

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

*Consolidated Financial Statements  
for the Years Ended September 30, 2008  
and 2007, and Report of Independent  
Registered Public Accounting Firm*

# **RGC RESOURCES, INC. AND SUBSIDIARIES**

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**BROWN,  
EDWARDS &  
COMPANY, L.L.P.**  
Certified Public Accountants

**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, 2008 and 2007, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the years then ended. The Company’s management is responsible for these financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

CERTIFIED PUBLIC ACCOUNTANTS

319 McClanahan Street, S.W.  
Roanoke, Virginia  
November 7, 2008

# RGC RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2008 AND 2007

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	2008	2007
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 875,436	\$ 1,408,317
Short-term investments	500,000	-
Accounts receivable, less allowance for doubtful accounts of \$63,791 in 2008 and \$46,710 in 2007	5,086,790	4,447,928
Note receivable	87,000	-
Materials and supplies	553,604	515,722
Gas in storage	26,122,686	19,156,833
Assets available for sale	-	12,825,344
Prepaid income taxes	1,479,693	1,649,788
Deferred income taxes	2,187,795	1,001,162
Under-recovery of gas costs	1,013,087	-
Other	<u>505,761</u>	<u>455,445</u>
Total current assets	<u>38,411,852</u>	<u>41,460,539</u>
UTILITY PROPERTY:		
In service	113,533,184	108,348,844
Accumulated depreciation and amortization	<u>(39,038,120)</u>	<u>(36,424,831)</u>
In service, net	<u>74,495,064</u>	<u>71,924,013</u>
Construction work in progress	<u>1,113,008</u>	<u>663,256</u>
Utility plant, net	<u>75,608,072</u>	<u>72,587,269</u>
OTHER ASSETS:		
Note receivable	1,213,000	-
Regulatory assets	2,762,241	2,154,145
Other	<u>132,549</u>	<u>130,502</u>
Total other assets	<u>4,107,790</u>	<u>2,284,647</u>
TOTAL ASSETS	<u>\$ 118,127,714</u>	<u>\$ 116,332,455</u>

# RGC RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2008 AND 2007

	2008	2007
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ -	\$ 5,000,000
Borrowings under lines-of-credit	13,960,000	4,808,000
Dividends payable	690,538	667,245
Accounts payable	8,215,319	6,457,602
Customer credit balances	4,237,043	4,308,415
Income taxes payable	3,206	-
Customer deposits	1,522,480	1,439,765
Accrued expenses	2,111,614	2,106,222
Liabilities of assets available for sale	-	7,558,605
Over-recovery of gas costs	-	567,295
Fair value of marked-to-market transactions	875,487	86,025
	<u>31,615,687</u>	<u>32,999,174</u>
Total current liabilities		
	<u>31,615,687</u>	<u>32,999,174</u>
LONG-TERM DEBT, excluding current maturities	<u>23,000,000</u>	<u>23,000,000</u>
DEFERRED CREDITS AND OTHER LIABILITIES:		
Asset retirement obligations	2,608,995	2,499,345
Regulatory cost of retirement obligations	6,843,338	6,043,088
Benefit plan liabilities	4,768,785	3,855,292
Deferred income taxes	5,471,667	5,442,563
Deferred investment tax credits	96,184	127,760
	<u>19,788,969</u>	<u>17,968,048</u>
Total deferred credits and other liabilities		
	<u>19,788,969</u>	<u>17,968,048</u>
COMMITMENTS AND CONTINGENCIES (Notes 10 and 11)		
CAPITALIZATION:		
Stockholders' Equity:		
Common stock, \$5 par value; authorized 10,000,000 shares; issued and outstanding 2,209,471 and 2,186,143 shares in 2008 and 2007, respectively	\$ 11,047,355	\$ 10,930,715
Preferred stock, no par; authorized 5,000,000 shares; no shares issued or outstanding in 2008 and 2007	-	-
Capital in excess of par value	15,990,961	15,466,756
Retained earnings	17,909,134	16,443,017
Accumulated other comprehensive loss	(1,224,392)	(475,255)
	<u>43,723,058</u>	<u>42,365,233</u>
Total stockholders' equity		
	<u>43,723,058</u>	<u>42,365,233</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u><u>\$ 118,127,714</u></u>	<u><u>\$ 116,332,455</u></u>

(Concluded)

See notes to consolidated financial statements.

