

RGC RESOURCES INC
Form 10-Q
May 13, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For Quarterly Period Ended March 31, 2011

Commission File Number 000-26591

RGC Resources, Inc.

(Exact name of Registrant as Specified in its Charter)

VIRGINIA
(State or Other Jurisdiction of
Incorporation or Organization)

54-1909697
(I.R.S. Employer
Identification No.)

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519 Kimball Ave., N.E., Roanoke, VA
(Address of Principal Executive Offices)

24016
(Zip Code)

(540) 777-4427

(Registrant's Telephone Number, Including Area Code)

None

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated-filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 30, 2011
Common Stock, \$5 Par Value	2,298,133

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

UNAUDITED

	March 31, 2011	September 30, 2010
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 18,585,330	\$ 6,745,630
Accounts receivable (less allowance for uncollectibles of \$380,503 and \$65,275, respectively)	9,047,270	3,273,627
Note receivable	87,000	87,000
Materials and supplies	577,035	563,178
Gas in storage	4,455,933	13,810,208
Prepaid income taxes		2,532,057
Deferred income taxes	4,360,521	3,436,923
Other	1,347,720	1,206,367
Total current assets	38,460,809	31,654,990
UTILITY PROPERTY:		
In service	125,858,376	123,073,541
Accumulated depreciation and amortization	(44,317,105)	(43,084,808)
In service, net	81,541,271	79,988,733
Construction work in progress	1,389,649	1,466,658
Utility plant, net	82,930,920	81,455,391
OTHER ASSETS:		
Note receivable	952,000	1,039,000
Regulatory assets	6,389,313	6,480,325
Other	103,376	53,610
Total other assets	7,444,689	7,572,935
TOTAL ASSETS	\$ 128,836,418	\$ 120,683,316

See notes to condensed consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

UNAUDITED

	March 31, 2011	September 30, 2010
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 15,000,000	\$
Dividends payable	781,365	750,786
Accounts payable	6,231,888	4,572,917
Customer credit balances	574,654	2,637,380
Income taxes payable	1,532,466	
Customer deposits	1,751,469	1,632,977
Accrued expenses	2,033,041	2,058,643
Over-recovery of gas costs	4,766,699	2,581,600
Fair value of marked-to-market transactions	2,498,990	3,619,705
 Total current liabilities	 35,170,572	 17,854,008
 LONG-TERM DEBT	 13,000,000	 28,000,000
 DEFERRED CREDITS AND OTHER LIABILITIES:		
Asset retirement obligations	3,115,304	3,073,782
Regulatory cost of retirement obligations	8,017,798	7,699,319
Benefit plan liabilities	9,989,248	9,850,526
Deferred income taxes	8,885,528	7,860,064
Deferred investment tax credits	28,520	35,870
 Total deferred credits and other liabilities	 30,036,398	 28,519,561
 STOCKHOLDERS EQUITY:		
Common stock, \$5 par value; authorized 10,000,000 shares; issued and outstanding 2,297,387 and 2,274,432, respectively	11,486,935	11,372,160
Preferred stock, no par, authorized 5,000,000 shares; no shares issued and outstanding		
Capital in excess of par value	18,032,457	17,462,670
Retained earnings	24,272,165	21,341,740
Accumulated other comprehensive loss	(3,162,109)	(3,866,823)
 Total stockholders equity	 50,629,448	 46,309,747
 TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	 \$ 128,836,418	 \$ 120,683,316

