

***RGC Resources, Inc.
and Subsidiaries***

*Consolidated Financial Statements
for the Years Ended September 30, 2010
and 2009, and Report of Independent
Registered Public Accounting Firm*

RGC RESOURCES, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

	Page
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM	1
CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED SEPTEMBER 30, 2010 AND 2009:	
Consolidated Balance Sheets	2-3
Consolidated Statements of Income and Comprehensive Income	4
Consolidated Statements of Stockholders' Equity	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-30



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
RGC Resources, Inc.
Roanoke, Virginia

We have audited the accompanying consolidated balance sheets of RGC Resources, Inc. and Subsidiaries (“the Company”) as of September 30, 2010 and 2009, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of RGC Resources, Inc. and Subsidiaries as of September 30, 2010 and 2009, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Brown, Edwards & Company, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

319 McClanahan Street, S.W.
Roanoke, Virginia
November 5, 2010

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2010 AND 2009

	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 6,745,630	\$ 7,422,360
Accounts receivable , less allowance for doubtful accounts of \$65,275 in 2010 and \$50,687 in 2009	3,273,627	3,562,837
Note receivable	87,000	87,000
Materials and supplies	563,178	587,815
Gas in storage	13,810,208	16,072,911
Prepaid income taxes	2,532,057	1,974,917
Deferred income taxes	3,436,923	3,424,628
Other	1,206,367	985,110
	<u>31,654,990</u>	<u>34,117,578</u>
UTILITY PROPERTY:		
In service	123,073,541	118,009,532
Accumulated depreciation and amortization	<u>(43,084,808)</u>	<u>(41,104,408)</u>
	<u>79,988,733</u>	<u>76,905,124</u>
In service, net		
Construction work in progress	<u>1,466,658</u>	<u>1,604,046</u>
Utility plant, net	<u>81,455,391</u>	<u>78,509,170</u>
OTHER ASSETS:		
Note receivable	1,039,000	1,126,000
Regulatory assets	6,480,325	4,989,347
Other	53,610	59,797
	<u>7,572,935</u>	<u>6,175,144</u>
Total other assets		
	<u>7,572,935</u>	<u>6,175,144</u>
TOTAL ASSETS	<u><u>\$ 120,683,316</u></u>	<u><u>\$ 118,801,892</u></u>

(Continued)

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2010 AND 2009

	2010	2009
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Dividends payable	\$ 750,786	\$ 716,556
Accounts payable	4,572,917	4,449,735
Customer credit balances	2,637,380	4,204,556
Customer deposits	1,632,977	1,601,206
Accrued expenses	2,058,643	2,219,587
Over-recovery of gas costs	2,581,600	5,651,847
Fair value of marked-to-market transactions	3,619,705	2,451,055
	<u>17,854,008</u>	<u>21,294,542</u>
TOTAL CURRENT LIABILITIES	17,854,008	21,294,542
LONG-TERM DEBT	28,000,000	28,000,000
DEFERRED CREDITS AND OTHER LIABILITIES:		
Asset retirement obligations	3,073,782	2,735,735
Regulatory cost of retirement obligations	7,699,319	7,401,024
Benefit plan liabilities	9,850,526	7,970,074
Deferred income taxes	7,860,064	6,534,621
Deferred investment tax credits	35,870	66,025
	<u>28,519,561</u>	<u>24,707,479</u>
TOTAL DEFERRED CREDITS AND OTHER LIABILITIES	28,519,561	24,707,479
COMMITMENTS AND CONTINGENCIES (Notes 9 and 10)		
CAPITALIZATION:		
Stockholders' Equity:		
Common Stock, \$5 par value; authorized 10,000,000 shares; issued and outstanding 2,274,432 and 2,238,987 shares in 2010 and 2009, respectively	11,372,160	11,194,935
Preferred stock, no par; authorized 5,000,000 shares; no shares issued and outstanding in 2010 and 2009	-	-
Capital in excess of par value	17,462,670	16,607,897
Retained earnings	21,341,740	19,881,745
Accumulated other comprehensive loss	(3,866,823)	(2,884,706)
	<u>46,309,747</u>	<u>44,799,871</u>
TOTAL STOCKHOLDERS' EQUITY	46,309,747	44,799,871
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 120,683,316	\$ 118,801,892

(Concluded)

See notes to consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME YEARS ENDED SEPTEMBER 30, 2010 AND 2009

	2010	2009
OPERATING REVENUES:		
Gas utilities	\$ 72,426,658	\$ 80,786,228
Other	1,397,256	1,398,245
Total operating revenues	<u>73,823,914</u>	<u>82,184,473</u>
COST OF SALES:		
Gas utilities	46,690,247	54,408,778
Other	693,394	699,771
Total cost of sales	<u>47,383,641</u>	<u>55,108,549</u>
GROSS MARGIN	<u>26,440,273</u>	<u>27,075,924</u>
OTHER OPERATING EXPENSES:		
Operations	10,934,210	10,565,267
Maintenance	1,419,269	1,765,511
General taxes	1,286,593	1,240,209
Depreciation and amortization	<u>3,818,020</u>	<u>3,660,421</u>
Total other operating expenses	<u>17,458,092</u>	<u>17,231,408</u>
OPERATING INCOME	8,982,181	9,844,516
OTHER EXPENSE, net	(10,453)	(70,091)
INTEREST EXPENSE	<u>1,835,291</u>	<u>1,918,106</u>
INCOME BEFORE INCOME TAXES	7,136,437	7,856,319
INCOME TAX EXPENSE	<u>2,691,001</u>	<u>2,987,309</u>
NET INCOME	4,445,436	4,869,010
OTHER COMPREHENSIVE LOSS, NET OF TAX	<u>(982,117)</u>	<u>(1,671,535)</u>
COMPREHENSIVE INCOME	<u>\$ 3,463,319</u>	<u>\$ 3,197,475</u>
EARNINGS PER COMMON SHARE:		
Basic	\$ 1.97	\$ 2.19
Diluted	\$ 1.96	\$ 2.18
WEIGHTED AVERAGE SHARES OUTSTANDING:		
Basic	2,257,131	2,223,727
Diluted	2,264,080	2,231,040

See notes to consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY YEARS ENDED SEPTEMBER 30, 2010 AND 2009

	<u>Common Stock</u>	<u>Capital in Excess of Par Value</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Stockholders' Equity</u>
Balance - September 30, 2008	\$ 11,047,355	\$ 15,990,961	\$ 17,909,134	\$ (1,224,392)	\$ 43,723,058
Change in measurement date - benefit plans, net of tax	-	-	(44,931)	11,221	(33,710)
Net income	-	-	4,869,010	-	4,869,010
Losses on hedging activities, net of tax	-	-	-	(1,000,965)	(1,000,965)
Change in net loss and transition obligation of defined benefit plans, net of tax	-	-	-	(670,570)	(670,570)
Tax benefits from stock option exercise	-	16,407	-	-	16,407
Cash dividends declared (\$1.28 per share)	-	-	(2,851,468)	-	(2,851,468)
Issuance of common stock (29,516 shares)	147,580	600,529	-	-	748,109
Balance - September 30, 2009	<u>\$ 11,194,935</u>	<u>\$ 16,607,897</u>	<u>\$ 19,881,745</u>	<u>\$ (2,884,706)</u>	<u>\$ 44,799,871</u>
Net income	-	-	4,445,436	-	4,445,436
Losses on hedging activities, net of tax	-	-	-	(673,438)	(673,438)
Change in net loss and transition obligation of defined benefit plans, net of tax	-	-	-	(308,679)	(308,679)
Tax benefits from stock option exercise	-	34,906	-	-	34,906
Cash dividends declared (\$1.32 per share)	-	-	(2,985,441)	-	(2,985,441)
Issuance of common stock (35,445 shares)	177,225	819,867	-	-	997,092
Balance - September 30, 2010	<u>\$ 11,372,160</u>	<u>\$ 17,462,670</u>	<u>\$ 21,341,740</u>	<u>\$ (3,866,823)</u>	<u>\$ 46,309,747</u>

