RGC RESOURCES INC
Form ARS
December 20, 2011

SOLID AND STEADY, RGC EMBRACES A NEW ERA

At RGC Resources, we re not rushing into things. Straightforward, solid performance has always been at the heart of our steady success. But when the time is right to invest in the latest technology to enhance safety and efficiency, we do it right.

It s been a significant year for financial gains and technological advancement at RGC. As city revitalization projects multiplied the number of downtown Roanoke residences, we felt it was important to replace the natural gas distribution system beneath the streets. Some of these pipes cast iron mains and bare steel service lines were close to 100 years old. After a monumental, six-month undertaking completed in October, 9,000 feet of modern plastic and coated steel pipe are now beneath the streets downtown.

RGC is one of the first in the country to remove meters from the basements of old downtown buildings and secure them in vaults in sidewalks, creating a much safer scenario in the event of an emergency. It s a proactive move, incorporating high-tech features such as excess flow automatic cutoff valves. Along with ensuring safety and reliability, these system upgrades will enhance service to downtown residents and commercial properties by providing higher operating gas pressure a vital improvement.

The infrastructure investment of 2011 reflects RGC s commitment to our customers and to the future of the company. Earnings, stock prices and dividends continued to rise consistently in 2011 despite the economy, and we were especially pleased to announce a 100 percent stock dividend to shareholders in September.

It s all about solid performance and steady success.

YEAR ENDED SEPTEMBER 30,	2011	2010	2009
	$ 69,483,620	$ 72,426,658	$ 80,786,228
	$ 1,315,251	$ 1,397,256	$ 1,398,245
	$ 4,653,473	$ 4,445,436	$ 4,869,010
	$ 1.01	$ 0.98	$ 1.09
	$ 0.68	$ 0.66	$ 0.64
	57,684	56,975	56,119
	9,544,598	9,314,151	9,260,469
	$ 7,589,386	$ 5,973,586	$ 5,752,780

To Our Shareholders:

I am pleased to report earnings of $4,653,000, a 4.7 percent improvement over last year. I am also pleased to report that our Board of Directors approved an annualized dividend increase to $0.70 per share effective February 1, 2012, following the 100 percent stock dividend to shareholders that was effective September 1, 2011. In spite of several years of recession and very sluggish national and international economic growth, we have weathered the economic turmoil and malaise reasonably well. Our level of infrastructure investment, stock price and dividends, while not immune to the economic cycle and volatility, have improved as follows:

YEAR	NET PLANT BALANCE	OCTOBER 1 STOCK PRICE PER SHARE	ANNUALIZED DIVIDEND PER SHARE
2011	**$ 85,722,000**	**$ 18.65**	**$ 0.68**
2010	$ 81,455,000	$ 15.10	$ 0.66
2009	$ 78,509,000	$ 13.49	$ 0.64
2008	$ 75,608,000	$ 15.00	$ 0.625
2007	$ 72,587,000	$ 13.49	$ 0.61

(per share items adjusted for stock split)

JOHN B. WILLIAMSON, III

RGC Resources, Inc.

Chairman of the Board, President & CEO

Operationally, 2011 was a very busy year. We replaced approximately 9 miles of bare steel and cast iron pipeline, including all of the remaining cast iron and bare steel pipe in downtown Roanoke. Prior to the 1960s, Roanoke Gas Company installed either cast iron or bare steel pipe to deliver gas to customers. Twenty years ago, we began a program to replace the cast iron and bare steel pipe with either plastic or coated steel pipe. As a result, bare steel and cast iron pipe comprise approximately 5 percent of our distribution system compared to 25 percent in 1991. We plan to replace the remaining cast iron and bare steel pipe over the next few years, continuing to reduce maintenance costs and further enhance system reliability and safety.

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We are investing in infrastructure to add new customers, currently at a modest rate given the still depressed new home construction sector. Customers converting to natural gas from other energy sources for space heating, such as fuel oil and electricity, is a significant portion

of new customer growth, as natural gas prices in 2011 were at or near historical lows for the decade. The long-term outlook for domestic natural gas supplies remains strong as development of natural gas reserves from shale deposits continues in many parts of the country. While I expect the increasing conversion of electricity generation plants from coal to natural gas for environmental and EPA compliance reasons to continue, the apparent abundance of gas supply should help mitigate related upward price pressure. Natural gas should maintain its

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price advantage for space and water heating for the foreseeable future. We feel fortunate to be part of an industry that provides both the environmentally friendly fuel and the most economical option for customers.