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED MARCH 31, 2011 AND 2010

UNAUDITED

	Three Months Ended		Six Months Ended	
	2011	March 31, 2010	2011	March 31, 2010
OPERATING REVENUES:				
Gas utilities	\$ 26,773,008	\$ 31,242,734	\$ 49,021,561	\$ 54,051,901
Other	299,561	397,587	598,767	741,330
Total operating revenues	27,072,569	31,640,321	49,620,328	54,793,231
COST OF SALES:				
Gas utilities	17,723,904	22,085,000	31,875,665	37,267,354
Other	147,299	186,228	313,733	363,785
Total cost of sales	17,871,203	22,271,228	32,189,398	37,631,139
GROSS MARGIN	9,201,366	9,369,093	17,430,930	17,162,092
OTHER OPERATING EXPENSES:				
Operations	2,992,916	2,821,444	5,926,237	5,576,801
Maintenance	357,241	364,977	717,112	725,697
General taxes	343,211	345,065	658,864	669,771
Depreciation and amortization	1,001,978	958,987	2,003,957	1,917,975
Total other operating expenses	4,695,346	4,490,473	9,306,170	8,890,244
OPERATING INCOME	4,506,020	4,878,620	8,124,760	8,271,848
OTHER INCOME, Net	14,940	15,985	32,748	38,452
INTEREST EXPENSE	456,285	455,871	918,468	920,768
INCOME BEFORE INCOME TAXES	4,064,675	4,438,734	7,239,040	7,389,532
INCOME TAX EXPENSE	1,544,861	1,685,716	2,749,862	2,806,234
NET INCOME	2,519,814	2,753,018	4,489,178	4,583,298
OTHER COMPREHENSIVE INCOME (LOSS) NET OF TAX	207,673	(138,169)	704,714	159,239

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COMPREHENSIVE INCOME	\$ 2,727,487	\$ 2,614,849	\$ 5,193,892	\$ 4,742,537
BASIC EARNINGS PER COMMON SHARE	\$ 1.10	\$ 1.22	\$ 1.96	\$ 2.04
DILUTED EARNINGS PER COMMON SHARE	\$ 1.10	\$ 1.22	\$ 1.96	\$ 2.03
DIVIDENDS DECLARED PER COMMON SHARE	\$ 0.34	\$ 0.33	\$ 0.68	\$ 0.66

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX-MONTH PERIODS

ENDED MARCH 31, 2011 AND 2010

UNAUDITED

	Six Months Ended	
	2011	March 31, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,489,178	\$ 4,583,298
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,082,455	1,990,591
Cost of removal of utility plant, net	(146,269)	(146,127)
Changes in assets and liabilities which used cash, exclusive of changes and noncash transactions shown separately	9,053,571	5,699,951
Net cash provided by operating activities	15,478,935	12,127,713
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to utility plant and nonutility property	(2,882,623)	(3,235,029)
Net cash used in investing activities	(2,882,623)	(3,235,029)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds on collection of note	87,000	87,000
Proceeds from issuance of stock (22,955 and 19,301 shares, respectively)	684,562	536,378
Cash dividends paid	(1,528,174)	(1,457,555)
Net cash used in financing activities	(756,612)	(834,177)
NET INCREASE IN CASH AND CASH EQUIVALENTS	11,839,700	8,058,507
BEGINNING CASH AND CASH EQUIVALENTS	6,745,630	7,422,360
ENDING CASH AND CASH EQUIVALENTS	\$ 18,585,330	\$ 15,480,867
<u>SUPPLEMENTAL INFORMATION:</u>		
Cash paid (refunded) during the period for:		
Interest	\$ 900,233	\$ 907,505
Income taxes	(1,000,000)	583,000
See notes to condensed consolidated financial statements.		

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

UNAUDITED

1. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary to present fairly RGC Resources, Inc.'s financial position as of March 31, 2011 and the results of its operations for the three months and six months ended March 31, 2011 and 2010 and its cash flows for the six months ended March 31, 2011 and 2010. The results of operations for the three months and six months ended March 31, 2011 are not indicative of the results to be expected for the fiscal year ending September 30, 2011 as quarterly earnings are affected by the highly seasonal nature of the business and weather conditions generally result in greater earnings during the winter months.

The condensed consolidated interim financial statements and condensed notes are presented as permitted by Rule 8-03 of Regulation S-X and the instructions to Form 10-Q and do not contain certain information included in the Company's annual consolidated financial statements and notes thereto. The condensed consolidated financial statements and condensed notes should be read in conjunction with the financial statements and notes contained in the Company's Form 10-K. The September 30, 2010 balance sheet was included in the Company's Form 10-K.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company has evaluated subsequent events through the date the financial statements were issued. There were no items not otherwise disclosed which would have materially impacted the Company's condensed consolidated financial statements.

2. Rates and Regulatory Matters

The State Corporation Commission of Virginia (SCC) exercises regulatory authority over the natural gas operations of Roanoke Gas. Such regulation encompasses terms, conditions, and rates to be charged to customers for natural gas service, safety standards, extension of service, accounting and depreciation.

