

Investing in growth



NW Natural

2003 Annual Report



Financial Briefs

	2003	2002	Percent increase (decrease)
Earnings			
Financial facts (\$000):			
Net operating revenues	288,066	287,544	0
Net income	45,983	43,792	5
Earnings applicable to common stock	45,689	41,512	10
Financial ratios (%):			
Return on average common equity	9.3	8.7	6
Capital structure at year-end			
Long-term debt	49.7	47.6	
Preferred stock	–	0.9	
Common stock equity	50.3	51.5	

Common stock

Shareholder data:

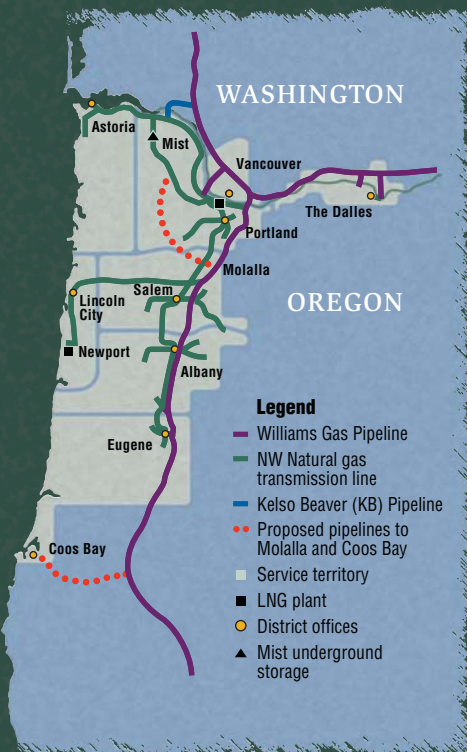
Common shareholders	9,695	10,026	(3)
Average shares outstanding (000)	25,741	25,431	1
Per share data (\$):			
Basic earnings	1.77	1.63	9
Diluted earnings	1.76	1.62	9
Dividends paid on common stock	1.27	1.26	1
Book value at year-end	19.52	18.85	4
Market value at year-end	30.75	27.06	14

Operating highlights

Gas sales and transportation deliveries (000 therms):			
	1,099,752	1,126,084	(2)
Degree-days (25-year average, 4,238)			
	3,952	4,232	(7)
Customers at year-end			
	578,150	560,067	3
Number of utility employees			
	1,291	1,261	2

Dividends paid on common stock

Payment date (per share)	2003	2002
February 15	\$ 0.315	\$ 0.315
May 15	\$ 0.315	\$ 0.315
August 15	\$ 0.315	\$ 0.315
November 15	\$ 0.325	\$ 0.315
Total dividends paid	\$ 1.270	\$ 1.260



Corporate Profile

NW Natural is a 145-year-old natural gas local distribution company headquartered in Portland, Oregon.

The Company has added customers at a rate of 3 percent or more per year for 17 consecutive years.

NW Natural serves more than 578,000 customers in Oregon and southwest Washington, including the Portland-Vancouver metropolitan area, the Willamette Valley, the northern Oregon coast and the Columbia River Gorge. More than 200,000 customers have been added to NW Natural's distribution system in the past 10 years.

In keeping with its steady growth, the Company has increased annual dividends paid to shareholders every year for 48 consecutive years.

NW Natural purchases natural gas for its core market from a variety of suppliers in the western United States and Canada. In addition, the Company operates an underground gas storage facility in Columbia County, Oregon, and leases additional gas storage outside its service area. NW Natural operates two liquefied natural gas plants in its service area. The Company also is active in the interstate storage services market, providing storage capacity to Northwest energy companies that has been developed in advance of its need for core customers.

On the cover:

Twenty-four-inch diameter pipe to be used for NW Natural's South Mist Pipeline Extension in a staging area south of Portland prior to installation. (See page 12)

DIVIDENDS PAID PER SHARE

IN DOLLARS



In 2003, NW Natural increased its annual dividends paid per share for the 48th consecutive year, a growth record matched by few companies.

EARNINGS PER SHARE

IN DOLLARS

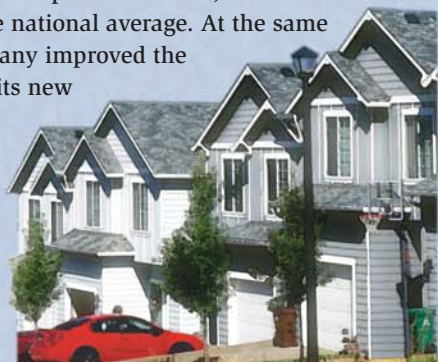


DILUTED EARNINGS PER SHARE
REDUCTION IN EARNINGS PER SHARE FROM INVESTMENT WRITEDOWNS:
 – 50 cents per share in 1998 due to asset impairment charges
 – 33 cents per share in 2002 due to a loss for PGE acquisition costs

Diluted earnings were \$1.76 per share in 2003, up 9 percent from \$1.62 per share in 2002.

Customer Growth

Despite a weak economy, NW Natural grew its customer base by more than 3 percent in 2003, a rate more than double the national average. At the same time, the Company improved the profitability of its new customer acquisition.



Page 8

Technology

Through employee ingenuity and technical expertise, NW Natural is steadily developing ways to improve productivity and, at the same time, serve customers better. From adapting technology to inventing its own, the Company is becoming more sophisticated in its operations.



Page 14

Investing in growth



Regulation

NW Natural's earnings now are normalized for average weather. Weather normalization and other regulatory outcomes in 2003 have reduced the Company's business risk.

Page 10



Community Involvement

At NW Natural, good corporate citizenship includes supporting critical programs that make a difference in local communities.

The Company also adopted policies in 2003 to step up employee volunteerism.

Page 16



Gas Storage

With the South Mist Pipeline Extension and growth in interstate storage services, gas storage is becoming an ever-more-important element in the Company's earnings and customer service.

Page 12

Letter to Shareholders 2
 Interview with the Executive Vice President 5
 Glossary 18
 Management's Discussion & Analysis 19
 Report of Independent Auditors 30
 Financial Statements 31
 Notes to Financial Statements 35
 Eleven-Year Financial Review 46
 Board of Directors 54
 Corporate Officers 56
 Corporate Information 57

Sound investment for continued growth



NW Natural President and Chief Executive Officer Mark Dodson at the entry to Portland's Classical Chinese Garden, in front of NW Natural headquarters.

To Our Shareholders:

In 2003, NW Natural built on its fundamental strengths as a natural gas distribution company, with shining results.

It was a year devoted to the basics — remembering who we are, planning for the future and investing in growth.

During the year, we improved Company processes for adding customers profitably, reduced business risks, invested in both core and non-core business expansion, and set a clear course for the future.

In 2003, NW Natural:

- earned \$1.76 a diluted share, within the range of our targeted earnings for the year;
- added 18,083 customers, an increase of 3.2 percent, marking NW Natural's 17th consecutive year of achieving customer growth at a rate of more than 3 percent;
- successfully concluded the Company's Oregon general rate case, achieving recovery of higher costs for a wide range of expenses such as pension, health care and insurance, and, in a major positive develop-

ment, weather normalization;

- completed the first 11.7 miles of the South Mist Pipeline Extension below budget and on time for the 2003-04 heating season;
- began construction on a natural gas distribution system to serve customers in Coos County, Oregon;
- maintained high customer satisfaction ratings despite moderate rate increases;
- expanded our gas storage business, earning 17 cents a share;
- hit an all-time high stock price of \$31.30 a share in December; and
- increased the dividend on common stock by 3.2 percent, making 2003 the 48th consecutive year in which the Company's dividend payments have increased.

Knowing Who We Are

NW Natural continues to focus on the strength of its core business. Over the past few years, we watched other energy companies diversify into unrelated fields, with generally disappointing results. We saw mergers and acquisitions come and go, many of them unsuccessful. We witnessed the rise and fall of Enron and the disappearance of many energy trading businesses.

Through it all, NW Natural held true to its course as a growing, thriving natural gas local distribution company. We concentrated on getting even better at what we do best. In considering any new business activity, we made sure it had a clear and direct link to our core competencies.

We believe the key to providing high shareholder value is capitalizing on our core strengths. These include:

1. Technical expertise and knowledge of our industry;

2. A thorough understanding of our customers' needs, and what it takes to satisfy them;
3. An ability to creatively and cost-effectively deploy technology;
4. Relentless pursuit of cost management;
5. Constructive regulatory relationships; and
6. A company-wide orientation to profitable growth.

Aggressive but Profitable Growth

Unlike natural gas LDCs in other parts of the country, NW Natural still has a relatively low market share — approximately 45 to 50 percent in the residential and commercial markets. At the same time, the vast majority of energy consumers continue to list natural gas as their fuel of choice.

Our challenge is to capture this growth potential and increase our customer base without spending too much to do it. In recent years we have refined our processes for identifying opportunities to add customers and to bring revenue growth to the bottom line.

The Company is improving the profitability of its customer growth in two ways: First, by becoming more savvy and sophisticated in targeting potential new customers.

In 2003, we refined our model for analyzing potential new customers to assure that we are pursuing only those we can acquire profitably.

Second, NW Natural has reduced the cost of acquiring new customers. Over the past three years, our employees have lowered construction costs per customer by 17 percent through such means as joint trenching with other utilities and the development of new technologies. This year, NW Natural pioneered the use of keyhole technology for residential conversions — an approach that dramatically reduces the costs of installing a service by minimizing disruption to street surfaces.

The Company's disciplined approach to growth is paying off. Over the past few years, we have increased the profitability of our new customer additions significantly, and we believe we can do even better in the future.

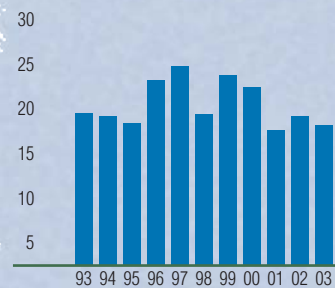
Reducing Business Risks

Results of the Company's Oregon general rate case included a milestone for NW Natural: weather normalization. The new WARM (Weather Adjusted Rate Mechanism) program, implemented in October, helps remove one of the major uncertainties in year-to-year earnings: weather variability. It gives us the ability to adjust customers' wintertime bills to reflect normal vs. actual weather. WARM assures that NW Natural customers pay only what it costs the Company to serve them — no more and no less. In the process, it provides for a more stable and predictable earnings stream.

Weather normalization is the perfect complement to another rate mechanism approved by Oregon regulators in 2002—the conservation tariff—which also smoothes earnings variability. The tariff protects NW Natural from much of the revenue lost when customers use energy more efficiently and in declining amounts. The conservation tariff stabilizes

CUSTOMER GROWTH

IN THOUSANDS



The Company added 18,083 new customers in 2003. The customer base has grown at an average annual rate of 4.5 percent over the past 10 years.

margin revenues while helping to align the Company's financial interests with customers' conservation goals. We believe NW Natural is the only natural gas distribution company in the nation that has both weather and consumption normalization.

Prudent Investment

In 2003, we made significant investments in our future growth. The fourth quarter was a particularly busy time for construction projects that had been years in the planning.

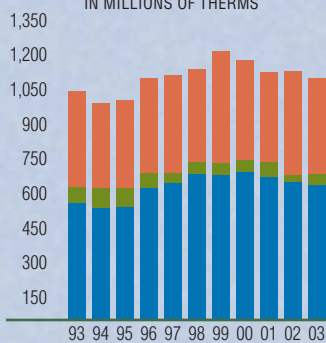
In March, NW Natural obtained the site certificate necessary to build a 62-mile extension of the 24-inch pipeline that extends from the Mist gas storage field to areas west and south of Portland. The pipeline is critical to NW Natural's future growth, in that it enables us to serve burgeoning areas in and around the Portland metropolitan area.

The Company's project team and contractors completed the first 11.7 miles of the project under budget and nearly a month early, and had begun work on the next segment by year-end. We expect to have the entire pipeline operational in time for the 2004-05 heating season. Once completed, it will double our capacity to move natural gas into and out of Mist storage.

At the same time, on the southern Oregon coast, the Company began

GAS SALES AND TRANSPORTATION DELIVERIES

IN MILLIONS OF THERMS



■ RESIDENTIAL, COMMERCIAL AND INDUSTRIAL FIRM SALES
 ■ INDUSTRIAL INTERRUPTIBLE SALES
 ■ TRANSPORTATION

Gas sales and transportation deliveries were 1.1 billion therms in 2003.

building a local distribution system to serve Coos County, an area we have wanted to serve for more than 30 years. Funding from state and local sources made it possible for Coos County to build a pipeline over the mountains to connect with the interstate pipeline.

In 2003, while the county was constructing the transmission line to link to the interstate pipeline, we were building the local distribution system. Completion of that system in 2004 will allow us to finally serve this county of 63,000 people.

Setting Our Course for the Future

In 2003, Company officers and employees completed a comprehensive strategic planning process to map NW Natural's course for the next several years. Nearly 100 employees were involved in planning teams, research activities, focus groups and strategy development.

The result was an ambitious new agenda for ramping up customer growth while also adding to Company profits. Key strategies include:

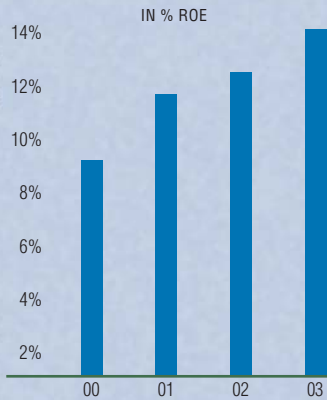
- further improving NW Natural's ability to add customers profitably, and at a faster rate;
- maintaining our reputation for exemplary service;
- reducing business risks;
- managing all costs, including capital;
- holding all employees to high performance standards; and
- judiciously growing beyond our local distribution business, where it complements our core assets and competencies.

Primary opportunities for non-core growth are distributed energy and interstate gas storage services.

We plan to develop and promote the market for combined heat and power and gas cooling technologies, primarily through partnerships for small projects. We will also analyze and target potential large cogeneration customers near our system.

The Company is continuing to grow interstate storage services from within the core utility, as authorized by the Federal Energy Regulatory

PROFITABILITY OF NEW RESIDENTIAL CUSTOMER ACQUISITIONS



NW Natural has improved its return on equity from new residential customers in the past three years by targeting the most profitable customers and managing main extension costs.

Commission. NW Natural's gas storage business contributed 17 cents a share of earnings in 2003, compared to 14 cents a share in 2002. Storage capacity is being expanded incrementally and timed according to market demand. NW Natural will continue to make use of its core gas distribution system capacity to transport gas from the Mist storage field to the interstate system. Our goal is for interstate storage and related services to contribute 10 percent of corporate earnings by 2006.

Challenges Ahead

With the Company's recent regulatory successes, we have eliminated major uncertainties from our year-to-year earnings — in particular, weather variability and declining energy use. Minimizing these business risks puts NW Natural in a better position to deal with the issues to come.

In the next few years, we think the most challenging external factors for NW Natural will be: 1) the pace and magnitude of economic recovery in the Pacific Northwest; and 2) the costs of complying with the federal 2002 Pipeline Safety Improvement Act. We will approach our regulatory

commissions in 2004 with detailed plans and resource needs for meeting pipeline safety mandates.

Assuring Continued Success

Going forward, your company is in a superb position to grow and prosper.

Investors are seeing the value in lower-risk, higher-payout companies like NW Natural.

While we are ideally positioned in today's marketplace, we want to make sure that NW Natural will continue to be an investment of choice if the market shifts again. Our preparation for future growth will help assure continued strong performance in the years ahead.

In closing, I would like to thank you for the honor and privilege of serving as CEO at NW Natural. In completing my first year in that role, I can confidently tell you: You have invested in a truly fine company. It is a standout in the region and a leader in its industry.

I can also tell you that I have never seen a more dedicated, talented group of employees than those at NW Natural. Whether helping out at the Food Bank or restoring heat in freezing temperatures, they are as committed a workforce as you will ever find.

Thank you for your continued confidence in us. We look forward to another great year in 2004. Sincerely,

Mark S. Dodson
President and Chief Executive Officer
March 31, 2004

Providing low-cost supplies

*Interview with
Mike McCoy, Executive
Vice President*

How have natural gas prices changed over the past year?

Mr. McCoy: Nationally, we're seeing continued volatility in gas prices because of the tight balance between supply and demand. That makes for a highly sensitive market. Even relatively small events — such as weather changes and plant shutdowns — can move the market. We've seen prices come down from where they were two years ago, but they are still relatively high. We expect the volatility to continue until there is a significant increase in supplies or a decrease in demand.

How do your prices compare to your competitors'?

Mr. McCoy: Despite commodity cost increases in the past few years, we are still able to sell natural gas in our service area with a significant price advantage compared to electricity. Our prices are competitive with heating oil as well. One way we keep our prices down is through our gas hedging strategies, which allow us to lock in our costs and minimize the Company's exposure to daily, monthly and seasonal price volatility.

What's the gas supply picture for NW Natural?

Mr. McCoy: Our gas supply picture is very positive, for several reasons. Most of our supplies are committed under multi-year contracts with reputable companies. We also own or contract for storage at five regional facilities, which together can supply more than half of our peak day requirements. Finally, Oregon and Washington regulators have been supportive of our long-term gas supply planning and contracting practices, which encourage stability and reliability.

How does gas storage benefit the Company and its customers?

Mr. McCoy: The primary advantage is that it helps us keep prices down. We purchase and store gas in the summer, typically when it's less expensive, and use it to help meet peak loads in the winter, when gas is in higher demand and usually more expensive. By using stored gas in the winter we can reduce the amount of year-round pipeline capacity we must purchase for our customers' needs.

What growth opportunities does the Company see in gas storage or gas commodity services?

Mr. McCoy: We are very optimistic about the prospects for growing our storage business, which includes two activities: interstate storage services, and asset optimization. The year 2003 was a good one for



Mike McCoy, Executive Vice President, Customer and Utility Operations, stands at the newly improved Molalla Gate Station, where the South Mist Pipeline Extension connects to the interstate pipeline.

asset optimization, but looking ahead, we expect interstate storage services to provide most of the earnings from this segment.

Our Mist storage field will continue to be our primary focus for gas storage activities. However, NW Natural is considering whether to look more broadly at other storage opportunities.

We are not planning to offer gas commodity trading services.

Besides moving gas from storage, are there other benefits from the Company's construction of the South Mist Pipeline Extension (SMPE)?

Mr. McCoy: Yes. When complete, the SMPE will increase the takeaway capacity from Mist storage for both core customers and customers on the interstate pipeline system. It will provide a second direct connection between our storage fields and Williams Gas Pipeline, which will allow us to increase injections as the field is expanded. Finally, the SMPE will reinforce our existing distribution system in the Portland area, helping to assure the safe and reliable delivery of natural gas to our customers.



A photograph of a construction site for a pipeline. In the foreground, several large, light blue pipes are laid out on the ground. In the background, several workers in safety vests are visible, some working on a trench. The background is a dense forest of evergreen trees under a clear sky.

Laying the foundation for future success

7

Nothing is more fundamental to a natural gas utility than pipelines. In 2003, NW Natural made major strides in expanding its distribution network (including the first phase of the South Mist Pipeline Extension, shown here) to serve current and future customers.

But physical infrastructure is only one part of the Company's service. Equally important are the right plans, processes and people.

NW Natural is focused on growing its customer base and increasing returns to shareholders. To achieve those goals, the Company is refining its strategies, improving its operations and empowering its employees. With all forces pulling in the same direction, increased levels of profitable growth become achievable.

Having the pipes is one thing. Having the people is another. NW Natural is investing in both to continue its 145-year legacy of superior service and industry-leading growth.

Profitably growing our customer base

Despite a slow economy, NW Natural met or nearly met its customer growth goals in every market segment in 2003.

The Company added 18,083 customers during the year, for an increase of 3.2 percent.

Residential new construction leads the way

New construction in the residential market was the strongest growth sector for the Company, as

builders and first-time homebuyers continued to respond to low interest rates.

Within NW Natural's service area, Clark County, Washington, continues to have the highest growth rate. As the economic recovery picks up steam, robust residential growth is expected in other parts of the Company's service area as well, particularly on the southern edges of the Portland metropolitan area and in the downtown core, where major multi-family housing projects are under construction.

Residential conversions were hurt by the slow economy in 2003. Gas price volatility and job losses discouraged some homeowners from converting their heating systems. In 2003, 5,534 customers converted to gas from electricity or heating oil, compared to 6,209 conversions in 2002.

The slow regional economy also meant a lag in commercial activity. Commercial new construction and conversions declined from 2002 but came close to the Company's 2003 targets.

Looking ahead, commercial redevelopment and revitalization are expected to present new growth opportunities for NW Natural. More commercial new construction is expected as well, once the



Coos Bay District Manager Cal Grimmer (left) and Field Engineering Technician Lee Hockema review plans for laying natural gas pipe to serve the new Wal-Mart in Coos Bay, which will convert from propane to natural gas service.

currently high vacancy rates for commercial development are reduced.

In the industrial sector, the Company met its targets for 2003. The main opportunity for NW Natural in this sector is the development of the generation market, both large and small.

Keeping Growth Profitable

In 2003, NW Natural improved the profitability of its new customer acquisitions by targeting the most profitable sectors and customers for growth, and by more carefully managing main extensions.

The Company is currently growing mostly along its existing distribution system. It has reduced the level of investment in main extensions, and is now targeting only those extensions that offer high levels of profitability. NW Natural is increasingly focused on batch customer acquisitions, rather than acquiring customers one at a time.

The Company has refined its information systems to improve the accuracy and availability of information on both the cost side and revenue side of profitability analysis. In 2004, the Company will be installing a more sophisticated information system to replace

the laborious manual processes required by the old system.

NW Natural is also reducing construction costs. Over the past three years, employees lowered construction costs per customer by 17 percent, mainly through new technologies and improved processes.

NW Natural's market share in multifamily new construction (like the subdivision on Portland's west side, shown below), has grown from 9 percent in 1996 to more than 70 percent in 2003.



Improving predictability of earnings

NW Natural's earnings have typically fluctuated with weather variations, changing consumer usage patterns and the costs associated with major capital investments. In 2003, NW Natural secured regulatory changes that will help reduce its earnings variability from all of these factors.

Adjusting for corporate expenses

In August 2003, the Public Utility Commission of Oregon approved a general rate case settlement among NW Natural, the OPUC staff and customer groups. In its decision, the OPUC allowed the Company to include in its rates a variety of increased expenses, including insurance, health benefits and pension costs.

The Commission authorized NW Natural to hire 20 additional customer service representatives to better serve the Company's growing customer base. The OPUC also authorized the Company to include in rates the costs for the South Mist Pipeline Extension and a new natural gas distribution system in Coos County, once these projects are completed.

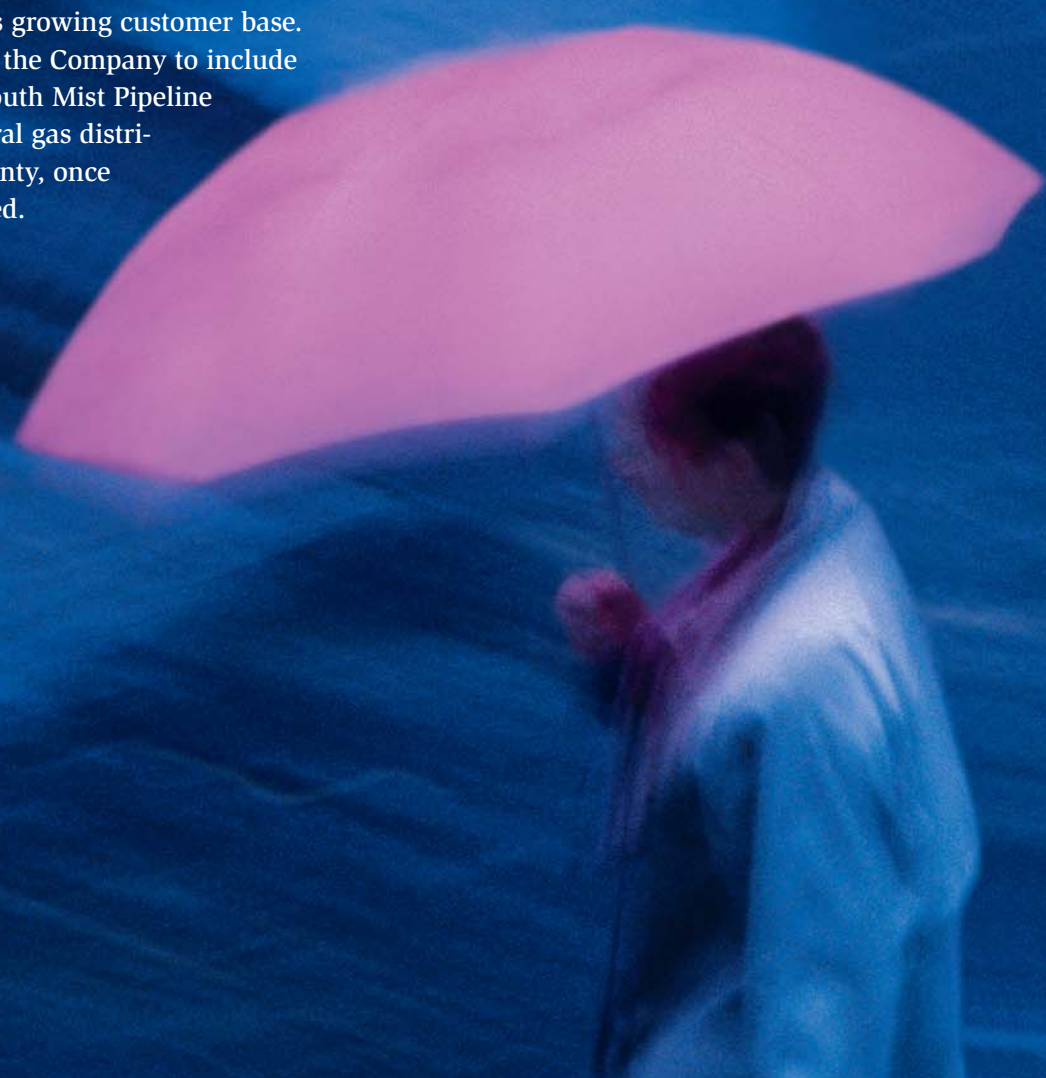
The settlement further authorized a restructuring

of large commercial and industrial customers' rates, developed with representatives of customer groups, that was implemented in late 2003. Many industrial customers saw their rates drop as a result of the restructuring.

Altogether, the OPUC approved about \$13.9 million per year in rate increases for NW Natural and an authorized return on equity of 10.2 percent.

Weather Adjusted Rate Mechanism (WARM)

The OPUC's approval of WARM marked the start of a new chapter in NW Natural's history. The weather normalization mechanism helps protect the Company from lower earnings due to warmer-than-average weather. Like the conservation tariff, which protects Company revenues



from declining usage due to conservation, WARM reduces earnings volatility for NW Natural.

Consumer advocates applauded the adoption of WARM because it helps ensure customers pay NW Natural what it costs to serve them — no more and no less.

Residential customers were given the opportunity to opt out of WARM, but more than 90 percent of the Company's Oregon customers were covered by the mechanism in its first year.

NW Natural's sophisticated customer information system allows the Company to adjust each resi-

dential customer's bill monthly. This means that during cold winters, customers will see the benefit of weather normalizing adjustments, rather than waiting for rates to be trued up in the following heating season.

Keeping the pipes safe

The natural gas industry faces major costs to comply with new federal pipeline safety regulations. The OPUC allowed rate coverage for NW Natural to conduct the research, planning and design work to meet federal pipeline integrity requirements. The Company is developing a detailed plan for compliance.

Washington rate case

NW Natural filed a general rate case in the state of Washington in November 2003. The filing includes a mechanism for decoupling revenues from usage — i.e., separating NW Natural's margin from the volume of gas sold. The mechanism would have an effect similar to WARM and the conservation tariff in Oregon. If approved by the Washington Utilities and Transportation Commission, the new mechanism would insulate investors from the effects of weather extremes in the State of Washington as well as changes in consumption patterns.



NW Natural customers Allen and Lois Wheeler enjoy convenience and cost savings by cooking with natural gas. Thanks to the Company's new weather normalization mechanism, they also will benefit from more stable winter-time bills.

