of construction.

(4) Investment in Phillips Pacific Chemical Company
Phillips Pacific owns a chemical fertilizer manufacturing plant in the state of Washington. Pipeline owns 49% of the common stock of Phillips Pacific, and the remaining 51% interest is owned by Phillips Petroleum Company, operator of the plant.

The Company received approximately $.3 million and $1 million in cash dividends from Phillips Pacific in 1978 and 1977, respectively. For the periods presented, the Company has provided Federal income taxes on its equity in earnings of Phillips Pacific at the statutory rate, recognizing dividend-received deductions, or an effective rate of 7.2%.

Sales of natural gas by Pipeline to Phillips Pacific reflected in the consolidated financial statements for 1978 and 1977 were approximately $9.6 million and $8.7 million, respectively.

In 1975, Phillips Pacific was named with several other codefendants in several class action suits alleging combination and conspiracy to restrain trade and monopolize the sale of commercial fertilizer in the northwest region of the United States. Treble damages are being sought in these class action suits, which are still pending. Management of Phillips Pacific believes the claims appear to be without merit. Therefore, based on the assessment of Phillips Pacific's management, the Company's management believes that the claims should not have a significant effect on these consolidated financial statements.

(5) Extraordinary Items
The extraordinary items for the year ended December 31, 1978 were comprised of the following items:

	(Thousands of Dollars)
Gain on liquidation of Apco Oil Corporation, net of income tax effect of $8.1 million	$18,626
Loss on forced abandonment of Ecuadorian gas exploration and development project, net of income tax benefits of $3 million	(3,199)
	$15,427

Apco Oil Corporation Liquidation
In 1975, Energy acquired 1,501,305 shares, or approximately 48% of the outstanding common stock of Apco Oil Corporation ("Apco"), an integrated oil company, pursuant to a cash tender offer. Energy's equity interest was subsequently reduced to approximately 35.3% as a result of issuance of additional Apco common stock in exchange for Apco's convertible debt securities.

The Board of Directors of Apco, after considering the possible liquidating value of Apco's principal assets, compared with continuing operations, determined liquidation to be in the best interests of Apco's stockholders. Accordingly, a special meeting of the stockholders of Apco was held on October 27, 1977, and a plan of liquidation for Apco was adopted.

Substantially all assets of Apco were liquidated in 1978. Energy received liquidating dividends from Apco in 1978 of approximately $67.6 million, or approximately $26.7 million in excess of its investment in Apco. After provision for income taxes of approximately $8.1 million, an extraordinary gain of $18.6 million was recognized and is reflected in the accompanying consolidated financial statements. A liquidating trust has been established for the remaining assets and liabilities of Apco from which Energy expects to receive some additional distributions as obligations of the trust are satisfied.

Ecuador Project
In April 1975, the Company entered into an agreement with the Ecuadorian government for the exploration and development of gas reserves off the coast of Ecuador. In connection with this agreement, the Company was obligated to make minimum, qualified expenditures of $8 million, subject to exchange variations, during a five-year exploration period ending in 1980, or forfeit a $1.6 million performance guarantee established through a bank. In 1978, the government of Ecuador rejected the only currently economically feasible plan for ultimate utilization of any gas to be produced, thereby effecting the forced abandonment of this project. Total accumulated costs as of December 31, 1978 amounted to approximately $6.2 million, including the performance guarantee, which net of income tax benefits of $3 million resulted in an extraordinary loss of $3.2 million.

(6) Common Stock
Effective as of February 1, 1974, EPNG transferred to Pipeline certain assets required to be divested under a Federal court divestiture decree. In connection with the divestiture, participation certificates were issued under a voting trust established to insulate Pipeline from any ownership or control by EPNG and, subsequently, The El Paso Company ("El Paso"), the new parent company of EPNG. On February 28, 1975, pursuant to a corporate restructuring, the outstanding common stock of Pipeline was changed share for share into common stock of Energy, and Pipeline became a wholly owned subsidiary of Energy.

The Voting Trustee was required to close the transfer books on February 7, 1979 and to permit no further transfers of ownership of participation certificates. However, participation certificate holders who are not stockholders of El Paso were permitted through February 28, 1979 to exchange their participation certificates for an equivalent number of shares of Energy common stock.

Under the terms of the divestiture decree, the shares of Energy common stock remaining in the Voting Trust on February 28, 1979 are required to be sold by the Voting Trustee. Of such shares, 500,000 are to be sold in an underwritten public offering. The remaining shares are to be sold by the Voting Trustee to Energy's Bonus Employee Stock Ownership Plan (the "ESOP") pursuant to a contract with Citibank, N.A., as trustee for the ESOP. The net proceeds of the sales will be distributed to the participation certificate holders and the participation certificates will then be deemed cancelled and void.