On November 1, 2010, Roanoke Gas Company placed into effect new base rates, subject to refund, that provided for approximately \$1,400,000 in additional annual non-gas revenues. On March 11, 2011, the Company reached a stipulated agreement with the SCC staff for a non-gas rate award in the amount of \$814,000 in additional annual non-gas revenues. On March 31, 2011, the Hearing Examiner issued a report accepting the stipulated agreement

RGC RESOURCES, INC. AND SUBSIDIARIES

and recommended the Commission issue a final order approving the stipulated amount. On April 6, 2011, the SCC issued a final order accepting the Hearing Examiner's report. The Company has recorded a provision for rate refund including interest associated with customer billings for the difference between the rates placed into effect on November 1 and the final rates approved by the SCC.

3. Debt

On March 14, 2011, the Company and Wells Fargo Bank (formerly Wachovia Bank) renewed its line-of-credit agreement. The new agreement maintained the same variable interest rate of 30 day LIBOR plus 100 basis points and the availability fee equal to 15 basis points applied to the difference between the face amount of the note and the average outstanding balance during the period. The Company continued the multi-tiered borrowing limits to accommodate seasonal borrowing demands and to minimize borrowing costs. Effective April 1, 2011, the Company's total available borrowing limits during the term of the line-of-credit agreement ranges from \$1,000,000 to \$5,000,000.

The line-of-credit agreement will expire March 31, 2012, unless extended. The Company anticipates being able to extend or replace the credit line upon expiration. At March 31, 2011, the Company had no outstanding balance under its line-of-credit agreement.

On October 20, 2010, the Company executed a modification of the \$15,000,000 unsecured variable rate note dated November 28, 2005 with the current lender. This modification extended the due date for the principal balance to March 31, 2012 from the original maturity date of December 1, 2010. All other terms and conditions provided for in the original note remain in place after the modification.

4. Derivatives and Hedging

The Company's risk management policy allows management to enter into derivatives for the purpose of managing commodity and financial market risks of its business operations. The Company's risk management policy specifically prohibits the use of derivatives for speculative purposes. The key market risks that the Company seeks to hedge include the price of natural gas and the cost of borrowed funds.

The Company enters into collars, swaps and caps for the purpose of hedging the price of natural gas in order to provide price stability during the winter months. The fair value of these instruments is recorded in the balance sheet with the offsetting entry to either under-recovery of gas costs or over-recovery of gas costs. Net income and other comprehensive income are not affected by the change in market value as any cost incurred or benefit received from these instruments is recoverable or refunded to customers through the purchased gas adjustment clause (PGA) included as part of the Company's billing rate. During the quarter ended March 31, 2011, the Company had settled all outstanding derivative collar arrangements for the purchase of natural gas.

RGC RESOURCES, INC. AND SUBSIDIARIES

The Company has two interest rate swaps associated with its variable rate notes. The first swap relates to the \$15,000,000 note issued in November 2005. This swap essentially converts the floating rate note based upon LIBOR into fixed rate debt with a 5.74% effective interest rate. The second swap relates to the \$5,000,000 variable rate note issued in October 2008. This swap converts the variable rate note based on LIBOR into a fixed rate debt with a 5.79% effective interest rate. Both swaps mature on December 1, 2015 and qualify as cash flow hedges with changes in fair value reported in other comprehensive income. No portions of interest rate swaps were deemed ineffective during the periods presented.

The table below reflects the fair values of the derivative instruments and their corresponding classification in the consolidated balance sheets under the current liabilities caption of "Fair value of marked-to-market transactions" as of March 31, 2011 and September 30, 2010:

	March 31, 2011	September 30, 2010
Derivatives designated as hedging instruments:		
Interest rate swaps	\$ 2,498,990	\$ 3,536,545
Natural gas collar arrangements		83,160
Total derivatives designated as hedging instruments	\$ 2,498,990	\$ 3,619,705

The table in Note 5 reflects the effect on income and other comprehensive income of the Company's cash flow hedges.

Based on the current interest rate environment, management estimates that approximately \$900,000 of the fair value on the interest rate hedges will be reclassified from other comprehensive loss into interest expense on the income statement over the next 12 months. Changes in LIBOR rates during this period could significantly change the amount estimated to be reclassified to income as well as the fair value of the interest rate hedges.