Enhancing storage to serve customers

What began in 1979 as an exploration near Mist, Ore., for a new peaking resource has grown into one of NW Natural's and its customers' most important assets. Each year, millions of dollars in gas savings flow through to customers as the Company supplements pipeline gas with lower-cost stored gas to meet demand during peak periods.

A big win: SMPE site certificate

In 2003, NW Natural gained clearance to build a major enhancement to its storage facilities: a 62-mile, 24-inch diameter pipeline that strengthens the links between the storage field and fast-growing neighborhoods in the Portland area.

After years of planning, and almost two years after submitting the application, in March 2003 the Company received a site certificate from the Oregon Energy Facility Siting Council for the South Mist Pipeline Extension.

Property owners appealed EFSC's decision to the Oregon

Supreme Court, which ruled in favor of NW Natural on Nov. 6. Before making its final decision, the court denied the appellants' request for a construction stay, thus allowing the Company to begin building the first segment of the pipeline in August 2003.

The SMPE will increase gas delivery capacity to the Company's service area, reinforcing the distribution system in rapidly growing parts of the Portland metropolitan area and adding a second connection to the interstate pipeline system.

Building in record time

On Aug. 18, construction crews began building the 11.7 miles of the South Mist Pipeline Extension between the Molalla gate station and the Aurora Airport south of Portland. The construction



project, which benefited from exceptional planning and management along with unusually dry weather, was completed three weeks ahead of schedule and approximately \$2 million under budget. Gas began flowing through the pipe on Nov. 6.

The completion of the SMPE's first phase and the upgrade of the Willamette Valley Feeder at the end of 2003 positioned the Company well to serve customers during cold weather conditions in early January 2004, resulting in record system sendout. The improvements allowed NW Natural to provide service at levels required by the Company's contract with SP Newsprint, which, with the addition of two 40 MW gas-powered turbines, has become NW Natural's largest volume customer.

New wells planned

NW Natural continues to plan expansions of its underground storage facilities. In anticipation of a growing customer base — both core and interstate — the Company expects to install wells at new and existing reservoirs in the Mist storage field. The Company also plans to add equipment at Miller Station, the control center for gas storage at Mist.

In 2004, NW Natural will continue to upgrade its infrastructure (below) for injecting and withdrawing natural gas from the Company's storage reservoirs.



The South Mist Pipeline Extension will give SP Newsprint in Newberg a more reliable source of natural gas at the pressure needed to run the plant's gas-fired turbines. Above, Denny Henderson (left), NW Natural's general manager of industrial/commercial solutions, observes SP operations with Dennis Lakey, SP's manager of power and utilities.



Using technology creatively

NW Natural has had roughly the same number of employees for the past 10 years, while adding 200,000 customers. What's the Company's secret? Its wise and creative use of technology.

In 2003, NW Natural developed and adapted various technologies to serve customers better, reduce costs and work more efficiently.

Customer Relationship Management System

During the year, NW Natural surpassed most other utilities' technology by designing its own Customer Relationship Management System (CRMS).

The system integrates programs that previously ran separately. With CRMS, Consumer Services employees can use one integrated system to sign up new customers for service, start the installation process and send new sales leads to vendors and contractors. Marketing staff also can access the system's integrated database to target promotions to certain market segments.

Engineers and distribution crews use CRMS to read system maps, learn about soil conditions and find other information to plan the most cost-effective construction process. A key element of CRMS is an

updated Geographical Information System that is one of the most advanced in the utility industry.

Keyhole innovation

NW Natural's technological breakthrough of the year was keyhole technology — the arthroscopy of pipe installation — for residential conversions. Crews use keyhole tools to connect service lines to polyethylene gas mains through a 12-inch diameter hole in the street, avoiding the disruption and expense of trenching. This technology, designed for NW Natural based on an employee's drawing on a napkin, not only saves time and money on service installations, but also allows the Company to serve customers that otherwise would have been unprofitable to connect. Use of keyhole tools eliminates the cost of a backhoe and about half a day's crew time.

NW Natural began using keyhole technology in June 2003 on a pilot basis. Since then, the Company has obtained additional sets of tools and has trained employees in several districts. NW Natural also has ordered tools to expand the use of keyhole technology beyond polyethylene pipe.





Clark County Distribution Crew Leader Clark Apodaca and Pipe Joiner Wendy McDowell install a new residential service using keyhole technology pioneered by NW Natural.

In 2003, NW Natural used keyhole technology to install about 75 services — a number that is expected to grow rapidly in 2004, along with the construction cost savings. For example, crews use keyhole tools to install services when a trench would be deep enough to require shoring.

Field Office Technology

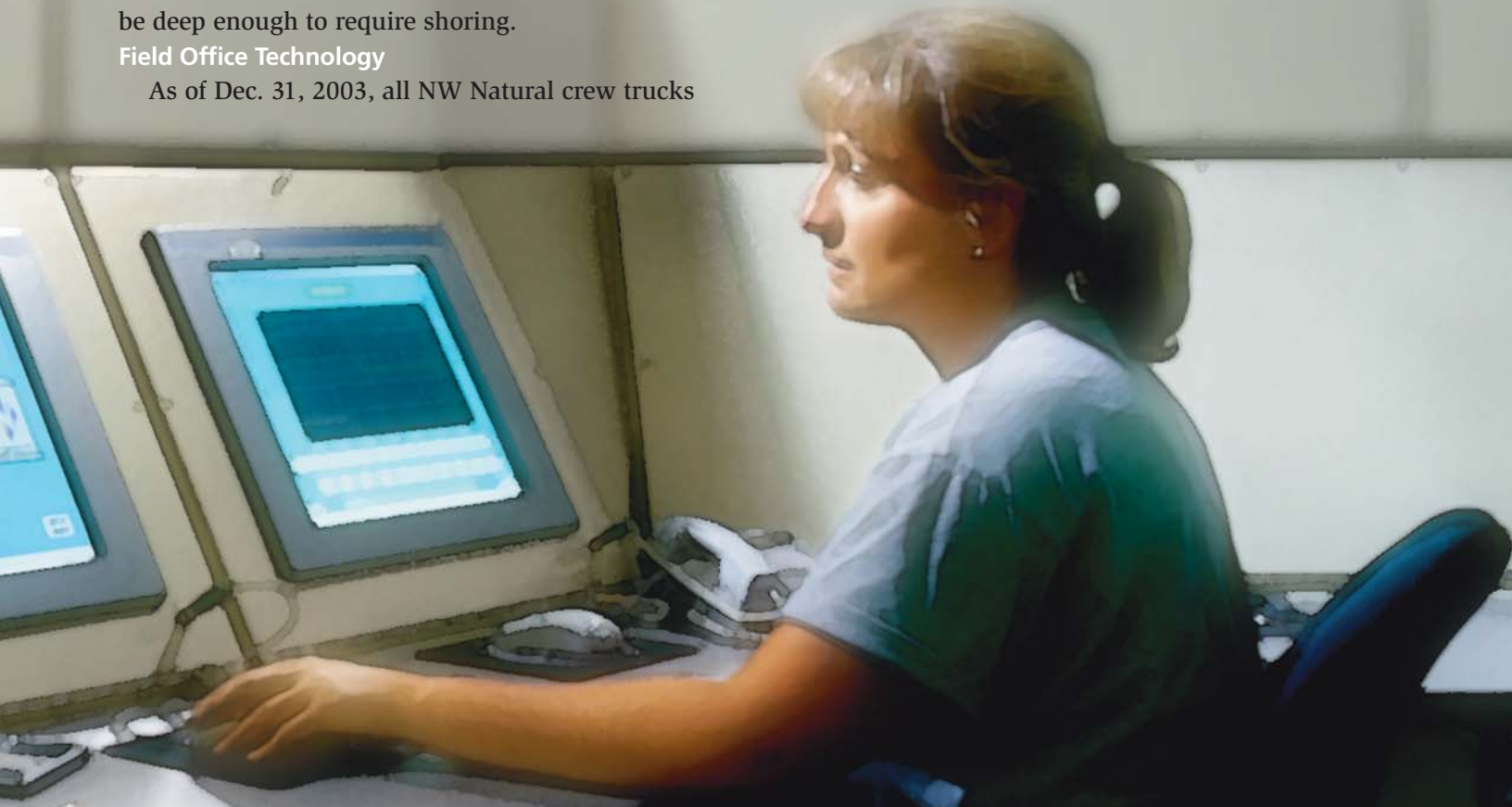
As of Dec. 31, 2003, all NW Natural crew trucks

were equipped with laptop computers, completing the first step in bringing computer technology to approximately 600 field employees. In the first quarter of 2004, field employees involved in inspection, engineering and gas supply were “wired” for the first time.

Currently, the computers give crews access to Mapframe, which provides detailed maps of the Company’s distribution system. As the year progresses, NW Natural will be able to update Mapframe daily based on data entered by crew members.

Ultimately, online construction reports will provide field employees the key information they need to plan the most efficient use of crews and equipment. Computerized information also will help crews anticipate maintenance needs and assure the long-term safety and reliability of the system.

In addition to adopting new technologies, NW Natural regularly upgrades its existing technology where needed. Below, LNG Operator Linda Butterfield uses an improved computer system at the Company’s liquefied natural gas plant in Portland.



Building Community partnerships

NW Natural takes pride in being actively involved in the communities it serves. The Company recognizes that its success depends on the health and vitality of its service area.

In 2003, the Company strengthened its commitment to community involvement through new plans and initiatives.

New Community Involvement Plan

Last year, the NW Natural Board of Directors approved a new Community Involvement Plan. To strengthen the impact of the Company's charitable dollars, the plan focused on one philanthropic priority: Helping Families and Kids at Risk. A high percentage of the Company's corporate contributions are now funneled to this area.

Under the plan, NW Natural is using a new method to determine its annual corporate contributions

to the Black United Fund of Oregon, Earth Share and United Way through the Company's annual Charitable Giving Campaign. In each of its districts, NW Natural will contribute an amount equal to the total employee contributions made to each organization in that district. Employee contributions are matched dollar for dollar up to a limit of \$10,000 per employee.

The Community Involvement Plan also commits NW Natural to promoting ethnic and cultural diversity in the workplace and expanding opportunities for minorities. As a first step, NW Natural entered into a partnership with De La Salle North Catholic High School. De La Salle students (more than 40 percent of whom are African American) earn money to pay most of their tuition through the school's innovative work-studies program. Four De La Salle students are working at NW Natural during the 2003/2004 school year.

Employee volunteerism

Last year, the Company ramped up efforts to encourage employees and retirees to volunteer in their communities. To oversee these efforts, NW Natural selected an employee to



serve as volunteer coordinator. The coordinator organized an employee volunteer fair in September to kick off the new volunteerism initiative. Some 175 employees attended.

As part of its Community Involvement Plan, NW Natural announced it would target one or more agencies for direct dollar contributions and employee volunteerism. In 2003, a year when Oregon ranked number one in hunger among the 50 states, the Company named The Oregon Food Bank as its "Signature Program." It also chose Habitat for Humanity, The Oregon Children's Foundation and Tualatin Valley Centers as Programs of Focus.

In August, NW Natural placed an insert in its bills asking customers to donate to The Oregon Food Bank. The response far exceeded expectations: Customers sent in more than \$124,000. In October, NW Natural helped raise another \$291,000 for The Oregon Food Bank as the presenting sponsor of a gala fundraising event with Oregon's governor. The money the Company raised will help the Food Bank leverage more than \$4 million worth of food for distribution in Oregon and affiliated Washington food pantries.

By providing its distinctive blue tents for community events, NW Natural becomes a highly visible sponsor of gatherings like the Oregon Jamboree (below), a country music festival held in August in Sweet Home, Oregon.



NW Natural employees help Habitat for Humanity construct eight homes for low-income families in September during a nine-day Blitz Build. From left to right are Consumer Services employees Von Summers, Tim Abshire, Phil Damiano, Jeremy Anderson and on rooftop, Darrell Nelson and Lance Cheeley.



Basic earnings per share: earnings applicable to common stock for a period, divided by the average number of shares of common stock actually outstanding during that period.

Bcf: one billion cubic feet, a volumetric measure of natural gas, roughly equal to 10 million therms.

Book value: the common stock equity on the company's balance sheet, which was \$506 million for NW Natural at year-end 2003. The book value divided by the number of shares of common stock outstanding equals book value per share, or \$19.52 for NW Natural at year-end 2003.

BTU: British thermal unit, a basic unit of thermal energy measurement. One Btu equals the energy required to raise one pound of water one degree Fahrenheit. One hundred thousand Btus equal one therm.

Bypass: a direct connection to the interstate gas pipeline which circumvents the pipes of the local distribution company; usually considered only by large industrial users.

CIS: customer information system. NW Natural's computerized CIS is used for customer orders, bills, account histories and collections.

Demand charge: a component in all gas rates that covers the cost of securing pipeline capacity to meet peak demand, whether that full capacity is used or not.

Deregulation: in the energy industry, a broad term that generally refers to changes in industry structure intended to provide consumers more direct access to competitive forces in the commodity markets.

Diluted earnings per share: earnings applicable to common stock for a period, divided by the average number of shares of stock that would be outstanding if all securities convertible into common stock were converted and all options to purchase common stock at prices lower than the average price for the period were exercised.

Distributed generation: the generation of electricity on a smaller scale than centralized power stations, using new gas-fired technologies such as fuel cells and micro-turbines for onsite commercial or residential use.

DRIP: dividend reinvestment plan enabling participating shareholders to further invest in the Company by directly reinvesting dividends into the purchase of additional shares.

FERC: Federal Energy Regulatory Commission, the agency with regulatory jurisdiction over interstate natural gas transportation.

Firm service: natural gas service offered to customers under contracts or rate schedules that provide for no service interruptions.

General rate case: a periodic filing with state regulators to establish equitable rates and balance the interests of all classes of customers with those of the Company and its shareholders. NW Natural's most recent general rate case was concluded in Oregon in 2003.

Interruptible service: service offered to customers (usually large industrial or commercial) under contracts or rate schedules that allow for interruptions during times of peak demand.

Heating degree-days: units of measure that reflect temperature-sensitive consumption of natural gas, calculated by subtracting the average of a day's high and low temperature from 65 degrees Fahrenheit.

LNG: liquefied natural gas, the cryogenic liquid form of natural gas. At temperatures below minus 258 degrees Fahrenheit, natural gas can be stored in a liquid form which is 600 times more dense than its gaseous form.

LDC: a local distribution company, such as NW Natural, that is mainly involved in the final distribution and sale of natural gas to customers.

Margin: in NW Natural's case, the difference between gross sales revenue and the cost of gas included in the sale.

Market value: also known as market capitalization. The market value of a company is the number of shares of common stock outstanding multiplied by the market price per share.

Mcf: one thousand cubic feet, a volumetric measure of natural gas, roughly equal to 10 therms.

Natural gas: a naturally occurring, flammable hydrocarbon found in porous underground formations, primarily consisting of methane (CH₄).

OPUC: the Public Utility Commission of Oregon, a three-member panel appointed by the Governor that has regulatory authority over public utilities in Oregon.

PGA: purchased gas adjustment, or gas tracker, a mechanism for adjusting rates due to changes in gas costs and recovering from customers deferred gas cost imbalances caused by fluctuating gas commodity costs.

Therm: the basic unit of natural gas measurement, equal to 100,000 Btus. An average residential customer in NW Natural's service area uses about 662 therms in an average weather year.

Throughput: the amount of natural gas transported through a distribution system in any given period.

Transportation customer: typically a large industrial customer that secures its own natural gas supply and pays only for use of the distribution system to transport it.

Underground storage: storage of natural gas by injection into underground rock formations for withdrawal during the winter heating season, such as at NW Natural's Mist storage field.

WARM: Weather Adjusted Rate Mechanism, a weather-normalizing rate mechanism approved by the OPUC in 2003 which allows NW Natural to adjust customers' bills during the heating season to reduce variations in margin recovery due to deviations from average temperatures.

WUTC: the Washington Utilities and Transportation Commission, a three-member panel appointed by the Governor that has regulatory authority over public utilities in Washington.

The following is management's assessment of Northwest Natural Gas Company's financial condition including the principal factors that affect results of operations. The discussion refers to the consolidated activities of the Company for the three years ended Dec. 31, 2003. Unless otherwise indicated, references in this discussion to "Notes" are to the notes to the consolidated financial statements.

The consolidated financial statements include:

Regulated utility:

■ Northwest Natural Gas Company (NW Natural)

Non-regulated wholly owned subsidiaries of NW Natural:

■ NNG Financial Corporation (Financial Corporation), and its wholly owned subsidiaries

■ Northwest Energy Corporation (Northwest Energy), and its wholly owned subsidiary

Together these businesses are referred to herein as the "Company" (see "Results of Operations-Non-utility Operations," below, and Note 2).

In addition to presenting results of operations and earnings amounts in total, certain measures are expressed in cents per share. These amounts reflect factors that directly impact the Company's earnings and are reported net of tax. The Company believes this per share information is useful because it enables readers to better understand the impact of these factors on the Company's earnings. All references in this report to earnings per share are on the basis of diluted shares (see Note 1).

EXECUTIVE SUMMARY

Highlights

Among its accomplishments in 2003, the Company:

■ grew its utility customer base by more than 3 percent for the 17th year in a row, adding 18,083 customers to its gas distribution system during the year;

■ increased earnings from its business segment for interstate gas storage services from 14 cents a share in 2002 to 17 cents a share in 2003;

■ secured a permit for the construction of a major extension of its pipeline from the Mist storage field to the Portland metropolitan area and completed the first 11.7-mile segment of the pipeline extension, below budget and on time for the 2003-04 heating season;

■ successfully completed its general rate case in Oregon with a result that included phased rate increases, the recovery of costs relating to its gas storage investments and higher operating expenses, and approval of a new weather normalization mechanism;

■ secured reliable and adequate gas supplies during a time of volatile wholesale pricing, at costs that required only relatively small rate increases for customers; and

■ paid dividends on common stock of \$1.27 a share, making 2003 the 48th consecutive year in which the Company's dividend payments have increased.

Issues, Challenges and Performance Measures

Issues and challenges the Company expects to face in 2004 include the effects and uncertainties relating to a general rate case in Washington; volatile gas commodity prices; continuing weak economic conditions in Oregon and Washington; completion of the remaining portion of the pipeline extension from NW Natural's Mist gas storage field including the acquisition of rights-of-way necessary to build the pipeline; and higher capital and operating costs due to federal mandates in the area of pipeline integrity.

In order to deal with these and other issues affecting the business, in 2003 NW Natural completed a new strategic plan to map the Company's course during the next several years. The plan includes strategies for further improving NW Natural's ability to add customers both profitably and at a rapid pace; maintaining NW Natural's reputation for exemplary service; reducing business risk; managing all costs, including capital costs; holding all employees to

high performance standards; and judiciously growing beyond the Company's local distribution business where it would complement core assets and competencies. Among the key performance measures the Company will use in monitoring progress against its goals in these areas are utility earnings per share, customer satisfaction ratings, new customer additions, operations and maintenance expense per customer, construction cost per meter connected, and non-revenue producing capital expenditures per customer.

EARNINGS AND DIVIDENDS

The Company's earnings applicable to common stock in 2003 were \$45.7 million, compared to \$41.5 million in 2002 and \$47.8 million in 2001. Earnings were \$1.76 a share in 2003, compared to \$1.62 a share in 2002 and \$1.88 a share in 2001.

Net operating revenues in 2003 were about the same as in 2002, but higher amounts for other income (\$17 million) in 2003 more than offset higher operating expenses (\$14.5 million). Earnings for 2002 were reduced by charges of \$13.9 million (before tax) representing the Company's transaction costs incurred in its efforts to acquire Portland General Electric Company (PGE) from Enron. Excluding these charges, earnings per share from consolidated operations in 2002 would have been \$1.95 a share. Earnings for 2001 were the highest on record for the Company.

NW Natural earned \$1.57 a diluted share from gas utility operations in 2003, compared to \$1.76 a share in both 2002 and 2001. Weather conditions in its service territory in 2003 were 7 percent warmer than the 25-year average and 7 percent warmer than 2002. Temperatures in 2002 were very close to average but were 2 percent warmer than 2001. Weather in 2001 was 1 percent colder than average.

Results in 2003 from the Company's non-utility operations were earnings of 19 cents a share, including 17 cents a share from NW Natural's gas storage business segment and 2 cents a share from subsidiary and other non-utility operations (see "Results of Operations - Non-utility Operations," below). Non-utility results for 2002 were a loss of 14 cents a share, including earnings of 14 cents a share from the gas storage segment, a loss of 33 cents a share relating to the Company's efforts to purchase PGE, and earnings of 5 cents a share from other subsidiary and non-utility operations. Non-utility results for 2001 were earnings of 12 cents a share, including 8 cents a share from the gas storage segment.

For the 48th consecutive year, the Company's dividends paid on common stock increased in 2003. Dividends paid on common stock were \$1.27 a share in 2003 compared to \$1.26 a share in 2002 and \$1.245 a share in 2001.

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing the Company's financial statements using generally accepted accounting principles in the United States of America (GAAP), management exercises judgment in the selection and application of accounting principles, including making estimates and assumptions that affect reported amounts of assets, liabilities, revenues, expenses and related disclosures in the financial statements. Management considers its critical accounting policies to be those which are most important to the representation of the Company's financial condition and results of operations and which require management's most difficult and subjective or complex judgments, including accounting estimates that could result in materially different amounts if the Company reported under different conditions or using different assumptions.

The Company's most critical estimates or judgments involve regulatory cost recovery, unbilled revenues, derivative instruments, pension assumptions, and environmental contingencies. Management has discussed the estimates and judgments used in the application of critical accounting policies with the Audit Committee of

the Board. The Company's critical accounting policies and estimates are described below.

Regulatory Accounting

NW Natural is regulated by the Public Utility Commission of Oregon (OPUC) and the Washington Utilities and Transportation Commission (WUTC), which establish rules governing the Company's utility rates and services, and to a certain extent set forth the accounting treatment for certain regulatory transactions. In general, NW Natural uses the same accounting principles as other non-regulated companies reporting under GAAP. However, certain accounting principles, primarily Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation," require different accounting treatment for regulated companies to show the effects of regulation. For example, NW Natural accounts for the cost of gas using a deferral and cost recovery mechanism called the Purchased Gas Adjustment (PGA), which is approved annually by the OPUC and WUTC (see "Results of Operations – Cost of Gas Sold," below). There are other expenses or revenues that the OPUC or WUTC may require the Company to defer and recover or refund in future periods. SFAS No. 71 requires the Company to account for these types of deferred expenses (or deferred revenues) as regulatory assets (or regulatory liabilities) on the balance sheet. When NW Natural is allowed to recover these expenses from or refund them to customers, it recognizes the expense or revenue on the income statement at the same time it realizes the adjustment to amounts included in utility rates and charged to customers.

The conditions a regulated company must satisfy to apply the accounting policies and practices of SFAS No. 71 include:

- an independent regulator sets rates;
- the regulator sets the rates to cover specific costs of delivering service; and
- the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

NW Natural applies SFAS No. 71 in accounting for its regulated utility operations. The Company periodically assesses whether it can continue to apply SFAS No. 71. If NW Natural should determine in the future that all or a portion of its regulatory assets and liabilities no longer meet the criteria for continued application of SFAS No. 71, then it would be required to write off the net unrecoverable balances of its regulatory assets and liabilities as a charge to income.

Revenue Recognition

Utility revenues, derived primarily from the sale and transportation of natural gas, are recognized when the gas is delivered to and received by the customer. Revenues are accrued for gas delivered to customers but not yet billed based on estimates of gas deliveries from the last meter reading date to month end (unbilled revenues). Unbilled revenues are dependent upon a number of factors that require management's judgment, including total gas receipts and deliveries, customer usage patterns and weather. Unbilled revenue estimates are reversed the following month when actual billings occur. NW Natural's unbilled revenues at Dec. 31, 2003 and 2002 were \$59.1 million and \$44.1 million, respectively.

In November 2003, NW Natural implemented a weather normalization mechanism in Oregon that helps stabilize the Company's net operating revenues by adjusting current customer billings based on temperature variances from average weather (see "Results of Operations – Regulatory Matters – Rate Mechanisms," below).

Non-utility revenues, derived primarily from gas storage services, are recognized upon delivery of the service to customers. Revenues from optimization of excess storage and transportation capacity are recognized over the life of the contract for guaranteed amounts under the contract, or are recognized as earned for amounts above the guaranteed value.

Accounting for Derivative Instruments and Hedging Activities

The Company's Derivatives Policy sets forth the guidelines for using selected financial derivative products to support prudent risk management strategies within designated parameters (see Note 1). The policy specifically prohibits the use of derivatives for trading or speculative purposes. The Company's primary hedging activities consist of natural gas commodity price and foreign currency exchange rate hedges, which are accounted for as cash flow hedges.

The Company's commodity and foreign currency hedge transactions are included in the annual PGA mechanism, and as such all gains and losses are subject to regulatory deferral under SFAS No. 71 (see "Regulatory Accounting," above). The following table summarizes the realized gains and losses from NW Natural's commodity and currency hedge transactions in 2003, 2002 and 2001:

<i>(Thousands)</i>	2003	2002	2001
Gains (losses) on commodity swap contracts	\$ 29,660	\$ (73,922)	\$ 44,191
Gains (losses) on commodity option contracts	2,723	(1,601)	13,383
Subtotal	32,383	(75,523)	57,574
Gains on currency contracts	4,129	521	824
Total gains (losses) on commodity and currency contracts	<u>\$ 36,512</u>	<u>\$ (75,002)</u>	<u>\$ 58,398</u>

Realized gains (losses) from commodity and foreign currency hedge contracts are recorded as reductions (increases) to the cost of gas and are included in the calculation of annual PGA rate changes. Unrealized gains and losses resulting from mark-to-market valuations are not recognized in current income or other comprehensive income, but are reported as regulatory liabilities or regulatory assets, which are offset by a corresponding balance in non-trading derivative assets or liabilities (see Note 11).

Accounting for Pensions

NW Natural has two qualified non-contributory defined benefit pension plans covering all regular employees with more than one year of service. These plans are funded through a trust dedicated to providing retirement benefits. Net periodic pension costs and accumulated benefit obligations are determined in accordance with SFAS No. 87, "Employers' Accounting for Pensions" (see "Financial Condition – Pension Cost (Income) and Funding Status," below, and Note 7), using a number of assumptions including the discount rate, the rate of compensation increases, retirement ages, mortality rates and expected long-term return on plan assets. These assumptions have a significant impact on the amounts reported. NW Natural's pension cost consists of service costs, interest costs, amortization of actuarial gains and losses, expected returns on plan assets and, in part, on a market-related valuation of assets. Variances between expected returns and actual investment returns are recognized over a three-year period from the year in which they occur, thereby reducing year-to-year volatility.

The Company considers a number of factors in developing its pension assumptions, including an evaluation of relevant discount rates, expected long-term returns on plan assets, plan asset allocations, expected changes in wages and retirement benefits, analyses of current market conditions and input from actuaries and other consultants. For the Dec. 31, 2003 measurement date, the Company:

- decreased its discount rate assumption from 6.75 percent to 6.25 percent;
- lowered its salary and wage increase assumption from a range of 4.25-5.00 percent to a range of 4.00-4.75 percent; and
- increased its expected long-term return on plan assets from 8.00 percent to 8.25 percent.

Changes in these factors were the primary contributors to a net increase in the Company's accumulated benefit obligation from \$172 million at Dec. 31, 2002, to \$192 million at Dec. 31, 2003.

The Company believes its pension assumptions to be appropriate based upon the above factors. However, if the discount rate were changed by one-quarter percentage point, the net periodic pension cost would be changed by approximately \$0.6 million. If the expected return on plan assets were changed by one-quarter percentage point, the net periodic pension cost would be changed by approximately \$0.4 million.

Contingencies

The Company records loss contingencies as liabilities when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Estimating probable losses requires an analysis of uncertainties that often depend upon judgments about potential actions by third parties. In the normal course of business, the Company records accruals for loss contingencies based on an analysis of potential results, developed in consultation with outside counsel when appropriate, including allowances for uncollectible accounts, environmental claims and property damage and personal injury claims. It is possible, however, that future results of operations could be materially affected by changes in assumptions or estimates regarding these contingencies. With respect to environmental claims, the Company records receivables for anticipated recoveries under insurance contracts, or from future utility rates, when recovery is probable. See Note 12.