See notes to consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2010 AND 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,445,436	\$ 4,869,010
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	3,959,887	3,815,009
Cost of removal of utility plant, net	(307,375)	(263,446)
Change in over/under recovery of gas costs	(2,987,087)	6,627,084
Deferred taxes and investment tax credits	1,884,235	812,532
Other noncash items, net	95,658	39,111
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable and customer deposits, net	320,981	1,602,679
Inventories and gas in storage	2,287,340	10,015,564
Other current assets	(640,846)	(781,945)
Accounts payable, customer credit balances and accrued expenses, net	(1,939,425)	(4,029,786)
Total adjustments	<u>2,673,368</u>	<u>17,836,802</u>
Net cash provided by operating activities	<u>7,118,804</u>	<u>22,705,812</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Expenditures for utility property	(5,973,586)	(5,752,780)
Proceeds from disposal of utility property	10,265	27,826
Proceeds from sale of short-term investments	-	500,000
Net cash used in investing activities	<u>(5,963,321)</u>	<u>(5,224,954)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt	-	5,000,000
Proceeds on collection of note	87,000	87,000
Net repayments under line-of-credit agreements	-	(13,960,000)
Proceeds from issuance of common stock	1,031,998	764,516
Cash dividends paid	(2,951,211)	(2,825,450)
Net cash used in financing activities	<u>(1,832,213)</u>	<u>(10,933,934)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(676,730)	6,546,924
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>7,422,360</u>	<u>875,436</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 6,745,630</u>	<u>\$ 7,422,360</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	\$ 1,807,863	\$ 1,897,818
Income taxes, net of refunds	1,329,000	2,629,308

See notes to consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED SEPTEMBER 30, 2010 AND 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation—RGC Resources, Inc. is an energy services company engaged in the sale and distribution of natural gas. The consolidated financial statements include the accounts of RGC Resources, Inc. and its wholly owned subsidiaries (“Resources” or the “Company”); Roanoke Gas Company (“Roanoke Gas”); Diversified Energy Company; and RGC Ventures of Virginia, Inc., operating as Application Resources. Roanoke Gas is a natural gas utility, which distributes and sells natural gas to approximately 57,000 residential, commercial and industrial customers within its service areas in Roanoke, Virginia and the surrounding localities. 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. Roanoke Gas is regulated by the Virginia State Corporation Commission (“SCC” or “Virginia Commission”). Application Resources provides information system services to software providers in the utility industry. Diversified Energy Company is currently inactive.

The Company follows accounting and reporting standards set by the Financial Accounting Standards Board (“FASB”) and the Securities and Exchange Commission (“SEC”).

Resources has only one reportable segment as defined under FASB ASC No. 280 – *Segment Reporting*. All intercompany transactions have been eliminated in consolidation.

Rate Regulated Basis of Accounting—The Company’s regulated operations follow the accounting and reporting requirements of FASB ASC No. 980, *Regulated Operations*. The economic effects of regulation can result in a regulated company deferring costs that have been or are expected to be recovered from customers in a period different from the period in which the costs would be charged to expense by an unregulated enterprise. When this situation occurs, costs are deferred as assets in the consolidated balance sheet (regulatory assets) and recorded as expenses when such amounts are reflected in rates. Additionally, regulators can impose liabilities upon a regulated company for amounts previously collected from customers and for current collection in rates of costs that are expected to be incurred in the future (regulatory liabilities). In the event that the provisions of FASB ASC No. 980 no longer apply to any or all regulatory assets or liabilities, the Company would write off such amounts and include them in the consolidated statement of income and comprehensive income for the period in which FASB ASC No. 980 no longer applied.

Regulatory assets and liabilities included in the Company's consolidated balance sheets as of September 30, 2010 and 2009 are as follows:

	<u>September 30</u>	
	<u>2010</u>	<u>2009</u>
Regulatory Assets:		
Current Assets:		
Other:		
Accrued pension and postretirement medical	\$ 579,613	\$ 442,062
Utility Property:		
In service:		
Other	11,945	11,945
Other Assets:		
Regulatory assets:		
Premium on early retirement of debt	156,947	187,324
Accrued pension and postretirement medical	<u>6,323,378</u>	<u>4,802,023</u>
Total regulatory assets	<u>\$ 7,071,883</u>	<u>\$ 5,443,354</u>
Regulatory Liabilities:		
Current Liabilities:		
Over-recovery of gas costs	\$ 2,581,600	\$ 5,651,847
Deferred Credits and Other Liabilities:		
Asset retirement obligations	3,073,782	2,735,735
Regulatory cost of retirement obligations	<u>7,699,319</u>	<u>7,401,024</u>
Total regulatory liabilities	<u>\$ 13,354,701</u>	<u>\$ 15,788,606</u>

As of September 30, 2010, the Company had regulatory assets in the amount of \$6,838,973 on which the Company did not earn a return during the recovery period. These assets pertain to the net funded position of the Company's benefit plans related to its regulated operations. As such, the amortization period is not specifically defined.

Utility Plant and Depreciation—Utility plant is stated at original cost. The cost of additions to utility plant includes direct charges and overhead. The cost of depreciable property retired is charged to accumulated depreciation. The cost of asset removals, less salvage, is charged to “regulatory cost of retirement obligations” or “asset retirement obligations” as explained under Asset Retirement Obligations below. Maintenance, repairs, and minor renewals and betterments of property are charged to operations and maintenance.

Provisions for depreciation are computed principally at composite straight-line rates as determined by depreciation studies required to be performed on the regulated utility assets of Roanoke Gas Company every five years. The Company completed its most recent depreciation study in July 2009 and received notification from the SCC to implement these new rates retroactive to October 1, 2008. The composite weighted-average depreciation rate under the new depreciation study was 3.32% and 3.31% for the fiscal years ended September 30, 2010 and 2009, respectively. The implementation of

the new depreciation rates reduced depreciation expense for the year ended September 30, 2009 by \$888,466 when compared to the rates in effect for fiscal 2008, and increased net income by \$551,204 and earnings per share by \$0.25.

The composite rates are comprised of two components, one based on average service life and one based on cost of retirement. As a result, the Company accrues the estimated cost of retirement of long-lived assets through depreciation expense. Retirement costs are not a legal obligation but rather the result of cost-based regulation and are accounted for under the provisions of FASB ASC No. 980. Such amounts are classified as a regulatory liability.

The Company reviews long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. These reviews have not identified any impairments which would cause a material effect on the results of operations or financial condition.

Asset Retirement Obligations – FASB ASC No. 410, *Asset Retirement and Environmental Obligations*, requires entities to record the fair value of a liability for an asset retirement obligation when there exists a legal obligation for the retirement of the asset. When the liability is initially recorded, the entity capitalizes the cost, thereby increasing the carrying amount of the underlying asset. In subsequent periods, the liability is accreted, and the capitalized cost is depreciated over the useful life of the underlying asset. The Company recorded asset retirement obligations for its future legal obligations related to purging and capping its distribution mains and services upon retirement, although the timing of such retirements is uncertain.