## RGC RESOURCES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	2008	2007
OPERATING REVENUES:		
Gas utilities	\$ 93,606,593	\$ 89,175,661
Other	<u>1,030,233</u>	<u>725,640</u>
Total operating revenues	<u>94,636,826</u>	<u>89,901,301</u>
COST OF SALES:		
Gas utilities	68,283,129	64,342,382
Other	<u>440,085</u>	<u>337,143</u>
Total cost of sales	<u>68,723,214</u>	<u>64,679,525</u>
GROSS MARGIN	<u>25,913,612</u>	<u>25,221,776</u>
OTHER OPERATING EXPENSES:		
Operations	10,107,242	10,624,555
Maintenance	1,470,212	1,419,830
General taxes	1,167,293	1,130,522
Depreciation and amortization	<u>4,330,839</u>	<u>4,088,590</u>
Total other operating expenses	<u>17,075,586</u>	<u>17,263,497</u>
OPERATING INCOME	8,838,026	7,958,279
OTHER INCOME (EXPENSE), Net	34,622	(24,758)
INTEREST EXPENSE	<u>2,033,082</u>	<u>1,931,444</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	6,839,566	6,002,077
INCOME TAX EXPENSE FROM CONTINUING OPERATIONS	<u>2,581,742</u>	<u>2,236,408</u>
INCOME FROM CONTINUING OPERATIONS	<u>4,257,824</u>	<u>3,765,669</u>
DISCONTINUED OPERATIONS:		
Income (loss) from discontinued operations, net of income tax expense (benefit) of (\$14,628) and \$835,836, respectively	<u>(36,690)</u>	<u>40,540</u>
NET INCOME	4,221,134	3,806,209
OTHER COMPREHENSIVE LOSS, NET OF TAX	<u>(749,137)</u>	<u>(50,542)</u>
COMPREHENSIVE INCOME	<u>\$ 3,471,997</u>	<u>\$ 3,755,667</u>

(Continued)

## RGC RESOURCES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME YEARS ENDED SEPTEMBER 30, 2008 AND 2007

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	2008	2007
BASIC EARNINGS PER COMMON SHARE:		
Income from continuing operations	\$ 1.94	\$ 1.74
Discontinued operations	(0.02)	0.02
Net income	<u>\$ 1.92</u>	<u>\$ 1.76</u>
DILUTED EARNINGS PER COMMON SHARE:		
Income from continuing operations	\$ 1.93	\$ 1.73
Discontinued operations	(0.02)	0.02
Net income	<u>\$ 1.91</u>	<u>\$ 1.75</u>
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:		
Basic	2,201,263	2,162,803
Diluted	2,211,226	2,173,258
		(Concluded)

See notes to consolidated financial statements.

## RGC RESOURCES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
BALANCE—September 30, 2006	\$ 10,692,975	\$ 14,521,812	\$ 15,282,909	\$ (2,828)	\$ 40,494,868
Net income	-	-	3,806,209	-	3,806,209
Losses on hedging activities, net of tax	-	-	-	(50,542)	(50,542)
Adoption of SFAS No. 158	-	-	-	(421,885)	(421,885)
Cash dividends declared (\$1.22 per share)	-	-	(2,646,101)	-	(2,646,101)
Issuance of common stock (47,548 shares)	<u>237,740</u>	<u>944,944</u>	<u>-</u>	<u>-</u>	<u>1,182,684</u>
BALANCE—September 30, 2007	<u>\$ 10,930,715</u>	<u>\$ 15,466,756</u>	<u>\$ 16,443,017</u>	<u>\$ (475,255)</u>	<u>\$ 42,365,233</u>
Net income	-	-	4,221,134	-	4,221,134
Losses on hedging activities, net of tax	-	-	-	(466,300)	(466,300)
Change in net loss and transition obligation of defined benefit plans	-	-	-	(282,837)	(282,837)
Cash dividends declared (\$1.25 per share)	-	-	(2,755,017)	-	(2,755,017)
Issuance of common stock (23,328 shares)	<u>116,640</u>	<u>524,205</u>	<u>-</u>	<u>-</u>	<u>640,845</u>
BALANCE—September 30, 2008	<u>\$ 11,047,355</u>	<u>\$ 15,990,961</u>	<u>\$ 17,909,134</u>	<u>\$ (1,224,392)</u>	<u>\$ 43,723,058</u>

See notes to consolidated financial statements.