RESULTS OF OPERATIONS

Regulatory Matters

NW Natural provides gas utility service in Oregon and Washington, with Oregon representing over 90 percent of its revenues. Future earnings and cash flows from utility operations will be determined largely by the pace of continued growth in the residential and commercial markets and by NW Natural's ability to remain price competitive in the large industrial market, to control expenses, and to obtain reasonable and timely regulatory ratemaking treatment for investments made in utility plant.

General Rate Cases

In August 2003, the OPUC entered an order covering all of the issues in NW Natural's first Oregon general rate case since 1999. The order included, among other things, (i) the settlement of NW Natural's cost of service, including operations and maintenance expenses, (ii) projected investments for the prospective test year, (iii) a capital structure including 49.5 percent common equity, (iv) a return on common shareholders' equity (ROE) of 10.2 percent, (v) a rate redesign that shifted \$4.8 million of margin revenue requirement from industrial rate schedules to residential and commercial rate schedules, and (vi) the adoption of a weather normalization mechanism. The order authorized a revenue increase of \$13.9 million per year, of which \$6.2 million went into effect on Sept. 1, 2003 and \$2.8 million went into effect on a deferred basis on Nov. 12, 2003 as the first 11.7 miles of the Company's South Mist Pipeline Extension (SMPE) was placed into service. The remainder will go into effect as all or portions of the SMPE project and the Company's Coos County distribution system project are completed and go into service in 2004 (see "Financial Condition – Investing Activities," below).

NW Natural's most recent general rate increase in Washington, which was fully effective in October 2001, authorized rates designed to produce an ROE of 10.8 percent. The WUTC approved a revenue increase of \$4.3 million per year, or 12.1 percent.

In November 2003, NW Natural filed a new general rate case in Washington. The filing proposes a revenue increase of \$7.9 million per year from Washington operations through rate increases averaging 15 percent. The proposed rates are designed to produce an ROE of 11 percent and to recover increases in NW Natural's cost of service including costs for expansion of the Mist gas storage system and construction of a new service center in Vancouver; higher expenses in

areas such as pensions, health benefits and insurance; and revenue declines due to changes in customers' consumption patterns. NW Natural also is proposing a decoupling mechanism for residential and commercial customers that includes weather normalization, and a re-design of industrial rates. The schedule for the case provides for settlement conferences in April 2004, the filing of WUTC staff and intervenor testimony in May, hearings in July and a decision by the WUTC determining new rates by the end of October 2004. The Company is unable to determine the extent to which its proposals will be accepted by the WUTC.

Rate Mechanisms

The weather normalization mechanism approved by the OPUC will be applied to NW Natural's Oregon residential and commercial customers' bills between Nov. 15 and May 15 of each heating season, beginning November 2003. The mechanism adjusts the margin component of customers' rates to reflect "normal" weather using the 25-year average temperature for each day of the billing period. The mechanism is intended to stabilize the recovery of fixed costs and reduce fluctuations in customers' bills due to colder- or warmer-than-average weather.

Rate changes are applied each year under the PGA mechanisms in NW Natural's tariffs in Oregon and Washington to reflect changes in the costs of natural gas commodity purchased under contracts with gas producers (see "Comparison of Gas Operations – Cost of Gas Sold," below), the application of temporary rate adjustments to amortize balances in regulatory asset or liability accounts and the removal of temporary rate adjustments effective the previous year. In 2003, the OPUC approved a rate increase averaging 3.5 percent for Oregon sales customers and the WUTC approved a rate increase averaging 16.8 percent for Washington sales customers, both effective on Oct. 1, 2003. In 2002, the OPUC approved PGA rate decreases averaging 14 percent for NW Natural's Oregon sales customers and the WUTC approved PGA rate decreases averaging 25 percent for NW Natural's Washington sales customers, both effective on Oct. 1, 2002. In 2001, the OPUC approved PGA rate increases averaging 22 percent for Oregon sales customers and the WUTC approved PGA rate increases averaging 21 percent for Washington sales customers, both effective on Oct. 1, 2001.

In an order issued in 1999, the OPUC formalized a process that tests for excessive earnings in connection with gas utilities' annual filings under their PGA mechanisms. The OPUC confirmed NW Natural's ability to pass through 100 percent of its prudently incurred gas costs into rates. Under this order, NW Natural is authorized to retain all of its earnings up to a threshold level equal to its authorized ROE plus 300 basis points. One-third of any earnings above that level will be refunded to customers. The excess earnings threshold is subject to adjustment up or down each year depending on movements in interest rates. No amounts were identified in this process for refund to customers with respect to NW Natural's earnings results in 2002 or 2001. NW Natural does not expect there will be amounts identified for refund with respect to its earnings in 2003, which will be reviewed by the OPUC in the second quarter of 2004.

In 2002, the OPUC approved a rate mechanism designed to stabilize margin revenues in the face of above- or below-normal consumption patterns. NW Natural believes that reductions in recent years in its customers' gas consumptions per degree-day (see "Comparison of Gas Operations – Residential and Commercial," below) were caused by increases in the cost of purchased gas that were passed on to customers as rate increases, and to efforts throughout the region to conserve energy. The mechanism adjusts for rate changes according to the impact of price elasticity, starting with small increases to residential and commercial rates that became effective on Oct. 1, 2002. These rate changes contributed an estimated \$3.5 million of margin, equivalent to 8 cents a share of earnings, dur-

ing the fourth quarter of 2002 and an estimated \$6.5 million of margin, equivalent to 15 cents a share of earnings, during the first eight months of 2003 before the Oregon general rate increase took effect.

In addition, the OPUC authorized NW Natural to implement a partial decoupling mechanism effective Oct. 1, 2002. Decoupling mechanisms are used to break the link between a utility's earnings and the energy consumed by its customers so the utility does not have an incentive to discourage customers' conservation efforts. The decoupling mechanism works by adding margin revenues during periods when customer consumptions are lower than baseline consumption or by deducting margin revenues when consumptions are higher than the baseline. Under the partial decoupling mechanism, NW Natural uses a balancing account to defer and subsequently amortize 90 percent of the margin differentials between baseline usage by its residential and commercial customers and weather-normalized actual usage by these customers. The deferred amounts are treated as adjustments to be refunded or collected in future periods. Baseline consumption is based on customer consumption patterns determined in the Oregon general rate case, adjusted for consumptions resulting from new customers. The partial decoupling mechanism will expire at the end of September 2005 unless the OPUC approves an extension based on the results of an independent study to measure the mechanism's effectiveness.

In connection with the OPUC's approval of the decoupling mechanism, NW Natural agreed to adopt certain service quality measures that establish the Company's performance goal for minimizing complaints by customers where the Company is determined to be at fault. If NW Natural exceeds the prescribed level of at-fault complaints, it will be subject to penalties. NW Natural was not subject to penalties relating to these measures in 2003.

Comparison of Gas Operations

The following table summarizes the composition of gas utility volumes and revenues for the three years ended Dec. 31:

(Thousands, except customers and degree-days)

	2003		2002		2001	
Utility gas sales and transportation volumes – therms:						
Residential and						
commercial sales	569,791		597,246		592,358	
Unbilled volumes	12,099		(6,617)		1,771	
Weather-sensitive						
volumes	581,890	53%	590,629	52%	594,129	53%
Industrial firm sales	55,314	5%	63,215	6%	79,778	7%
Industrial interruptible sales	47,994	4%	26,241	2%	63,597	6%
Total gas sales	685,198	62%	680,085	60%	737,504	66%
Transportation deliveries	414,554	38%	445,999	40%	385,783	34%
Total volumes sold and delivered	1,099,752	100%	1,126,084	100%	1,123,287	100%
Utility operating revenues – dollars:						
Residential and						
commercial sales	\$ 504,849		\$ 556,210		\$ 520,141	
Unbilled revenues	14,474		(12,702)		13,774	
Weather-sensitive						
revenues	519,323	86%	543,508	86%	533,915	84%
Industrial firm sales	33,578	6%	42,965	7%	49,662	8%
Industrial interruptible sales	23,661	4%	15,937	2%	34,283	5%
Total gas sales	576,562	96%	602,410	95%	617,860	97%
Transportation revenues	17,962	3%	26,020	4%	20,637	3%
Other revenues	7,460	1%	4,018	1%	(2,325)	-
Total utility operating revenues	\$ 601,984	100%	\$ 632,448	100%	\$ 636,172	100%
Cost of gas sold	\$ 323,128		\$ 353,034		\$ 364,699	
Utility net operating revenues (margin)	\$ 278,856		\$ 279,414		\$ 271,473	
Total number of customers (end of period)	578,150		560,067		540,931	
Actual degree-days	3,952		4,232		4,325	
25-year average degree-days	4,238		4,257		4,267	

NW Natural refunded deferred gas cost savings to its Oregon customers through billing credits in June 2002. These refunds were the customers' 67 percent portion of gas cost savings realized between October 2001 and March 2002, which had been deferred, with interest, pursuant to NW Natural's PGA tariff in Oregon (see "Cost of Gas Sold," below). The refunds reduced gross operating revenues during 2002 by \$30.4 million, and reduced both cost of gas and deferred gas costs payable by \$29.5 million. The refunds also reduced margin by about \$0.9 million, but this amount was almost entirely offset by corresponding reductions in franchise tax expense and uncollectible accounts expense such that the effect of the refunds on net income was negligible.

Residential and Commercial Sales

NW Natural continued to grow its customer base, with a net increase of 18,083 customers during 2003. This represents a growth rate of 3.2 percent, compared to 3.5 percent in 2002 and 3.3 percent in 2001. In the three years ended Dec.

31, 2003, more than 54,000 customers were added to the system, representing an average annual growth rate of 3.5 percent.

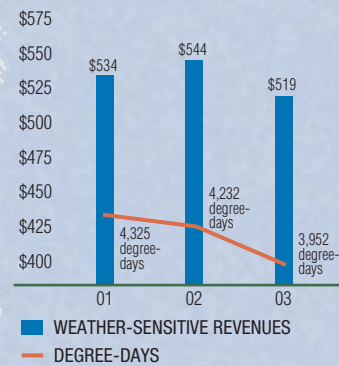
The volumes of gas sold to residential and commercial customers were 1 percent lower in 2003 than in 2002, reflecting warmer weather that was partially offset by customer growth and the price elasticity effects of lower rates. Related revenues were 4 percent lower in 2003 than in 2002. Excluding the impact of gas cost refunds totaling \$30.4 million to Oregon customers during 2002, related revenues were \$54.6 million, or 10 percent, lower in 2003 than in 2002, primarily due to lower rates effective Oct. 1, 2002 (see "Regulatory Matters – Rate Mechanisms," above). The volumes of gas sold to residential and commercial customers were 1 percent lower in 2002 than in 2001, reflecting warmer weather as well as lower consumption patterns by customers due to higher gas commodity prices included in rates in previous years. Excluding the impact of the refunds to Oregon customers during 2002, related revenues increased 7 percent, primarily due to PGA rate increases effective Oct. 1, 2001.

Typically, 80 percent or more of NW Natural's annual operating revenues are derived from gas sales to weather-sensitive residential and commercial customers. Accordingly, variations in temperatures between periods will affect volumes of gas sold to these customers. Weather conditions in 2003 were 7 percent warmer than average. Temperatures were very close to average in 2002 and 1 percent colder than average in 2001. Weather in 2003 was 7 percent warmer than 2002 and 2002 was 2 percent warmer than 2001. Average weather conditions are calculated from the most recent 25 years of temperature data measured by heating degree-days.

In November 2003, NW Natural implemented a weather normalization mechanism that will be applied to Oregon residential and commercial customers' bills between Nov. 15 and May 15 of each heating season (see "Regulatory Matters – Rate Mechanisms," above). Customers may opt out of the mechanism during a defined period each year; less than 10 percent of NW Natural's Oregon residential

WEATHER-SENSITIVE OPERATING REVENUES AND DEGREE-DAYS

IN MILLIONS OF DOLLARS



Weather-sensitive operating revenues have been at record levels over the past three year period. Weather conditions in 2003 were 7 percent warmer than the 25-year average.

and commercial customers opted out during its first heating season. The mechanism contributed \$2.1 million of margin in the fourth quarter of 2003 due to warmer-than-average weather. The contribution was equivalent to 5 cents a share of earnings, making up a significant portion of the weather-related margin loss in that quarter.

In order to match revenues with related purchased gas costs, NW Natural records unbilled revenues for gas delivered and sold to customers, but not yet billed, through the end of the period. Amounts reported as unbilled revenues reflect the increase or decrease in the balance of unbilled revenues over the prior year-end. Weather conditions, rate changes and customer billing dates from one period to the next affect year-end balances.

Industrial Sales and Transportation

The following table summarizes the delivered volumes and utility net operating revenues (margin) in the industrial and electric generation markets:

(Thousands)	2003	2002	2001
Delivered volumes – therms:			
Industrial sales and transportation	519,265	531,195	486,116
Electric generation	1,667	3,400	42,867
Total volumes	<u>520,932</u>	<u>534,595</u>	<u>528,983</u>
Utility net operating revenues – dollars:			
Industrial sales and transportation	\$ 37,693	\$ 40,666	\$ 43,251
Electric generation	6	4,584	4,721
Total margin	<u>\$ 37,699</u>	<u>\$ 45,250</u>	<u>\$ 47,972</u>

Total volumes delivered to industrial and electric generation customers were 3 percent lower in 2003 than in 2002, and 1 percent higher in 2002 than in 2001. Combined margins from these customers were 17 percent lower in 2003 than in 2002 and 6 percent lower in 2002 than in 2001.

Excluding electric generation customers, volumes delivered to end-use industrial sales and transportation customers were 2 percent lower and margin was 7 percent lower in 2003 than in 2002. Results from the industrial market in 2003 reflect weak economic conditions during the year, as well as some cost-related changes in the design of industrial rates in the Oregon general rate case that reduced industrial margins in the fourth quarter. Volumes delivered to industrial customers were 9 percent higher in 2002 than in 2001, but margin was 6 percent lower. The decline in margin from these customers in 2002 was due to migrations of some industrial customers from higher margin firm service to lower margin interruptible service and to plant shutdowns or cutbacks in the manufacturing sector because of economic conditions. NW Natural re-designed its industrial rates in Oregon as part of its general rate case in 2003, transferring \$4.8 million of annual revenue requirement from industrial rates to residential and commercial rates in order to better reflect relative costs of service and to become more competitive in the industrial market.

In the electric generation market, margin was negligible in 2003 but was \$4.6 million and \$4.7 million in 2002 and 2001, respectively, equivalent to 11 cents a share in each year. More than 90 percent of the margin, but only about 14 percent of the gas deliveries, in 2002 and 2001 was from two customers that were served under contracts that went into effect in the second half of 2001 and expired at the end of the second quarter of 2002. Most of the margin from these contracts was from fixed charges. A third electric generation customer used 3.0 million therms in 2002 and 36.8 million therms in 2001 under contracts with low volumetric charges.

Other Revenues

Other revenues include revenues and revenue adjustments from sources other than the sale and transportation of gas (see Note 1), including deferrals to and amortizations from regulatory asset and liability accounts and miscellaneous customer fees. In 2003, other revenues contributed \$7.5 million to utility operating revenues compared to \$4.0 million in 2002 and a negative \$2.3 million in 2001.

Other revenues in 2003 included positive contributions due to amortizations of regulatory accounts covering customer consumption under NW Natural's decoupling mechanism (see "Regulatory Matters – Rate Mechanisms," above), amortizations of income shared with customers from interstate gas storage services, and customer late payment and collection fees and miscellaneous revenues, partially offset by amortizations from regulatory accounts covering conservation programs and Year 2000 costs.

The following table summarizes other revenues by primary category in 2003, 2002 and 2001:

(Thousands)	2003	2002	2001
Rate adjustments:			
Decoupling deferrals	\$ 3,466	\$ 1,720	\$ –
Decoupling amortizations	(783)	–	–
Interstate storage amortization	3,057	1,212	–
Conservation programs amortization	(2,408)	(2,074)	(4,941)
Year 2000 amortization	(949)	(1,539)	(1,236)
Miscellaneous revenues:			
Customer fees	2,919	3,115	2,991
Other	2,158	1,584	861
Total other revenues	<u>\$ 7,460</u>	<u>\$ 4,018</u>	<u>\$ (2,325)</u>

Cost of Gas Sold

Natural gas commodity prices have fluctuated dramatically in recent years. NW Natural has sought to mitigate the effect of higher gas commodity prices and price volatility on core utility customers through the use of its underground storage facilities, by entering into gas commodity-based financial hedge contracts, and by making short-term sales of gas commodity and transportation capacity to on-system or off-system customers in periods when core utility customers do not fully utilize firm pipeline capacity and gas supplies.

In 2003, the Company replaced all of its expiring long-term contracts with supply contracts for gas purchases of similar aggregate volume levels. All of the new contracts have terms of five years or less and contain commodity price provisions that are tied directly to monthly market index prices for the term of the contract. The Company enters into financial hedge contracts that are intended to have the effect of converting these monthly market index prices into fixed prices for most of its gas purchases under these contracts.

The cost per therm of gas sold was 9 percent lower in 2003 than in 2002, and 5 percent higher in 2002 than in 2001. The cost per therm of gas sold includes current gas purchases, gas drawn from storage inventory, gains or losses from commodity hedges, margin from off-system gas sales, demand cost balancing adjustments (demand equalization), regulatory deferrals and company use. Results for 2002 included an adjustment that reduced cost of gas by \$29.5 million (see "Comparison of Gas Operations," above). Excluding this adjustment, cost per therm of gas sold was 16 percent lower in 2003 than in 2002, reflecting decreases in gas commodity prices effective in late 2002, and 14 percent higher in 2002 than in 2001, reflecting increases in gas commodity prices effective in late 2001.

Results for 2002 also included adjustments reducing cost of gas relating to amounts of deferred expenses for the recovery of pipeline demand charges under NW Natural's PGA mechanism. These adjustments contributed 7 cents a share to earnings in 2002, of which 6 cents a share applied to periods prior to 2002. The rate methodology represented in the adjustments continues to be applied in the Company's accounting for pipeline demand charges.

NW Natural's recorded amount of unaccounted-for gas was 0.55 percent of gas sendout in 2003, compared to 0.75 percent in 2002. Unaccounted-for gas is the difference between the amount of gas the Company receives from all sources, including pipeline deliveries and withdrawals from storage, and the amount of gas it delivers to customers or other delivery points. Unaccounted-for gas may be caused in part by physical gas leakage, but it also may be due to cumulative inaccuracies in gas metering, estimates of unbilled gas or other

causes. NW Natural considers a normal amount of unaccounted-for gas to be 0.50 percent of its total gas sendout during a period, but the amount may vary within a range around this estimate. During 2003, the lower estimated amount of unaccounted-for gas had the effect of reducing cost of gas and increasing margin by \$1.2 million as compared to 2002.

NW Natural uses a natural gas commodity-price hedge program under the terms of its Derivatives Policy to help manage its variable price gas commodity contracts (see "Application of Critical Accounting Policies and Estimates – Accounting for Derivative Instruments and Hedging Activities," above). NW Natural recorded net hedging gains of \$32.4 million from this program during 2003, compared to net hedging losses of \$75.5 million in 2002 and net hedging gains of \$57.6 million in 2001, with negligible impact on net income in any of those years. Hedging gains and losses relating to gas commodity purchases are included in cost of gas and factored into NW Natural's annual PGA rate adjustments.

Under NW Natural's PGA tariff in Oregon, net income from Oregon operations is affected within defined limits by changes in purchased gas costs. NW Natural is allowed to collect an amount for purchased gas costs based on estimates that are included in current utility rates. If the actual purchased gas costs are higher than the amounts included in rates, NW Natural is not allowed to charge its customers currently for those higher gas costs but is allowed to defer the costs and collect them in the future. Similarly, when the actual purchased gas costs are lower than the amount included in rates, the savings are not immediately passed on to customers but are deferred and refunded in future periods. NW Natural absorbs 33 percent of the higher cost of gas sold, or retains 33 percent of the lower cost, in either case as compared to the projected costs built into rates. The remaining 67 percent of the higher or lower gas costs is recorded as deferred regulatory assets or liabilities for recovery from or refund to customers in future rates. NW Natural's gas costs in 2003 were slightly lower than the gas costs embedded in rates, with the effect that NW Natural's share of the lower costs increased margin by \$0.3 million, equivalent to less than 1 cent a share of earnings. In 2002 and 2001, NW Natural's gas costs were much lower than the projected costs built into rates and the Company's share of the savings realized from gas purchases contributed \$10.8 million and \$4.1 million of margin, equivalent to 26 cents a share and 10 cents a share of earnings, respectively.

Due to the warm weather and the reduced gas requirements of its industrial sales customers during 2003, NW Natural was able to use gas supplies that were under contract for the winter season, but were not required for delivery to core market customers, to make off-system gas sales. The Company's purchase prices for this gas had been locked in through commodity swap and call option agreements entered into in the prior year at levels lower than market prices during 2003. Under the PGA tariff, the margin from these sales is treated as a reduction to cost of gas, with the effect that 67 percent is deferred for refund to NW Natural's customers and the remaining 33 percent is retained by the Company. NW Natural's share of the margin from off-system gas sales in 2003 was \$4.9 million, equivalent to 11 cent a share of earnings, compared to margin of \$0.9 million or 2 cents a share of earnings in 2002 and margin of \$1.0 million or 2 cents a share of earnings in 2001.

Non-utility Operations

At Dec. 31, 2003 and 2002, the Company's non-utility operations consisted of gas storage operations and two wholly-owned subsidiaries, Financial Corporation and Northwest Energy. Of the subsidiaries, only Financial Corporation had active operations during 2002 and 2003.

Gas Storage

NW Natural realized net income from its non-utility gas storage business segment in 2003, after regulatory sharing and income taxes, of \$4.3 million or 17 cents a share, compared to \$3.6 million or 14 cents a share in 2002 and \$2.1 million or 8 cents a share in 2001.

Gas storage services include sales to off-system interstate customers using storage capacity that has been developed in advance of core utility customers' requirements. NW Natural retains 80 percent of the income before tax from gas storage services and credits the remaining 20 percent to a deferred regulatory account for distribution to its core utility customers.

Results for the gas storage business segment also include revenues, net of amounts shared with core utility customers, from a contract with an independent energy trading company that seeks to optimize the use of NW Natural's assets by trading temporarily unused portions of its gas storage capacity and upstream pipeline transportation capacity. NW Natural retains 80 percent of the pre-tax income from the optimization of storage and pipeline transportation capacity when the costs of such capacity have not been included in core utility rates, or 33 percent of the pre-tax income from such capacity when the costs have been included in core utility rates. The remaining 20 percent and 67 percent, respectively, are credited to a deferred regulatory account for distribution to NW Natural's core utility customers.

Financial Corporation

Financial Corporation's operating results in 2003 were net income of \$0.7 million, compared to \$1.2 million in 2002 and \$0.7 million in 2001. The decrease in net income in 2003 compared to 2002 was primarily due to lower income from investments in limited partnerships in wind and solar electric generation projects in California, and lower miscellaneous receivables. The increase in net income in 2002 compared to 2001 was due to higher income from these investments. The Company's investment in Financial Corporation at Dec. 31, 2003, was \$5.5 million, compared to \$9.1 million and \$7.9 million at Dec. 31, 2002 and 2001, respectively. The reduced investment in Financial Corporation at Dec. 31, 2003, was primarily due to a \$4.2 million cash dividend that Financial Corporation paid to NW Natural in the fourth quarter of 2003.

Northwest Energy

Northwest Energy was formed in 2001 to serve as the holding company for NW Natural and PGE if the acquisition of PGE had been completed. Northwest Energy recorded nominal expenses for corporate development activities in 2003. Upon the termination of the proposed acquisition effort in 2002, Northwest Energy recorded a loss totaling \$8.4 million (after tax) for the transaction costs incurred in connection with this effort. These charges were equivalent to 33 cents a share.

Operating Expenses

Operations and Maintenance

Operations and maintenance expenses of \$96.4 million in 2003 were \$11.3 million, or 13 percent, higher than in 2002. The increase was primarily due to higher operating payroll costs from added positions and wage, salary, vacation and bonus increases (\$4.1 million), higher pension costs including the impact of changes in actuarial assumptions (\$3.1 million) (see "Financial Condition – Pension Cost (Income) and Funding Status," below), higher premiums for health care and prescription drug coverage (\$0.9 million), higher renewal premiums on business risk insurance (\$0.9 million), higher employee benefit costs (\$0.8 million), higher professional services fees (\$0.7 million), and higher expenses relating to workers compensation (\$0.5 million) and other operating costs (\$1.2 million). These cost increases were partially offset by a decrease in uncollectible accounts expense (\$0.9 million) due to lower net write-offs of accounts receivable compared to 2002, when customer bills and subsequent write-offs were

impacted by higher gas prices and colder weather. Most of the cost increases NW Natural experienced in 2003 were recognized in the rate increases resulting from the Company's general rate case in Oregon (see "Regulatory Matters – General Rate Cases," above).

Operations and maintenance expenses of \$85.1 million in 2002 were \$1.2 million, or 1 percent, higher than in 2001. The increase in 2002 resulted primarily from higher pension costs (\$2.5 million), higher premiums for health care and prescription drug coverage (\$1.0 million), higher payroll costs due to wage and salary increases and incentive bonus accruals (\$0.8 million) and higher renewal premiums on business risk insurance (\$0.3 million), partially offset by a litigation reserve in 2001 (\$1.7 million), lower information technology expenses (\$1.0 million) and lower uncollectible accounts expense (\$0.5 million).

Taxes Other Than Income Taxes

Taxes other than income taxes, which are principally comprised of property, franchise and payroll taxes, increased \$1.0 million, or 3 percent, in 2003 over 2002. Property taxes increased \$0.9 million, or 7 percent, due to utility plant additions and slightly higher property tax rates. Franchise taxes, regulatory fees and payroll tax expenses accounted for the remaining \$0.1 million increase.

In 2002, taxes other than income taxes increased \$1.8 million, or 6 percent, over 2001. Property taxes increased \$1.6 million, or 13 percent, due to utility plant additions and higher property tax rates.

Depreciation and Amortization

The following table summarizes the increases in total plant and property and total depreciation and amortization for the three years ended Dec. 31, 2003:

(Thousands)	2003	2002	2001
Plant and property:			
Utility plant:			
Depreciable	\$ 1,598,485	\$ 1,498,903	\$ 1,434,009
Non-depreciable, including construction work in progress	60,604	41,062	31,070
	<u>1,659,089</u>	<u>1,539,965</u>	<u>1,465,079</u>
Non-utility property:			
Depreciable	22,353	20,832	18,203
Non-depreciable, including construction work in progress	1,042	-	-
	<u>23,395</u>	<u>20,832</u>	<u>18,203</u>
Total plant and property	<u>\$ 1,682,484</u>	<u>\$ 1,560,797</u>	<u>\$ 1,483,282</u>
Depreciation and amortization:			
Utility plant	\$ 53,798	\$ 51,693	\$ 49,413
Non-utility property	451	397	227
Total depreciation and amortization expense	<u>\$ 54,249</u>	<u>\$ 52,090</u>	<u>\$ 49,640</u>
Average depreciation rate	<u>3.5%</u>	<u>3.5%</u>	<u>3.5%</u>

The Company's total depreciation and amortization expense increased by \$2.2 million, or 4 percent, in 2003 and by \$2.5 million, or 5 percent, in 2002. The increased expense for both years is primarily due to additional investments in utility property that were made to meet continuing customer growth and to expand the use of the Company's Mist gas storage system (see "Financial Condition – Cash Flows – Investing Activities," below).

As a percentage of average depreciable plant and property, both total depreciation and amortization expense and utility depreciation and amortization expense was 3.5 percent in each of 2003, 2002 and 2001. Non-utility depreciation and amortization expense as a percentage of average depreciable non-utility property was 2.1 percent in 2003, 2.0 percent in 2002 and 1.7 percent in 2001.

Other Income (Expense)

Other income (expense) improved by \$17.0 million in 2003, primarily due to the \$13.9 million pre-tax charge for costs incurred in 2002 for the effort to acquire PGE. Excluding this charge, the Company's other income (expense) increased by \$3.1 million in 2003.