(7) Long-Term Debt

Under the terms of Pipeline's indentures for its Sinking Fund Debentures, restrictions exist which substantially preclude the issuance of additional mortgage bonds. The indentures for both the First Mortgage Pipe Line Bonds and the Sinking Fund Debentures contain provisions for the acceleration of sinking fund payments under certain conditions related to potential future exhaustion of Pipeline's available gas supply.

Under the terms of the Company's mortgage indentures and secured notes, substantially all property, plant and equipment, major gas purchase and sales contracts and certain gas exchange and operating agreements are pledged as collateral.

At December 31, 1978, approximately $10.3 million of consolidated retained earnings was restricted under Pipeline's debt indentures as to payment of cash dividends on its common stock.

Sinking fund requirements and other maturities of long-term debt for each of the five years subsequent to December 31, 1978, are as follows:

Year Ending December 31,	Thousands of Dollars
1979	$17,970
1980	16,382
1981	19,003
1982	23,427
1983	27,718

(8) Line-of-Credit Arrangements

Through a number of banks, Pipeline and Energy have unsecured line-of-credit arrangements which aggregated $160 million at December 31, 1978 and $85 million at December 31, 1977, against which $9 million and $56.5 million were drawn at December 31, 1978 and 1977, respectively. Such lines-of-credit contain compensating balance arrangements under which the banks agree to provide credit as indicated above, and Pipeline or Energy agrees to maintain average annual bank balances equal to 10% of credit availability plus 10% of outstanding loan balances. No legal restrictions exist prohibiting the withdrawal of funds used to meet these requirements. Under such arrangements, the maximum aggregate short-term borrowings outstanding at any month-end during 1978 and 1977 were $114 million and $56.5 million, respectively. The average daily short-term borrowings were approximately $34.1 million and $7.4 million during 1978 and 1977, respectively. The average annual compensating balance required, based on credit availability and borrowings outstanding at December 31, 1978, was approximately $16.9 million.

Interest on amounts borrowed pursuant to these arrangements is at the banks' prime rates in effect during the time the loans are outstanding. At December 31, 1978, the prime rate for all such banks was 11.75%. The weighted average interest rates during 1978 and 1977 were 8.42% and 7.8%, respectively, based on interest charges incurred and loans outstanding during the periods.

(9) Income Taxes

The provision for income taxes reflected in the consolidated statement of income consists of the following components:

Year Ended December 31,	1978	1977
	(Thousands of Dollars)	
Included in Operating Expenses:		
Currently payable—		
Federal	$ 9,289	$ 5,590
State	746	680
Subtotal	10,035	6,270
Deferred Federal and state—		
Current	(184)	6,969
Noncurrent	11,295	9,215
Subtotal	11,111	16,184
Investment tax credit recognized currently	(5,120)	(3,011)
Total included in operating expenses	16,026	19,443
Included in Other Income and (Income Deductions):		
Provision for taxes on equity in earnings of Phillips Pacific—		
Currently payable	21	71
Deferred	(1)	(16)
Provision for income taxes	$16,046	$19,498
Included in Extraordinary Items:		
Provision for taxes on gain from liquidation of Apco Oil Corporation—		
Currently payable:		
Federal	$ 9,334	$ —
State	228	—
Subtotal	9,562	—
Deferred Federal and state	(1,439)	—
Subtotal	8,123	—
Tax benefit from write-off of Ecuador project— Deferred Federal and state	(3,002)	—
	$ 5,121	$ —

Deferred tax expense results from timing differences in the recognition of revenues and expenses for tax and financial reporting purposes. The sources of these differences and the tax effect of each are as follows:

Year Ended December 31,	1978	1977
	(Thousands of Dollars)	
Current:		
Unrecovered (excess recovery of) gas purchase costs, deferred in the financial statements and deducted currently for tax reporting purposes	$ 6,635	$ (4,899)
Unrecovered special overriding royalty payments, deferred in the financial statements and deducted currently for tax reporting purposes	(6,382)	14,658
Gas sales rate adjustments, recognized currently in the financial statements and deferred for tax reporting purposes until collected	170	(1,539)
Gas sales rate adjustments, recognized currently for tax reporting purposes and reserved for in the financial statements	(607)	(1,251)
Noncurrent:		
Liberalized tax depreciation in excess of straight-line depreciation	4,226	3,639
Intangible drilling and development costs, capitalized in the financial statements and deducted currently for tax reporting purposes	4,075	3,272
Distributive share of tax loss of the Alaskan Northwest partnership, capitalized in the financial statements and deducted currently for tax reporting purposes	1,133	—
Allowance for borrowed funds used during construction, recognized currently in the financial statements and deferred for tax reporting purposes	1,385	626
Other	476	1,678
	11,111	16,184
Phillips Pacific:		
Equity in earnings, recognized currently in the financial statements and deferred for tax reporting purposes	20	55
Dividends received, recognized currently for tax reporting purposes and recognized previously in the financial statements	(21)	(71)
	(1)	(16)
	$11,110	$16,168