# RGC RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income from continuing operations	\$ 4,257,824	\$ 3,765,669
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,526,670	4,301,102
Cost of removal of utility plant, net	(202,843)	(252,931)
Loss on disposal of property	7,304	-
Change in over/under-recovery of gas costs	(1,542,532)	(3,027,101)
Deferred taxes and investment tax credits	(730,442)	2,003,043
Other noncash items, net	28,329	18,201
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable and customer deposits, net	(556,147)	304,787
Inventories and gas in storage	(7,003,735)	813,282
Other current assets	310,119	(832,712)
Accounts payable, customer credit balances and accrued expenses, net	1,403,231	(1,463,285)
Total adjustments	(3,760,046)	1,864,386
Net cash provided by continuing operating activities	497,778	5,630,055
Net cash provided by (used in) discontinued operations	(277,913)	991,317
Net cash provided by operating activities	219,865	6,621,372
CASH FLOWS FROM INVESTING ACTIVITIES:		
Expenditures for utility property	(6,539,369)	(6,004,190)
Proceeds from disposal of utility property	17,540	12,340
Proceeds from sale of Bluefield Operations	3,855,323	-
Purchase of short-term investments	(500,000)	-
Net cash used in continuing investing activities	(3,166,506)	(5,991,850)
Net cash used in discontinued investing activities	(12,360)	(204,107)
Net cash used in investing activities	(3,178,866)	(6,195,957)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Retirement of long-term debt	(5,000,000)	-
Net borrowings under line-of-credit agreements	9,152,000	1,455,000
Proceeds from issuance of common stock	640,845	1,182,684
Cash dividends paid	(2,731,725)	(2,621,923)
Net cash provided by continuing financing activities	2,061,120	15,761
Net cash provided by (used in) discontinued financing activities	365,000	(523,000)
Net cash provided by (used in) financing activities	2,426,120	(507,239)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(532,881)	(81,824)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	1,408,317	1,490,141
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 875,436	\$ 1,408,317

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## RGC RESOURCES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

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	2008	2007
SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION:		
Cash paid during the year for:		
Interest	<u>\$ 2,188,420</u>	<u>\$ 2,335,713</u>
Income taxes, net of refunds	<u>\$ 3,094,944</u>	<u>\$ 1,952,794</u>

Non-cash transactions:

A note in the amount of \$1,300,000 was received as partial payment for the sale of the assets of the Bluefield division of Roanoke Gas Company.

(Concluded)

See notes to consolidated financial statements.

# RGC RESOURCES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**General**—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, Inc. of Virginia, operating as Application Resources. Roanoke Gas is a natural gas utility, which distributes and sells natural gas to approximately 55,700 residential, commercial and industrial customers within its service areas in Roanoke, Virginia and the surrounding areas. 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.

Resources has only one reportable segment as defined under Statement of Financial Accounting Standards (“SFAS”) No. 131, *Disclosures about Segments of an Enterprise and Related Information*. All intercompany transactions have been eliminated in consolidation.

Effective October 31, 2007, Resources sold all of the capital stock of Bluefield Gas Company (“Bluefield Gas”) and Roanoke Gas sold the natural gas distribution assets located in the Town of Bluefield and the County of Tazewell, Virginia (“Bluefield division of Roanoke Gas Company”). See footnote 2 for additional information on the sale and corresponding discontinued operations.

**Rate Regulated Basis of Accounting**—The Company’s regulated operations follow the accounting and reporting requirements of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. 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 results, 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 SFAS No. 71 no longer applied to any or all regulated assets or liabilities, the Company would write off such amounts which would have an impact on net income for the period.

Regulatory assets and liabilities included in the Company's consolidated balance sheets as of September 30, 2008 and 2007 are as follows:

	<u>September 30</u>	
	<u>2008</u>	<u>2007</u>
Regulatory assets:		
Under-recovery of gas costs	\$ 1,013,087	\$ -
Premium on early retirement of debt	217,701	248,077
Benefit plan assets	2,731,674	1,906,068
Other	<u>11,945</u>	<u>11,945</u>
Total regulatory assets	<u>\$ 3,974,407</u>	<u>\$ 2,166,090</u>
Regulatory liabilities:		
Over-recovery of gas costs	\$ -	\$ 567,295
Asset retirement obligation	2,608,995	2,499,345
Regulatory cost of retirement obligations	6,843,338	6,043,088
Other	<u>-</u>	<u>330</u>
Total regulatory liabilities	<u>\$ 9,452,333</u>	<u>\$ 9,110,058</u>

Regulatory assets are included in "Under-recovery of gas costs", "Other current assets" and "Regulatory assets". Regulatory liabilities are included in "Over-recovery of gas costs", "Regulatory cost of retirement obligations" and "Asset retirement obligations". As of September 30, 2008, the Company had regulatory assets in the amount of \$2,731,674 on which the Company does not earn a return during the recovery period. These assets pertain to the net funded position of the Company's benefit plans related to the 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 in footnote 13. 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. The composite weighted-average depreciation rates were 4.12% of average depreciable property for the years ended September 30, 2008 and 2007. The annual composite rates for utility property are determined by periodic depreciation studies that are approved by the SCC. The Virginia Commission requires Roanoke Gas to conduct a depreciation study every five years and propose new depreciation rates for approval. The results of Roanoke Gas' last depreciation study were placed into effect January 1, 2004.