We had an active year from a regulatory perspective. The rate case filed in September 2010 was settled with the Virginia State Corporation Commission (SCC) in April 2011 for $814,000. We filed a new rate case in September 2011 for $1,088,000 and put those rates into effect November 1, 2011 subject to SCC audit and hearing. Any difference between the SCC final order and the implemented rates will be refunded to customers following receipt of a final order expected in mid 2012. Our rate increases, while modest, are necessary to recover increased depreciation expense on added or replaced plant as well as increased employee, operational and regulatory compliance costs.

We completed our Distribution Integrity Management Plan in 2011 as required by federal regulation. The plan is designed to improve our year-to-year operating risk assessment, system maintenance and safety programs. While we believe we are ahead of most of the industry as a result of having already replaced much of our older plant, the new model for improved risk-based assessment should enhance our already strong safety and system reliability programs.

National and international weak economic conditions continue to weigh heavily on U.S. business activity and national unemployment remains stubbornly high at roughly 9 percent. Unemployment in our service area peaked in 2010 at 7.4 percent, but declined to approximately 6.7 percent by the end of fiscal year 2011. We experienced significant industrial sales decline during the recession, however gas deliveries to industrial customers improved in 2011, though

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not to pre-recession levels. I expect some continued softness for fuel demand by our larger industrial customers in 2012. Space heating sales should be reasonably strong based on long-range weather forecasts. If the forecasts are inaccurate, the Company does have a regulatory tariff mechanism to protect heating sales margins against weather that is more than 3 percent warmer than the long-term average for our service territory.

Fortunately, interest rates have remained low and are expected to remain so for at least another year. Overall 2012 will likely be another anemic year for the U.S. economy. However, we look forward to reporting to you at the end of 2012 on what I anticipate to be another solid performance.

On behalf of our employees and members of the Board of Directors, I thank you for your continued interest in our operations and for your ongoing decision to invest in RGC Resources.

JOHN B. WILLIAMSON, III

RGC Resources, Inc.

Chairman of the Board, President & CEO

SELECTED FINANCIAL DATA

YEAR ENDED SEPTEMBER 30,	2011	2010	2009	2008	2007
OPERATING REVENUES	**$ 70,798,871**	$ 73,823,914	$ 82,184,473	$ 94,636,826	$ 89,901,301
GROSS MARGIN	**27,269,566**	26,440,273	27,075,924	25,913,612	25,221,776
OPERATING INCOME	**9,313,046**	8,982,181	9,844,516	8,838,026	7,958,279
NET INCOME - CONTINUING OPERATIONS	**4,653,473**	4,445,436	4,869,010	4,257,824	3,765,669
NET INCOME (NET LOSS) - DISCONTINUED OPERATIONS				(36,690)	40,540
BASIC EARNINGS PER SHARE - CONTINUING OPERATIONS	**$ 1.01**	$ 0.98	$ 1.09	$ 0.97	$ 0.87
BASIC EARNINGS PER SHARE - DISCONTINUED OPERATIONS				(0.01)	0.01
CASH DIVIDENDS DECLARED PER SHARE	**$ 0.680**	$ 0.660	$ 0.640	$ 0.625	$ 0.610
BOOK VALUE PER SHARE	**10.55**	10.18	10.00	9.89	9.69
AVERAGE SHARES OUTSTANDING	**4,592,713**	4,514,262	4,447,454	4,402,527	4,325,607
TOTAL ASSETS	**125,549,049**	120,683,316	118,801,892	118,127,714	116,332,455
LONG-TERM DEBT (LESS CURRENT PORTION)	**13,000,000**	28,000,000	28,000,000	23,000,000	23,000,000
STOCKHOLDERS EQUITY	**48,785,778**	46,309,747	44,799,871	43,723,058	42,365,233
SHARES OUTSTANDING AT SEPT. 30	**4,624,682**	4,548,864	4,477,974	4,418,942	4,372,286

Forward Looking Statements

This report contains forward-looking statements that relate to future transactions, events or expectations. In addition, RGC Resources, Inc. (Resources or the Company) may publish forward-looking statements relating to such matters as anticipated financial performance, business prospects, technological developments, new products, research and development activities and similar matters. These statements are based on management s current expectations and information available at the time of such statements and are believed to be reasonable and are made in good faith. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company s actual results and experience to differ materially from the anticipated results or expectations expressed in the Company s forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company s business include, but are not limited to, the following: (i) general economic conditions both locally and nationally; (ii) impact of potential increased regulatory oversight and compliance requirements due to financial, environmental, safety or system integrity laws and regulations; (iii) impact of potential climate change legislation regarding limitations on carbon dioxide emissions; (iv) failure to obtain timely rate relief from regulatory authorities for increased operating or gas costs including a reasonable return on invested capital; (v) the potential loss of large-volume industrial customers to alternative fuels, facility closings or production changes; (vi) ability to attract and retain professional and technical employees to replace an aging workforce; (vii) access to capital markets and the availability of debt and equity financing to support future capital expenditures; (viii) volatility in the price and availability of natural gas, including restrictions on the exploration