The increase was primarily due to reductions in interest charges on deferred regulatory account balances (\$1.4 million) reflecting lower net credit balances outstanding in these accounts, and an increase in gains from Company-owned life insurance (\$2.0 million) due to increases in market value of equity-based life insurance investments, partially offset by a decrease in earnings from equity investments (\$0.5 million) due to lower income from partnership investments held by Financial Corporation.

Other income (expense) decreased \$16.2 million in 2002 compared to 2001, primarily due to the \$13.9 million charge relating to the charge for PGE transaction costs. Excluding this charge, other income (expense) decreased \$2.3 million in 2002, primarily due to higher interest accrued on deferred regulatory account balances (\$2.6 million), an increase in miscellaneous non-operating expenses (\$0.6 million) and a decrease in miscellaneous non-operating income (\$0.3 million), partially offset by an increase in earnings from Financial Corporation's investments (\$1.3 million).

Interest Charges – Net

The Company's net interest expense in 2003 was \$1.0 million, or 3 percent, higher than in 2002. Interest expense in 2003 included dividends paid in the second half of 2003 totaling \$0.2 million on the Company's redeemable preferred stock, which were classified as interest expense upon the adoption of SFAS No. 150 (see Note 1). The increase in interest expense in 2003 was primarily due to higher balances of debt outstanding during the period. The increase was partially offset by lower average interest rates and higher amounts of Allowance for Funds Used During Construction (AFUDC) due to higher average balances of construction work in progress (CWIP).

The Company's net interest expense in 2002 was \$0.3 million, or 1 percent, higher than in 2001, also due to higher balances of debt outstanding.

AFUDC represents the cost of funds used for construction work in progress (see Note 1). In 2003, AFUDC reduced interest expense by \$0.9 million compared to reductions of \$0.6 million in 2002 and \$1.0 million in 2001. The average interest rate component of AFUDC, comprised of short-term and long-term borrowing rates as appropriate, was 2.3 percent in 2003, 2.8 percent in 2002 and 6.2 percent in 2001.

Income Taxes

The effective corporate income tax rates were 33.7 percent and 34.9 percent for the years ended Dec. 31, 2003 and 2002, respectively. The lower tax rate for 2003 reflects increased tax benefits from a non-taxable gain on Company- and trust-owned life insurance. Excluding these benefits, the effective tax rate for 2003 would have been 35.0 percent. The tax rate for 2002 includes the effect of the tax benefit from the \$13.9 million charge for PGE transaction costs. Excluding this charge, the effective tax rate for 2002 would have been 35.6 percent compared to 35.4 percent for 2001 (see Note 8).

Redeemable Preferred and Preference Stock Dividend Requirements

Redeemable preferred and preference stock dividend requirements decreased \$2.0 million in 2003. In November 2003, NW Natural redeemed all of the outstanding shares of its \$7.125 Series of Redeemable Preferred Stock with an aggregate stated value of \$7.5 million at the applicable early redemption price of 102.375 percent. In December 2002, NW Natural redeemed all 250,000 outstanding shares (\$25 million aggregate stated value) of its \$6.95 Series of Redeemable Preference Stock pursuant to the mandatory redemption provisions applicable to that Series. Dividend requirements for the preferred and preference stock decreased by \$0.1 million in both 2002 and 2001 due to annual sinking fund redemptions. At Dec. 31, 2003, no shares of redeemable preferred or preference stock were outstanding.

FINANCIAL CONDITION

Capital Structure

The Company's goal is to maintain a capital structure comprised of 45 to 50 percent common stock equity, up to 5 percent preferred stock and 45 to 50 percent short-term and long-term debt. When additional capital is required, debt or equity securities are issued depending upon both the target capital structure and market conditions. These sources also are used to meet long-term debt and preferred stock redemption requirements and to pay down outstanding commercial paper (see "Liquidity and Capital Resources," below, and Notes 3 and 5).

Liquidity and Capital Resources

At Dec. 31, 2003, the Company had \$4.7 million in cash and cash equivalents compared to \$7.3 million at Dec. 31, 2002. Short-term liquidity is provided by cash from operations and from the sale of commercial paper notes, which are supported by commercial bank lines of credit. The Company has available through Sept. 30, 2004, committed lines of credit with four commercial banks (see "Lines of Credit," below, and Note 6).

NW Natural's capital expenditures are primarily related to utility construction resulting from customer growth and system improve-



ments (see "Cash Flows – Investing Activities," below). In addition, NW Natural has certain contractual commitments under capital leases, operating leases and gas supply purchase and other contracts that require an adequate source of funding. These capital and contractual expenditures are financed through cash from operations and from the issuance of short-term debt, which is periodically refinanced through the sale of long-term debt or equity securities.

In October 2002, the Company filed a registration statement with the Securities and Exchange Commission (SEC) registering \$150 million of Medium-Term Notes, Series B (MTNs). This filing became effective in January 2003. Pursuant to this registration statement, during 2003 the Company issued \$90 million of MTNs and used the proceeds to pay down outstanding commercial paper balances and to fund, in part, NW Natural's ongoing utility construction program (see "Financing Activities," below). In February 2004, the Company filed a universal shelf registration statement with the SEC for the registration of \$200 million of securities, which may include First Mortgage Bonds, unsecured debt, preferred stock and common stock. Concurrent with the February 2004 shelf filing, the Company withdrew from registration the \$60 million of MTNs remaining on its previous shelf registration. The \$200 million universal shelf registration statement became effective in February 2004.

Neither NW Natural's Mortgage and Deed of Trust nor the indentures under which other long-term debt is issued contain credit rating triggers or stock price provisions that require the acceleration of debt repayment. Also, there are no rating triggers or stock price provisions contained in contracts or other agreements with third parties, except for agreements with certain counter-parties under NW Natural's Derivatives Policy which require the affected party to provide substitute collateral such as cash, guaranty or letter of credit if credit ratings are lowered to non-investment grade, or in some cases if the mark-to-market value exceeds a certain threshold.

Off-Balance Sheet Arrangements

The Company has no material off-balance sheet financing arrangements.

Contractual Obligations

The following table shows the Company's contractual obligations by maturity and type of obligation. NW Natural also has obligations with respect to its pension and post-retirement medical benefit plans (see Note 7).

(Thousands)	Payments Due in Years Ending Dec. 31,						Total
	2004	2005	2006	2007	2008	Thereafter	
Commercial paper	\$ 85,200	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 85,200
Long-term debt	-	15,000	8,000	29,500	5,000	442,819	500,319
Capital leases	125	114	81	15	-	-	335
Operating leases	4,289	3,767	3,754	3,686	3,626	55,326	74,448
Gas supply commitments	52,515	56,759	53,991	53,991	52,463	294,464	564,183
SMPE commitments	22,696	-	-	-	-	-	22,696
Other purchase commitments	14,330	95	-	-	-	-	14,425
Total	\$ 179,155	\$ 75,735	\$ 65,826	\$ 87,192	\$ 61,089	\$ 792,609	\$ 1,261,606

SMPE commitments in 2004 primarily consist of obligations NW Natural has to a general contractor to complete the construction of the remaining portion of the SMPE project. A construction contract is in place for one segment of the pipeline and an additional contract is currently being negotiated for the remainder of the project. Other purchase commitments primarily consist of remaining balances under existing purchase orders. These and other contractual obligations are financed through cash from operations and from the issuance of short-term debt, which is periodically refinanced through the sale of long-term debt or equity securities.

Holders of certain MTNs have put options that, if exercised, would accelerate the maturity of long-term debt by \$10 million in 2005, \$20 million in 2007 and \$20 million in 2008.

Commercial Paper

The Company's primary source of short-term funds is commercial

paper notes payable. Both NW Natural and Financial Corporation issue commercial paper under agency agreements with a commercial bank. NW Natural's commercial paper is supported by its committed bank lines of credit (see "Lines of Credit," below), while Financial Corporation's commercial paper is supported by committed bank lines of credit and the guaranty of NW Natural (see Note 6). NW Natural had \$85.2 million in commercial paper notes outstanding at Dec. 31, 2003, compared to \$69.8 million outstanding at Dec. 31, 2002. Financial Corporation had no commercial paper notes outstanding at Dec. 31, 2003 or 2002.

Lines of Credit

NW Natural has lines of credit with four commercial banks totaling \$150 million. Half of the credit facility with each bank, totaling \$75 million, is committed and available through Sept. 30, 2004, and the other \$75 million is committed and available through Sept. 30,

2005. NW Natural may be unable to draw upon the two-year portions of the credit lines, totaling \$75 million, until filings are made or approvals received from the OPUC or the WUTC with respect to its notes relating to the two-year commitments. NW Natural expects that it will be able to make the necessary filings or secure such approvals, if required.

In addition, Financial Corporation has available through Sept. 30, 2004, committed lines of credit with two commercial banks totaling \$10 million. Financial Corporation's lines are supported by the guaranty of NW Natural.

Under the terms of these lines of credit, NW Natural and Financial Corporation pay commitment fees but are not required to maintain compensating bank balances. The interest rates on borrowings under these lines of credit, if any, are based on current market rates. There were no outstanding balances on either the NW Natural or Financial Corporation lines of credit at Dec. 31, 2003 or 2002.

NW Natural's lines of credit require that credit ratings be maintained in effect at all times and that notice be given of any change in its senior unsecured debt ratings. A change in NW Natural's credit rating is not an event of default, nor is the maintenance of a specific minimum level of credit rating a condition to drawing upon the lines of credit. However, interest rates on any loans outstanding under NW Natural's bank lines are tied to credit ratings, which would increase or decrease the cost of bank debt, if any, when ratings are changed.

The lines of credit require the Company to maintain an indebtedness to total capitalization ratio of 65 percent or less and to maintain a consolidated net worth at least equal to 80 percent of its net worth at Sept. 30, 2003, plus 50 percent of the Company's net income for each subsequent fiscal quarter. Failure to comply with either of these covenants would entitle the banks to terminate their lending commitments and to accelerate the maturity of all amounts outstanding. The Company was in compliance with both of these covenants at Dec. 31, 2003, and with the equivalent covenants in the prior year's lines of credit at Dec. 31, 2002.

Optional Redemptions of Long-Term Debt and Redeemable Preferred Stock

In 2003, the Company exercised early redemption provisions applicable to certain of its long-term debt, including all \$4 million of the 7.50% Series B MTNs due 2023, all \$11 million of the 7.52% Series B MTNs due 2023, and all \$20 million of the 7.25% Series B MTNs due 2023. These MTNs were redeemed in the third quarter of 2003 at 103.75 percent, 103.76 percent and 103.65 percent of their respective principal amounts. In the fourth quarter of 2003, the Company also exercised early redemption provisions applicable to all of the remaining shares of its \$7.125 Series of Redeemable Preferred Stock with an aggregate stated value of \$7.5 million, at a redemption price equivalent to 102.375 percent. The Company redeemed the MTNs and the preferred stock with available cash or with the proceeds from sales of commercial paper, and re-financed this long-term debt and preferred stock through the sale of new long-term debt in the fourth quarter of 2003. Early redemption premiums are recognized as unamortized costs on debt redemptions pursuant to SFAS No. 71 and are amortized to expense over the life of the new debt.

Cash Flows

Operating Activities

Operations provided net cash of \$107 million in 2003 compared to \$124 million in 2002. The 14 percent decrease was due to a decrease in cash from operations before working capital changes (\$19 million), partially offset by an increase in working capital (\$2.1 million). The decrease in cash from operations before working capital changes compared to 2002 was primarily due to non-cash adjustments to net income in 2002, including the loss recorded for PGE

costs (\$13.9 million), combined with a decrease in other assets and liabilities (\$27.2 million) compared to an increase in 2002, and a decrease in deferred gas costs (\$5.6 million), partially offset by an adjustment to reverse the minimum pension liability recorded in 2002 (\$5.0 million), a larger increase in deferred income taxes and investment tax credits (\$18.7 million), higher net income from operations (\$2.2 million) and higher depreciation and amortization (\$2.2 million). The increase in working capital was primarily due to an increase in accrued interest and taxes compared to a decrease in 2002 (\$25.9 million), a decrease in inventories compared to an increase in 2002 (\$15.9 million), a larger increase in accounts payable (\$7.9 million) and a larger decrease in other current assets and liabilities (\$4.4 million), partially offset by increases in accounts receivable (\$23.1 million) and in accrued unbilled revenue (\$28.7 million), in both cases compared to decreases in 2002.

NW Natural's refunds to customers of approximately \$30.4 million of deferred gas cost savings in 2002 (see "Results of Operations - Comparison of Gas Operations," above) reduced cash flows from operations by that amount, but the reduction was more than offset by the other factors affecting cash flows cited above.

Continuing operations provided net cash of \$124 million in 2002 compared to \$72 million in 2001. The 73 percent increase was due to increased cash from operations before working capital changes (\$5.7 million) and lower working capital requirements (\$47 million). The increase in cash from operations before working capital changes was due to an increase in deferred income taxes and investment tax credits in 2002 compared to a reduction in 2001 (\$22.5 million), the loss provision for the PGE transaction costs (\$13.9 million) and higher depreciation and amortization (\$2.4 million), largely offset by a small increase in deferred gas cost payables in 2002 compared to a large swing from net gas cost receivables to payables in 2001 (\$26.5 million), and lower net income in 2002 (\$6.4 million). The decrease in working capital requirements was due to an increase in accounts payable in 2002 compared to a decrease in 2001 (\$44 million), a decrease in accrued unbilled revenue in 2002 compared to an increase in 2001 (\$26 million), and a decrease in accounts receivable in 2002 compared to an increase in 2001 (\$22 million), partially offset by a decrease in accrued interest and taxes in 2002 compared to an increase in 2001 (\$40 million) and a larger increase in inventories in 2002 (\$6.2 million).

The Company has lease and purchase commitments relating to its operating activities that are financed with cash flows from operations (see "Liquidity and Capital Resources," above, and Note 12).

The Job Creation and Worker Assistance Act of 2002 (the Assistance Act) combined with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the Reconciliation Act), allows an additional first-year tax depreciation deduction on the adjusted basis of "qualified property." The Assistance Act provides for an additional depreciation deduction equal to 30 percent of an asset's adjusted basis. The Reconciliation Act increased this first-year additional depreciation deduction to 50 percent of an asset's adjusted basis. The additional first-year depreciation deduction is an acceleration of depreciation deductions that otherwise would have been taken in the later years of an asset's recovery period. In general, the extra first-year depreciation deduction is available for most personal property acquired after Sept. 10, 2001, and before Sept. 11, 2004. The Company anticipates enhanced cash flow from reduced income taxes, totaling an estimated \$30 million to \$50 million, during the effective period, based on actual and projected plant investments between Sept. 11, 2001 and Sept. 10, 2004.

Investing Activities

Cash requirements for investing activities in 2003 totaled \$127 million, up from \$84 million in 2002. Cash requirements for acquisition and construction of utility plant totaled \$125 million, up from \$80

million in 2002. The increase in cash requirements for utility construction in 2003 was primarily the result of higher capital expenditures relating to NW Natural's SMPE project (\$27 million), higher system improvements and support (\$12 million) and other special projects to serve new customer load or new service areas (\$8.9 million).

Cash requirements for investing activities in 2002 totaled \$84 million, down from \$87 million in 2001, primarily due to lower amounts of cash used for investments in non-utility property (\$6.9 million) and for the PGE transaction (\$5.2 million), partially offset by higher amounts of cash used for the construction of utility plant (\$7.6 million) and lower cash proceeds from the sale of assets (\$2.8 million). Cash requirements for utility construction in 2002 totaled \$80 million, up from \$72 million in 2001, primarily as a result of capital expenditures related to NW Natural's pipeline safety program (\$4.7 million) and special projects expanding service to existing customers or into new service areas (\$3.4 million).

Investments in non-utility property totaled \$2.6 million in both 2003 and 2002, including expenditures in both years for certain improvements to the Company's gas pipeline system that were primarily related to interstate storage services.

During the five-year period 2004 through 2008, utility construction expenditures are estimated at between \$500 million and \$600 million. The level of capital expenditures over the next five years reflects projected customer growth, the SMPE project and system improvement projects resulting in part from requirements under the Pipeline Safety Improvement Act of 2002 (Pipeline Safety Act) (see below). An estimated 60 percent of the required funds are expected to be internally generated over the five-year period; the remainder will be funded through a combination of long-term debt and equity securities with short-term debt providing liquidity and bridge financing.

NW Natural's utility capital expenditures in 2004 are estimated to total \$165 million, including \$31 million for customer growth, \$38 million for system improvement and support, \$71 million for the SMPE and related gas storage projects, \$8 million for the construction of a gas distribution system in Coos County, Oregon and \$17 million for construction overhead.

The SMPE project has a scheduled completion date in late 2004. NW Natural must obtain easements and rights-of-way for the construction of the pipeline and may need to use condemnation proceedings to secure some of them.

NW Natural entered into a stipulation with the OPUC in 2001 for an enhanced pipeline safety program that includes an accelerated bare steel replacement program and a geo-hazard safety program. The bare steel replacement program accelerates the replacement of NW Natural's bare steel piping over 20 years instead of 40 years. The geo-hazard safety program includes the identification, assessment and remediation of risks to piping infrastructure created by landslides, washouts, earthquakes or similar occurrences. The stipulation allowed NW Natural to receive deferred accounting rate treatment commencing Oct. 1, 2002, for costs associated with the programs exceeding \$3 million per year, expected to be approximately \$1.5 million annually.

In December 2003, the U.S. Department of Transportation's Office of Pipeline Safety issued a rule that specifies the detailed requirements for transmission pipeline integrity management programs (IMPs) as mandated by the Pipeline Safety Act. The Pipeline Safety Act requires operators of gas transmission pipelines to identify lines located in High Consequence Areas (HCAs) and to develop IMPs to periodically inspect the integrity of the pipelines and make repairs or replacements as necessary to ensure the ongoing integrity of the pipelines. The legislation requires NW Natural to complete inspection of the 50 percent highest risk pipelines located in its HCAs within the first five years, and the remaining covered pipelines with-

in 10 years of the date of the enactment. The Pipeline Safety Act also requires re-inspections of the covered pipelines every seven years thereafter for the life of the pipelines. The capital and operating costs of compliance with the legislation and rules, and the accounting and regulatory treatments for these costs, are uncertain. Currently, however, NW Natural estimates that its IMP will cost \$5 million to \$8 million in 2004 and \$5 million to \$15 million per year beginning in 2005, totaling \$50 million to \$100 million over the next 10 years.

Financing Activities

Cash provided by financing activities in 2003 totaled \$17 million, compared to cash used in financing activities in 2002 of \$43 million. Factors contributing to the \$60 million difference were an increase in short-term debt in 2003 (\$15.4 million) compared to a decrease in 2002 (\$38.5 million) and the redemption of the \$6.95 Series of Preference Stock in 2002 (\$25 million), partially offset by a higher amount used for the retirement of long-term debt (\$55 million in 2003 compared to \$40.5 million in 2002) and the redemption of the \$7.125 Series of Preferred Stock in 2003 (\$8.4 million).

Cash used in financing activities in 2002 totaled \$43 million, compared to cash provided by financing activities in 2001 of \$15 million. Factors contributing to the \$58 million difference were a reduction in short-term debt in 2002 (\$38 million) compared to an increase in 2001 (\$52 million), the redemption of the \$6.95 Series of Preference Stock in 2002 (\$25 million), and a higher amount used for the retirement of long-term debt (\$40.5 million in 2002 compared to \$20 million in 2001), partially offset by an increase in long-term debt issued (\$90 million in 2002 compared to \$18 million in 2001) and a reduction in common stock repurchased (\$5.8 million).

NW Natural sold \$90 million of its secured Medium-Term Notes, Series B (MTNs) in each of 2003 and 2002 and used the proceeds to redeem long-term debt (\$55 million in 2003 and \$40.5 million in 2002), provide cash for investments in utility plant and reduce short-term borrowings.

In 2000, NW Natural commenced a program to repurchase up to 2 million shares, or up to \$35 million in value, of NW Natural's common stock through a repurchase program that has been extended through May 2004. The purchases are made in the open market or through privately negotiated transactions. No shares were repurchased in 2002 or in 2003. Since the program's inception the Company has repurchased 355,400 shares of common stock at a total cost of \$8.2 million.

Pension Cost (Income) and Funding Status

Net periodic pension cost is determined in accordance with SFAS No. 87, "Employers' Accounting for Pensions" (see "Application of Critical Accounting Policies - Accounting for Pensions," above). The annual pension cost or income is allocated between operations and maintenance expense and construction overhead.

Net periodic pension cost for the Company's qualified defined benefit pension plans was \$6.2 million in 2003, compared to net pension income of \$0.1 million and \$4.1 million in 2002 and 2001, respectively. The increase in pension cost was largely due to investment losses in 2001 and 2002, which are recognized over a three-year period, and to lower discount rates which had the effect of increasing accumulated benefit obligations. The Company is required to make a cash contribution of at least \$1.9 million, and may make an additional contribution up to a total of \$6.8 million, to its non-bargaining employee pension plan for the 2003 plan year, payable by Sept. 15, 2004. No cash contributions to the qualified plans were required for the 2002 or 2001 plan years. The fair value of the plan assets increased to \$168 million at Dec. 31, 2003, from \$143 million at Dec. 31, 2002, including \$36 million in investment gains, partially offset by \$10 million in withdrawals to pay benefits and \$0.9 million in eligible expenses of the plans. The present value of benefit obligations under the plans increased from an estimated \$172

million to \$192 million over that period, however, so the plans remained under-funded by about \$24 million at Dec. 31, 2003.

Despite the decline from a position of pension income in 2001 and 2002 to a position of pension expense in 2003, and the reductions in recent years in the funded status of the plans, NW Natural believes it will be able to maintain well-funded pension plans. NW Natural does not expect its current or future cash contributions to the plans to have a material adverse effect on its liquidity or financial condition.

Ratios of Earnings to Fixed Charges

For the years ended Dec. 31, 2003, 2002 and 2001, the Company's ratios of earnings to fixed charges, computed using the Securities and Exchange Commission method, were 2.83, 2.74 and 3.01, respectively. For this purpose, earnings consist of net income before taxes plus fixed charges, and fixed charges consist of interest on all indebtedness, dividends on all preferred and preference stock, the amortization of debt expense and discount or premium and the estimated interest portion of rentals charged to income.

CONTINGENT LIABILITIES

Environmental Matters

The Company is subject to federal, state and local laws and regulations related to environmental matters. These evolving laws and regulations may require expenditures over a long timeframe to control environmental impacts. The Company believes, at this time, that appropriate investigation or remediation is being undertaken at all the relevant sites. Based on existing knowledge, the Company does not expect that the ultimate resolution of these matters will have a material adverse effect on its financial condition, results of operations or cash flows. See Note 12.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary market risk exposures associated with activities involving derivative financial instruments and other financial instruments are natural gas commodity price risk, foreign currency exchange risk and interest rate risk. Derivative financial instruments are used as tools to mitigate certain of these market risks (see Notes 1 and 11). Such instruments are used for hedging purposes, not for trading purposes. Market risks associated with the derivative financial instruments are monitored by management personnel who do not directly enter into these contracts and by the Audit Committee of the Board of Directors.

Physical and Financial Commodity, Foreign Currency and Interest Rate Transactions

NW Natural enters into short-term and long-term natural gas purchase contracts with demand and commodity fixed-price and floating-price components, along with associated short-term and long-term natural gas transportation contracts. Foreign currency forward contracts are used to hedge against foreign exchange rate fluctuations on purchases made under these contracts that are denominated in Canadian dollars.

Historically, NW Natural has taken physical delivery of at least the minimum quantities specified in its natural gas purchase contracts. The contracts are subject to annual re-pricing, a process that is intended to reflect anticipated market price trends during the next year. NW Natural's PGA mechanism in Oregon provides for the recovery from customers of actual commodity costs in comparison with established benchmark costs, except that NW Natural absorbs 33 percent of the higher cost of gas sold, or retains 33 percent of the lower cost, in either case as compared to projections.

At Dec. 31, 2003, differences between notional values and fair values with respect to NW Natural's open positions in derivative financial instruments were not material to the Company's financial position or results of operations because of the treatment of these instruments in regulatory mechanisms relating to gas costs (see "Results of Operations – Comparison of Gas Operations – Cost of Gas," above, and Notes 1 and 11).

To the degree that market risks exist due to potential adverse changes in commodity prices, foreign exchange rates and interest rates in relation to these financial and physical contracts, the Company considers the risks to be:

Commodity Price Risk

The prices of natural gas commodity are subject to fluctuations due to unpredictable factors including weather, pipeline transportation congestion and other factors that affect short-term supply and demand. Commodity swap and call option contracts (also known as financial hedge contracts) are used to convert certain natural gas purchase contracts from floating prices to fixed prices. At Dec. 31, 2003 and 2002, notional amounts under these commodity swap and call option contracts totaled \$304.1 million and \$180.6 million, respectively. At Dec. 31, 2003, five of these commodity hedge contracts extended beyond Dec. 31, 2004. If all of the commodity swap and call option contracts had been settled on Dec. 31, 2003, a regulatory gain of \$23.7 million would have been realized (see Note 11).

Foreign Currency Risk

The costs of natural gas commodity and certain pipeline services purchased from Canadian suppliers are subject to changes in the value of Canadian currency in relation to U.S. currency. Foreign currency forward contracts are used to hedge against fluctuations in exchange rates with respect to purchases of natural gas from Canadian suppliers. At Dec. 31, 2003 and 2002, notional amounts under foreign currency forward contracts totaled \$6.4 million and \$15.5 million, respectively. As of Dec. 31, 2003, no foreign currency forward contracts extended beyond Dec. 31, 2004. If all of the foreign currency forward contracts had been settled on Dec. 31, 2003, a gain of \$0.2 million would have been realized (see Note 11).

Interest Rate Risk

Interest rate risk relates to new debt financing needed to fund capital requirements, including maturing debt securities, and to the issuance of commercial paper. Interest rate risk is managed through the issuance of fixed-rate debt with varying maturities and the reduction of debt through optional redemption when interest rates are favorable. No derivative financial instruments to hedge interest rates were in place at Dec. 31, 2003 or 2002.

Report of Independent Auditors

To the Board of Directors and Shareholders
of Northwest Natural Gas Company:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of earnings invested in the business, of cash flows and of capitalization present fairly, in all material respects, the financial position of Northwest Natural Gas Company (doing business at NW Natural) and its subsidiaries (the "Company") at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PRICEWATERHOUSECOOPERS 

Portland, Oregon
February 26, 2004

Consolidated Statements of Income

<i>Thousands, except per share amounts (year ended December 31)</i>	2003	2002	2001
Operating revenues:			
Gross operating revenues	\$ 611,256	\$ 641,376	\$ 650,252
Cost of sales	<u>323,190</u>	<u>353,832</u>	<u>374,241</u>
Net operating revenues	<u>288,066</u>	287,544	276,011
Operating expenses:			
Operations and maintenance	96,420	85,120	83,920
Taxes other than income taxes	35,125	34,076	32,240
Depreciation and amortization	<u>54,249</u>	<u>52,090</u>	<u>49,640</u>
Total operating expenses	<u>185,794</u>	<u>171,286</u>	<u>165,800</u>
Income from operations	102,272	116,258	110,211
Other income (expense)	2,150	(14,890)	1,334
Interest charges – net of amounts capitalized	35,099	<u>34,132</u>	<u>33,805</u>
Income before income taxes	69,323	67,236	77,740
Income tax expense	23,340	<u>23,444</u>	<u>27,553</u>
Net income	45,983	43,792	50,187
Redeemable preferred and preference stock dividend requirements	294	2,280	2,401
Earnings applicable to common stock	\$ 45,689	<u>\$ 41,512</u>	<u>\$ 47,786</u>
Average common shares outstanding:			
Basic	25,741	25,431	25,159
Diluted	26,061	25,814	25,612
Earnings per share of common stock:			
Basic	\$ 1.77	\$ 1.63	\$ 1.90
Diluted	\$ 1.76	\$ 1.62	\$ 1.88

See Notes to Consolidated Financial Statements.