The composite rates are comprised of two components, one based on average service life and one based on cost of retirement. Therefore, the Company accrues the estimated cost of retirement of long-lived assets through depreciation expense. Retirement costs are not a legal obligation as

defined by SFAS No. 143 but rather the result of cost-based regulation and are accounted for under the provisions of SFAS No. 71. Therefore, such amounts are classified as a regulatory liability. See footnote 13 regarding legal obligations related to asset retirements.

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 a material effect on results of operations or financial condition.

**Cash, Cash Equivalents and Short-Term Investments**—From time to time, the Company will have on deposit at banks balances 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, 2008, the Company had approximately \$486,000 in bank deposits in excess of the FDIC insurance limits of \$100,000, which were raised to \$250,000 subsequent to year end. 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**—The accounts receivable consist 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>2008</u>	<u>2007</u>
Balances, beginning of year	\$ 46,710	\$ 26,584
Additions charged to bad debt expense	197,272	120,671
Recoveries of accounts written off	199,210	294,887
Accounts written off	<u>(379,401)</u>	<u>(395,432)</u>
Balances, end of year	<u>\$ 63,791</u>	<u>\$ 46,710</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 and, therefore, an accrual is made to estimate natural gas delivered to customers not yet billed during the accounting period. The Company recognizes revenue when gas is delivered. The amounts of unbilled revenue receivable included in accounts receivable on the consolidated balance sheets at September 30, 2008 and 2007 were \$1,475,406 and \$1,287,362, 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 a consolidated income tax return.

**Debt Expenses**—Debt issuance expenses are being 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, increases or decreases in natural gas costs incurred by regulated operations, including gains and losses on derivative hedging instruments, are passed through to customers. Accordingly, the difference between actual costs incurred and costs recovered through the application of the PGA is reflected 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.

**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.

**Reclassifications** – Certain prior period amounts have been reclassified to conform to current year presentation. Specifically, the Company reclassified the regulatory assets contained in other non-current assets into a separate line item under the “Other Assets” section of the Balance Sheet. The reclassification did not impact income or equity.

**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:

	<b>Years Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Weighted average common shares	2,201,263	2,162,803
Effect of dilutive securities:		
Options to purchase common stock	<u>9,963</u>	<u>10,455</u>
Diluted average common shares	<u><u>2,211,226</u></u>	<u><u>2,173,258</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***—SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, 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 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 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. At September 30, 2008, the Company has collar agreements outstanding for the winter period to hedge 370,000 decatherms of natural gas with a fair value liability of \$37,850.

The Company also entered into an interest rate swap related to the \$15,000,000 note issued in November 2005. The swap essentially converted the floating rate note based on LIBOR into fixed rate debt with a 5.74% interest rate. The swap qualifies as a cash flow hedge with changes in fair value reported in other comprehensive income.

No derivative instruments were deemed to be ineffective as defined under SFAS No. 133 for any period.

***Other Comprehensive Income***—A summary of other comprehensive income and financial instrument activity including the effect of adopting SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, is provided below:

	<b>Interest Rate Swap</b>	<b>Natural Gas Derivative</b>	<b>Defined Benefit Plans</b>	<b>Total</b>
Accumulated Comprehensive Loss - 9/30/06	\$ (2,828)	\$ -	\$ -	\$ (2,828)
Other Comprehensive Loss - Year Ended September 30, 2007:				
Unrealized losses	\$ (37,233)	\$ -	\$ -	\$ (37,233)
Income tax benefit	14,134	-	-	14,134
Net unrealized losses	(23,099)	-	-	(23,099)
Transfer of realized gains to income	(44,233)	-	-	(44,233)
Income tax expense	16,790	-	-	16,790
Net transfer of realized gains to income	(27,443)	-	-	(27,443)
Net other comprehensive loss	\$ (50,542)	\$ -	\$ -	\$ (50,542)
Adoption of SFAS No. 158	-	-	(421,885)	(421,885)
Accumulated Comprehensive Loss - 9/30/07	\$ (53,370)	\$ -	\$ (421,885)	\$ (475,255)