RGC RESOURCES, INC. AND SUBSIDIARIES**5. Comprehensive Income**

A summary of other comprehensive income and loss is provided below:

	Three Months Ended		Six Months Ended	
	March 31,		March 31,	
	2011	2010	2011	2010
Interest Rate SWAPs				
Unrealized gains (losses)	\$ 53,038	\$ (494,445)	\$ 567,038	\$ (290,871)
Income tax	(20,133)	187,692	(215,246)	110,416
Net unrealized gains (losses)	32,905	(306,753)	351,792	(180,455)
Transfer of realized losses to interest expense	232,529	234,343	470,517	472,758
Income tax	(88,268)	(88,957)	(178,609)	(179,460)
Net transfer of realized losses to interest expense	144,261	145,386	291,908	293,298
Defined Benefit Plans				
Transfer of realized losses to income	37,401	25,619	74,802	51,238
Income tax	(14,198)	(9,725)	(28,396)	(19,450)
Net transfer of realized losses to income	23,203	15,894	46,406	31,788
Amortization of transition obligation	11,773	11,773	23,546	23,546
Income tax	(4,469)	(4,469)	(8,938)	(8,938)
Net amortization of transition obligation	7,304	7,304	14,608	14,608
Net other comprehensive income (loss)	\$ 207,673	\$ (138,169)	\$ 704,714	\$ 159,239
Accumulated comprehensive loss - beginning of period	(3,369,782)	(2,587,298)	(3,866,823)	(2,884,706)
Accumulated comprehensive loss - end of period	\$ (3,162,109)	\$ (2,725,467)	\$ (3,162,109)	\$ (2,725,467)

RGC RESOURCES, INC. AND SUBSIDIARIES

The components of accumulated comprehensive loss as of March 31, 2011 and September 30, 2010 include:

	March 31 2011	September 30 2010
Interest rate swaps	\$ (1,550,373)	\$ (2,194,073)
Pension plan	(1,080,261)	(1,113,787)
Postretirement benefit plan	(531,475)	(558,963)
 Total accumulated comprehensive loss	 \$ (3,162,109)	 \$ (3,866,823)

6. Weighted Average Shares

Basic earnings per common share for the three months and six months ended March 31, 2011 and 2010 are calculated by dividing net income by the weighted average common shares outstanding during the period. Diluted earnings per common share for the three months and six months ended March 31, 2011 are calculated by dividing net income by the weighted average common shares outstanding during the period plus dilutive potential common shares. Dilutive potential common shares are calculated in accordance with the treasury stock method, which assumes that proceeds from the exercise of all stock options are used to repurchase common stock at market value. The amount of shares remaining after the proceeds are exhausted represents the potentially dilutive effect of the securities. There were no anti-dilutive securities in the respective periods. A reconciliation of the weighted average common shares and the diluted average common shares is provided below:

	Three Months Ended		Six Months Ended	
	March 31, 2011	March 31, 2010	March 31, 2011	March 31, 2010
Weighted average common shares	2,292,015	2,251,922	2,286,046	2,247,111
Effect of dilutive securities:				
Options to purchase common stock	4,318	7,719	4,731	7,665
 Diluted average common shares	 2,296,333	 2,259,641	 2,290,777	 2,254,776

7. Commitments and Contingencies

Roanoke Gas currently holds the only franchises and/or certificates of public convenience and necessity to distribute natural gas in its service area. These franchises are effective through January 1, 2016. Certificates of public convenience and necessity in Virginia are exclusive and are intended for perpetual duration.

Due to the nature of the natural gas distribution business, the Company has entered into agreements with both suppliers and pipelines for natural gas commodity purchases, storage capacity and pipeline delivery capacity. The Company obtains most of its regulated natural

RGC RESOURCES, INC. AND SUBSIDIARIES

gas supply from an asset manager. The Company uses an asset manager to assist in optimizing the use of its transportation, storage rights, and gas supply in order to provide a secure and reliable source of natural gas to its customers. The Company also has storage and pipeline capacity contracts to store and deliver natural gas to the Company's distribution system. Roanoke Gas is served directly by two primary pipelines. These two pipelines deliver 100% of the natural gas supplied to the Company's customers. Depending on weather conditions and the level of customer demand, failure of one or both of these transmission pipelines could have a major adverse impact on the Company.

There have been no changes to the status of the lawsuits reported in the Annual Report on Form 10-K for the year ended September 30, 2010.