The total provision for income taxes shown above is less than the amount which would be computed by applying the statutory Federal income tax rate to income before income taxes, extraordinary items and preferred stock dividend requirements of Pipeline. The table below summarizes the major reasons for such difference:

Year Ended December 31,	1978	1977
	(Thousands of Dollars)	
Tax expense computed at statutory rate	$20,814	$21,565
Increase (decrease) in tax provision resulting from:		
Investment tax credit recognized currently	(5,120)	(3,011)
Allowance for equity funds capitalized during engineering, design and preliminary construction on the Alaska Highway Pipeline Project, which does not constitute taxable income	(1,509)	—
Amortization of tax timing differences for which deferred taxes were not previously provided	905	363
Other	956	581
Provision for income taxes	$16,046	$19,498

On October 1, 1978, Pipeline placed gas sales rates into effect that reflect the amortization of previously accumulated tax timing differences for which deferred income taxes have not been provided. These timing differences are being amortized at a rate based on the remaining depreciable lives of the related assets, representing approximately 13.5 years.

(10) Gas Sales

During the periods presented, more than 10% of the Company's consolidated operating revenues was generated from sales to each of the following customers:

Year Ended December 31,	1978	1977
	(Thousands of Dollars)	
Sales of natural gas to:		
Northwest Natural Gas Company	$170,690	$158,643
Washington Natural Gas Company	139,672	128,976
Cascade Natural Gas Corporation	87,261	92,193
Colorado Interstate Gas Company	85,814	80,039
Other operating revenues	336,545	313,280
Consolidated operating revenues	$819,982	$773,131

(11) Executive Incentive Plan

The Company's Executive Incentive Plan provides for four biennial awards, starting in 1974, of up to 150,000 performance share units to certain of the Company's executives and key employees. The plan entitles recipients to earn over a four-year period from each award date, common stock of Energy or cash, or a combination thereof, based on the Company's cumulative earnings performance during each such period. Awards earned will be paid at the end of each four-year period. The first awards were paid in February 1978, resulting in the issuance of 18,258 additional shares of common stock of Energy and cash payments approximating $.4 million. Under the plan, at December 31, 1978 and 1977, there were 44,825 and 49,680 units outstanding, respectively.

Accrued compensation expenses related to the plan were approximately $.1 million and $.7 million for 1978 and 1977, respectively.

(12) Employee Benefit Plans

The Company's Restated Employees Retirement Income Plan covers employees who have completed one year of service with the Company. The plan provides retirement benefits, at no cost to the employee, on the basis of length of service and rate of compensation. The plan provides for full vesting after ten years of service or attainment of age 55. Costs accrued for 1978 and 1977 were approximately $2.3 million and $2.1 million, respectively. Such accrued costs are being funded currently. At December 31, 1977 (the most recent actuarial determination date), the actuarially computed value of vested benefits exceeded the assets of the plan by approximately $.4 million. Unfunded prior service costs at that date of $11.6 million are being funded over a 20-year period ending December 31, 1993.

The Company adopted, as of January 1, 1978, an unfunded supplemental retirement plan for certain key executives. Participation in this plan is determined by the Board of Directors. Participants are eligible to receive a monthly benefit, upon retirement or disability, based on earnings and considering the number of years of industry or related service as determined by the Board of Directors. Benefits payable under the plan are reduced by payments received under the Company's Retirement Income Plan or similar plans of previous employers. Costs accrued for 1978 were approximately $.4 million.

Under the Company's Restated Employees Savings Plan, eligible employees may contribute from 2% to 8% of their base compensation (depending upon their length of service) and the Company contributes an equal amount. Vesting of the Company's contribution is at the rate of 20% per year after entry into the plan. Contributions by the Company under the plan for both 1978 and 1977 were approximately $.7 million.

The Company adopted an Employee Stock Ownership Plan as allowed under the Tax Reduction Act of 1975. Under such plan, the Company annually claims an additional 1% investment tax credit and contributes such amount to a stock trust account for the benefit of its employees.