Consolidated Statements of Earnings Invested in the Business and Comprehensive Income

<i>Thousands (year ended December 31)</i>	2003		2002		2001	
Earnings invested in the business:						
Balance at beginning of year	\$ 157,136		\$ 147,950		\$ 134,189	
Net income	45,983	\$ 45,983	43,792	\$ 43,792	50,187	\$ 50,187
Cash dividends paid:						
Redeemable preferred and preference stock	(392)		(2,579)		(2,410)	
Common stock	(32,655)		(32,024)		(31,307)	
Common stock repurchased	–		–		(2,688)	
Common stock expense	<u>(19)</u>		<u>(3)</u>		<u>(21)</u>	
Balance at end of year	<u>\$ 170,053</u>		<u>\$ 157,136</u>		<u>\$ 147,950</u>	
Accumulated other comprehensive income (loss):						
Balance at beginning of year	\$ (3,084)		\$ (375)		\$ –	
Other comprehensive income (loss) – net of tax:						
Minimum pension liability adjustment	2,068	2,068	(2,936)	(2,936)	(148)	(148)
Change in unrealized loss from price risk management activities	–	–	227	227	(227)	(227)
Comprehensive income	<u>–</u>	<u>\$ 48,051</u>	<u>–</u>	<u>\$ 41,083</u>	<u>(227)</u>	<u>(227)</u>
Balance at end of year	<u>\$ (1,016)</u>		<u>\$ (3,084)</u>		<u>\$ (375)</u>	

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheets

<i>Thousands (December 31)</i>	2003	2002
Assets:		
Plant and property:		
Utility plant	\$ 1,659,089	\$ 1,539,965
Less accumulated depreciation	471,716	435,601
Utility plant – net	<u>1,187,373</u>	<u>1,104,364</u>
Non-utility property	23,395	20,832
Less accumulated depreciation and amortization	4,855	4,404
Non-utility property – net	<u>18,540</u>	<u>16,428</u>
Total plant and property	<u>1,205,913</u>	<u>1,120,792</u>
Other investments	<u>12,635</u>	<u>12,703</u>
Current assets:		
Cash and cash equivalents	4,706	7,328
Accounts receivable, less allowance for uncollectible accounts of \$1,763 in 2003 and \$1,815 in 2002	52,213	46,936
Accrued unbilled revenue	59,109	44,069
Inventories of gas, materials and supplies	50,859	58,030
Prepayments and other current assets	32,661	36,934
Total current assets	<u>199,548</u>	<u>193,297</u>
Regulatory assets:		
Income tax asset	63,449	47,975
Unamortized costs on debt redemptions	7,803	6,508
Other	6,020	7,040
Total regulatory assets	<u>77,272</u>	<u>61,523</u>
Other assets:		
Investment in life insurance	59,710	54,916
Fair value of non-trading derivatives	23,885	12,426
Other	12,369	11,620
Total other assets	<u>95,964</u>	<u>78,962</u>
Total assets	<u>\$ 1,591,332</u>	<u>\$ 1,467,277</u>
Capitalization and liabilities:		
Capitalization		
Common stock	\$ 82,137	\$ 81,023
Premium on common stock	255,871	248,028
Earnings invested in the business	170,053	157,136
Unearned stock compensation	(729)	(711)
Accumulated other comprehensive income (loss)	(1,016)	(3,084)
Total common stock equity	<u>506,316</u>	<u>482,392</u>
Redeemable preferred stock	–	8,250
Long-term debt	<u>500,319</u>	<u>445,945</u>
Total capitalization	<u>1,006,635</u>	<u>936,587</u>
Current liabilities:		
Notes payable	85,200	69,802
Accounts payable	86,029	74,436
Long-term debt due within one year	–	20,000
Taxes accrued	8,605	7,822
Interest accrued	2,998	2,902
Other current and accrued liabilities	31,589	30,045
Total current liabilities	<u>214,421</u>	<u>205,007</u>
Regulatory liabilities:		
Accrued asset removal costs	135,638	125,197
Customer advances	1,564	1,791
Deferred gas costs payable	5,627	10,635
Unrealized gain on non-trading derivatives	23,885	12,426
Total regulatory liabilities	<u>166,714</u>	<u>150,049</u>
Other liabilities:		
Deferred income taxes	171,797	141,732
Deferred investment tax credits	6,945	7,824
Other	24,820	26,078
Total other liabilities	<u>203,562</u>	<u>175,634</u>
Commitments and contingencies (see Note 12)	–	–
Total capitalization and liabilities	<u>\$ 1,591,332</u>	<u>\$ 1,467,277</u>

See Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

<i>Thousands (year ended December 31)</i>	2003	2002	2001
Operating activities:			
Net income from operations	\$ 45,983	\$ 43,792	\$ 50,187
Adjustments to reconcile net income to cash provided by operations:			
Depreciation and amortization	54,249	52,090	49,640
(Gain) loss on sale of assets	10	(221)	-
Loss for PGE acquisition costs	-	13,873	-
Minimum pension liability adjustment	2,068	(2,936)	(148)
Unrealized gain (loss) from price risk management activities	-	227	(227)
Deferred income taxes and investment tax credits	29,186	10,450	(12,088)
Undistributed (earnings) losses from equity investments	(474)	(988)	321
Allowance for funds used during construction	(1,734)	(550)	(959)
Deferred gas costs - net	(5,008)	546	27,062
Other	(22,599)	4,582	1,345
Cash from operations before working capital changes	101,681	120,865	115,133
Changes in operating assets and liabilities:			
Accounts receivable - net of allowance for uncollectible accounts	(5,277)	17,786	(3,969)
Accrued unbilled revenue	(15,040)	13,680	(12,130)
Inventories of gas, materials and supplies	7,171	(8,693)	(2,454)
Accounts payable	11,593	3,738	(40,000)
Accrued interest and taxes	1,145	(24,725)	15,435
Other current assets and liabilities	5,533	1,176	(494)
Cash provided by operating activities	106,806	123,827	71,521
Investing activities:			
Acquisition and construction of utility plant assets	(124,660)	(79,530)	(71,943)
Investment in non-utility property	(2,563)	(2,629)	(9,554)
PGE acquisition costs	-	(4,316)	(9,557)
Proceeds from sale of assets	18	500	3,256
Other investments	542	1,848	529
Cash used in investing activities	(126,663)	(84,127)	(87,269)
Financing activities:			
Common stock issued	8,331	6,533	5,157
Common stock repurchased	-	-	(5,792)
Redeemable preferred and preference stock retired	(8,428)	(25,750)	(750)
Long-term debt issued	90,000	90,000	18,000
Long-term debt retired	(55,000)	(40,500)	(20,000)
Change in short-term debt	15,398	(38,489)	52,028
Cash dividend payments:			
Redeemable preferred and preference stock	(392)	(2,579)	(2,410)
Common stock	(32,655)	(32,024)	(31,307)
Common stock expense	(19)	(3)	(21)
Cash provided by (used in) financing activities	17,235	(42,812)	14,905
Decrease in cash and cash equivalents	(2,622)	(3,112)	(843)
Cash and cash equivalents - beginning of year	7,328	10,440	11,283
Cash and cash equivalents - end of year	\$ 4,706	\$ 7,328	\$ 10,440
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest and preferred dividends	\$ 35,210	\$ 34,640	\$ 33,034
Income taxes	\$ 13,940	\$ 33,474	\$ 25,201
Supplemental disclosure of non-cash financing activities:			
Conversion to common stock:			
7-1/4% Series of Convertible Debentures	\$ 626	\$ 1,932	\$ 413

See Notes to Consolidated Financial Statements.

Consolidated Statements of Capitalization

<i>Thousands, except share amounts (December 31)</i>	2003		2002	
Common stock equity:				
Common stock – par value \$3-1/6 per share, authorized 60,000,000 shares: outstanding – 2003, 25,938,002 shares; 2002, 25,586,313 shares	\$ 82,137		\$ 81,023	
Premium on common stock	255,871		248,028	
Earnings invested in the business	170,053		157,136	
Unearned compensation	(729)		(711)	
Accumulated other comprehensive income (loss)	(1,016)		(3,084)	
Total common stock equity	<u>506,316</u>	50%	<u>482,392</u>	51%
Redeemable preferred stock, authorized 1,500,000 shares:				
\$7.125 Series, stated value \$100 per share; outstanding – 2003, none; 2002, 82,500 shares	–	0%	8,250	1%
Long-term debt:				
Medium-Term Notes				
First Mortgage Bonds:				
6.400% Series B due 2003	–		20,000	
6.340% Series B due 2005	5,000		5,000	
6.380% Series B due 2005	5,000		5,000	
6.450% Series B due 2005	5,000		5,000	
6.050% Series B due 2006	8,000		8,000	
6.310% Series B due 2007	20,000		20,000	
6.800% Series B due 2007	9,500		9,500	
6.500% Series B due 2008	5,000		5,000	
4.110% Series B due 2010	10,000		–	
7.450% Series B due 2010	25,000		25,000	
6.665% Series B due 2011	10,000		10,000	
7.130% Series B due 2012	40,000		40,000	
8.260% Series B due 2014	10,000		10,000	
7.000% Series B due 2017	40,000		40,000	
6.600% Series B due 2018	22,000		22,000	
8.310% Series B due 2019	10,000		10,000	
7.630% Series B due 2019	20,000		20,000	
9.050% Series A due 2021	10,000		10,000	
5.620% Series B due 2023	40,000		–	
7.250% Series B due 2023	–		20,000	
7.500% Series B due 2023	–		4,000	
7.520% Series B due 2023	–		11,000	
7.720% Series B due 2025	20,000		20,000	
6.520% Series B due 2025	10,000		10,000	
7.050% Series B due 2026	20,000		20,000	
7.000% Series B due 2027	20,000		20,000	
6.650% Series B due 2027	20,000		20,000	
6.650% Series B due 2028	10,000		10,000	
7.740% Series B due 2030	20,000		20,000	
7.850% Series B due 2030	10,000		10,000	
5.820% Series B due 2032	30,000		30,000	
5.660% Series B due 2033	40,000		–	
Convertible Debentures				
7-1/4% Series due 2012	5,819		6,445	
	<u>500,319</u>		<u>465,945</u>	
Less long-term debt due within one year	–		<u>20,000</u>	
Total long-term debt	<u>500,319</u>	50%	<u>445,945</u>	48%
Total capitalization	<u>\$ 1,006,635</u>	<u>100%</u>	<u>\$ 936,587</u>	<u>100%</u>

See Notes to Consolidated Financial Statements.

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**Organization and Principles of Consolidation**

The consolidated financial statements include the accounts of:
Regulated utility:

- Northwest Natural Gas Company (NW Natural)

Non-regulated wholly-owned subsidiaries of NW Natural:

- NNG Financial Corporation (Financial Corporation), and its wholly-owned subsidiaries

- Northwest Energy Corporation (Northwest Energy), and its wholly-owned subsidiary

Together these businesses are referred to herein as the Company (see Note 2). Intercompany accounts and transactions have been eliminated.

Investments in corporate joint ventures and partnerships in which the Company's ownership interest is 50 percent or less and over which the Company does not exercise control are accounted for by the equity method or the cost method (see Note 9).

Certain amounts from prior years have been reclassified to conform, for comparison purposes, with the current financial statement presentation. These reclassifications had no impact on prior year consolidated results of operations.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect reported amounts in the consolidated financial statements and accompanying notes. Actual amounts could differ from those estimates, and changes would be reported in future periods. Management believes that the estimates and assumptions used are reasonable.

Industry Regulation

The Company's principal business is the distribution of natural gas, which is regulated by the Public Utility Commission of Oregon (OPUC) and the Washington Utilities and Transportation Commission (WUTC). Accounting records and practices conform to the requirements and uniform system of accounts prescribed by these regulatory authorities in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation."

In applying SFAS No. 71, NW Natural capitalizes certain costs and revenues as regulatory assets and liabilities pursuant to orders of the OPUC or WUTC in general rate or expense deferral proceedings, to provide for recovery of revenues or expenses from, or refunds to, utility customers in future periods. At Dec. 31, 2003 and 2002, the amounts deferred as regulatory assets and liabilities were net liabilities of \$89.4 million and \$88.5 million, respectively. The net amounts recognized at Dec. 31, 2003 and 2002 include \$135.6 million and \$125.2 million, respectively, of accumulated removal costs, which have been reclassified from accumulated depreciation to regulatory liabilities at Dec. 31, 2003, in accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations" (see "New Accounting Standards," below). In addition, the "Income tax asset" balance increased by \$15.5 million primarily reflecting the grossed-up tax benefit of removal costs passed through in rate base after Dec. 31, 1992.

If NW Natural should determine that all or a portion of these regulatory assets or liabilities no longer meet the criteria for continued application of SFAS No. 71, then it would be required to write off the net unrecoverable balances against earnings.

New Accounting Standards**Adopted Standards**

Effective Jan. 1, 2003, the Company adopted SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires the recognition of an Asset Retirement Obligation (ARO) for

legal obligations associated with the retirement of tangible long-lived assets, including the recording of fair value of the liability, if reasonably estimable, for an ARO in the period in which it is incurred. The ARO liability is recorded and the cost is capitalized as part of the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period and the capitalized cost is depreciated over the useful life of the related asset. The Company did not have any material legal obligations associated with the retirement of its tangible long-lived assets, except for certain assets with indefinite system lives for which the Company cannot estimate the ARO because the settlement date is indeterminable. However, the Company's adoption of SFAS No. 143 did result in a balance sheet reclassification of asset removal cost obligations from accumulated depreciation and amortization to regulatory liabilities (see "Plant and Property," below, for a discussion of the Company's policy on asset removal costs).

Also effective Jan. 1, 2003, the Company adopted SFAS No. 145, "Rescission of FASB Statement Nos. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which replaces Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 145, which updates, clarifies and simplifies existing accounting pronouncements, addresses the reporting of debt extinguishments and accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities, such as lease termination costs and certain employee severance costs, when they are incurred rather than at the date of a commitment to an exit or disposal plan. The primary effect of applying SFAS No. 146, which was effective for all exit or disposal activities initiated after Dec. 31, 2002, is on the timing of recognition of costs associated with exit or disposal activities. The adoption of SFAS Nos. 145 and 146 did not have a material impact on the Company's financial condition or results of operations.

Also effective Jan. 1, 2003, the Company adopted the disclosure requirements of SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment to FASB Statement No. 123," but continues to account for its stock-based compensation plans using the intrinsic value method prescribed in Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," rather than adopt a fair value method of accounting for its stock-based employee compensation. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value method. In addition, SFAS No. 148 requires prominent disclosures in annual and interim financial statements about the accounting method used for stock-based employee compensation and its effect on reported results. SFAS No. 148 encourages, but does not require, companies to record compensation expense using the fair value method of accounting. The adoption of SFAS No. 148 did not have a material impact on the Company's financial condition or results of operations, and it would not have had a material impact if the Company had elected to adopt a fair value method of accounting for stock-based compensation (see "Stock-Based Compensation," below, and Note 4).

Effective July 1, 2003, the Company adopted SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 primarily amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," to clarify the definition of a derivative and to require derivative instruments that include up-front cash payments to be classified as financing activity in the statement of cash flows. SFAS No. 149

is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 did not have a material impact on the Company's financial condition or results of operations.

Also effective July 1, 2003, the Company adopted SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures in its financial statements certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires an issuer to classify a financial instrument as a liability if that financial instrument embodies an obligation of the issuer. The adoption of SFAS No. 150 resulted in the Company's reclassifying dividends of \$0.2 million after July 1, 2003 on its redeemable preferred stock as interest expense, thus affecting the Company's reported net income for 2003. The Company redeemed its last remaining shares of preferred stock outstanding during the fourth quarter of 2003. The adoption of SFAS No. 150 did not have a material impact on the Company's financial condition or results of operations.

In December 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106." SFAS No. 132 requires that expanded disclosures on pension and other postretirement benefit plans be included in financial statements for fiscal years ending on or after Dec. 15, 2003. The Company has adopted SFAS No. 132. See Note 7.

In November 2002, the FASB issued FASB Interpretation No. (FIN) 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 clarifies the requirements of FASB Statement No. 5, "Accounting for Contingencies," relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. A guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee and provide additional disclosures about the obligations associated with guarantees issued. In connection with the settlement of litigation involving leases in the Mist gas storage field, NW Natural agreed to defend and indemnify a party against claims relating to the validity and enforceability of certain transferred leases. However, NW Natural has no obligation to defend or indemnify the party from any claims for recovery of punitive or other exemplary damages. The Company has provided no other guarantees of indebtedness of others. Accordingly, the application of FIN 45 did not have a material impact on the Company's financial condition or results of operations.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." FIN 46 provides guidance on the identification of, and the financial reporting for, entities over which control is achieved through means other than voting rights, known as "variable interest entities." FIN 46 provides guidance for determining whether consolidation is required. Certain variable interest entities must be consolidated by the primary beneficiary if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 was effective immediately for all new variable interest entities created or acquired after Jan. 31, 2003. The Company did not have any significant interests in any variable interest entities during any of the current reporting periods. The application of FIN 46 had no material impact on the Company's financial condition or results of operations.

Plant and Property

Plant and property is stated at cost, including labor, materials and overhead (see Note 9). The cost of utility plant and interstate storage includes an allowance for funds used during construction

in construction overhead to represent the net cost of borrowed funds used for construction purposes (see "Allowance for Funds Used During Construction," below).

NW Natural's provision for depreciation of utility property is computed under the straight-line, age-life method in accordance with independent engineering studies and as approved by regulatory authorities. The average depreciation rate was approximately 3.5 percent for each of the years 2003, 2002 and 2001. The depreciation rate reflects the approximate economic life of the utility property.

Effective Jan. 1, 2003, the Company adopted SFAS No. 143 (see "New Accounting Standards," above). Among other things, SFAS No. 143 requires that future asset retirement costs (removal costs) that meet the requirements of SFAS No. 71, as amended and supplemented, be classified as a regulatory liability. In accordance with long-standing industry practice, the Company accrues for future removal costs on many long-lived assets through a charge to depreciation expense allowed in rates. Prior to the adoption of SFAS No. 143, the resulting regulatory liabilities were recognized as accruals to accumulated depreciation. At the time when removal costs were incurred, accumulated depreciation was charged with the costs of removal and the book cost of the asset being retired. Upon the adoption of SFAS No. 143, the Company reclassified on its Dec. 31, 2003 and 2002 consolidated balance sheets \$135.6 million and \$125.2 million, respectively, of previously accrued asset removal costs recovered through rates from accumulated depreciation and amortization to regulatory liabilities – accrued asset removal costs. This reclassification is based on the Company's estimate of accumulated removal costs using its most recent depreciation study. The Company will continue to accrue future asset removal costs through depreciation expense, with a corresponding credit to regulatory liabilities – accrued asset removal costs. When the Company retires depreciable utility plant and equipment, it will charge the associated original costs to accumulated depreciation and amortization, and any related removal costs incurred will be charged to regulatory liabilities – accrued asset removal costs. No gain or loss is recognized upon normal retirement. In the rate setting process, the accrued asset removal costs are treated as a reduction to the net rate base.

Allowance for Funds Used During Construction

Certain additions to utility plant include an allowance for funds used during construction (AFUDC). AFUDC represents the cost of funds borrowed during construction and is calculated using actual commercial paper interest rates. If commercial paper borrowings are less than the total costs of construction work in progress, then a composite rate of interest on all debt, shown as a reduction to interest charges, and a return on equity funds, shown as other income, is used to compute AFUDC. While cash is not realized currently from AFUDC, it is realized in future years through increased revenues from rate recovery resulting from higher rate base and higher depreciation expense. NW Natural's composite AFUDC rates were 4.5 percent in 2003, 2.8 percent in 2002 and 6.2 percent in 2001.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand and highly liquid temporary investments with original maturity dates of three months or less.

Revenue Recognition

Utility revenues, derived primarily from the sale and transportation of natural gas, are recognized when the gas is delivered to and received by the customer. Revenues include accruals for gas delivered but not yet billed to customers based on estimates of gas deliveries from meter reading dates to month end (unbilled revenues). Unbilled revenues are dependent upon a number of factors that require management judgment, including total gas receipts and

deliveries, customer use and weather. Unbilled revenues are reversed the following month when actual billings occur. The Company's accrued unbilled revenues at Dec. 31, 2003 and 2002 were \$59.1 million and \$44.1 million, respectively.

Non-utility revenues, derived primarily from gas storage services, are recognized upon delivery of the service to customers. Revenues from optimization of excess storage and transportation capacity are recognized over the life of the contract for guaranteed amounts under the contract, or are recognized as earned for amounts above the guaranteed value.

Inventories

Inventories, consisting primarily of natural gas in storage, are stated at the lower of average cost or net realizable value.

Derivatives Policy

NW Natural's Derivatives Policy sets forth the guidelines for using selected financial derivative products to support prudent risk management strategies within designated parameters. The Derivatives Policy allows for the use of derivatives to manage natural gas commodity prices related to natural gas purchases, foreign currency prices related to gas purchase commitments from Canada, oil or propane commodity prices related to gas sales and transportation services under rate schedules pegged to other commodities, and interest rates related to long-term debt maturing in less than five years or expected to be issued in future periods. NW Natural's objective for using derivatives is to decrease the volatility of earnings and cash flows associated with changes in commodity prices, foreign currency prices and interest rates. The use of derivatives is permitted only after the commodity price, exchange rate, and interest rate exposures have been identified, are determined to exceed acceptable tolerance levels and are considered to be unavoidable because they are necessary to support normal business activities (see Note 11). The Policy is intended to prevent speculative risk. NW Natural does not enter into derivative instruments for trading purposes and believes that any increase in market risk created by holding derivatives should be offset by the exposures they modify.

In accounting for derivative activities, the Company applies SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," and SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," (collectively referred to as SFAS No. 133). SFAS No. 133 requires that the Company recognize derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. SFAS No. 133 also requires that changes in the fair value of a derivative be recognized currently in earnings unless specific hedge accounting criteria are met. SFAS No. 133 provides an exception for contracts intended for normal purchase and normal sale, other than a financial instrument or derivative instrument for which physical delivery is probable. Many of the Company's gas supply and transportation contracts are considered derivative instruments as defined under SFAS No. 133, but qualify for the normal purchase and normal sale exception.

NW Natural designates its derivatives as fair value or cash flow hedges based upon the criteria established by SFAS No. 133. For fair value hedges, the gain or loss is recognized in earnings in the period of change. For cash flow hedges, the effective portion of the gain or loss is initially reported in accumulated other comprehensive income (OCI), unless the derivative is subject to deferral under NW Natural's regulated tariffs with the OPUC or the WUTC. The ineffective portion of the gain or loss in a cash flow hedge is recognized in current earnings, but only to the extent that the amount is not covered under NW Natural's regulatory deferral mechanism. Effectiveness is measured by comparing changes in cash flows of the hedged item to gains or losses on derivative instruments.

NW Natural's primary hedging activities, consisting of natural gas commodity price and foreign currency exchange rate hedges, are principally accounted for as cash flow hedges under SFAS No. 133 and are subject to regulatory deferral under SFAS No. 71. Unrealized gains and losses from mark-to-market valuations of these contracts are not recognized in current income but are reported as derivative assets or liabilities and offset by a corresponding deferred account balance included under "regulatory liabilities" or "regulatory assets." Due to their regulatory deferral treatment, effective portions of changes in the fair value of these derivatives are not recorded in OCI but are recognized as a regulatory asset or liability.

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, the Company recognizes deferred income taxes for all temporary differences between the financial statement and tax basis of assets and liabilities at current income tax rates. Deferred tax liabilities and assets reflect the expected future tax consequences, based on enacted tax law, of temporary differences between the tax basis of assets and liabilities and their financial reporting amounts (see Note 8).

SFAS No. 109 also requires recognition of the additional deferred income tax assets and liabilities for temporary differences where regulators prohibit deferred income tax treatment for ratemaking purposes. Consistent with rate and accounting orders of regulatory authorities, deferred income taxes are not currently collected for those temporary income tax differences where the prescribed regulatory accounting methods do not provide for current recovery in rates. NW Natural has recorded a regulatory tax asset for amounts pending recovery from customers in future rates, equivalent to \$63.4 million and \$48 million at Dec. 31, 2003 and 2002, respectively. These amounts are primarily based on differences between the book and tax bases of net utility plant in service.

Investment tax credits on utility plant additions and leveraged leases, which reduce income taxes payable, are deferred for financial statement purposes and are amortized over the life of the related plant or lease. Investment and energy tax credits generated by non-regulated subsidiaries are amortized over a period of one to five years.

Other Income (Expense)

Other income (expense) consists of interest income, gain on sale of assets, investment income of Financial Corporation, the costs incurred in connection with the Company's effort to acquire Portland General Electric Company (PGE) from Enron Corp. and other miscellaneous income from merchandise sales, rents, leases and other items.

Earnings Per Share

Basic earnings per share are computed based on the weighted average number of common shares outstanding each year. Diluted earnings per share reflect the potential effects of the conversion of convertible debentures and the exercise of stock options. Diluted earnings are calculated as follows:

<i>Thousands, except per share amounts</i>	2003	2002	2001
Net income	\$ 45,983	\$ 43,792	\$ 50,187
Redeemable preferred and preference stock dividend requirements	294	2,280	2,401
Earnings applicable to common stock - basic	45,689	41,512	47,786
Debt interest less taxes	257	285	370
Earnings applicable to common stock - diluted	\$ 45,946	\$ 41,797	\$ 48,156
Average common shares outstanding - basic	25,741	25,431	25,159
Stock options	28	59	32
Convertible debentures	292	324	421
Average common shares outstanding - diluted	26,061	25,814	25,612
Earnings per share of common stock - basic	\$ 1.77	\$ 1.63	\$ 1.90
Earnings per share of common stock - diluted	\$ 1.76	\$ 1.62	\$ 1.88

Notes to Consolidated Financial Statements

For the years ended Dec. 31, 2003, 2002 and 2001, 77,500 shares, 84,000 shares and 138,491 shares, respectively, representing the number of stock options the exercise prices for which were greater than the average market prices for the Company's common stock for such years, were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

Stock-Based Compensation

The Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," to account for its stock-based compensation plans. Accordingly, the Company does not recognize compensation expense for the fair value of its stock option grants. Instead, the Company has elected to continue using the intrinsic value method of accounting for stock options rather than adopting the fair value method of accounting. However, the Company does recognize compensation expense for the fair value of stock awards granted under its Long-Term Incentive Plan and Non-Employee Directors Stock Compensation Plan in the period when shares are earned (see Note 4).

2 CONSOLIDATED SUBSIDIARY OPERATIONS AND SEGMENT INFORMATION:

At Dec. 31, 2003, the Company had two direct, wholly-owned subsidiaries, Financial Corporation and Northwest Energy. Northwest Energy was formed in 2001 to serve as the holding company for NW Natural and PGE if the acquisition of PGE had been completed. Since the acquisition of PGE has been terminated, Northwest Energy remains a non-active subsidiary of the Company.

The Company's core business is the distribution and sale of natural gas ("Utility" segment). Another segment, "Gas Storage," represents natural gas storage services provided to interstate customers, including asset optimization services under a contract with an independent energy trading company. The remaining business segment, "Other," primarily consists of non-regulated investments in alternative energy projects in California (see "Financial Corporation," below), a Boeing 737-300 aircraft leased to Continental Airlines and Northwest Energy's limited acquisition activities (see Note 9).

Gas Storage

Gas storage services are provided to off-system interstate customers using Company-owned storage capacity that has been developed in advance of core utility customers' (residential, commercial and industrial firm) requirements. NW Natural retains 80 percent of the income before tax from gas storage services and credits the remaining 20 percent to a deferred regulatory account for sharing with its core utility customers.

Results for the gas storage segment also include revenues, net of amounts shared with core utility customers, from a contract with an independent energy trading company that seeks to optimize the use of NW Natural's assets by trading temporarily unused portions of its gas storage capacity and upstream pipeline transportation capacity. NW Natural retains 80 percent of the pre-tax income from the optimization of storage and pipeline transportation capacity when the costs of such capacity have not been included in core utility rates, or 33 percent of the pre-tax income from such capacity when the costs have been included in core utility rates. The remaining 20 percent and 67 percent, respectively, are credited to a deferred regulatory account for distribution to NW Natural's core utility customers.

Financial Corporation

Financial Corporation has several financial investments, including investments as a limited partner in solar electric generating systems, windpower electric generating projects and low-income housing projects. Financial Corporation's total assets were \$8.0 million and \$11.6 million at Dec. 31, 2003 and 2002, respectively.