Except to the extent, if any, described above, the Company is not a party to any material pending legal proceedings.

8. Employee Benefit Plans

The Company has both a defined benefit pension plan (the pension plan) and a postretirement benefit plan (the postretirement plan). The pension plan covers substantially all of the Company's employees and provides retirement income based on years of service and employee compensation. The postretirement plan provides certain healthcare and supplemental life insurance benefits to retired employees who meet specific age and service requirements. Net pension plan and postretirement plan expense recorded by the Company is detailed as follows:

	Three Months Ended		Six Months Ended	
	March 31,		March 31,	
	2011	2010	2011	2010
Components of net periodic pension cost:				
Service cost	\$ 119,809	\$ 112,215	\$ 239,618	\$ 224,430
Interest cost	227,219	213,411	454,438	426,822
Expected return on plan assets	(232,052)	(204,657)	(464,104)	(409,314)
Recognized loss	81,793	68,778	163,586	137,556
Net periodic pension cost	\$ 196,769	\$ 189,747	\$ 393,538	\$ 379,494

RGC RESOURCES, INC. AND SUBSIDIARIES

	Six Months Ended			
	Three Months Ended		March 31,	
	2011	2010	2011	2010
Components of postretirement benefit cost:				
Service cost	\$ 48,711	\$ 39,946	\$ 97,422	\$ 79,892
Interest cost	144,994	128,359	289,988	256,718
Expected return on plan assets	(89,320)	(81,263)	(178,640)	(162,526)
Amortization of transition obligation	47,223	47,223	94,446	94,446
Recognized loss	50,288	17,134	100,576	34,268
Net postretirement benefit cost	\$ 201,896	\$ 151,399	\$ 403,792	\$ 302,798

The Company contributed \$300,000 to its pension plan during the six-month period ended March 31, 2011. The Company currently expects to make a total contribution of approximately \$1,000,000 to its pension plan and \$700,000 to its postretirement benefit plan during the fiscal year ending September 30, 2011. The Company will continue to evaluate its benefit plan funding levels throughout the year.

9. Environmental Matters

Both Roanoke Gas Company and a previously owned gas subsidiary operated manufactured gas plants (MGPs) as a source of fuel for lighting and heating until the early 1950s. A by-product of operating MGPs was coal tar, and the potential exists for on-site tar waste contaminants at the former plant sites. Should the Company eventually be required to remediate either site, it will pursue all prudent and reasonable means to recover any related costs, including insurance claims and regulatory approval for rate case recognition of expenses associated with any work required.

10. Recently Adopted Accounting Standards

In July 2010, the FASB issued guidance under FASB ASC No. 310 - *Receivables*, to provide greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables on a disaggregated basis. Financing receivables represent a contractual right to receive money either on demand or on fixed or determinable dates and recognized as assets on the entity's balance sheet. The Company has two primary types of financing receivables: trade accounts receivable, resulting from the sale of natural gas and other services to its customers, and a note receivable. Trade accounts receivable are specifically excluded from the provisions of this guidance as they are short-term in nature. The Company's note receivable represents the balance on a five year note with a fifteen year amortization for partial payment on the sale of the Bluefield, Virginia natural gas distribution assets to ANGD, LLC in October 2007. Interest on the note is accrued monthly and paid quarterly. The note is a performing asset with all principle and interest payments current. Management evaluates the status of the note each reporting period to make an assessment on the collectibility of the balance. In its most recent evaluation, management concluded that the note continued to be fully collectible and no loss reserve was required. The note would

RGC RESOURCES, INC. AND SUBSIDIARIES

be considered past due if either the quarterly interest payment or the annual principle installment were outstanding for more than 30 days after their contractual due date. Additional information regarding this note is included under the fair value measurements section below.

Other accounting standards that have been issued by the FASB or other standard-setting bodies are not currently applicable to the Company or are not expected to have a material impact on the Company's financial position, results of operations and cash flows.

11. Fair Value Measurements

FASB ASC No. 820, *Fair Value Measurements and Disclosures*, established a fair value hierarchy that prioritizes each input to the valuation method used to measure fair value of financial and nonfinancial assets and liabilities that are measured and reported on a fair value basis into one of the following three broad levels:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 Inputs other than quoted prices in Level 1 that are either for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, or inputs that are der