	<u>Interest Rate Swap</u>	<u>Natural Gas Derivative</u>	<u>Defined Benefit Plans</u>	<u>Total</u>
Other Comprehensive Loss - Year Ended September 30, 2008:				
Unrealized losses	\$ (994,914)	\$ -	\$ -	\$ (994,914)
Income tax benefit	<u>377,669</u>	<u>-</u>	<u>-</u>	<u>377,669</u>
Net unrealized losses	<u>(617,245)</u>	<u>-</u>	<u>-</u>	<u>(617,245)</u>
Transfer of realized losses to income	243,302	-	-	243,302
Income tax benefit	<u>(92,357)</u>	<u>-</u>	<u>-</u>	<u>(92,357)</u>
Net transfer of realized gains to income	<u>150,945</u>	<u>-</u>	<u>-</u>	<u>150,945</u>
Defined Benefit Plans under SFAS No. 158:				
Unrecognized net loss arising during the period	-	-	(503,411)	(503,411)
Income tax benefit	<u>-</u>	<u>-</u>	<u>191,296</u>	<u>191,296</u>
Net unrecognized loss arising during the period	<u>-</u>	<u>-</u>	<u>(312,115)</u>	<u>(312,115)</u>
Loss reclassified to income	-	-	-	-
Income tax expense	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net loss reclassified to income	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Amortization of transition obligation	-	-	47,223	47,223
Income tax benefit	<u>-</u>	<u>-</u>	<u>(17,945)</u>	<u>(17,945)</u>
Net amortization of transition obligation	<u>-</u>	<u>-</u>	<u>29,278</u>	<u>29,278</u>
Net other comprehensive loss	<u>\$ (466,300)</u>	<u>\$ -</u>	<u>\$ (282,837)</u>	<u>\$ (749,137)</u>
Accumulated comprehensive loss - 9/30/08	<u>\$ (519,670)</u>	<u>\$ -</u>	<u>\$ (704,722)</u>	<u>\$ (1,224,392)</u>
Fair value of derivatives - 9/30/07	<u>\$ (86,025)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (86,025)</u>
Fair value of derivatives - 9/30/08	<u>\$ (837,637)</u>	<u>\$ (37,850)</u>	<u>\$ -</u>	<u>\$ (875,487)</u>

***New Accounting Standards***— In June 2006, the Financial Accounting Standards Board (“FASB”) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. This statement clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The recognition threshold is based upon whether it is more-likely-than-not that a tax position taken by an enterprise will be sustained upon examination. The measurement attribute of a more-likely-than-not tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. On

October 1, 2007, the Company adopted FASB Interpretation No. 48. The adoption of FIN 48 did not result in a material impact on the Company's financial position, results of operations or cash flows.

On September 30, 2007, the Company adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132R*. This statement required an employer to recognize the overfunded or underfunded status of defined benefit pensions 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. The adoption of SFAS No. 158 resulted in the Company recording an additional benefit liability of \$2,586,528 associated with the net underfunded positions of its defined benefit pension plan and post-retirement benefit plan. The Company also recorded a regulatory asset of \$1,906,068 associated with the regulated operations of Roanoke Gas in accordance with the provisions of SFAS No. 71 whereby the Company believes that it will continue to be able to recover the change in funded status of the plans through future rates. The Company also recognized other comprehensive loss of \$421,885, net of tax, for those liabilities not associated with the regulated operations. SFAS No. 158 also requires an employer to measure the funded status of each plan as of the Company's fiscal year end. The Company currently uses a June 30 measurement date for its benefit plans. The company will adopt the change in measurement date provision in the first quarter ending December 31, 2008. The change in measurement date will eliminate the three month lag in recognizing expense between the measurement date and the end of the Company's fiscal year. The Company expects to record an adjustment 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 currently requesting SFAS No. 71 treatment to defer this amount and provide for a three year amortization in the current rate filing before the SCC.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value methods. This statement does not require any new fair value measurements. Instead, it provides for increased consistency and comparability in fair value measurements and for expanded disclosure surrounding the fair value measurements whenever other standards require (or permit) the measurement of assets or liabilities at fair value. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Accordingly, the Company will adopt SFAS No. 157 in the first quarter of its fiscal year ending September 30, 2009. The Company does not anticipate the adoption of this statement to have a material impact on its financial position, results of operations or cash flows. In February 2008, the FASB issued FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 for one year for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually.)