Segment Information Summary

The following table presents summary financial information about the reportable segments for 2003, 2002 and 2001. Inter-segment transactions are insignificant.

Thousands	Utility	Gas Storage	Other	Total
2003				
Net operating revenues	\$ 278,856	\$ 9,036	\$ 174	\$ 288,066
Depreciation and amortization	53,798	451	-	54,249
Other operating expenses	130,619	804	122	131,545
Income from operations	94,439	7,781	52	102,272
Income from financial investments	3,406	-	474	3,880
Net income	40,913	4,312	758	45,983
Total assets at Dec. 31, 2003	1,558,342	18,464	14,526	1,591,332
2002				
Net operating revenues	\$ 279,414	\$ 7,944	\$ 186	\$ 287,544
Depreciation and amortization	51,693	396	1	52,090
Other operating expenses	118,156	962	78	119,196
Income from operations	109,565	6,586	107	116,258
Income from financial investments	1,390	-	988	2,378
Loss provision for PGE transaction costs	-	-	(8,414)	(8,414)
Net income (loss)	47,280	3,646	(7,134)	43,792
Total assets at Dec. 31, 2002	1,432,776	16,403	18,098	1,467,277
2001				
Net operating revenues	\$ 271,473	\$ 4,368	\$ 170	\$ 276,011
Depreciation and amortization	49,413	227	-	49,640
Other operating expenses (income)	115,708	489	(37)	116,160
Income from operations	106,352	3,652	207	110,211
Income (loss) from financial investments	1,646	-	(321)	1,325
Net income	47,233	2,112	842	50,187
Total assets at Dec. 31, 2001	1,506,787	14,243	29,623	1,550,653

3 CAPITAL STOCK:

Common Stock

At Dec. 31, 2003, NW Natural had reserved 134,240 shares of common stock for issuance under the Employee Stock Purchase Plan, 353,059 shares for future conversions of its 7-1/4% Convertible Debentures, 389,951 shares under its Dividend Reinvestment and Stock Purchase Plan, 1,751,544 shares under its Restated Stock Option Plan (see Note 4), and 3,000,000 shares under the Shareholder Rights Plan.

Redeemable Preferred Stock

On Nov. 14, 2003, NW Natural redeemed all of the remaining shares of its \$7.125 Series of Redeemable Preferred Stock with an aggregate stated value of \$7.5 million, at a redemption price equivalent to 102.375 percent with proceeds from sales of commercial paper. The Company re-financed the commercial paper with the sale of new long-term debt in the fourth quarter of 2003. The early redemption premium from the redemption of the \$7.125 Series was recognized as an unamortized cost pursuant to SFAS No. 71 and will be amortized to expense over the life of the new debt.

Redeemable Preference Stock

On Dec. 31, 2002, NW Natural redeemed all 250,000 shares of its \$6.95 Series of Redeemable Preference Stock with proceeds from the sale of commercial paper.

Stock Repurchase Program

NW Natural's Board of Directors approved a stock repurchase program in 2000 to purchase up to 2 million shares, or up to \$35 million in value, of NW Natural's common stock in the open market or through privately negotiated transactions. The repurchase program has been extended through May 2004. No shares were repurchased in 2002 or 2003. Since the program's inception, the Company has repurchased 355,400 shares of common stock at a total cost of \$8.2 million.

Restated Stock Option Plan

In May 2002, the shareholders approved an amendment to the Restated Stock Option Plan that increased the total number of shares authorized for option grants from 1,200,000 to 2,400,000

shares. At Dec. 31, 2003, options on 1,429,500 shares were available for grant and options on 322,044 shares were outstanding.

The following table shows the changes in the number of shares of NW Natural's capital stock and the premium on common stock for the years 2003, 2002 and 2001:

	Common stock	Shares Redeemable preference stock	Redeemable preferred stock	Premium on common stock (thousands)
Balance, Dec. 31, 2000	25,233,424	250,000	97,500	\$ 238,215
Sales to employees	30,952	-	-	498
Sales to stockholders	177,624	-	-	3,854
Exercise of stock options - net	12,289	-	-	110
Conversion of convertible debentures to common	20,485	-	-	343
Stock repurchases	(246,700)	-	-	(2,323)
Sinking fund purchases	-	-	(7,500)	-
Balance, Dec. 31, 2001	25,228,074	250,000	90,000	240,697
Sales to employees	42,862	-	-	748
Sales to stockholders	157,288	-	-	3,854
Exercise of stock options - net	61,020	-	-	1,105
Conversion of convertible debentures to common	97,069	-	-	1,624
Sinking fund purchases	-	-	(7,500)	-
Redemption	-	(250,000)	-	-
Balance, Dec. 31, 2002	25,586,313	-	82,500	248,028
Sales to employees	14,175	-	-	425
Sales to stockholders	178,714	-	-	4,347
Exercise of stock options - net	127,357	-	-	2,545
Conversion of convertible debentures to common	31,443	-	-	526
Sinking fund purchases	-	-	(7,500)	-
Early redemption	-	-	(75,000)	-
Balance, Dec. 31, 2003	25,938,002	-	-	\$ 255,871

4 STOCK-BASED COMPENSATION:

NW Natural has the following stock-based compensation plans: the Long-Term Incentive Plan (LTIP); the Restated Stock Option Plan (Restated SOP); the Employee Stock Purchase Plan (ESPP); and the Non-Employee Directors Stock Compensation Plan (NEDSCP). These plans are designed to promote stock ownership in NW Natural by employees, officers and, in the case of the NEDSCP, non-employee directors.

NW Natural's shareholders approved the LTIP effective Jan. 1, 2001, to provide a flexible, competitive compensation program for eligible officers. An aggregate of 500,000 shares of common stock was authorized for grants under the LTIP as stock bonus, restricted stock or performance-based stock awards. Shares awarded under the LTIP are purchased on the open market. Through Dec. 31, 2003, NW Natural has granted four performance-based awards, one based on a two-year performance period (2001-02) and three based on three-year performance periods (2001-03, 2002-04 and 2003-05), and one restricted stock award. The aggregate target awards for each of the 2001-02 and the 2001-03 performance-based award periods were 26,000 shares and the maximum awards were 52,000 shares; the aggregate target and maximum awards for the 2002-04 award period were 29,000 and 58,000 shares, respectively; and the aggregate target and maximum awards for the 2003-05 award period were 32,000 and 64,000 shares, respectively. Final awards depend on the attainment of certain return on equity performance goals. At Dec. 31, 2003, the two-year and three-year performance-based awards that started in 2001 lapsed because the performance-based measures were not achieved. The restricted stock award consists of 4,500 shares granted in 2001 with a vesting period of 65 months. The LTIP stock awards are compensatory awards for which compensation expense is recognized based on the market value of performance shares earned, or a pro rata amortization over the vesting period for the restricted stock award.

The Restated SOP authorizes an aggregate of 2,400,000 shares

of common stock for issuance as incentive or non-statutory stock options. These options may be granted only to officers and key employees designated by a committee of NW Natural's Board of Directors. All options are granted at an option price not less than the market value at the date of grant and may be exercised for a period not exceeding 10 years from the date of grant. Option holders may exchange shares they have owned for at least six months, at the current market price, to purchase shares at the option price. Since inception in 1985, options on 1,100,921 shares of common stock have been granted at prices ranging from \$11.75 to \$27.875 per share, and options on 130,421 shares have expired.

In accordance with APB No. 25, no compensation expense is recognized for options granted under the Restated SOP or shares issued under the ESPP. If compensation expense for awards under these two plans had been determined based on fair value at the grant dates using the method prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation," net income and earnings per share would have been reduced to the pro forma amounts shown below:

Pro Forma Effect of Stock Options: Thousands, except per share amounts	2003	2002	2001
Net income as reported	\$ 45,983	\$ 43,792	\$ 50,187
Pro forma stock-based compensation expense determined under the fair value based method - net of tax	(279)	(478)	(338)
Pro forma net income	45,704	43,314	49,849
Redeemable preferred and preference stock	(294)	(2,280)	(2,401)
Pro forma earnings applicable to common stock - basic	45,410	41,034	47,448
Debt interest less taxes	257	285	370
Pro forma earnings applicable to common stock - diluted	\$ 45,667	\$ 41,319	\$ 47,818
Basic earnings per share			
As reported	\$ 1.77	\$ 1.63	\$ 1.90
Pro forma	\$ 1.76	\$ 1.61	\$ 1.89
Diluted earnings per share			
As reported	\$ 1.76	\$ 1.62	\$ 1.88
Pro forma	\$ 1.75	\$ 1.60	\$ 1.87

The fair value of each stock option grant is estimated on the grant date (there were no stock option grants in 2003) using the Black-Scholes option pricing model with the following weighted average assumptions:

	2002	2001
Expected life in years	7.0	7.0
Risk-free interest rate	3.6%	5.2%
Expected volatility	29.1%	31.0%
Dividend yield	4.8%	4.9%
Present value of options granted	\$ 20.49	\$ 17.34

Information regarding the Restated SOP's activity is summarized as follows:

	Options	Price per Share	
		Range	Weighted-Average Exercise Price
Balance outstanding, Dec. 31, 2000	416,005	\$ 20.17 - 27.875	\$ 22.75
Granted	15,000	24.91	24.91
Exercised	(12,289)	20.17 - 20.920	20.36
Expired	(31,625)	20.25 - 27.875	24.31
Balance outstanding, Dec. 31, 2001	387,091	20.25 - 27.875	22.79
Granted	163,750	26.07 - 27.850	26.35
Exercised	(68,827)	20.25 - 27.875	21.74
Expired	(18,200)	20.25 - 27.875	25.43
Balance outstanding, Dec. 31, 2002	463,814	20.25 - 27.875	24.10
Exercised	(140,470)	20.25 - 27.875	21.14
Expired	(1,300)	20.25	20.25
Balance outstanding, Dec. 31, 2003	322,044	20.25 - 27.875	\$ 25.35
Shares available for grant Dec. 31, 2001	373,750		
Shares available for grant Dec. 31, 2002	1,428,200		
Shares available for grant Dec. 31, 2003	1,429,500		

The weighted average remaining contractual life of outstanding stock options at Dec. 31, 2003 was 6.5 years.

The characteristics of exercisable stock options at Dec. 31, 2003 were as follows:

Range of Exercise Prices	Exercisable Stock Options	Weighted-Average Exercise Price
\$20.25 - \$27.875	213,144	\$ 24.86

The ESPP allows employees to purchase common stock at 85 percent of the closing price on the trading day immediately preceding the subscription date, which is set annually. Each eligible employee may purchase up to \$24,000 worth of stock through payroll deduction over a six to 12-month period.

Effective Feb. 26, 2004, the NEDSCP was amended to permit non-employee directors to receive awards either in cash or in Company stock. If non-employee directors elect to receive their awards in stock, approximately \$100,000 worth of the Company's common stock is awarded upon joining the Board. These stock awards are subject to vesting and to restrictions on sale and transferability. The shares vest in monthly installments over the five calendar years following the award. On Jan. 1 of each year following the initial award, non-employee directors who elect to receive awards in Company stock are awarded an additional \$20,000 worth of restricted Company stock, which vests in monthly installments in the fifth year following the award (after the previous award has fully vested). The Company holds the certificates for the restricted shares until the non-employee director ceases to be a director. Participants receive all dividends and have full voting rights on both vested and unvested shares. All awards vest immediately upon a change in control of the Company. Any unvested shares are considered to be unearned compensation, and thus are forfeited if the recipient ceases to be a director. The shares are purchased in the open market by the Company at the time of the award.

The following table presents the changes in unearned stock compensation for the years 2003 and 2002, which are reported as a reduction to total common equity in the consolidated balance sheets:

Thousands	2003	2002
Unearned stock compensation:		
Balance at beginning of year	\$ 711	\$ 372
Purchases of restricted stock	328	891
Restricted stock amortizations	(310)	(552)
Balance at end of year	\$ 729	\$ 711

Under a separate plan, non-employee directors also may elect to invest their cash fees and retainers for board service in shares of the Company's common stock.

5 LONG-TERM DEBT:

The issuance of first mortgage debt, including secured medium-term notes, under the Mortgage and Deed of Trust (Mortgage) is limited by property additions, adjusted net earnings and other provisions of the Mortgage. The Mortgage constitutes a first mortgage lien on substantially all of NW Natural's utility property.

The 7-1/4% Series of Convertible Debentures may be converted at any time into 50-1/4 shares of common stock for each \$1,000 face value (\$19.90 per share).

The maturities on the long-term debt and redeemable preferred stock outstanding, for each of the 12-month periods through Dec. 31, 2008 amount to: none in 2004; \$15 million in 2005; \$8 million in 2006; \$29.5 million in 2007; and \$5 million in 2008. Holders of certain Medium-Term Notes (MTNs) have put options that, if exercised, would accelerate the maturity of long-term debt by \$10 million in 2005, \$20 million in 2007 and \$20 million in 2008.

6 NOTES PAYABLE AND LINES OF CREDIT:

The Company's primary source of short-term funds is commercial paper notes payable. Both NW Natural and Financial Corporation issue commercial paper under agency agreements with a commercial bank. NW Natural's commercial paper is supported by its committed bank lines of credit (see below), while Financial Corporation's commercial paper is supported by committed bank lines of credit and the guaranty of NW Natural. The amounts and average interest rates of commercial paper debt outstanding at Dec. 31 were as follows:

Thousands	2003		2002	
	Amount	Rate	Amount	Rate
NW Natural	\$ 85,200	1.1%	\$ 69,802	1.4%
Financial Corporation	-	-	-	-
Total	\$ 85,200		\$ 69,802	

NW Natural has lines of credit with four commercial banks totaling \$150 million. Half of the credit facility with each bank, totaling \$75 million, is committed and available through Sept. 30, 2004, and the other \$75 million is committed and available through Sept. 30, 2005. NW Natural may be unable to draw upon the two-year portions of the credit lines, totaling \$75 million, until filings are made or approvals received from the OPUC or the WUTC with respect to its notes relating to the two-year commitments. NW Natural expects that it will be able to make the necessary filings or secure such approvals, if required.

Financial Corporation has available through Sept. 30, 2004, committed lines of credit with two commercial banks totaling \$10 million. Financial Corporation's lines are supported by the guaranty of NW Natural.

Under the terms of these lines of credit, NW Natural and Financial Corporation pay commitment fees but are not required to maintain compensating bank balances. The interest rates on borrowings under these lines of credit, if any, are based on current market rates. There were no outstanding balances on either the NW Natural or Financial Corporation lines of credit as of Dec. 31, 2003 or 2002.

NW Natural's lines of credit require that credit ratings be maintained in effect at all times and that notice be given of any change in its senior unsecured debt ratings. A change in NW Natural's credit rating is not an event of default, nor is the maintenance of a specific minimum level of credit rating a condition to drawing upon the lines of credit. However, interest rates on any loans outstanding under NW Natural's bank lines are tied to credit ratings, which would increase or decrease the cost of bank debt, if any, when ratings are changed.

The lines of credit require the Company to maintain an indebtedness to total capitalization ratio of 65 percent or less and to maintain a consolidated net worth at least equal to 80 percent of its net worth at Sept. 30, 2003, plus 50 percent of the Company's net income for each subsequent fiscal quarter. Failure to comply with either of these covenants would entitle the banks to terminate their lending commitments and to accelerate the maturity of all amounts outstanding. The Company was in compliance with both of these covenants at Dec. 31, 2003, and with the equivalent covenants in the prior year's lines of credit at Dec. 31, 2002.

7 PENSION AND OTHER POSTRETIREMENT BENEFITS:

NW Natural maintains two qualified non-contributory defined benefit pension plans covering all regular employees with more than one year of service, a non-qualified supplemental pension plan for eligible executive officers and other postretirement benefit plans for its employees. Only the two qualified defined benefit pension plans have plan assets. Those assets are held in a qualified trust to fund retirement benefits.

The following table provides a reconciliation of the changes in benefit obligations and fair value of assets, as applicable, for the pension plans and other postretirement benefit plans over the three-year period ended Dec. 31, 2003, and a statement of the funded status and amounts recognized in the consolidated balance sheets, using measurement dates of Dec. 31, 2003, 2002 and 2001:

Thousands	Pension Benefits			Post-Retirement Benefits		
	2003	2002	2001	2003	2002	2001
Change in benefit obligation:						
Benefit obligation at Jan. 1	\$ 185,124	\$ 166,751	\$ 146,802	\$ 18,457	\$ 16,987	\$ 14,069
Service cost	4,748	4,637	3,964	456	395	325
Interest cost	12,402	11,807	11,332	1,336	1,174	1,116
Expected benefits paid	(10,363)	(9,453)	(9,152)	(1,027)	(979)	(942)
Plan amendments	-	-	1,838	(111)	(300)	-
Net actuarial (gain) loss	13,441	11,382	11,967	4,268	1,180	2,419
Benefit obligation at Dec. 31	<u>205,352</u>	<u>185,124</u>	<u>166,751</u>	<u>23,379</u>	<u>18,457</u>	<u>16,987</u>
Change in plan assets:						
Fair value of plan assets at Jan. 1	143,164	168,964	190,451	-	-	-
Actual return on plan assets	34,520	(17,082)	(13,077)	-	-	-
Employer contributions	1,003	735	742	1,027	979	942
Benefits paid	(10,363)	(9,453)	(9,152)	(1,027)	(979)	(942)
Fair value of plan assets at Dec. 31	<u>168,324</u>	<u>143,164</u>	<u>168,964</u>	<u>-</u>	<u>-</u>	<u>-</u>
Funded status:						
Funded status at Dec. 31	(37,028)	(41,960)	2,212	(23,379)	(18,457)	(16,987)
Unrecognized transition obligation	-	-	351	3,703	4,226	4,795
Unrecognized prior service cost	6,240	7,371	8,575	-	-	172
Unrecognized net actuarial (gain) loss	32,156	42,060	(2,956)	8,304	4,437	3,405
Net amount recognized	<u>\$ 1,368</u>	<u>\$ 7,471</u>	<u>\$ 8,182</u>	<u>\$ (11,372)</u>	<u>\$ (9,794)</u>	<u>\$ (8,615)</u>
Amounts recognized in the consolidated balance sheets at Dec. 31						
Prepaid benefit cost	\$ 11,113	\$ 17,339	\$ 17,211	\$ -	\$ -	\$ -
Accrued benefit liability	(11,319)	(18,741)	(9,346)	(11,372)	(9,794)	(8,615)
Intangible asset	-	4,438	169	-	-	-
Other comprehensive loss	1,574	4,435	148	-	-	-
Net amount recognized	<u>\$ 1,368</u>	<u>\$ 7,471</u>	<u>\$ 8,182</u>	<u>\$ (11,372)</u>	<u>\$ (9,794)</u>	<u>\$ (8,615)</u>

The Company's qualified defined benefit pension plans had an accumulated benefit obligation in excess of plan assets at Dec. 31, 2003. The plans' aggregate accumulated benefit obligation was \$192 million, \$172 million and \$156 million at Dec. 31, 2003, 2002 and 2001, respectively, and the fair value of plan assets was \$168 million, \$143 million and \$169 million, respectively. The fair value of plan assets increased from Dec. 31, 2002 to Dec. 31, 2003 due to \$36 million in investment gains, partially offset by \$10 million in withdrawals to pay benefits and \$0.9 million to pay eligible expenses of the plans. The combination of investment returns and cash contributions is expected to provide sufficient funds to cover all benefit obligations of the plans. The Company is required to make a cash contribution of at least \$1.9 million, and may make an additional contribution up to a total of \$6.8 million, to its non-bargaining employee pension plan for the 2003 plan year, payable by Sept. 15, 2004.

The Company's investment policy and performance objectives for the qualified pension plan assets (plan assets) held in the Northwest Natural Gas Company Retirement Trust Fund was approved by a retirement committee composed of management employees. The policy sets forth the guidelines and objectives governing the investment of plan assets. Plan assets are invested for total return with appropriate consideration for liquidity and portfolio risk. All investments are expected to satisfy the requirements of the rule of prudent investments as set forth under the Employee Retirement Security Act of 1974 (ERISA). The approved asset classes are cash and short-term investments, fixed income, common stock and convertible securities, absolute return strategies, real estate and investments in securities of NW Natural, and may be invested in separately managed accounts or in commingled or mutual funds. Re-balancing will take place at least annually, or when significant cash flows occur, in order to maintain the allocation of assets within the stated target allocation ranges. The Retirement Trust Fund is not currently invested in any NW Natural securities.

The Company's pension plan asset allocation at Dec. 31, 2003 and 2002, and the target allocation and expected long-term rate of return by asset category for 2004 are as follows:

Asset Category	Percentage of Plan Assets		Target Allocation	Expected Long-Term Rate of Return
	2003	Dec. 31, 2002		
US Large Cap Equity	40.2%	36.3%	40%	9.00%
US Small/Mid Cap Equity	7.3%	4.3%	8%	9.50%
Non-US Equity	16.0%	17.1%	15%	9.00%
Fixed Income	24.8%	34.7%	25%	6.00%
Real Estate	3.9%	2.0%	40%	8.00%
Absolute Return	7.8%	5.6%	8%	9.00%
Weighted Average				8.25%

The Company's non-qualified supplemental pension plan's accumulated benefit obligation was \$13.0 million, \$12.8 million and \$10.7 million at Dec. 31, 2003, 2002 and 2001, respectively. Although this plan is an unfunded plan with no plan assets due to its nature as a non-qualified plan, the Company indirectly funds its obligations with trust-owned life insurance. The amount of life insurance coverage is designed to provide sufficient returns to cover the benefit obligations and other costs of the plan.

The Company's plans for providing postretirement benefits other than pensions also are unfunded plans. The aggregate benefit obligation for those plans was \$23.4 million, \$18.5 million and \$17.0 million at Dec. 31, 2003, 2002 and 2001, respectively.

Notes to Consolidated Financial Statements

The following tables provide the components of net periodic benefit cost (income) for the pension and other postretirement benefit plans for the years ended Dec. 31, 2003, 2002 and 2001, and the assumptions used in measuring these costs and benefit obligations:

Thousands	Pension Benefits			Other Postretirement Benefits		
	2003	2002	2001	2003	2002	2001
Service cost	\$ 4,748	\$ 4,637	\$ 3,964	\$ 456	\$ 395	\$ 325
Interest cost	12,402	11,807	11,332	1,336	1,174	1,116
Expected return on plan assets	(12,232)	(16,335)	(17,198)	-	-	-
Amortization of transition obligation	-	351	351	411	436	436
Amortization of prior service cost	1,132	1,204	1,284	-	6	19
Recognized actuarial (gain) loss	1,058	(216)	(2,464)	401	147	75
Net periodic benefit cost (income)	<u>\$ 7,108</u>	<u>\$ 1,448</u>	<u>\$ (2,731)</u>	<u>\$ 2,604</u>	<u>\$ 2,158</u>	<u>\$ 1,971</u>
Assumptions:						
Discount rate for net periodic benefit cost (NPBC)	6.75%	7.25%	7.50%	6.75%	7.25%	7.50%
Rate of increase in compensation for NPBC	4.25 - 5.00%	4.25 - 5.00%	4.25 - 5.00%	n/a	n/a	n/a
Expected long-term rate of return for NPBC	8.00%	9.00%	9.00%	n/a	n/a	n/a
Discount rate for determination of funded status	6.25%	6.75%	7.25%	6.25%	6.75%	7.25%
Rate of increase in compensation for funded status	4.00 - 4.75%	4.25 - 5.00%	4.25 - 5.00%	n/a	n/a	n/a
Expected long-term rate of return for funded status	8.25%	8.00%	9.00%	n/a	n/a	n/a

The assumed annual trend rates used in measuring postretirement benefits as of Dec. 31, 2003 were 9 percent for medical and 14 percent for prescription drugs. Medical costs were assumed to decrease gradually each year to a rate of 4.5 percent for 2008, while prescription drug costs were assumed to decrease gradually each year to a rate of 4.5 percent for 2013.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects:

Thousands	1% Increase	1% Decrease
Effect on the total service and interest cost components of net periodic postretirement health care benefit cost	\$ 71	\$ (67)
Effect on the health care component of the accumulated postretirement benefit obligation	\$ 955	\$ (858)

The following table provides information regarding employer contributions and benefit payments for the pension and other postretirement benefit plans for the years ended Dec. 31, 2003 and 2002, and estimated future payments:

Thousands	Pension Benefits	Other Postretirement Benefits
Employer Contributions by Plan Year		
2002	\$ 735	\$ 979
2003	2,949	1,027
2004 (estimated)	3,007	1,509
Benefit Payments		
2002	\$ 9,440	\$ 979
2003	10,363	1,027
Estimated Future Benefit Payments		
2004	\$ 11,667	\$ 1,509
2005	12,224	1,555
2006	12,698	1,674
2007	12,965	1,770
2008	13,811	1,883
2009 - 2013	78,915	10,312

NW Natural's Retirement K Savings Plan (RKSP) is a qualified defined contribution plan under Internal Revenue Code Section 401(k). NW Natural also has a non-qualified deferred compensation plan for eligible officers and senior managers. These plans are designed to enhance the retirement program of employees and to assist them in strengthening their financial security by providing an incentive to save and invest regularly. NW Natural's matching contributions to these plans totaled \$1.6 million in 2003, \$1.4 million in 2002 and \$1.3 million in 2001.

Effective Jan. 1, 2002, the RKSP was amended to establish an Employee Stock Ownership Plan (ESOP) within the RKSP by converting the existing RKSP Company Stock Fund into an ESOP. This amendment allowed the Company to claim a tax benefit of \$0.2 million in both 2003 and 2002 for the dividends paid on the Company's common stock held by the ESOP. In order to claim this deduction, the Company was required to allow RKSP participants the option of receiving the dividends paid on the Company's common stock in the ESOP account in cash rather than having the dividends automatically reinvested (see Note 8).

8 INCOME TAXES:

A reconciliation between income taxes calculated at the statutory federal tax rate and the tax provision reflected in the financial statements is as follows:

Thousands	2003	2002	2001
Computed income taxes based on statutory federal income tax rate of 35%	\$ 24,263	\$ 23,533	\$ 27,209
Increase (reduction) in taxes resulting from:			
Difference between book and tax depreciation	222	222	222
Current state income tax, net of federal tax benefit	2,310	2,299	2,672
Federal income tax credits	(357)	(362)	(362)
Amortization of investment tax credits	(879)	(858)	(855)
Gains on Company and trust-owned life insurance	(1,192)	(487)	(576)
Removal costs	(925)	(573)	(508)
Reversal of amounts provided in prior years	(226)	(240)	(72)
Other - net	124	(90)	(177)
Total provision for income taxes	<u>\$ 23,340</u>	<u>\$ 23,444</u>	<u>\$ 27,553</u>
Total income taxes paid	<u>\$ 13,940</u>	<u>\$ 33,474</u>	<u>\$ 25,201</u>

The provision for income taxes consists of the following:

Thousands	2003	2002	2001
Income taxes currently payable:			
Federal	\$ 10,011	\$ 9,377	\$ 32,682
State	1,175	1,239	5,912
Total	<u>11,186</u>	<u>10,616</u>	<u>38,594</u>
Deferred taxes - net:			
Federal	10,747	11,476	(8,606)
State	2,286	2,210	(1,580)
Total	<u>13,033</u>	<u>13,686</u>	<u>(10,186)</u>
Investment and energy tax credits restored:			
From utility operations	(801)	(800)	(800)
From subsidiary operations	(78)	(58)	(55)
Total	<u>(879)</u>	<u>(858)</u>	<u>(855)</u>
Total provision for income taxes	<u>\$ 23,340</u>	<u>\$ 23,444</u>	<u>\$ 27,553</u>
Percentage of pretax income	<u>33.7%</u>	<u>34.9%</u>	<u>35.4%</u>

Deferred tax assets and liabilities are comprised of the following:

<i>Thousands</i>	2003	2002
Deferred tax liabilities:		
Plant and property	\$ 113,781	\$ 96,525
Regulatory income tax assets	63,449	47,975
Regulatory liabilities	-	319
Other deferred liabilities	6,109	6,569
Total	<u>183,339</u>	<u>151,388</u>
Deferred tax assets:		
Regulatory assets	970	-
Minimum pension liability	557	1,883
Other deferred assets	10,015	7,773
Total	<u>11,542</u>	<u>9,656</u>
Net accumulated deferred income tax liability	<u>\$ 171,797</u>	<u>\$ 141,732</u>

Tax benefits of \$1.3 million associated with charges for minimum pension liabilities in 2002 were reversed in OCI for the year ended Dec. 31, 2003.