The Company's composite depreciation rates include a component to provide for the cost of retirement of assets. As a result, the Company accrues the estimated cost of retirement of its utility plant through depreciation expense and creates a corresponding regulatory liability. The costs of retirement considered in the development of the depreciation component include those costs associated with the legal liability. Therefore, the Company reclassified a portion of its regulatory liability for cost of retirement to asset retirement obligations for the legal liability as determined above. The accretion of the asset retirement obligation is reclassified from the regulatory cost of retirement obligation. If the legal obligations were to exceed the regulatory liability provided for in the depreciation rates, the Company would establish a regulatory asset for such difference with the anticipation of future recovery through rates charged to customers.

The following is a summary of the asset retirement obligation:

	<u>Years Ended September 30</u>	
	<u>2010</u>	<u>2009</u>
Balance, beginning of year	\$ 2,735,735	\$ 2,608,995
Liabilities incurred	21,446	16,312
Liabilities settled	(62,512)	(31,388)
Accretion	150,019	141,816
Revisions to estimated cash flows	<u>229,094</u>	<u>-</u>
Balance, end of year	<u>\$ 3,073,782</u>	<u>\$ 2,735,735</u>

Cash, Cash Equivalents and Short-Term Investments—From time to time, the Company will have balances on deposit at banks in excess of the amount insured by the Federal Deposit Insurance Corporation (“FDIC”). The Company has not experienced any losses on these accounts and does not consider these amounts to be at credit risk. As of September 30, 2010, the Company did not have any bank deposits in excess of the FDIC insurance limits of \$250,000. For purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Customer Receivables and Allowance for Doubtful Accounts – Accounts receivable consists of amounts billed to customers for natural gas sales and related services. The Company provides an estimate for losses on these receivables by utilizing historical information, current account balances, account aging and current economic conditions. Customer accounts are charged off annually when deemed uncollectible or when turned over to a collection agency for action.

A reconciliation of changes in the allowance for doubtful accounts is as follows:

	<u>Years Ended September 30</u>	
	<u>2010</u>	<u>2009</u>
Balance, beginning of year	\$ 50,687	\$ 63,791
Additions charged to bad debt expense	140,178	202,892
Recoveries of accounts written off	194,395	196,982
Accounts written off	<u>(319,985)</u>	<u>(412,978)</u>
Balance, end of year	<u>\$ 65,275</u>	<u>\$ 50,687</u>

Inventories—Inventories, consisting of natural gas in storage and materials and supplies, are recorded at average cost. Injections into storage are priced at the purchase cost at the time of injection and withdrawals from storage are priced at the weighted average price in storage. Materials and supplies are removed from inventory at average cost.

Unbilled Revenues—The Company bills its natural gas customers on a monthly cycle basis; however, the billing cycle period for most customers does not coincide with the accounting periods used for financial reporting. As the Company recognizes revenue when gas is delivered, an accrual is made to estimate revenues for natural gas delivered to customers but not billed during the

accounting period. The amounts of unbilled revenue receivable included in accounts receivable on the consolidated balance sheets at September 30, 2010 and 2009 were \$1,070,062 and \$1,173,561, respectively.

Income Taxes—Income taxes are accounted for using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the years in which those temporary differences are expected to be recovered or settled. A valuation allowance against deferred tax assets is provided if it is more likely than not the deferred tax asset will not be realized. The Company and its subsidiaries file state and federal consolidated income tax returns.

Debt Expenses—Debt issuance expenses are amortized over the lives of the debt instruments.

Over/Under-Recovery of Natural Gas Costs—Pursuant to the provisions of the Company’s Purchased Gas Adjustment (“PGA”) clause, the SCC provides the Company with a method of passing along increases or decreases in natural gas costs incurred by its regulated operations, including gains and losses on natural gas derivative hedging instruments, to its customers. On a quarterly basis, the Company files a PGA rate adjustment request with the SCC to adjust the gas cost component of its rates up or down depending on projected price and activity. Once administrative approval is received, the Company adjusts the gas cost component of its rates to reflect the approved amount. As actual costs will differ from the projections used in establishing the PGA rate, the Company may either over-recover or under-recover its actual gas costs during the period. Any difference between actual costs incurred and costs recovered through the application of the PGA is recorded as a regulatory asset or liability. At the end of the deferral period, the balance of the net deferred charge or credit is amortized over an ensuing 12-month period as amounts are reflected in customer billings.

Fair Value – Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company determines fair value based on the following fair value hierarchy which prioritizes each input to the valuation methods 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 derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 – Unobservable inputs for the asset or liability where there is little, if any, market activity which require the Company to develop its own assumptions.

The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs (Level 3). All fair value disclosures are categorized within one of the three categories in the hierarchy. See fair value disclosures in derivatives and hedging activities below and in Notes 6 and 11.

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 the reported amounts of assets and liabilities, disclosure of contingent 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.

Excise and Sales Taxes – Certain excise and sales taxes imposed by the state and local governments in the Company’s service territory are collected by the Company from its customers. These taxes are accounted for on a net basis and therefore are not included as revenues in the Company’s Consolidated Statements of Income and Comprehensive Income.

Earnings Per Share—Basic earnings per share and diluted earnings per share are calculated by dividing net income by the weighted average common shares outstanding during the period and the weighted average common shares outstanding during the period plus dilutive potential common shares, respectively. Dilutive potential common shares are calculated in accordance with the treasury stock method, which assumes that proceeds from the exercise of all 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. A reconciliation of the weighted average common shares to diluted average common shares is provided below:

	Years Ended September 30	
	2010	2009
Weighted average common shares	2,257,131	2,223,727
Effect of dilutive securities:		
Options to purchase common stock	<u>6,949</u>	<u>7,313</u>
Diluted average common shares	<u><u>2,264,080</u></u>	<u><u>2,231,040</u></u>

Business and Credit Concentrations—The primary business of the Company is the distribution of natural gas to residential, commercial and industrial customers in its service territories.

No regulated sales to individual customers accounted for more than 5% of total revenue in any period or amounted to more than 5% of total accounts receivable.

Roanoke Gas currently holds the only franchises and/or certificates of public convenience and necessity to distribute natural gas in its Virginia 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.

Roanoke Gas is served directly by two primary pipelines. These two pipelines provide 100% of the natural gas supplied to the Company’s customers. Depending upon 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.

Derivative and Hedging Activities—FASB ASC No. 815, *Derivatives and Hedging*, requires the recognition of all derivative instruments as assets or liabilities in the Company’s balance sheet and measurement of those instruments at fair value.

The Company's hedging and derivatives policy allows management to enter into derivatives for the purpose of managing commodity and financial market risks of its business operations. The Company's hedging and derivatives policy specifically prohibits the use of derivatives for speculative purposes. The key market risks that RGC Resources, Inc. hedges against 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 through the PGA as the SCC allows for full recovery of prudent costs associated with natural gas purchases. At September 30, 2010, the Company had collar agreements outstanding for the winter period to hedge 1,300,000 decatherms of natural gas with a fair value of \$83,160. As the market value of natural gas fell below the floor price for a portion of the collar agreements, the Company recorded the fair value adjustment under the balance sheet caption "Fair value of marked-to-market transactions" with the offsetting entry to "Over-recovery of gas costs." At September 30, 2009, the Company had collar agreements outstanding to hedge 800,000 decatherms of natural gas. As the market value of natural gas fell between the floor and ceiling prices of the collar agreements, there was no fair value reflected in the financial statements at September 30, 2009.