and development of natural gas reserves; (ix) changes in accounting regulations and practices, which could change the accounting treatment for certain transactions and increase the cost of compliance; (x) effect of the federal budget deficit and its potential impact on corporate taxes; (xi) effect of weather conditions and natural disasters on production and distribution facilities and the related effect on supply availability and price; (xii) potential effect of health-care legislation on healthcare costs; (xiii) increased customer delinquencies and conservation efforts resulting from difficult economic conditions and/or colder weather; and (xiv) volatility in the actuarially determined benefit costs and asset performance of the Company s benefit plans. All of these factors are difficult to predict and many are beyond the Company s control. Accordingly, while the Company believes its forward-looking statements to be reasonable, there can be no assurance that they will approximate actual experience or that the expectations derived from them will be realized. When used in the Company s documents or news releases, the words anticipate, believe, intend, plan, estimate, expect, objective, projection, forecast, budget, assume, indicate or sim conditional verbs such as will, would, should, can, could or may are intended to identify forward-looking statements.

Forward-looking statements reflect the Company s current expectations only as of the date they are made. The Company assumes no duty to update these statements should expectations change or actual results differ from current expectations except as required by applicable laws and regulations.

MANAGEMENT S DISCUSSION AND ANALYSIS

OVERVIEW

RGC Resources is an energy services company primarily engaged in the regulated sale and distribution of natural gas to approximately 57,700 residential, commercial and industrial customers in Roanoke, Virginia and the surrounding localities through its Roanoke Gas Company (Roanoke Gas) subsidiary. Resources also provides certain unregulated services through Roanoke Gas and utility consulting and information system services through RGC Ventures of Virginia, Inc., which operates as The Utility Consultants and Application Resources. The unregulated operations represent less than 3% of revenues and margins of Resources.

The utility operations of Roanoke Gas are regulated by the Virginia State Corporation Commission (SCC) which oversees the terms, conditions, and rates to be charged to customers for natural gas service, safety standards, extension of service, accounting and depreciation. The Company is also subject to federal regulation from the Department of Transportation in regard to the construction, operation, maintenance, safety and pipeline integrity of its transmission and distribution pipelines. The Federal Energy Regulatory Commission regulates the prices for the transportation and delivery of natural gas to the Company s distribution system and underground storage services. The Company is also subject to other regulations which are not necessarily industry specific.

The SCC authorizes the rates and fees that the Company charges its customers for regulated natural gas service. These rates are designed to provide the Company with the opportunity to recover its gas and non-gas expenses and to earn a reasonable rate of return for shareholders. The Company s business is seasonal in nature and weather dependent as a majority of natural gas sales are for space heating during the winter season. Volatility in winter weather and the commodity price of natural gas can impact the effectiveness of the Company s rates in recovering its costs and providing a reasonable rate of return for its shareholders. Over the past several years, the Company has implemented certain approved rate mechanisms that reduce some of the volatility in earnings associated with variations in winter weather and the cost of natural gas.

Since 2003, Roanoke Gas has had in place a weather normalization adjustment mechanism (WNA) based on a weather measurement band around the most recent 30-year temperature average. Because the SCC authorizes billing rates for the utility operations of Roanoke Gas based on normal weather, warmer than normal weather may result in the Company failing to earn its authorized rate of return. Therefore, the WNA provides the Company with a level of earnings protection when weather is significantly warmer than normal and provides its customers with price protection when the weather is significantly colder than normal. The WNA mechanism provides for a weather band of 3% above and below the 30-year average, whereby the Company would bill its customers for the lost margin (excluding gas costs) for the impact of weather that was more than 3% warmer than normal or refund customers the excess margin earned for weather that was more than 3% colder than normal. The annual WNA period extends from April to March. The total number of heating degree days during both the current and the prior WNA periods fell within the weather band. As a result, the WNA mechanism was not triggered for either period.