9 PROPERTY AND INVESTMENTS:

The following table sets forth the major classifications of NW Natural's utility plant and accumulated depreciation at Dec. 31:

<i>Thousands</i>	2003		2002	
	Amount	Average Depreciation Rate	Amount	Average Depreciation Rate
Transmission and distribution	\$ 1,347,402	3.3%	\$ 1,254,624	3.4%
Utility storage	107,547	2.7%	107,110	2.7%
General	87,107	6.0%	83,878	6.3%
Intangible and other	56,429	5.1%	53,291	4.3%
Utility plant in service	1,598,485	3.5%	1,498,903	3.5%
Gas stored long-term	12,778		11,301	
Construction work in progress	47,826		29,761	
Total utility plant	1,659,089		1,539,965	
Accumulated depreciation	(471,176)		(435,601)	
Utility plant - net	<u>\$ 1,187,373</u>		<u>\$ 1,104,364</u>	

Accumulated depreciation does not include \$135.6 million and \$125.2 million at Dec. 31, 2003 and 2002, respectively, due to the reclassification of accumulated depreciation relating to removal costs in accordance with SFAS No. 143 (see Note 1).

The following table summarizes the Company's investments in non-utility plant at Dec. 31:

<i>Thousands</i>	2003	2002
Non-utility storage	\$ 18,507	\$ 17,037
Dock, land, oil station and other	3,846	3,795
Construction work in progress	1,042	-
Total non-utility plant	23,395	20,832
Less accumulated depreciation	4,855	4,404
Non-utility plant - net	<u>\$ 18,540</u>	<u>\$ 16,428</u>

The following table summarizes the Company's partnership and joint venture investments accounted for under the equity or cost methods, and its investment in an aircraft leveraged lease, at Dec. 31:

<i>Thousands</i>	2003	2002
Aircraft leveraged lease	\$ 6,438	\$ 6,489
Gas pipeline and other	2,880	2,950
Electric generation	3,317	3,264
Total other investments	<u>\$ 12,635</u>	<u>\$ 12,703</u>

In 1987, the Company invested in a Boeing 737-300 aircraft, which is leased to Continental Airlines for 20 years under a leveraged lease agreement.

A Financial Corporation subsidiary, KB Pipeline Company, has a 10 percent ownership interest in an 18-mile interstate natural gas pipeline and is the operator of this pipeline. In December 2003, KB Pipeline gave notice to the pipeline co-owners that it is resigning

as pipeline operator effective in June 2004 due to increased obligations resulting from the Federal Energy Regulatory Commission's final regulations implementing Standards of Conduct for Transmission Providers. Those regulations govern the relationship between interstate natural gas pipelines and their energy affiliates or marketing functions and impose obligations previously inapplicable to KB Pipeline with regard to separation of duties and related matters. The regulations will continue to be applicable to KB Pipeline as a co-owner after its resignation as Pipeline operator.

Financial Corporation has ownership interests ranging from 4.0 to 5.3 percent in solar electric generation plants located near Barstow, California. Power generated by these plants is sold to Southern California Edison Company under long-term contracts. Financial Corporation also has ownership interests ranging from 25 to 41 percent in wind power electric generation projects located near Livermore and Palm Springs, California. The wind-generated power is sold to Pacific Gas and Electric Company and Southern California Edison Company under long-term contracts.

10 FAIR VALUE OF FINANCIAL INSTRUMENTS:

The estimated fair value for NW Natural's financial instruments has been determined using available market information and appropriate valuation methodologies. The following are financial instruments whose carrying values are sensitive to market conditions:

<i>Thousands</i>	Dec. 31, 2003		Dec. 31, 2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Redeemable preferred stock	\$ -	\$ -	\$ 8,250	\$ 8,333
Long-term debt including amount due within one year	\$ 500,319	\$ 562,688	\$ 465,945	\$ 518,495

Fair value of the redeemable preferred stock and long-term debt was estimated using market prices in effect on the valuation date. Interest rates for debt with similar terms and remaining maturities were used to estimate fair value for long-term debt issues.

11 USE OF FINANCIAL DERIVATIVES:

NW Natural enters into short-term and long-term natural gas purchase contracts with suppliers, including contracts tied to floating prices. As such, NW Natural is exposed to changes in commodity prices. Natural gas prices are subject to fluctuations due to unpredictable factors including weather, inventory levels, pipeline transportation availability, and the economy, each of which affects short-term supply and demand. As part of its overall strategy to maintain an acceptable level of exposure to gas price fluctuations, NW Natural uses a targeted mix of fixed-rate and cap-protected derivative instruments to hedge the exposure under floating price gas supply contracts. Swap contracts are used to convert certain long-term gas purchase contracts from floating prices to fixed prices. Call option contracts are used to limit the maximum adverse impact from floating price contracts while retaining the potential favorable impact from declining gas prices. The prices embedded in these commodity hedge contracts are incorporated in NW Natural's annual rate changes under its Purchased Gas Adjustment rate mechanisms, thereby limiting customers' exposure to frequent changes in purchased gas costs. The estimated fair value of gains and losses from commodity hedge contracts are recorded as a derivative asset or liability, and are offset by a corresponding amount recorded to a deferred regulatory asset or liability account for the effective portion of each hedge contract. The actual gains and losses realized at settlement of the hedge contracts are used to offset the actual purchase cost from NW Natural's physical supply contracts.

Certain natural gas purchases from Canadian suppliers are invoiced in Canadian dollars, including both commodity and demand charges, thereby exposing NW Natural to adverse changes in foreign currency rates. Foreign currency forward contracts are used to minimize the impact of fluctuations in currency rates. Foreign currency contracts for commodity costs are purchased on a month-to-month basis because the Canadian cost is priced at the average noonday exchange rate for each month. Foreign currency contracts for demand costs have terms ranging up to 24 months. The gains and losses on the shorter-term currency contracts for commodity costs are recognized immediately in cost of gas. The gains and losses on the longer-term currency contracts for demand charges are subject to a regulatory deferral tariff and, as such, are recorded as a derivative asset or liability which is offset by a corresponding amount to a deferred asset or liability account.

NW Natural did not use any derivative instruments to hedge oil or propane prices or interest rates during 2003, 2002 or 2001.

At Dec. 31, 2003, NW Natural had the following derivatives outstanding covering its exposures to commodity and foreign currency prices: a series of 20 natural gas price swap contracts, three natural gas call option contracts, and 77 foreign currency forward contracts. Each of these contracts was designated as a cash flow hedge. The estimated fair values and the notional amounts of derivative instruments (unrealized gains and losses) outstanding were as follows:

Thousands	— Dec. 31, 2003 —		— Dec. 31, 2002 —	
	Fair Value Gain (Loss)	Notional Amount	Fair Value Gain (Loss)	Notional Amount
Fixed-price natural gas commodity swap contracts	\$ 23,285	\$ 284,317	\$ 11,422	\$ 159,724
Fixed-price natural gas call option contracts	366	19,761	717	18,084
Physical natural gas supply contract with embedded derivative	-	-	448	2,754
Foreign currency forward purchase contracts	234	6,417	(161)	15,525
Total	\$ 23,885	\$ 310,495	\$ 12,426	\$ 196,087

In 2003, NW Natural realized net gains of \$32.4 million from the settlement of natural gas commodity swap and call option contracts, which were recorded as decreases to the cost of gas, compared to net losses of \$75.5 million during 2002 and net gains of \$57.6 million during 2001. The currency exchange rate in all foreign currency forward purchase contracts is included in NW Natural's cost of gas at settlement; therefore, no gain or loss was recorded from the settlement of those contracts. The change in value of cash flow hedge contracts, not included in regulatory recovery, is included in OCI.

The fair value of derivative instruments at Dec. 31, 2003 (see table above) was determined using estimated or quoted market prices for the periods covered by the contracts. Market prices for the natural gas commodity-price swap and call option contracts were obtained from external sources. NW Natural reviews these third-party valuations for reasonableness using fair value calculations for other contracts with similar terms and conditions. The market prices for the foreign currency forward contracts were based on currency exchange rates quoted by The Bank of Canada.

As of Dec. 31, 2003, NW Natural had five natural gas commodity price swap contracts extending beyond Dec. 31, 2004, but none extends beyond Oct. 31, 2005. None of the natural gas commodity call option contracts extends beyond March 31, 2004.

12 COMMITMENTS AND CONTINGENCIES:

Lease Commitments

The Company leases land, buildings and equipment under agreements that expire in various years through 2018. Rental expense under operating leases was \$4.9 million, \$4.8 million and \$4.7 million for the years ended Dec. 31, 2003, 2002 and 2001, respectively. The table below reflects the future minimum lease payments due under non-cancelable leases at Dec. 31, 2003. Such payments total \$74.5 million for operating leases. The net present value of payments on capital leases less imputed interest was \$0.3 million. These commitments principally relate to the lease of the Company's office headquarters, underground gas storage facilities, vehicles and computer equipment.

Millions	2004	2005	2006	2007	2008	Later years
Operating leases	\$ 4.3	\$ 3.8	\$ 3.8	\$ 3.7	\$ 3.6	\$ 55.3
Capital leases	0.1	0.1	0.1	-	-	-
Minimum lease payments	\$ 4.4	\$ 3.9	\$ 3.9	\$ 3.7	\$ 3.6	\$ 55.3

Pipeline Capacity Purchase and Release Commitments

NW Natural has signed agreements providing for the availability of firm pipeline capacity under which it must make fixed monthly payments for contracted capacity. The pricing component of the monthly payment is established, subject to change, by U.S. or Canadian regulatory bodies. In addition, NW Natural has entered into long-term sale agreements to release firm pipeline capacity. The aggregate amounts of these agreements were as follows at Dec. 31, 2003:

Thousands	Pipeline Capacity Purchase Agreements	Pipeline Capacity Release Agreements
2004	\$ 56,296	\$ 3,781
2005	60,540	3,782
2006	57,772	3,781
2007	57,773	3,782
2008	56,245	3,781
2009 through 2023	301,397	6,933
Total	590,023	25,840
Less: Amount representing interest	128,151	3,463
Total at present value	\$ 461,872	\$ 22,377

NW Natural's total payments of fixed charges under capacity purchase agreements in 2003, 2002 and 2001 were \$86.7 million, \$86.2 million and \$86.5 million, respectively. Included in the amounts for 2003, 2002 and 2001 were reductions for capacity release sales of \$3.7 million, \$4.2 million and \$3.8 million, respectively. In addition, per-unit charges are required to be paid based on the actual quantities shipped under the agreements. In certain take-or-pay purchase commitments, annual deficiencies may be offset by prepayments subject to recovery over a longer term if future purchases exceed the minimum annual requirements.

Environmental Matters

NW Natural owns property in Multnomah County, Oregon that is the site of a former gas manufacturing plant that was closed in 1956 (the Gasco site). The Gasco site has been under investigation by NW Natural for environmental contamination under the Oregon Department of Environmental Quality's (ODEQ) Voluntary Clean-Up Program. On June 30, 2003, the Company filed a Feasibility Scoping Plan and an Ecological and Human Health Risk Assessment with the ODEQ, which outlined a range of remedial alternatives for the most contaminated portion of the Gasco site. NW Natural will work with the ODEQ to determine the appropriate remedial action from among the alternatives. Based upon the proposed actions in the draft plan, the Company estimates its range of remaining liability, including the cost of investigation, from feasible alternatives, at

between \$1.5 million and \$7 million. At Dec. 31, 2003, NW Natural recorded liabilities totaling \$1.5 million outstanding, regulatory deferred costs of \$0.2 million, and a \$2.5 million insurance receivable, for its estimated costs of investigation and interim remediation at the Gasco site, including consultants' fees, ODEQ oversight reimbursement and legal fees.

NW Natural previously owned property adjacent to the Gasco site that now is the location of a manufacturing plant owned by Wacker Siltronic Corporation (the Wacker site). In 2000, the ODEQ issued an order requiring Wacker and NW Natural to determine the nature and extent of releases of hazardous substances to Willamette River sediments from the Wacker site. NW Natural has completed the majority of the studies required under the ODEQ work plan and the agency is reviewing data generated by the studies. At Dec. 31, 2003, NW Natural recorded liabilities totaling \$0.3 million for its estimated costs of the investigation and initial remediation on the Wacker site, nearly all of which had been spent as of Dec. 31, 2003.

In 1998, the ODEQ and the U.S. Environmental Protection Agency (EPA) completed a study of sediments in a 5.5-mile segment of the Willamette River (the Portland Harbor) that includes the area adjacent to the Gasco site and the Wacker site. In 2000, the EPA listed the Portland Harbor as a Superfund site and notified the Company that it is a potentially responsible party. Between 2000 and 2003, NW Natural recorded liabilities totaling \$2.6 million, of which \$1.9 million had been spent as of Dec. 31, 2003. The amount of NW Natural's liability is based on estimates of the Company's share of the lower end of a range of probable liability for the costs of the Remedial Investigation/Feasibility Study for the Portland Harbor. Available information is insufficient to determine either the total amount of liability for investigation and remediation of the Portland Harbor or the higher end of a range for NW Natural's estimated share of that liability. On March 1, 2004, the Company received a letter from the EPA requesting that the Company enter into a consent order relating to removal of certain contaminants in the riverbed adjacent to the Gasco site. The Company is reviewing the EPA's request and has not determined what its response will be, or what a reasonable estimate of the cost would be for any action the Company might take in response to the request.

The City of Portland notified NW Natural that it was planning a sewer improvement project that would include excavation within the former site of a gas manufacturing plant (the Portland Gas site) that was owned and operated by a predecessor of the Company between 1860 and 1913. The preliminary assessment of this site performed by a consultant for the EPA in 1987 indicated that it could be assumed that by-product tars may have been disposed of on site. The report concluded, however, that it is likely that waste residues from the plant, if present on the site, were covered by deep fill during construction of the nearby seawall bordering the Willamette River and probably have stabilized due to physical and chemical processes. Neither the City of Portland nor the ODEQ has notified NW Natural whether a further investigation or potential remediation might be required on the site in connection with the sewer project, which has commenced. Available information is insufficient to determine either the total amount of NW Natural's liability or a probable range, if any, of potential liability.

In May 2003, the OPUC approved NW Natural's request for deferral of environmental costs associated with specific sites, including the Gasco, Wacker, Portland Gas and Portland Harbor sites. The authorization, effective for a 12-month period beginning April 7, 2003, allows NW Natural to defer and seek recovery of unreimbursed environmental costs in a future general rate case. The Company recorded a cumulative deferral of \$1.0 million in environmental costs related to these specific sites in 2003. Additionally, on a cumulative basis through Dec. 31, 2003, the Company has accrued environmental costs totaling \$8.0 million relating to the sites, including \$5.9 million that has already been disbursed.

NW Natural has accrued all material loss contingencies relating to environmental matters that it believes to be probable of assertion and reasonably estimable. Due to the preliminary nature of these environmental investigations, the range of any additional possible loss contingency cannot be currently estimated. NW Natural will first seek to recover the costs of further investigation and remediation for which it may be responsible with respect to the Gasco site, the Wacker site, the Portland Harbor site and the Portland Gas site, if any, from insurance. If these costs are not recovered from insurance, then NW Natural will seek recovery through future rates. At Dec. 31, 2003, NW Natural had a \$3.7 million receivable representing an estimate of the environmental costs NW Natural expects to incur and recover from insurance, including \$2.5 million for costs relating to the Gasco site and \$1.25 million for costs relating to the Portland Harbor site.

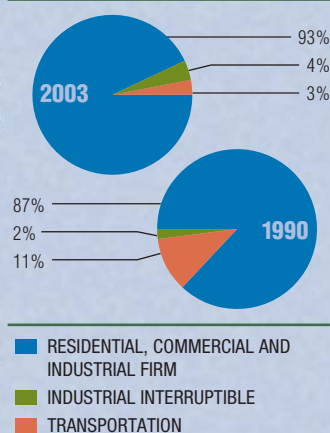
Enron Gas Supply Contract

On Oct. 16, 2003, NW Natural received a demand letter from Enron North America Corp. (Enron) seeking payment of \$1.1 million allegedly owed pursuant to a gas supply contract between NW Natural and Enron, which was in effect when Enron filed for bankruptcy in December 2001. The contract was terminated when Enron filed for bankruptcy, and NW Natural does not believe that any amounts are owed to Enron under the contract.

Comparative Consolidated Income Statements

UTILITY GAS REVENUES

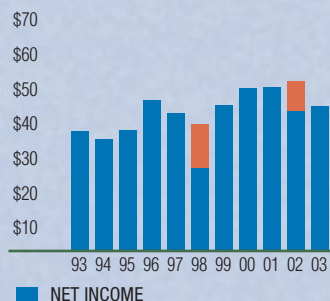
BY CUSTOMER CLASS



Revenues from residential, commercial and industrial firm sales customers have consistently exceeded 87 percent of total gas revenues since 1990.

NET INCOME

IN MILLIONS OF DOLLARS



NET INCOME

REDUCTION OF NET INCOME FROM INVESTMENT WRITEDOWNS:

- \$10.8 million loss for Financial Corporation and \$1.7 million loss for Canor for asset impairment charges in 1998
- \$8.4 million loss (after tax) from PGE acquisition costs in 2002

The Company earned \$46.0 million in net income in 2003.

Thousands, except per share amounts (year ended December 31)

	2003	2002
Operating revenues:		
Gross operating revenues*	\$ 611,256	\$ 641,376
Cost of sales*	<u>323,190</u>	<u>353,832</u>
Net operating revenues*	<u>288,066</u>	<u>287,544</u>
Operating expenses:		
Operations and maintenance	96,420	85,120
Taxes other than income taxes	35,125	34,076
Depreciation, depletion and amortization	<u>54,249</u>	<u>52,090</u>
Total operating expenses	<u>185,794</u>	<u>171,286</u>
Income from continuing operations	<u>102,272</u>	<u>116,258</u>
Other income (expense)*	<u>2,150</u>	<u>(14,890)</u>
Interest charges – net	<u>35,099</u>	<u>34,132</u>
Income before income taxes	<u>69,323</u>	<u>67,236</u>
Income taxes	<u>23,340</u>	<u>23,444</u>
Net income from continuing operations	<u>45,983</u>	<u>43,792</u>
Discontinued segment		
Income from discontinued segment – net of tax	–	–
Gain on sale of discontinued segment – net of tax	–	–
Net income	<u>45,983</u>	<u>43,792</u>
Redeemable preferred and preference stock dividend requirements	<u>294</u>	<u>2,280</u>
Earnings applicable to common stock	<u>\$ 45,689</u>	<u>\$ 41,512</u>
Average common shares outstanding		
Basic	25,741	25,431
Diluted	26,061	25,814
Basic earnings per share of common stock:		
From continuing operations	\$ 1.77	\$ 1.63
From discontinued segment	–	–
From gain on sale of discontinued segment	–	–
Total basic earnings per share	<u>\$ 1.77</u>	<u>\$ 1.63</u>
Diluted earnings per share of common stock:		
From continuing operations	\$ 1.76	\$ 1.62
From discontinued segment	–	–
From gain on sale of discontinued segment	–	–
Total diluted earnings per share	<u>\$ 1.76</u>	<u>\$ 1.62</u>
Dividends per share of common stock	<u>\$ 1.27</u>	<u>\$ 1.26</u>

See Notes to Consolidated Financial Statements.

*Interest on deferred regulatory accounts for years prior to 1998 was reclassified from gross operating revenues or cost of sales to other income (expense).

2001	2000	1999	1998	1997	1996	1995	1994	1993
\$ 650,252	\$ 532,110	\$ 455,834	\$ 404,390	\$ 351,709	\$ 370,826	\$ 355,627	\$ 367,861	\$ 358,452
<u>374,241</u>	<u>274,160</u>	<u>212,197</u>	<u>173,424</u>	<u>130,599</u>	<u>141,842</u>	<u>142,025</u>	<u>162,199</u>	<u>138,751</u>
276,011	257,950	243,637	230,966	221,110	228,984	213,602	205,662	219,701
83,920	77,817	73,209	78,226	73,864	76,204	72,018	70,881	70,723
32,240	28,351	24,652	21,939	19,952	21,597	24,181	24,263	25,561
<u>49,640</u>	<u>47,440</u>	<u>51,008</u>	<u>43,937</u>	<u>39,051</u>	<u>37,971</u>	<u>40,594</u>	<u>38,058</u>	<u>39,683</u>
165,800	153,608	148,869	144,102	132,867	135,772	136,793	133,202	135,967
<u>110,211</u>	<u>104,342</u>	<u>94,768</u>	<u>86,864</u>	<u>88,243</u>	<u>93,212</u>	<u>76,809</u>	<u>72,460</u>	<u>83,734</u>
1,334	3,860	4,816	(13,723)	4,138	6,891	9,055	8,393	1,116
<u>33,805</u>	<u>33,561</u>	<u>30,052</u>	<u>31,586</u>	<u>28,469</u>	<u>26,711</u>	<u>25,679</u>	<u>24,919</u>	<u>25,107</u>
77,740	74,641	69,532	41,555	63,912	73,392	60,185	55,934	59,743
<u>27,553</u>	<u>26,829</u>	<u>24,591</u>	<u>14,604</u>	<u>21,034</u>	<u>27,118</u>	<u>22,120</u>	<u>20,473</u>	<u>22,096</u>
50,187	47,812	44,941	26,951	42,878	46,274	38,065	35,461	37,647
-	-	355	350	181	519	-	-	-
<u>-</u>	<u>2,412</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
50,187	50,224	45,296	27,301	43,059	46,793	38,065	35,461	37,647
2,401	2,456	2,515	2,577	2,646	2,723	2,806	2,983	3,488
<u>\$ 47,786</u>	<u>\$ 47,768</u>	<u>\$ 42,781</u>	<u>\$ 24,724</u>	<u>\$ 40,413</u>	<u>\$ 44,070</u>	<u>\$ 35,259</u>	<u>\$ 32,478</u>	<u>\$ 34,159</u>
25,159	25,183	24,976	24,233	22,698	22,391	21,817	19,943	19,611
25,612	25,638	25,468	24,763	23,248	22,963	22,428	20,577	20,296
\$ 1.90	\$ 1.80	\$ 1.70	\$ 1.01	\$ 1.77	\$ 1.95	\$ 1.62	\$ 1.63	\$ 1.74
-	-	0.01	0.01	0.01	0.02	-	-	-
<u>-</u>	<u>0.10</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
<u>\$ 1.90</u>	<u>\$ 1.90</u>	<u>\$ 1.71</u>	<u>\$ 1.02</u>	<u>\$ 1.78</u>	<u>\$ 1.97</u>	<u>\$ 1.62</u>	<u>\$ 1.63</u>	<u>\$ 1.74</u>
\$ 1.88	\$ 1.79	\$ 1.69	\$ 1.01	\$ 1.75	\$ 1.92	\$ 1.60	\$ 1.61	\$ 1.72
-	-	0.01	0.01	0.01	0.02	-	-	-
<u>-</u>	<u>0.09</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
<u>\$ 1.88</u>	<u>\$ 1.88</u>	<u>\$ 1.70</u>	<u>\$ 1.02</u>	<u>\$ 1.76</u>	<u>\$ 1.94</u>	<u>\$ 1.60</u>	<u>\$ 1.61</u>	<u>\$ 1.72</u>
<u>\$ 1.245</u>	<u>\$ 1.24</u>	<u>\$ 1.225</u>	<u>\$ 1.22</u>	<u>\$ 1.205</u>	<u>\$ 1.20</u>	<u>\$ 1.18</u>	<u>\$ 1.173</u>	<u>\$ 1.167</u>

Comparative Consolidated Balance Sheets

NET UTILITY PLANT

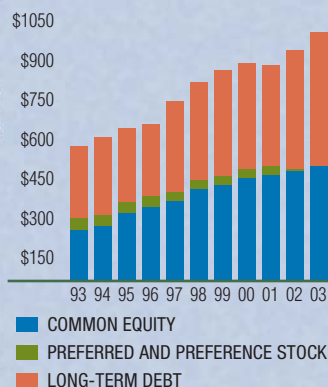
IN MILLIONS OF DOLLARS



Utility plant, net of removal cost regulatory liabilities, continued to increase in 2003 as a result of customer growth and investments in technology and gas storage.

CAPITALIZATION

IN MILLIONS OF DOLLARS



\$32.7 million in cash dividends were paid to common shareholders in 2003, \$8.3 million in Preferred Stock and \$55 million in Medium-Term Notes were retired, and \$90 million in Medium-Term Notes were issued.

Thousands of dollars (December 31)

2003

2002

Assets:

Plant and property:

Utility plant	\$ 1,659,089	\$ 1,539,965
Less accumulated depreciation**	471,716	435,601
Utility plant - net	<u>1,187,373</u>	<u>1,104,364</u>
Non-utility property	23,395	20,832
Less accumulated depreciation and depletion	4,855	4,404
Non-utility property - net	<u>18,540</u>	<u>16,428</u>
Total plant and property	<u>1,205,913</u>	<u>1,120,792</u>
Other investments	<u>12,635</u>	<u>12,703</u>

Current assets:

Cash and cash equivalents	4,706	7,328
Accounts receivable - net	52,213	46,936
Accrued unbilled revenue	59,109	44,069
Inventories of gas, materials and supplies	50,859	58,030
Investment in discontinued segment		
Property held for sale		
Prepayments and other current assets	<u>32,661</u>	<u>36,934</u>
Total current assets	<u>199,548</u>	<u>193,297</u>

Regulatory tax assets

63,449 47,975

Deferred gas costs receivable

- -

Unrealized loss on non-trading derivatives

- -

Deferred debits and other

109,787 92,510

Total assets

\$ 1,591,332 \$ 1,467,277

Capitalization and liabilities:

Capitalization:

Common stock equity	\$ 506,316	\$ 482,392
Redeemable preference stock	-	-
Redeemable preferred stock	-	8,250
Long-term debt:		
First mortgage bonds	494,500	439,500
Unsecured debt	5,819	6,445
Total long-term debt	<u>500,319</u>	<u>445,945</u>
Total capitalization	<u>1,006,635</u>	<u>936,587</u>

Minority interest

- -

Current liabilities:

Notes payable	85,200	69,802
Accounts payable	86,029	74,436
Long-term debt due within one year	-	20,000
Taxes accrued	8,605	7,822
Interest accrued	2,998	2,902
Other current and accrued liabilities	<u>31,589</u>	<u>30,045</u>
Total current liabilities	<u>214,421</u>	<u>205,007</u>

Deferred investment tax credits

6,945 7,824

Deferred income taxes

171,797 141,732

Fair value of non-trading derivatives

- -

Deferred gas costs payable

5,627 10,635

Accrued asset removal costs**

135,638 125,197

Other

50,269 40,295

Total capitalization and liabilities

\$ 1,591,332 \$ 1,467,277

*Deferred gas costs were included in deferred debits or regulatory accounts prior to 1995.

**Removal costs were reclassified from accumulated depreciation to regulatory liabilities and other accrued asset removable costs.