The Company also 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 derivative instruments were deemed to be ineffective for any period 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 September 30, 2010 and 2009, respectively:

Fair Value of Derivative Instruments

	September 30	
	2010	2009
Derivatives designated as hedging instruments:		
Interest rate swaps	\$ 3,536,545	\$ 2,451,055
Natural gas collar arrangement	<u>83,160</u>	<u>-</u>
Total derivatives designated as hedging instruments	<u>\$ 3,619,705</u>	<u>\$ 2,451,055</u>

See Note 11 for additional information on fair value.

Based on the interest rate environment as of September 30, 2010, 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 that period could significantly change the estimated amount to be reclassified to income as well as the fair value of the interest rate hedges.

Other Comprehensive Loss—A summary of other comprehensive loss and financial instrument activity is provided below:

	<u>Year Ended September 30</u>	
	<u>2010</u>	<u>2009</u>
Interest Rate Swaps		
Unrealized losses	\$ (2,025,678)	\$ (2,369,923)
Income tax	<u>768,948</u>	<u>899,623</u>
Net unrealized losses	<u>(1,256,730)</u>	<u>(1,470,300)</u>
Transfer of realized losses to interest expense	940,188	756,505
Income tax	<u>(356,896)</u>	<u>(287,170)</u>
Net transfer of realized losses to interest expense	<u>583,292</u>	<u>469,335</u>
Defined Benefit Plans		
Unrecognized net losses arising during the period	(647,439)	(1,153,897)
Income tax	<u>246,031</u>	<u>438,481</u>
Net unrecognized losses arising during the period	<u>(401,408)</u>	<u>(715,416)</u>
Transfer of realized losses to income	102,478	25,252
Income tax	<u>(38,942)</u>	<u>(9,599)</u>
Net transfer of realized losses to income	<u>63,536</u>	<u>15,653</u>
Amortization of transition obligation	47,093	47,093
Income tax	<u>(17,900)</u>	<u>(17,900)</u>
Net amortization of transition obligation	<u>29,193</u>	<u>29,193</u>
Net other comprehensive loss	<u>\$ (982,117)</u>	<u>\$ (1,671,535)</u>
Change in measurement date	<u>-</u>	<u>11,221</u>
Accumulated comprehensive loss - beginning of period	<u>(2,884,706)</u>	<u>(1,224,392)</u>
Accumulated comprehensive loss - end of period	<u>\$ (3,866,823)</u>	<u>\$ (2,884,706)</u>

The components of accumulated comprehensive loss as of September 30, 2010 and 2009 include:

	<u>September 30</u>	
	<u>2010</u>	<u>2009</u>
Interest rate swaps	\$ (2,194,073)	\$ (1,520,635)
Pension plan	(1,113,787)	(954,797)
Postretirement benefit plan	<u>(558,963)</u>	<u>(409,274)</u>
Total accumulated comprehensive loss	<u>\$ (3,866,823)</u>	<u>\$ (2,884,706)</u>

Recently Adopted Accounting Standards - On October 1, 2008, the Company adopted the change in measurement date provision of FASB ASC No. 715, *Compensation – Retirement Benefits*, which requires an employer to measure the funded status of each plan as of the Company’s fiscal year end. The Company previously used a June 30 measurement date for its benefit plans. The change in measurement date eliminated the three month lag in recognizing expense between the measurement date and the end of the Company’s fiscal year. The Company recorded a reduction to retained earnings, net of tax, of \$44,931 for the effect of the change in measurement date on unregulated operations and a regulatory asset in the amount of \$177,284 for the portion attributable to the regulated operations of Roanoke Gas Company. The Company is amortizing the regulatory asset over a three year period consistent with the Company’s latest rate order.

In September 2006, the FASB issued guidance under FASB ASC No. 820 – *Fair Value Measurements and Disclosures* that established a framework for measuring fair value and expanded disclosures about fair value methods. No new fair value measurements are required. Instead, it provides for increased consistency and comparability in fair value measurements and for expanded disclosure surrounding the fair value measurements. The Company adopted the fair value provisions effective October 1, 2008. The adoption had no material impact on the Company’s financial position, results of operations or cash flows.

In January 2010, the FASB issued additional guidance under Accounting Standards Update (“ASU”) 2010-06, *Fair Value Measurements and Disclosures – Improving Disclosures about Fair Value Measurements*. This ASU improves disclosures regarding fair value under FASB ASC No. 820 including (1) requiring an entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; (2) in the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present separately information about purchases, sales, issuances and settlements; and (3) providing clarification that a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements. The Company adopted ASU 2010-06 effective with its March 31, 2010 reporting date. The adoption had no material impact on the Company’s financial position, results of operations or cash flows. The disclosures required by FASB ASC No. 820 are included in Note 11.

In March 2008, the FASB issued guidance under FASB ASC No. 815 – *Derivatives and Hedging*, to enhance the current disclosure framework by requiring entities to disclose (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flow. The adoption of the additional disclosure provisions of FASB ASC No. 815 had no material impact on the Company’s financial position,

results of operations or cash flows. The additional disclosures required by FASB No. 815 are included in Notes 1 and 11.

In December 2008, the FASB issued FASB Staff Position No. 132(R)-1, (FSP 132(R)-1), *Employers' Disclosures about Postretirement Benefit Plan Assets* (FASB ASC No. 715). FASB's objective of these changes is to improve disclosures about plan assets in employers' defined benefit pension or other postretirement plans by providing users of financial statements with an understanding of : (a) How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies; (b) The major categories of plan assets; (c) The inputs and valuation techniques used to measure the fair value of plan assets; (d) The effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period; and (e) Significant concentrations of risk within plan assets. The new disclosure requirements are included in Note 6.

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

2. REGULATORY MATTERS

The 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, extensions of service, accounting and depreciation.

On September 13, 2010, the Company filed a request for an expedited increase in rates with the SCC. The request was for an increase of approximately \$1,400,000 in annual non-gas revenues. As provided for under this expedited rate request, the Company was able to place the increased rates into effect for service rendered on and after November 1, 2010, subject to refund pending a final order by the SCC. The public hearing on the request for this rate increase is scheduled for March 24, 2011, with a final order expected some time after that date.

3. BORROWINGS UNDER LINE-OF-CREDIT

The Company has available an unsecured line-of-credit with a bank which will expire March 31, 2011. The Company anticipates being able to extend or replace this line-of-credit upon expiration. The Company's available unsecured line-of-credit varies during the year to accommodate its seasonal borrowing demands. Available limits under this agreement for the remaining term are as follows:

Effective	Available Line-of-Credit
September 30, 2010	\$ 3,000,000
October 22, 2010	12,000,000
November 24, 2010	13,000,000
January 25, 2011	12,000,000
February 24, 2011	5,000,000

A summary of the line-of-credit follows:

	<u>September 30</u>	
	2010	2009
Line-of-credit at year-end	\$ 3,000,000	\$ 3,000,000
Outstanding balance at year-end	-	-
Highest month-end balance outstanding	-	16,145,000
Average daily balance	-	3,758,000
Average rate of interest during year on outstanding balances	0.00%	2.44%
Interest rate at year end	1.26%	1.25%
Interest rate on unused line-of-credit	0.15%	0.15%

4. LONG-TERM DEBT

Long-term debt consists of the following:

	<u>September 30</u>	
	2010	2009
Unsecured note payable, with variable interest rate based on 30-day LIBOR (0.26% at September 30, 2010) plus 69 basis point spread, with provision for retirement on March 31, 2012	\$ 15,000,000	\$ 15,000,000
Unsecured note payable, with variable interest rate based on three month LIBOR (0.29% at September 30, 2010) plus 125 basis point spread, with provision for retirement on December 1, 2015	5,000,000	5,000,000
Unsecured senior note payable, at 7.66%, with provision for retirement of \$1,600,000 each year beginning December 1, 2014 through December 1, 2018	<u>8,000,000</u>	<u>8,000,000</u>
Total long-term debt	28,000,000	28,000,000
Less current maturities	<u>-</u>	<u>-</u>
Total long-term debt	<u>\$ 28,000,000</u>	<u>\$ 28,000,000</u>

The above debt obligations contain various provisions, including a minimum interest charge coverage ratio, limitations on debt as a percentage of total capitalization and a provision restricting the payment of dividends, primarily based on the earnings of the Company and dividends previously paid. The Company was in compliance with these provisions at September 30, 2010 and 2009. At September 30, 2010, approximately \$12,342,000 of retained earnings was available for dividends.