(13) Commitments

The total consolidated capital expenditures of the Company for 1979 are budgeted to be approximately $147 million, including $7 million representing Northwest Alaskan's share of the Partnership's 1979 budgeted capital expenditures.

(14) Leases

The Company does not conduct any significant operations with leased facilities. The Company's leasing arrangements, exclusive of mineral leases, include primarily premise and equipment leases that are classified as operating leases, with present terms extending seven years or less. FERC permits recovery, through Pipeline's current gas sales rates, of the rental payments made under its lease arrangements. If leases entered into by the Company which qualify as capital leases were required to be capitalized, the effect on assets, liabilities and expenses for the periods presented would not be significant.

(15) Related Party Transactions

Gulf Interstate Company ("Gulf"), through a subsidiary, rendered engineering services relating to Pipeline and the Partnership amounting to approximately $.8 million and $.5 million during 1978 and 1977, respectively. Gulf owns approximately 3.2% of the outstanding common shares of Energy and its chief executive officer was a director of Energy until November 7, 1978.

During the periods presented, the Company has entered into various transactions with certain other related parties, the amounts of which were not significant. The Company believes that the terms of all related party transactions were as favorable as could have been obtained from unrelated parties.

(16) Summarized Quarterly Data (Unaudited)
The following is a summary of quarterly, consolidated financial data for 1978 and 1977:

	Quarter of 1978				Quarter of 1977			
	First	Second	Third	Fourth	First	Second	Third	Fourth
	(Dollars in Thousands, Except Per Share Amounts)							
Operating revenues	$220,491	$167,032	$169,139	$263,320	$223,506	$168,701	$148,892	$232,032
Operating expenses, including income taxes	208,036	158,515	161,757	248,749	210,525	158,860	140,535	220,647
	12,455	8,517	7,382	14,571	12,981	9,841	8,357	11,385
Interest charges and other income, net	5,028	5,281	4,875	4,353	5,273	4,198	4,521	5,141
Income before extraordinary items	7,427	3,236	2,507	10,218	7,708	5,643	3,836	6,244
Extraordinary items, net	—	13,093	—	2,334	—	—	—	—
Net income	$ 7,427	$ 16,329	$ 2,507	$ 12,552	$ 7,708	$ 5,643	$ 3,836	$ 6,244
Per share of common stock:								
Income before extraordinary items	$ 1.73	$ .75	$ .58	$ 2.38	$ 1.80	$ 1.32	$ .89	$ 1.46
Extraordinary items	—	3.04	—	.54	—	—	—	—
Net income	$ 1.73	$ 3.79	$ .58	$ 2.92	$ 1.80	$ 1.32	$ .89	$ 1.46
Weighted average number of common shares outstanding, in thousands	4,295	4,304	4,304	4,304	4,286	4,286	4,286	4,286
Dividends declared per share of common stock	$ .55	$ .60	$ .60	$ .60	$ .50	$ .55	$ .55	$ .55

(17) Replacement Cost Data (Unaudited)
The impact of inflation on the Company's operating costs and its investment in property, plant and equipment has been significant. Replacing items of property, plant and equipment with assets having equivalent productive capacity has usually required a substantially greater capital investment than was required to acquire such assets originally. Similarly, the cost of natural gas, particularly imported Canadian gas, has increased significantly during recent years as growth in demand has exceeded the quantity of new reserves discovered.

Pipeline is subject to regulation by FERC as a "natural gas company" under the Natural Gas Act of 1938, as amended, and as such its rates and charges for the transportation and sale of natural gas in interstate commerce, the extension, enlargement or abandonment of facilities, and accounting, among other things, are subject to regulation. The accompanying consolidated financial statements, insofar as they relate to Pipeline, are presented on an original cost basis in conformity with FERC requirements and consistent with FERC ratemaking policy. Under established regulatory practices, Pipeline is allowed to recover, through rates, the cost of conducting its regulated operations, plus a return on its investment in facilities devoted to such operations. Accordingly, revenues can be generally anticipated to change to reflect changes in operating costs, including depreciation and gas purchase costs, and changes in the investment in facilities.

In accordance with SEC requirements, data reflecting the estimated replacement cost of the Company's facilities and storage gas, together with the related effects on depreciation and cost of gas purchases, is contained in the Company's filing with the SEC on Form 10-K.

Auditors' Report

To the Stockholders and Board of Directors
of Northwest Energy Company:

We have examined the consolidated balance sheet of Northwest Energy Company (a Delaware corporation) and subsidiaries as of December 31, 1978 and 1977, and the related consolidated statements of income, capitalization and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Northwest Energy Company and subsidiaries as of December 31, 1978 and 1977, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the periods.

ARTHUR ANDERSEN & CO.