The Company also has an approved rate structure in place that mitigates the impact of financing costs of its natural gas inventory. Over the past four years, the commodity price of natural gas has fluctuated significantly from a price of more than $13 a decatherm in July 2008 to around $4 a decatherm in 2011. Under this rate structure, Roanoke Gas recognizes revenue for the financing costs, or carrying costs , of its investment in natural gas inventory. The carrying cost revenue factor applied to inventory is based on the Company s weighted-average cost of capital including interest rates on short-term and long-term debt and the Company s authorized return on equity. During times of rising gas costs and rising inventory levels, the Company recognizes revenues to offset higher financing costs associated with higher inventory balances. Conversely, during times of decreasing gas costs and lower inventory balances, the Company recognizes less carrying cost

revenue as financing costs are lower. As a result of the lower commodity price of natural gas, the average price of gas in storage during fiscal 2011 has declined 10% from last year s levels from $5.75 to $5.16. Correspondingly, carrying cost revenues declined by $151,000 from $1,547,000 in fiscal 2010 to $1,396,000 in fiscal 2011. Carrying cost revenues are expected to be less during the next fiscal year due to lower average price of gas in storage.

Generally, as investment in natural gas inventory increases so does the level of borrowing under the Company s line-of-credit. However, as the carrying cost factor used in determining carrying cost revenues is based on the Company s weighted-average cost of capital, carrying cost revenues do not directly correspond with incremental short-term financing costs. Therefore, when inventory balances decline due to a reduction in commodity prices, net income will decline as carrying cost revenues decrease by a greater amount than short-term financing costs decrease. The inverse occurs when inventory costs increase. Due to its strong cash position related to lower gas costs and other factors, the Company has not accessed its line-of-credit facility since early 2009 to finance its natural gas inventory.

The economic environment generally has a direct correlation on business and industrial production,

customer growth and natural gas utilization. The economic downturn that began in 2008 continued into 2011. However, the impact on industrial production in the Company s service area appears to have stabilized and improved as transportation and industrial gas deliveries increased by 10% in fiscal 2011 compared to a 5% increase in fiscal 2010 and a 12% decline in fiscal 2009. Nevertheless, uncertainty continues to be an issue as three transportation customers have notified the Company of their anticipated reduction in natural gas consumption during the first quarter or portions of the second quarter of fiscal 2012 due to production cutbacks. Currently, the Company does not expect these reductions to have a significant impact on the overall transportation and interruptible sales in fiscal 2012. The economic issues have also directly impacted residential construction with housing starts remaining well below historical levels thereby limiting the opportunity to expand the Company s customer base. As a result, the Company has increased its total customer count through conversions where homeowners along the Company s distribution system are electing to convert their heating systems or other appliances to natural gas. The Company has also benefited from the conversion of certain apartment complexes from master meter configurations to individual metered apartments as discussed in further detail below.

Results of Operations

Fiscal Year 2011 Compared with Fiscal Year 2010

OPERATING REVENUES

Year Ended September 30,	2011	2010	(Decrease)	Percentage
Gas Utilities	**$ 69,483,620**	$ 72,426,658	$ (2,943,038)	-4%
Other	**1,315,251**	1,397,256	(82,005)	-6%
Total Operating Revenues	**$ 70,798,871**	$ 73,823,914	$ (3,025,043)	-4%

The table below reflects volume activity and heating degree days.

DELIVERED VOLUMES

Year Ended September 30,	2011	2010	Increase/ (Decrease)	Percentage
Regulated Natural Gas (DTH)				
Residential and Commercial	**6,582,487**	6,623,331	(40,844)	-1%
Transportation and Interruptible	**2,962,111**	2,690,820	271,291	10%
Total Delivered Volumes	**9,544,598**	9,314,151	230,447	2%

Heating Degree Days (Unofficial)	**4,091**	4,047	44	1%

Total gas utility operating revenues for the year ended September 30, 2011 (fiscal 2011) decreased by 4% from the year ended September 30, 2010 (fiscal 2010) even though total delivered volumes increased by 2% over fiscal 2010. The decrease in gas revenues is due to the continued downward trend in gas costs. Natural gas commodity prices were approximately $4 a decatherm as of the end of September 2011. For the year, the average per unit cost of natural gas reflected in cost of sales decreased by 10% compared to last year. Residential and commercial volumes declined by 1% from fiscal 2010 even though total heating degree days increased by 1%. The decline in residential and commercial

volumes resulted from a large commercial customer switching to firm transportation service at the beginning of the year combined with the continuing slow, steady decline in residential usage per customer as a result of installation of more efficient equipment, better insulation of homes and greater customer awareness regarding conservation. Transportation and interruptible volumes increased by 10% mainly due to additional consumption with the balance of the increase attributed to volumes associated with the previously discussed commercial customer switching to firm transportation service. Other revenues declined by 6% due to the decline in certain contract services from last year s levels.

GROSS MARGIN

Year Ended September 30,	2011	2010	Increase/ (Decrease)	Percentage
Gas Utility	$ 2			