The \$15,000,000 unsecured variable rate note was originally scheduled to mature on December 1, 2010. In October 2010, the Company executed a modification of the note with the current lender under the same interest terms and covenants providing for the extension of the maturity date until

March 31, 2012. The Company also has an interest rate swap related to the \$15,000,000 note. The swap essentially converts the variable rate note into fixed rate debt with a 5.74% interest rate. The swap has a maturity date of December 1, 2015. The Company has expressed to the lending institution its desire to extend the \$15,000,000 note each year at terms comparable to the note currently in place so that the note and corresponding swap mature at the same time.

The Company also has a \$5,000,000 variable rate note based on three-month LIBOR plus 125 basis points and an interest rate swap that converts the note into a fixed rate debt with a 5.79% effective interest rate. Both the variable rate note and the interest rate swap mature on December 1, 2015.

The aggregate annual maturities of long-term debt after September 30, 2010 are as follows:

Year Ending September 30	Maturities
2011	\$ -
2012	15,000,000
2013	-
2014	-
2015	1,600,000
Thereafter	<u>11,400,000</u>
Total	<u>\$ 28,000,000</u>

5. INCOME TAXES

The details of income tax expense (benefit) are as follows:

	<u>Years Ended September 30</u>	
	2010	2009
Current income taxes:		
Federal	\$ 543,852	\$ 1,700,418
State	<u>228,008</u>	<u>430,460</u>
Total current income taxes	<u>771,860</u>	<u>2,130,878</u>
Deferred income taxes:		
Federal	1,746,425	842,379
State	<u>202,871</u>	<u>44,210</u>
Total deferred income taxes	<u>1,949,296</u>	<u>886,589</u>
Amortization of investment tax credits	<u>(30,155)</u>	<u>(30,158)</u>
Total income tax expense	<u>\$ 2,691,001</u>	<u>\$ 2,987,309</u>

Income tax expense for the years ended September 30, 2010 and 2009 differed from amounts computed by applying the U.S. Federal income tax rate of 34% to earnings before income taxes due to the following:

	<u>Years Ended September 30</u>	
	2010	2009
Income before income taxes	<u>\$ 7,136,437</u>	<u>\$ 7,856,319</u>
Income tax expense computed at the federal statutory rate	\$ 2,426,389	\$ 2,671,148
State income taxes, net of federal income tax benefit	284,380	313,282
Amortization of investment tax credits	(30,155)	(30,158)
Other, net	<u>10,387</u>	<u>33,037</u>
Total income tax expense	<u>\$ 2,691,001</u>	<u>\$ 2,987,309</u>

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are as follows:

	<u>September 30</u>	
	2010	2009
Deferred tax assets:		
Allowance for uncollectibles	\$ 24,778	\$ 19,241
Accrued pension and postretirement medical benefits	2,278,268	2,148,874
Accrued vacation	215,548	204,615
Over-recovery of gas costs	1,011,544	2,145,442
Costs of gas held in storage	913,725	907,937
Deferred compensation	464,789	491,107
Interest rate swap	1,342,472	930,420
Other	<u>208,900</u>	<u>227,831</u>
Total deferred tax assets	<u>6,460,024</u>	<u>7,075,467</u>
Deferred tax liabilities:		
Utility plant	10,394,768	8,907,926
Accrued gas costs	<u>488,397</u>	<u>1,277,534</u>
Total deferred tax liabilities	<u>10,883,165</u>	<u>10,185,460</u>
Net deferred tax liability	<u>\$ 4,423,141</u>	<u>\$ 3,109,993</u>

FASB ASC No. 740 - *Income Taxes* provides for the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recognized in the financial statements. During 2008, the Company had an unrecognized tax benefit associated with line pack gas. The Company filed for a change in method in its fiscal 2008 tax return and the tax is being paid over a four year

period. The Company has evaluated its tax positions and accordingly has not identified any significant additional uncertain tax positions. The Company's policy is to classify interest associated with uncertain tax positions as interest expense in the financial statements. Penalties are classified under other expense.

The Company files a federal income tax return and state income tax returns in Virginia and West Virginia. The federal returns and the state returns for both Virginia and West Virginia for the tax years ended prior to September 30, 2007 are no longer subject to examination.

6. EMPLOYEE BENEFIT PLANS

The Company sponsors both a noncontributory defined benefit pension plan and a postretirement benefit plan ("Plans"). The defined benefit pension plan covers substantially all employees and benefits fully vest after five years of credited service. Benefits paid to retirees are based on age at retirement, years of service and average compensation. The postretirement benefit plan provides certain healthcare, supplemental retirement and life insurance benefits to retired employees who meet specific age and service requirements. Employees hired prior to January 1, 2000 are eligible to participate in the postretirement benefit plan. Employees must have a minimum of ten years of service and retire after attaining the age of 55 in order to vest in the postretirement plan. Retiree contributions to the plan are based on the number of years of service to the Company as determined under the defined benefit plan.

FASB ASC No. 715 - *Compensation – Retirement Benefits* requires employers who sponsor defined benefit plans to recognize the funded status of defined benefit pension and other postretirement plans as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. For pension plans, the benefit obligation is the projected benefit obligation, and for other postretirement plans, the benefit obligation is the accumulated benefit obligation. The Company applied the provisions of FASB ASC No. 890, *Regulated Operations* and established a regulatory asset for the portion of the obligation expected to be recovered in rates in future periods. The regulatory asset is adjusted for the amortization of the transition obligation and recognition of actuarial gains and losses. The portion of the obligation attributable to the unregulated operations of the holding company is recognized in comprehensive income.

The following tables set forth the benefit obligation, fair value of plan assets, the funded status of the benefit plans, amounts recognized in the Company's financial statements and the assumptions used. The information presented for 2009 includes the 15 month period from July 1, 2008 through September 30, 2009 as a result of adopting the change in measurement date provisions.