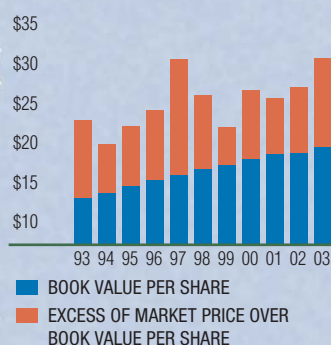
2001	2000	1999	1998	1997	1996	1995	1994	1993
\$ 1,465,079	\$ 1,406,970	\$ 1,331,415	\$ 1,239,690	\$ 1,164,499	\$ 1,055,112	\$ 969,075	\$ 908,238	\$ 840,030
398,668	371,437	337,995	313,149	283,495	260,089	239,493	216,711	198,939
1,066,411	1,035,533	993,420	926,541	881,004	795,023	729,582	691,527	641,091
18,203	8,649	8,548	89,050	52,422	45,689	53,807	49,586	42,764
4,007	3,451	7,654	29,927	22,843	19,388	16,997	24,456	20,646
14,196	5,198	894	59,123	29,579	26,301	36,810	25,130	22,118
1,080,607	1,040,731	994,314	985,664	910,583	821,324	766,392	716,657	663,209
23,233	14,526	16,557	16,714	35,126	34,723	37,882	37,097	34,574
10,440	11,283	10,013	7,383	6,731	8,219	7,782	8,068	4,198
64,722	60,753	43,349	47,476	39,420	40,833	34,385	42,152	43,972
57,749	45,619	31,550	34,258	23,911	22,340	21,493	20,320	25,890
49,337	46,883	33,919	21,258	17,385	14,439	14,254	14,958	16,838
		29,163						
		16,712						
28,086	22,834	18,349	16,105	17,226	12,483	12,396	10,041	16,412
210,334	187,372	183,055	126,480	104,673	98,314	90,310	95,539	107,310
48,469	49,515	51,060	56,860	56,860	57,940	60,430	60,430	62,130
-	16,973	20,950	27,795	28,628	-	-	*	*
111,641	-	-	-	-	-	-	-	-
76,369	76,297	76,878	69,191	58,859	52,620	43,472	41,982	38,156
<u>\$ 1,550,653</u>	<u>\$ 1,385,414</u>	<u>\$ 1,342,814</u>	<u>\$ 1,282,704</u>	<u>\$ 1,194,729</u>	<u>\$ 1,064,921</u>	<u>\$ 998,486</u>	<u>\$ 951,705</u>	<u>\$ 905,379</u>

\$ 468,161	\$ 452,309	\$ 429,596	\$ 412,404	\$ 366,265	\$ 346,778	\$ 323,552	\$ 274,408	\$ 258,565
25,000	25,000	25,000	25,000	25,000	25,000	25,000	26,252	26,633
9,000	9,750	10,564	11,499	12,429	13,749	14,840	15,950	17,041
370,000	382,000	377,000	347,000	324,000	236,000	238,000	234,000	215,000
8,377	18,790	19,379	19,738	20,303	35,838	41,945	57,076	57,931
378,377	400,790	396,379	366,738	344,303	271,838	279,945	291,076	272,931
880,538	887,849	861,539	815,641	747,997	657,365	643,337	607,686	575,170
-	-	-	16,322	-	-	-	-	-
108,291	56,263	94,149	87,264	89,317	50,058	28,832	53,654	72,548
70,698	110,698	68,163	56,039	58,775	64,795	41,784	48,517	44,318
40,000	20,000	10,000	10,000	16,000	26,000	21,000	1,000	-
22,539	8,066	4,101	7,486	4,656	3,196	10,281	6,584	6,757
3,658	2,696	4,673	6,204	6,058	5,396	4,617	4,570	4,438
28,396	23,638	39,153	23,477	21,390	19,418	13,204	11,757	10,180
273,582	221,361	220,239	190,470	196,196	168,863	119,718	126,082	138,241
8,682	9,538	10,393	11,248	11,949	11,668	12,493	13,530	14,567
130,424	141,656	136,150	140,310	139,953	123,625	118,692	112,433	104,300
111,868	-	-	-	-	-	-	-	-
10,089	-	-	-	-	8,058	19,914	*	*
115,631	106,701	98,391	90,968	83,112	76,052	69,209	62,401	56,343
19,839	18,309	16,102	17,745	15,522	19,290	15,123	29,573	16,758
<u>\$ 1,550,653</u>	<u>\$ 1,385,414</u>	<u>\$ 1,342,814</u>	<u>\$ 1,282,704</u>	<u>\$ 1,194,729</u>	<u>\$ 1,064,921</u>	<u>\$ 998,486</u>	<u>\$ 951,705</u>	<u>\$ 905,379</u>

Comparative Financial Statistics

YEAR-END MARKET PRICE & BOOK VALUE PER SHARE

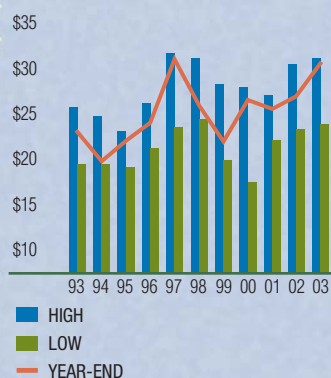
IN DOLLARS



The year-end market-to-book ratio averaged 1.54x over the past 10 years. Total return to shareholders from dividends paid and market appreciation averaged 8.4 percent per year for this period.

HIGH/LOW MARKET PRICE PER SHARE

(IN DOLLARS)



Price per share at year-end increased 34 percent in 10 years.

2003 2002

Common stock

Ratios – year-end:

Price/earnings ratio	17.3	16.6*
Dividend yield at year-end rate – %	4.1	4.7
Dividend payout – %	71.8	77.3*
Return on average common equity – %	9.3	8.7*
Per share data – (\$):		
Basic earnings	1.77	1.63*
Diluted earnings	1.76	1.62*
Dividends paid	1.27	1.26
Dividend rate at year-end	1.30	1.26
Book value at year-end	19.52	18.85*
Market price:		
High	31.30	30.70
Low	24.05	23.46
Year-end	30.75	27.06
Average	27.724	27.577
Number of shares of common stock outstanding (000):		
Year-end	25,938	25,586
Average	25,741	25,431

Coverage data – times earned

Fixed charges – Securities and Exchange Commission	2.83	2.74*
Fixed charges – Standard & Poor's	2.89	3.29

Utility plant

Capital expenditures (000)	\$ 124,660	\$ 79,530
Depreciation – % of average depreciable utility plant	3.5	3.5
Accumulated depreciation – % of depreciable utility plant	38.0	37.3

Capital structure – year-end (%)

(Exclusive of current portion of long-term debt)

First mortgage bonds	49.7	46.9
Unsecured debt	–	0.7
Total long-term debt	49.7	47.6
Redeemable preferred stock	–	0.9
Redeemable preference stock	–	–
Common stock equity	50.3	51.5
Total capital structure	100.0	100.0

Effective tax rate

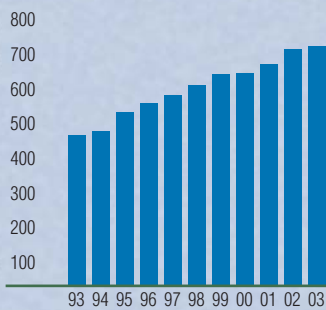
Effective tax rate – % of pretax income	34%	35%
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*Includes losses of \$0.50 per share in 1998 due to asset write-downs for Financial Corporation and Canor and loss of \$0.33 per share in 2002 for PGE acquisition costs.

	2001	2000	1999	1998	1997	1996	1995	1994	1993
	13.4	13.9	12.9	25.4*	17.4	12.2	13.6	12.1	13.1
	4.9	4.7	5.6	4.7	3.9	5.0	5.5	6.0	5.1
	65.5	65.3	71.6	119.6*	67.7	60.9	73.1	72.1	67.0
	10.4	10.8	10.2	6.4*	11.3	13.0	11.8	12.2	13.7
	1.90	1.90	1.71	1.02*	1.78	1.97	1.62	1.63	1.74
	1.88	1.88	1.70	1.02*	1.76	1.94	1.60	1.61	1.72
	1.245	1.24	1.225	1.22	1.205	1.20	1.18	1.173	1.167
	1.26	1.24	1.24	1.22	1.22	1.20	1.20	1.173	1.173
	18.56	17.93	17.12	16.59*	16.02	15.37	14.55	13.63	13.08
	26.69	27.50	27.88	30.75	31.25	25.75	22.67	24.33	25.33
	21.65	17.75	19.50	24.25	23.125	20.833	18.667	19.00	19.00
	25.50	26.50	21.94	25.88	31.00	24.00	22.00	19.67	22.83
	23.666	22.147	24.629	27.248	25.292	23.054	20.750	21.250	22.167
	25,228	25,233	25,092	24,853	22,864	22,555	22,243	20,129	19,766
	25,159	25,183	24,976	24,233	22,698	22,391	21,817	19,943	19,611
	3.01	3.00	2.97	2.12*	2.84	3.32	2.95	2.87	2.96
	3.30	3.16	3.19	2.72	3.05	3.71	2.87	2.98	3.47
\$	71,943	\$ 80,444	\$ 109,144	\$ 80,022	\$ 115,886	\$ 83,400	\$ 67,163	\$ 77,668	\$ 70,404
	3.5	3.5	4.0	3.9	3.8	3.8	4.2	4.1	4.1
	35.8	34.9	33.4	33.2	32.6	33.2	32.8	31.7	31.1
	42.0	44.1	43.6	42.6	43.3	35.9	37.0	38.5	37.4
	1.0	1.0	2.3	2.4	2.7	5.5	6.5	9.4	10.1
	43.0	45.1	45.9	45.0	46.0	41.4	43.5	47.9	47.5
	1.0	1.1	1.2	1.4	1.7	2.1	2.3	2.6	3.0
	2.8	2.8	2.9	3.1	3.3	3.8	3.9	4.3	4.6
	53.2	51.0	50.0	50.5	49.0	52.7	50.3	45.2	44.9
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	35%	36%	35%	35%	33%	37%	37%	37%	37%

Comparative Operating Statistics

NUMBER OF CUSTOMERS SERVED BY EACH OPERATING EMPLOYEE



Each operating employee served an average 724 customers in 2003, a 54 percent increase from the 469 customers served per employee in 1993.

COST OF PURCHASED GAS

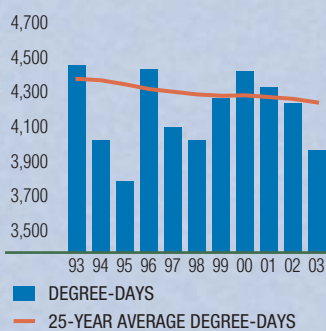
IN CENTS PER THERM



Cost of gas, including demand charges, decreased 8 percent in 2003 but was 103 percent higher than 10 years ago.

HEAT REQUIREMENTS

IN HEATING DEGREE-DAYS



Weather conditions in NW Natural's service area have been warmer than the rolling 25-year average in seven of the past 10 years.

Selected Utility Data

	2003	2002
Customers at year-end		
Residential	519,427	503,402
Commercial	57,969	56,087
Industrial firm	478	306
Industrial interruptible	165	31
Total sales customers	578,039	559,826
Transportation customers	111	241
Total customers	578,150	560,067

Gas sales and transportation deliveries (000 therms)

Residential	343,534	357,091
Commercial	226,257	240,155
Industrial firm	55,314	63,215
Industrial interruptible	47,994	26,241
Total gas sales	673,099	686,702
Transportation	414,554	445,999
Unbilled therms	12,099	(6,617)
Total volumes delivered	1,099,752	1,126,084

Operating revenues and cost of sales (000)

Sales revenues:		
Residential	\$ 328,464	\$ 354,735
Commercial	176,385	201,475
Industrial firm	33,578	42,965
Industrial interruptible	23,661	15,937
Total gas sales revenues	562,088	615,112
Transportation	17,962	26,020
Unbilled revenues	14,474	(12,702)
Other	7,460	4,018
Total utility operating revenues	601,984	632,448
Cost of gas	323,128	353,034
Net utility operating revenues	278,856	279,414
Non-utility net operating revenues	9,210	8,130
Net operating revenues	\$ 288,066	\$ 287,544

Customer data

Heat requirements:		
Actual degree-days	3,952	4,232
25-year average degree-days	4,238	4,257
Average use per customer in therms:		
Residential	673	725
Commercial	4,004	4,334
Average rate per therm (cents):		
Residential	95.6	99.3
Commercial	78.0	83.9
Industrial firm	60.7	68.0
Industrial interruptible	49.3	61.7
Total sales	83.5	89.6

Gas purchases (000 therms)	708,796	708,796
Gas purchased cost per therm - net (cents)	46.99	51.07
Average sendout cost of gas (cents)	47.16	51.91
Maximum day firm sendout (000 therms)	4,851	4,249
Maximum day total sendout (000 therms)	6,310	6,172

Payroll (000)

Operating	\$ 43,993	\$ 42,268
Construction and other	27,450	26,044
Total	\$ 71,443	\$ 68,312

Utility employees	1,291	1,261
Number of customers served by each operating employee	724	714

*Interest on deferred regulatory accounts for years prior to 1998 was reclassified from to other income (expense).

2001	2000	1999	1998	1997	1996	1995	1994	1993
485,207	468,087	447,659	425,606	407,061	385,213	363,903	346,950	329,157
55,096	54,684	52,870	51,159	50,315	47,309	45,402	44,078	42,657
383	384	388	411	403	407	410	401	396
148	126	115	108	122	119	143	142	153
540,834	523,281	501,032	477,284	457,901	433,048	409,858	391,571	372,363
97	125	131	123	120	121	91	67	64
<u>540,931</u>	<u>523,406</u>	<u>501,163</u>	<u>477,407</u>	<u>458,021</u>	<u>433,169</u>	<u>409,949</u>	<u>391,638</u>	<u>372,427</u>
350,065	356,375	352,969	315,686	306,356	306,310	256,462	260,218	267,818
242,293	250,380	252,382	229,124	225,249	225,115	196,723	201,925	209,642
79,778	76,559	84,630	87,275	84,523	91,122	82,958	81,348	80,588
63,597	56,632	52,938	51,521	53,929	63,261	84,173	89,899	66,370
735,733	739,946	742,919	683,606	670,057	685,808	620,316	633,390	624,418
385,783	431,136	480,570	446,165	440,452	410,062	379,116	364,461	415,367
1,771	8,691	(9,343)	8,645	3,615	3,759	4,946	(7,519)	3,844
<u>1,123,287</u>	<u>1,179,773</u>	<u>1,214,146</u>	<u>1,138,416</u>	<u>1,114,124</u>	<u>1,099,629</u>	<u>1,004,378</u>	<u>990,332</u>	<u>1,043,629</u>
\$ 329,905	\$ 280,642	\$ 242,952	\$ 205,388	\$ 177,835	\$ 183,802	\$ 165,662	\$ 176,510	\$ 168,217
190,236	159,660	139,425	117,889	100,677	104,582	99,079	108,452	103,476
49,662	37,378	35,857	34,303	27,025	30,672	31,268	34,443	31,340
34,283	23,483	17,182	15,337	13,944	17,097	24,113	27,361	18,884
604,086	501,163	435,416	372,917	319,481	336,153	320,122	346,766	321,917
20,637	21,491	21,351	19,958	22,029	22,533	16,650	14,702	17,892
13,774	12,661	(2,671)	8,314	1,647	1,627	1,173	(5,571)	5,153
(2,325)	(3,976)	1,194	2,617	7,884	9,824	9,411	429	2,625
636,172	531,339	455,290	403,806	351,041	370,137	347,356	356,326	347,587
364,699	273,978	212,021	173,242	130,381	141,789	142,025	162,437	138,751
271,473	257,361	243,269	230,564	220,660	228,348	205,331	193,889	208,836
4,538	589	368	402	450	636	8,271	11,773	10,865
<u>\$ 276,011</u>	<u>\$ 257,950</u>	<u>\$ 243,637</u>	<u>\$ 230,966</u>	<u>\$ 221,110</u>	<u>\$ 228,984</u>	<u>\$ 213,602</u>	<u>\$ 205,662</u>	<u>\$ 219,701</u>
4,325	4,418	4,256	4,011	4,092	4,427	3,779	4,020	4,452
4,267	4,274	4,274	4,283	4,299	4,312	4,340	4,365	4,372
738	781	810	749	777	823	726	776	844
4,435	4,670	4,851	4,540	4,670	4,874	4,420	4,680	5,029
94.2	78.7	68.8	65.1	58.0	60.0	64.6	67.8	62.8
78.5	63.8	55.2	51.5	44.7	46.5	50.4	53.7	49.4
62.2	48.8	42.4	39.3	32.0	33.7	37.7	42.3	38.9
54.0	41.5	32.5	29.6	25.9	27.0	28.6	30.4	28.5
82.1	67.7	58.6	54.6	47.7	49.0	51.6	54.7	51.6
739,620	745,582	773,258	712,602	702,820	692,894	640,976	642,607	628,172
47.19	37.68	27.85	25.09	24.05	22.25	20.67	23.44	23.11
49.45	36.60	28.90	25.03	19.35	20.56	22.71	25.95	22.08
4,247	4,691	4,144	6,414	4,447	5,997	4,375	3,920	4,069
5,996	5,814	6,211	7,446	5,744	7,422	5,717	5,291	5,607
\$ 40,856	\$ 38,979	\$ 38,066	\$ 37,573	\$ 35,669	\$ 34,037	\$ 33,669	\$ 33,888	\$ 33,539
25,626	24,756	24,322	24,625	24,630	22,920	22,074	20,795	21,056
<u>\$ 66,482</u>	<u>\$ 63,735</u>	<u>\$ 62,388</u>	<u>\$ 62,198</u>	<u>\$ 60,299</u>	<u>\$ 56,957</u>	<u>\$ 55,743</u>	<u>\$ 54,683</u>	<u>\$ 54,595</u>
1,284	1,315	1,275	1,303	1,337	1,304	1,288	1,338	1,293
671	646	643	611	583	560	533	478	469

Board of Directors

Timothy Boyle

Timothy P. Boyle, 54, is President and Chief Executive Officer of Columbia Sportswear Company located in Portland, Oregon. He was elected to the NW Natural Board of Directors in 2003, and serves on the Finance Committee, Strategic Planning Committee, and Organization and Executive Compensation Committee.

John Carter

A member of the NW Natural Board since 2002, John D. Carter, 58, chairs the Board's Governance Committee. He is also a member of the Audit and Finance Committees. Mr. Carter is a principal with Goldschmidt, Imeson, and Carter, a strategic planning and public affairs consulting firm in Portland, Oregon.

Mark Dodson

NW Natural's President and Chief Executive Officer is Mark S. Dodson, 59. He has served on the Board since 2003.

Scott Gibson

C. Scott Gibson, 51, is President of Gibson Enterprises, a company that manages private investments in Lake Oswego, Oregon. Mr. Gibson joined the NW Natural Board in 2002. He is a member of the Public Affairs and Environmental Policy Committee, Strategic Planning Committee, and Organization and Executive Compensation Committee.

Tod Hamachek

The Chair of the Strategic Planning Committee, Tod R. Hamachek, 58, has served on the NW Natural Board since 1986. Mr. Hamachek is also a member of the Board's Audit and Governance Committees. He is Chairman and Chief Executive Officer of Penwest Pharmaceuticals Company, a firm that develops pharmaceutical drug delivery products and technologies in Danbury, Connecticut.

Randall Papé

A member of the Board since 1996, Randall C. Papé, 53, chairs the Finance Committee. Mr. Papé is President and Chief Executive Officer of The Papé Group, Inc., headquartered in Eugene,

Oregon, which specializes in the sales and service of capital equipment. He serves on the Board's Governance Committee and the Public Affairs and Environmental Policy Committee.

Richard Reiten

Chairman of the Board Richard G. Reiten, 64, has been a member of the Board since 1996. Mr. Reiten serves on the Finance Committee, Public Affairs and Environmental Policy Committee, and Strategic Planning Committee.

Robert Ridgley

Retired Chairman Robert L. Ridgley, 70, has served on the NW Natural Board since 1984. Mr. Ridgley is a member of the Finance Committee, Public Affairs and Environmental Policy Committee, and Strategic Planning Committee.

Melody Teppola

A managing partner of National Builders Hardware Company in Portland, Melody C. Teppola, 61, has served on the NW Natural Board since 1987. National Builders Hardware is a regional and national distributor of builders' hard-

Below: (left to right)

Russell Tromley, John Carter, Richard Woolworth, Timothy Boyle, Mark Dodson, Richard Reiten, Scott Gibson, Melody Teppola, Robert Ridgley, Tod Hamachek and Randall Papé.



ware, decorative plumbing and wood-working machinery located in Portland, Oregon. Ms. Teppola chairs the Board's Public Affairs and Environmental Policy Committee and is a member of the Audit and Governance Committees.

Russell Tromley

The Chair of the Organization and Executive Compensation Committee is Russell F. Tromley, 64. He has served on the Board since 1994, and is a member of the Audit and Governance Committees. Mr. Tromley is President and Chief Executive Officer of Tromley Industrial Holdings, Inc., a company in Tualatin, Oregon, that manufactures foundry equipment and distributes nonferrous metals.

Richard Woolworth

Elected to the Board in 2000, Richard L. Woolworth, 62, chairs the Audit Committee. He also serves on the Governance Committee and the Organization and Executive Compensation Committee. Mr. Woolworth is the Retired Chairman and CEO of The Regence Group, a regional affiliation of health plans in Portland, Oregon.

The following mission and values statements were adopted by NW Natural in 2003 as part of the Company's new Strategic Plan.

Mission

"We bring warmth, comfort and convenience to people's lives and help businesses and communities succeed."

Core Values

Integrity

Integrity means being honest and ethical in everything we do, and being true to our word. It includes fiscal responsibility, trustworthiness and principled behavior. Integrity is fundamental to the Company's image, reputation and success.

Service Ethic

NW Natural employees are driven by a desire to help others. Whether their customers are external or internal, employees are responsive in solving people's problems. Employees take pride in the Company's service reputation. A service ethic also underlies the Company's commitment to reliable and efficient operations.

Caring

Employees respect each other professionally and care about each other personally. They enjoy a sense of teamwork, family and fun. At the same time, they value individual performance. The Company provides guidance and discipline to help each employee do his or her best. Caring is also reflected in NW Natural's diversity efforts, and its community involvement and employee volunteerism.

Safety

Safety is critically important in all aspects of the Company's operation. Employees are dedicated to safe work practices. The Company goes out of its way to educate consumers and the public on the safe use of natural gas. NW Natural also meets or exceeds all regulatory requirements for pipeline safety.





NW Natural officers gather at The Oregon Food Bank, selected in 2003 as the Company's Signature Program for philanthropic giving and employee volunteerism. From left to right are: Lea Anne Doolittle, Gregg Kantor, Richelle Luther, Mike McCoy, Steve Feltz, Mark Dodson, C.J. Rue, Beth Ugoretz and Bruce DeBolt.

Corporate Officers

Bruce R. DeBolt, 56 [1980]
Senior Vice President, Finance, and Chief Financial Officer (1990-)
 Senior Vice President, Finance and Administration and General Counsel (1987-1990)
 Vice President and General Counsel (1983-1987)

Mark S. Dodson, 59 [1997]
President, Chief Executive Officer (2003-)
 President, Chief Operating Officer (2001-2002)
 General Counsel (1997-2002)
 Senior Vice President, Public Affairs (1997-2001)

Lea Anne Doolittle, 48 [2000]
Vice President, Human Resources (2000-)
 Director of Compensation, PacifiCorp (1993-2000)

Stephen P. Feltz, 48 [1982]
Treasurer and Controller (1999-)
 Assistant Treasurer and Manager, General Accounting (1996-1999)

Gregg S. Kantor, 46 [1996]
Senior Vice President, Public and Regulatory Affairs (2003-)
 Vice President, Public Affairs and Communications (1998-2002)
 Director, Public Affairs and Communications (1996-1997)

Richelle T. Luther, 35 [2002]
Assistant Secretary (2002-)
 Associate, Stoel Rives LLP (1997-2002)

Michael S. McCoy, 60 [1969]
Executive Vice President, Customer and Utility Operations (2000-)
 Senior Vice President, Customer and Utility Operations (1999-2000)
 Senior Vice President, Customer Services (1992-1999)

C. J. Rue, 58 [1974]
Secretary (1982-)
 Assistant Treasurer (1987-)

Beth A. Ugoretz, 48 [2002]
Senior Vice President, General Counsel (2003-)
 Executive Vice President, KinderCare Learning Centers, Inc. (1997-2000)
 Senior Vice President, General Counsel and Secretary, Red Lion Hotels, Inc. (1993-1996)

[Date joined NW Natural]

Corporate Information

Notice of Annual Meeting

The 2004 Annual Meeting will be held at 2 p.m. Thursday, May 27, at the DoubleTree Hotel Portland-Lloyd Center, Lloyd Center Ballroom, 1000 NE Multnomah, Portland, Oregon. A meeting notice and proxy statement will be sent to all shareholders in mid-April.

Request for Publications

The following publications may be obtained without charge by contacting the Corporate Secretary:

Annual Report
Form 10-K
Form 10-Q
Corporate Governance Standards
Code of Ethics

These publications, as well as other filings made with the Securities and Exchange Commission, also are available on NW Natural's web site at www.nwnatural.com.

Stock Transfer Agent and Registrar

Effective March 22, 2004, for all Common Stock Issues:
American Stock Transfer & Trust Company
59 Maiden Lane
New York, NY 10038
Telephone: (888) 777-0321
Internet: www.amstock.com
E-mail: info@amstock.com

Trustee, Conversion and Interest Paying Agent

For Convertible Debentures:
The Bank of New York
Corporate Debt Operations, Floor 7-E
101 Barclay Street
New York, New York 10286
(800) 548-5075

Trustee and Bond Paying Agent

For all bond issues:
DB Services Tennessee Inc.
Security Holder Relations
P.O. Box 305050
Nashville, Tennessee 37230
(800) 735-7777

Quarterly Financial Information (unaudited)

Dollars (thousands except per share amounts)	Quarter ended				Total
	March 31	June 30	Sept. 30	Dec. 31	
2003					
Operating revenues	\$206,539	\$117,489	\$69,481	\$217,747	\$611,256
Net operating revenues	98,588	58,549	39,465	91,464	288,066
Net income (loss)	26,404	4,462	(6,546)	21,663	45,983
Basic earnings (loss) per share	1.03	0.17	(0.25)	0.84	1.77*
Diluted earnings (loss) per share	1.01	0.17	(0.25)	0.83	1.76*
2002					
Operating revenues	\$278,563	\$101,873	\$78,717	\$182,223	\$641,376
Net operating revenues	110,666	56,564	38,059	82,255	287,544
Net income (loss)	34,447	(2,992)	(6,008)	18,345	43,792
Basic earnings (loss) per share	1.34	(0.14)	(0.26)	0.70	1.63*
Diluted earnings (loss) per share	1.32	(0.14)	(0.26)	0.69	1.62*

*Quarterly earnings per share are based upon the average number of common shares outstanding during each quarter. Because the average number of shares outstanding has changed in each quarter shown, the sum of quarterly earnings (loss) per share may not equal earnings per share for the year. Variations in earnings between quarterly periods are due primarily to the seasonal nature of the Company's business.

Common Stock Prices

The Company's common stock is listed and trades on the New York Stock Exchange using the symbol NWN. The quarterly high and low trading range during 2002 and 2003 was:

2003 Quarter	High	Low
1	28.47	24.05
2	28.88	24.77
3	30.10	27.02
4	31.30	28.51

2002 Quarter	High	Low
1	28.50	24.20
2	30.30	27.60
3	30.20	23.46
4	30.70	25.50

Dividend Reinvestment Plan

Common shareholders of record may reinvest all or part of their dividends in additional shares under the Company's plan. Cash purchases also may be made at the current market price under this plan, and no brokerage fees will be charged. A prospectus will be sent to any registered shareholder on request.

Dividend Payment Dates

February 13, 2004
May 14, 2004
August 13, 2004
November 15, 2004

Shareholder Information



James R. Boehlke
Investor Relations
(503) 721-2451
(800) 422-4012,
Ext. 2451
jrb@nwnatural.com

Linda R. Williams
Shareholder Services
(503) 220-2590
(800) 422-4012,
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lrw@nwnatural.com

NW Natural

220 N.W. Second Avenue
Portland, Oregon 97209
(503) 226-4211
(800) 422-4012
www.nwnatural.com

Contact the NW Natural Board

Concerns may be directed to the non-management directors as follows:

- Call 1-800-541-9967, or
- Write to NW Natural Board of Directors, c/o Corporate Secretary, or
- Email Directors@nwnatural.com

Forward-looking Statements

NW Natural's future operating results will be affected by various uncertainties and risk factors, many of which are beyond the Company's control, including governmental policy and regulatory action, the competitive environment, economic factors and weather conditions. Some statements in this annual report may be forward-looking, and actual results may differ materially as a result of these uncertainties. For a more complete description of these uncertainties and risk factors, please refer to the Company's filings with the Securities and Exchange Commission on Forms 10-K and 10-Q.



NW Natural

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