Salt Lake City, Utah
February 7, 1979

Directory

Directors
Northwest Energy Company

John G. McMillian
Chairman of the Board

F. Arnold Daum

Thomas W. diZerega

L. P. Himmelman

Allan D. Insley

S. Lee Kling

Marne Obernauer

George S. Patterson

Louis B. Perry

David K. Watkiss

Officers
Northwest Energy Company

John G. McMillian
Chairman of the Board and President

Thomas W. diZerega
Vice President and Secretary

Gene E. Foulke
Vice President—Special Projects

John R. Grantham
Vice President—Administration

Robert W. Keener
Vice President—Pipeline Operations and Gas Supply

William D. Owens
Vice President—Energy Supply

A. N. Porter
Vice President—Finance

W. Merwyn Pittman
Controller

Herman F. Assmus
Treasurer

David M. Higbee
Assistant Secretary

James B. Mason
Assistant Secretary

Barbara Moreno
Assistant Secretary

Norman J. Provost
Assistant Secretary

Gene C. Brown
Assistant Treasurer

Louis L. Denton
Assistant Controller

Robert H. Rogers
Assistant Controller

Northwest Pipeline Corporation

John G. McMillian
Chairman of the Board, Chief Executive Officer and President

A. N. Porter
Executive Vice President

J. Stanley Charles
Vice President—Regulatory Affairs

Thomas W. diZerega
Vice President—Law and Secretary

John R. Grantham
Vice President—Administration

Robert W. Keener
Vice President—Pipeline Operations and Gas Supply

William G. Hagar
Assistant Vice President—Customer Relations

W. Merwyn Pittman
Controller

Gene C. Brown
Treasurer

Norman J. Provost
Assistant Secretary and Assistant General Counsel

David M. Higbee
Assistant Secretary

James B. Mason
Assistant Secretary

Barbara Moreno
Assistant Secretary

Herman F. Assmus
Assistant Treasurer

Keith D. Nelson
Assistant Controller

Northwest Exploration Company

John G. McMillian
Chairman of the Board and Chief Executive Officer

William D. Owens
President and Chief Operating Officer

Thomas W. diZerega
Vice President and Secretary

Donald J. Eckelberg
Vice President—Exploration

Robert W. Keener
Vice President—Drilling and Production

A. N. Porter
Vice President

John J. Grindinger
Controller

Herman F. Assmus
Treasurer

Betty Burnett
Assistant Secretary

David M. Higbee
Assistant Secretary

Norman J. Provost
Assistant Secretary

Gene C. Brown
Assistant Treasurer

Northwest Alaskan Pipeline Company

John G. McMillian
Chairman of the Board and Chief Executive Officer

R. R. Meyer
President and Chief Operating Officer

J. D. Bachman
Vice President—Law, General Counsel and Secretary

Darrell B. MacKay
Vice President—Regulatory Affairs

Peter W. Stevens
Vice President—Administration

Joseph N. Vallely
Vice President—Public Relations

John M. Viehweg
Vice President—Engineering

Vinton L. Wolfe
Controller

Howard E. Butner
Treasurer

H. Chad Beckstead, Jr.
Assistant Treasurer

David M. Higbee
Assistant Secretary

Barbara Moreno
Assistant Secretary

Northwest Coal Corporation

John G. McMillian
Chairman of the Board and President

Thomas W. diZerega
Vice President and Secretary

E. Peter Matthies
Vice President—Mining

William D. Owens
Vice President

A. N. Porter
Vice President

John J. Grindinger
Controller

Herman F. Assmus
Treasurer

David M. Higbee
Assistant Secretary

Gene C. Brown
Assistant Treasurer

General Offices

P.O. Box 1526
Salt Lake City, Utah 84110
Tel.: (801) 534-3600

Transfer Agent and Registrar

The Chase Manhattan Bank (N.A.)
One New York Plaza
New York, New York 10015

Co-Transfer Agent and Co-Registrar

Walker Bank & Trust Company
175 South Main
Salt Lake City, Utah 84111

Independent Public Accountants

Arthur Andersen & Co.
36 South State Street
Salt Lake City, Utah 84111

Availability of Form 10-K

The Company's Annual Report to the Securities and Exchange Commission on Form 10-K, which will contain certain information not presented in this report, will be filed on or about March 31, 1979. Copies of Form 10-K may be obtained after that date without charge—and Exhibits thereto at cost—upon written request to:
Stockholder Relations Department
Northwest Energy Company
P.O. Box 1526
Salt Lake City, Utah 84110

Northwest Energy Company

P.O. Box 1526
Salt Lake City, Utah 84110