	Pension Plan		Postretirement Plan	
	2010	2009	2010	2009
Accumulated benefit obligation	<u>\$ 13,920,786</u>	<u>\$ 12,431,936</u>	<u>\$ 11,832,322</u>	<u>\$ 9,569,792</u>
Change in benefit obligation:				
Benefit obligation at beginning of year	\$ 15,742,419	\$ 13,755,421	\$ 9,569,792	\$ 8,304,632
Service cost	448,858	504,533	159,784	154,570
Interest cost	853,643	1,058,627	513,437	630,026
Actuarial loss	961,201	980,245	2,004,774	951,608
Benefit payments, net of retiree contributions	<u>(466,433)</u>	<u>(556,407)</u>	<u>(415,465)</u>	<u>(471,044)</u>
Benefit obligation at end of year	<u>\$ 17,539,688</u>	<u>\$ 15,742,419</u>	<u>\$ 11,832,322</u>	<u>\$ 9,569,792</u>
Change in fair value of plan assets:				
Fair value of plan assets at beginning of year	\$ 11,178,556	\$ 11,400,327	\$ 6,163,581	\$ 5,190,941
Actual return on plan assets, net of taxes	970,635	(565,364)	390,610	143,684
Employer contributions	1,000,000	900,000	700,000	1,300,000
Benefit payments, net of retiree contributions	<u>(466,433)</u>	<u>(556,407)</u>	<u>(415,465)</u>	<u>(471,044)</u>
Fair value of plan assets at end of year	<u>\$ 12,682,758</u>	<u>\$ 11,178,556</u>	<u>\$ 6,838,726</u>	<u>\$ 6,163,581</u>
Funded status	<u>\$ (4,856,930)</u>	<u>\$ (4,563,863)</u>	<u>\$ (4,993,596)</u>	<u>\$ (3,406,211)</u>
Amounts recognized in the balance sheets consist of:				
Noncurrent liabilities	<u>\$ (4,856,930)</u>	<u>\$ (4,563,863)</u>	<u>\$ (4,993,596)</u>	<u>\$ (3,406,211)</u>
Amounts recognized in accumulated other comprehensive loss:				
Transition obligation, net of tax	\$ -	\$ -	\$ 80,698	\$ 109,896
Net actuarial loss, net of tax	<u>1,113,787</u>	<u>954,797</u>	<u>478,265</u>	<u>299,378</u>
Total amounts included in other comprehensive loss, net of tax	<u>\$ 1,113,787</u>	<u>\$ 954,797</u>	<u>\$ 558,963</u>	<u>\$ 409,274</u>
Amounts deferred to a regulatory asset:				
Transition obligation	\$ -	\$ -	\$ 389,297	\$ 531,096
Net actuarial loss	<u>3,481,209</u>	<u>3,203,563</u>	<u>2,968,467</u>	<u>1,386,314</u>
Amounts recognized as regulatory assets	<u>\$ 3,481,209</u>	<u>\$ 3,203,563</u>	<u>\$ 3,357,764</u>	<u>\$ 1,917,410</u>

The Company expects that approximately \$197,000, before tax, of accumulated other comprehensive loss will be recognized as a portion of net periodic benefit costs in fiscal 2011 and approximately \$580,000 of amounts deferred as regulatory assets will be amortized and recognized in net periodic benefit costs in fiscal 2011.

The Company amortizes the unrecognized transition obligation over 20 years.

The following table details the actuarial assumptions used in determining the projected benefit obligations and net benefit cost of the pension and the accumulated benefit obligations and net benefit cost of the postretirement plan for 2010 and 2009.

	<u>Pension Plan</u>		<u>Postretirement Plan</u>	
	2010	2009	2010	2009
Assumptions used to determine benefit obligations:				
Discount rate	5.25%	5.50%	5.00%	5.50%
Expected rate of compensation increase	4.00%	4.00%	N/A	N/A
Assumptions used to determine benefit costs:				
Discount rate	5.50%	6.25%	5.50%	6.25%
Expected long-term rate of return on plan assets	7.25%	7.50%	5.14%	5.18%
Expected rate of compensation increase	4.00%	5.00%	N/A	N/A

To develop the assumption on expected long-term rate of return on assets, the Company, with input from the plans actuaries and investment advisors, considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of each plan's portfolio. This resulted in the selection of the corresponding long-term rate of return assumptions used for each plan's assets.

Components of net periodic benefit cost are as follows:

	<u>Pension Plan</u>		<u>Postretirement Plan</u>	
	2010	2009	2010	2009
Service cost	\$ 448,858	\$ 504,533	\$ 159,784	\$ 154,570
Interest cost	853,643	1,058,627	513,437	630,026
Expected return on plan assets	(818,627)	(1,077,687)	(325,050)	(345,893)
Amortization of unrecognized transition obligation	-	-	188,892	236,115
Recognized loss	<u>275,112</u>	<u>88,233</u>	<u>68,535</u>	<u>-</u>
Net periodic benefit cost	<u>\$ 758,986</u>	<u>\$ 573,706</u>	<u>\$ 605,598</u>	<u>\$ 674,818</u>

The assumed health care cost trend rates used in measuring the accumulated benefit obligation for the postretirement medical plan as of September 30, 2010 and 2009 are presented below:

	<u>2010</u>	<u>2009</u>
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	4.75%	4.75%
Year that the rate reaches the ultimate trend rate	2017	2016

The health care cost trend rate assumptions could have a significant effect on the amounts reported. A change of 1% would have the following effects:

	<u>1% Increase</u>	<u>1% Decrease</u>
Effect on total service and interest cost components	\$ 130,390	\$ (104,587)
Effect on accumulated postretirement benefit obligation	1,785,893	(1,456,652)

The primary objectives of the Company's investment policy are to maintain investment portfolios that diversify risk through prudent asset allocation parameters, achieve asset returns that meet or exceed the plans' actuarial assumptions, achieve asset returns that are competitive with like institutions employing similar investment strategies and meet expected future benefits in both the short-term and long-term. The investment policy provides for a range of investment allocations to allow for flexibility in responding to market conditions. The investment policy is periodically reviewed by the Company and a third-party fiduciary for investment matters.

The Company's target and actual asset allocation in the pension and postretirement benefit plans as of September 30, 2010 and 2009 were:

	<u>Pension Plan</u>			<u>Postretirement Plan</u>		
	Target	2010	2009	Target	2010	2009
Asset category:						
Equity securities	60%	63%	58%	50%	51%	33%
Debt securities	40%	33%	33%	50%	45%	14%
Cash	0%	4%	9%	0%	3%	53%
Other	0%	0%	0%	0%	1%	0%

The assets of the plans are invested in mutual funds. The Company uses the fair value hierarchy described in Note 1 to classify these assets. The mutual funds are included under Level 2 in the fair value hierarchy as their fair values are determined based on the individual fund as a whole and not on the individual assets that make up the fund. The following table contains the fair value classifications of the benefit plan assets:

Defined Benefit Pension Plan
Fair Value Measurements - September 30, 2010

	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Asset Class:				
Cash	\$ 505,743	\$ 505,743	\$ -	\$ -
Mutual Funds				
US Equities	5,568,023	-	5,568,023	-
Non US Equities	2,395,338	-	2,395,338	-
Fixed Income	<u>4,213,654</u>	<u>-</u>	<u>4,213,654</u>	<u>-</u>
Total	<u>\$ 12,682,758</u>	<u>\$ 505,743</u>	<u>\$ 12,177,015</u>	<u>\$ -</u>

Postretirement Benefit Plan
Fair Value Measurements - September 30, 2010

	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Asset Class:				
Cash	\$ 183,952	\$ 183,952	\$ -	\$ -
Mutual Funds				
US Equities	2,807,336	-	2,807,336	-
Non US Equities	695,114	-	695,114	-
Fixed Income	3,082,562	-	3,082,562	-
Other	<u>69,762</u>	<u>-</u>	<u>69,762</u>	<u>-</u>
Total	<u>\$ 6,838,726</u>	<u>\$ 183,952</u>	<u>\$ 6,654,774</u>	<u>\$ -</u>

Each mutual fund has been categorized based on its primary investment strategy.

The Company expects to contribute \$1,000,000 to its pension plan and \$700,000 to its postretirement benefit plan in fiscal 2011.

The following table reflects expected future benefit payments:

Fiscal year ending September 30	Pension Plan	Postretirement Plan
2011	\$ 462,000	\$ 471,000
2012	467,000	497,000
2013	485,000	514,000
2014	486,000	543,000
2015	545,000	572,000
2016-2020	3,602,000	3,194,000

The Company also sponsors a defined contribution plan (“401k Plan”) covering all employees who elect to participate. Employees may contribute from 1% to 50% of their annual compensation to the 401k Plan, limited to a maximum annual amount as set periodically by the Internal Revenue Service. Effective April 2010, the Company began matching contributions to the 401(k) Plan with a 100% match on the participant’s first 4% of contributions and 50% on the next 2% of contributions. Prior to April 2010, the Company matched 100% of the participant’s first 3% of contributions and 50% on the next 3% of contributions. Company matching contributions were \$257,718 and \$246,186 for 2010 and 2009, respectively.

7. COMMON STOCK OPTIONS

The Company’s stockholders approved the RGC Resources, Inc. Key Employee Stock Option Plan (“KESOP”). The KESOP provides for the issuance of common stock options to officers and certain other full-time salaried employees to acquire a maximum of 100,000 shares of the Company’s common stock. The KESOP requires each option’s exercise price per share to equal the fair value of the Company’s common stock as of the date of the grant. As of September 30, 2010, the number of shares available for future grants under the KESOP was 2,000 shares.

FASB ASC No. 718 - *Compensation-Stock Compensation* requires that compensation expense be recognized for the issuance of equity instruments to employees. However, all options granted under the KESOP were issued prior to this requirement and fell under the provisions prescribed under Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB Opinion No. 25, the Company did not recognize stock-based employee compensation expense related to its KESOP in net income as all options granted under the KESOP had an exercise price equal to the market value of the underlying common stock on the date of the grant. The Company adopted the provisions of FASB ASC No. 718 using the modified prospective application. Under the modified prospective application, only new grants and grants that have been modified, cancelled or have not yet vested require recognition of compensation cost.

The aggregate number of shares under option pursuant to the KESOP are as follows:

	Number of Shares	Weighted- Average Exercise Price	Option Price Per Share
Options outstanding, September 30, 2008	29,500	\$ 19.416	\$18.100-\$20.875
Options exercised	(7,500)	\$ 20.767	
Options expired	<u>-</u>		
Options outstanding, September 30, 2009	22,000	\$ 18.955	\$18.100-\$19.360
Options exercised	(8,000)	\$ 19.148	
Options expired	<u>-</u>		
Options outstanding, September 30, 2010	<u>14,000</u>	\$ 18.845	\$18.100-\$19.360

The intrinsic value of the options exercised during fiscal 2010 and 2009 were \$91,956 and \$43,218, respectively.

Under the terms of the KESOP, the options become exercisable six months from the grant date and expire ten years subsequent to the grant date. All options outstanding were fully vested and exercisable at September 30, 2010 and 2009. No options were granted in 2010 and 2009. The Company received \$153,180 and \$155,750 from the exercise of options in 2010 and 2009, respectively.

Options Outstanding and Exercisable

	Shares	Remaining Life (Years)	Exercise Price	Intrinsic Value
	2,500	0.2	\$ 19.250	\$ 27,375
	6,000	1.2	19.360	65,040
	5,500	2.2	18.100	66,550
Weighted average	14,000	1.4	\$ 18.845	\$ 158,965

8. OTHER STOCK PLANS

Dividend Reinvestment and Stock Purchase Plan

The Company offers a Dividend Reinvestment and Stock Purchase Plan (“DRIP”) to shareholders of record for the reinvestment of dividends and the purchase of additional investments of up to \$40,000 per year in shares of common stock of the Company. Under the DRIP plan, the Company issued 22,619 and 16,696 shares in 2010 and 2009, respectively. As of September 30, 2010, the Company had 231,370 shares available for issuance.

Restricted Stock Plan

The Board of Directors of the Company implemented the Restricted Stock Plan for Outside Directors (“Plan”) effective January 27, 1997. The Plan is applicable to not more than 50,000 shares of Resources’ common stock. Under the Plan, a minimum of 40% of the monthly retainer fee paid to each non-employee director of Resources is paid in shares of common stock (“Restricted Stock”). The number of shares of Restricted Stock is calculated each month based on the closing sales price of Resources’ common stock on the NASDAQ National Market on the first day of the month, if the first day of the month is a trading day, or if not, the first trading day prior to the first day of the month. Beginning in fiscal 1998, a participant can, subject to approval of the Board, elect to receive up to 100% of his retainer fee for the fiscal year in Restricted Stock. Such election cannot be revoked or amended during the fiscal year.

The shares of Restricted Stock of Resources issued under the Plan will vest only in the case of a participant’s death, disability, retirement (including not standing for re-election to the Board), or in the event of a change in control of Resources. There is no option to take cash in lieu of stock upon vesting of shares under the Plan. The Restricted Stock may not be sold, transferred, assigned or pledged by the participant until the shares have vested under the terms of the Plan. At the time the Restricted Stock vests, a certificate for vested shares will be delivered to the participant or the participant’s beneficiary.

The shares of Restricted Stock will be forfeited to Resources by a participant's voluntary resignation during his term on the Board or removal for cause as a director. Subject to the terms of the Plan, a participant, as owner of the Restricted Stock, has all rights of a shareholder, including but not limited to, voting rights and the right to participate in any capital adjustment of Resources. Resources requires that all dividends or other distributions paid on shares of Restricted Stock be automatically sequestered and reinvested on an immediate or deferred basis in additional Restricted Stock.

The directors received a total of 4,195 shares of Restricted Stock in fiscal 2010, representing \$83,617 in compensation and \$44,187 in dividends reinvested. The directors also received a total of 4,802 shares of Restricted Stock in fiscal 2009, representing \$91,410 in compensation and \$37,087 in dividends reinvested. As of September 30, 2010, the Company had 7,325 shares available for issuance.

Stock Bonus Plan

Under the Stock Bonus Plan, executive officers are encouraged to own a position in the Company's common stock of at least 50% of the value of their annual salary. To promote this policy, the Plan provides that all officers with stock ownership positions below 50% of the value of their annual salaries must, unless approved by the Committee, receive no less than 50% of any performance bonus in the form of Company common stock. Shares from the Stock Bonus Plan may also be issued to certain employees and management personnel in recognition of their performance and service. Under the Stock Bonus Plan, the Company issued 711 and 848 shares valued at \$22,005 and \$21,880, respectively, in 2010 and 2009. As of September 30, 2010 the Company had 21,440 shares available for issuance.

9. ENVIRONMENTAL MATTERS

Both Roanoke Gas Company and Bluefield Gas Company, a previously owned subsidiary of the Company, 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 be required to remediate either site, the Company 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. While the Company sold the stock of Bluefield Gas Company to ANGD, LLC in 2007, it retained ownership of the former MGP site and entered into an Indemnification and Cost Sharing Agreement with ANGD to seek rate recovery of any remediation costs through rates and under any applicable insurance policies or from any third party for reimbursement to the Company for 25% of any such costs to the extent they are not otherwise recovered. If the Company incurs costs associated with a required clean-up of the Roanoke Gas Company MGP site, the Company anticipates recording a regulatory asset for such clean-up costs to be recovered in future rates.

10. COMMITMENTS AND CONTINGENCIES

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

The Company obtains most of its regulated natural gas supply from the asset management contract between Roanoke Gas Company and the asset manager. The Company uses an asset manager to

assist in optimizing the use of its transportation, storage rights, and gas supply inventories to provide a secure and reliable source of natural gas.

Under the same asset management contract mentioned above, the Company designated the asset manager as agent for their storage capacity and all gas balances in storage. The asset manager provides agency service and manages the utilization of storage assets and the corresponding withdrawals from and injections to storage. The Company retains physical ownership of storage. Under the provision of the asset management contract, the Company has an obligation to purchase its winter storage requirements during the spring and summer injection periods at market price. In September 2010, the Company entered into a new three-year agreement with the asset manager. The new agreement expires in October 2013.

The Company also has contracts for pipeline and storage capacity extending for various periods. These capacity costs and related fees are valued at tariff rates in place as of September 30, 2010. These rates may increase or decrease in the future based upon rate filings and rate orders granting a rate change to the pipeline or storage operator.

The following table reflects the financial and volumetric obligations as of September 30, 2010 for each of the next five years and thereafter for Roanoke Gas.

Fiscal Year Ending September 30,	Fixed Price Contracts	Market Price Contracts
	Pipeline and Storage Capacity	Natural Gas Contracts (Decatherms)
2011	\$ 10,016,718	2,225,059
2012	9,953,212	2,225,059
2013	9,315,864	2,225,059
2014	7,579,603	317,864
2015	3,270,070	-
Thereafter	6,616,519	-

The Company expended approximately \$43,384,000 and \$42,520,000 under the asset management, pipeline and storage contracts for Roanoke Gas Company in fiscal year 2010 and 2009, respectively.

The Company has historically entered into derivative financial contracts for the purpose of hedging the price on natural gas. As of September 30, 2010, the Company has contracted to hedge, through derivative collar arrangements, a set amount of decatherms of natural gas for each month in the 2010-2011 winter period. The collar arrangement reflects a total of 1,300,000 decatherms. All decatherm amounts have a ceiling price of \$8.00 per decatherm and a floor price ranging from \$4.13 to \$4.20 per decatherm. See *Derivative and Hedging Activities* in Note 1 for more information.

The Company also has agreements in place for software support and maintenance extending through September 30, 2014 with annual payments ranging from approximately \$131,000 to \$151,000.

In July 2010, the Company received notice that it had been named as a defendant in two civil lawsuits associated with an explosion and fire at a West Virginia residence in November 2009. The suits claimed that the fire was due to the ignition of propane within the residence. This residence was served by a propane tank installation at the time the assets of the Company's propane subsidiary, Highland Propane, were sold to Inergy Propane, LLC ("Inergy") in 2004. Inergy retained the name Highland Propane and assumed ownership and responsibility for all propane tanks including the tank located at the residence identified in the suits. No damage amounts are specified

in the suits; however, both property damage and bodily injury are claimed. The Company has not recorded a liability for the lawsuits as management does not believe the likelihood of a negative outcome to the Company is probable, nor is the amount of potential damages readily determinable. In addition, if the outcome of the lawsuits were adverse to the Company, management believes that any such damages would be covered by the Company's insurance.

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

11. FAIR VALUE MEASUREMENTS

The following table summarizes the Company's financial assets and liabilities that are measured at fair value on a recurring basis and the fair value measurements by level within the fair value hierarchy as defined in Note 1 at September 30, 2010 and 2009, respectively:

Fair Value Measurements - September 30, 2010				
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Liabilities:				
Natural gas purchases	\$ 980,334	\$ -	\$ 980,334	\$ -
Interest rate swaps	3,536,545	-	3,536,545	-
Natural gas derivatives	<u>83,160</u>	<u>-</u>	<u>83,160</u>	<u>-</u>
Total	<u>\$ 4,600,039</u>	<u>\$ -</u>	<u>\$ 4,600,039</u>	<u>\$ -</u>

Fair Value Measurements - September 30, 2009				
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Liabilities:				
Natural gas purchases	\$ 1,146,734	\$ -	\$ 1,146,734	\$ -
Interest rate swaps	<u>2,451,055</u>	<u>-</u>	<u>2,451,055</u>	<u>-</u>
Total	<u>\$ 3,597,789</u>	<u>\$ -</u>	<u>\$ 3,597,789</u>	<u>\$ -</u>

Under the asset management contract, a timing difference can exist between the payment for natural gas purchases and the actual receipt of such purchases. Payments are made based on a predetermined monthly volume with the price based on the actual first of the month index prices corresponding to the month of the scheduled payment. At September 30, 2010 and 2009, the Company had a liability in accounts payable reflecting the estimated fair value of the liability valued at the corresponding first of month index prices for which the liability is expected to be settled. The fair value of the interest rate swaps, included in the line item "Fair value of marked-to-market transactions", is determined by the financial institutions issuing those instruments. The valuation is a mathematical approximation of market value as of the balance sheet date using the counterparty's proprietary models and certain assumptions regarding past, present and future market conditions. The fair value of the natural gas derivatives also included in the line item "Fair Value of marked-to-market transactions" is determined by applying the NYMEX futures prices to the hedged volumes for each month covered by the derivative contracts.

The Company's nonfinancial assets and liabilities that are measured at fair value on a nonrecurring basis consist of its asset retirement obligations. The asset retirement obligations are measured at fair value at initial recognition based on expected future cash flows to settle the obligation.

The following table summarizes the fair value of the Company's financial assets and liabilities that are not adjusted to fair value in the financial statements as of September 30, 2010 and 2009. The carrying value of cash and cash equivalents, accounts receivable, accounts payable (with the exception of the timing difference under the asset management contract), customer credit balances and customer deposits is a reasonable estimate of fair value due to the short-term nature of these financial instruments.

	<u>September 30, 2010</u>		<u>September 30, 2009</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Assets:				
Note receivable	\$ 1,126,000	\$ 1,156,755	\$ 1,213,000	\$ 1,173,749
Liabilities:				
Long-term debt	28,000,000	29,452,040	28,000,000	29,382,055

Note receivable is composed of \$87,000 in current assets and \$1,039,000 in other assets.

The note receivable is a five year note with a fifteen year amortization as partial payment for the sale of the Bluefield, Virginia natural gas distribution assets to ANGD, LLC in October 2007. The fair value of the note receivable is estimated by discounting future cash flows based on a range of rates for similar investments adjusted for management's expectation of credit and other risks. The fair value of long-term debt is estimated by discounting the future cash flows of the fixed rate debt at rates extrapolated based on current market conditions. The variable rate long-term debt has interest rate swaps that effectively convert such debt to a fixed rate. The values of the swap agreements are included in the first table above.

FASB ASC 825 – *Financial Instruments* requires disclosures regarding concentrations of credit risk from financial instruments. Cash equivalents are investments in high-grade, short-term securities (original maturity less than three months), placed with financially sound institutions. Accounts receivable are from a diverse group of customers including individuals and small and large companies in various industries. At September 30, 2010 and 2009, no single customer accounted for more than 5% of the total accounts receivable balance. The Company maintains certain credit standards with its customers and requires a customer deposit if such evaluation warrants. The Company is also exposed to credit risk of nonperformance by the counterparty on its commodity-based collar agreements. The company uses financially sound institutions to mitigate the risk of nonperformance on these contracts.

12. SUBSEQUENT EVENTS

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 consolidated financial statements.

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