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement permits, but does not require, entities to choose to measure selected financial assets and liabilities at fair value. Although SFAS No. 159 does not eliminate the fair value disclosure requirements included in other accounting standards, it does provide for additional presentation and disclosures designed to facilitate comparisons between companies that choose different measurement attributes for similar assets and liabilities. The effective date of this statement is for fiscal years beginning after November 15, 2007. Accordingly, the Company will adopt SFAS No. 159 in the first quarter of its fiscal year ending September 30, 2009. The Company

does not anticipate the adoption of this statement to have a material impact on its financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. The purpose of this statement is to enhance the current disclosure framework of SFAS No. 133 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 under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flow. The effective date of this statement is for fiscal years and interim periods beginning after November 15, 2008. Accordingly, the Company will adopt SFAS No. 161 no later than the second quarter ending March 31, 2009. The Company does not anticipate the adoption of this statement to have material impact on its financial position, results of operations or cash flows.

## **2. DISCONTINUED OPERATIONS**

Effective as of October 31, 2007, Resources closed on the sale of the stock of Bluefield Gas Company ("Bluefield") to ANGD, LLC, and Roanoke Gas Company completed the sale of its natural gas distribution assets located in the Town of Bluefield and the County of Tazewell, Virginia ("Bluefield division of Roanoke Gas") to Appalachian Natural Gas Company ("Appalachian"), a subsidiary of ANGD, LLC. Resources received approximately \$1,900,000 in cash from the sale of the Bluefield stock after the retirement of approximately \$5,100,000 in Bluefield debt. Roanoke Gas received approximately \$1,900,000 in cash and a promissory note in the amount of \$1,300,000 payable by ANGD, LLC. The note has a 5-year term with a 15-year amortization schedule with annual principal payments and quarterly interest payments at a rate of 10%. The sale of the stock of Bluefield was at book value resulting in no gain or loss on the sale. The sale of assets of the Bluefield division of Roanoke Gas was equal to the book value of net plant plus 1% and the book value of accounts receivable, natural gas inventory, and certain other listed current assets. The gain on the sale of these assets was eliminated by the costs associated with completing the sale.

At the time of the sale, Bluefield and the Bluefield division of Roanoke Gas ("Bluefield Operations") represented approximately 8% of Resources natural gas distribution customers. The results of operations of both Bluefield Gas and the Bluefield division of Roanoke Gas Company up to the effective date of the sale are reflected as discontinued operations in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

In July 2006, the Company entered into an asset purchase and sale agreement for the sale of the assets relating to its Highland Energy gas marketing business. The assets sold included the gas supply contracts between Highland Energy and its customers and related business records. Under the agreement, a portion of the purchase price was deferred as realization of those revenues was subject to certain provisions. The Company met substantially all of the provisions of the agreement and recorded \$160,000 revenue in final settlement of the sales contract as part of discontinued operations in 2007.

The components of discontinued operations are summarized below:

	<b>Years Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
<b>Bluefield Operations</b>		
Revenues	\$ 457,777	\$ 11,229,432
Pretax Operating Loss	(105,216)	(134,650)
Continuing Costs	53,898	773,304
Income Tax Benefit (Expense)	<u>14,628</u>	<u>(745,598)</u>
Discontinued Operations	<u>\$ (36,690)</u>	<u>\$ (106,944)</u>
<b>Highland Energy</b>		
Revenues	\$ -	\$ -
Gain on Sale of Assets	-	160,162
Pretax Operating Income	-	77,560
Income Tax Expense	<u>-</u>	<u>(90,238)</u>
Discontinued Operations	<u>\$ -</u>	<u>\$ 147,484</u>
<b>Total</b>		
Revenues	\$ 457,777	\$ 11,229,432
Gain on Sale of Assets	-	160,162
Pretax Operating Loss	(105,216)	(57,090)
Continuing Costs	53,898	773,304
Income Tax Benefit (Expense)	<u>14,628</u>	<u>(835,836)</u>
Discontinued Operations	<u>\$ (36,690)</u>	<u>\$ 40,540</u>

The carrying amounts of the major classes of assets and liabilities subject to the sale as of September 30, 2007 were as follows:

	<u>September 30</u> <u>2007</u>
Assets:	
Accounts receivable, net	\$ 429,582
Gas in storage	3,230,624
Other current assets	90,913
Net utility plant	9,018,903
Other assets	<u>55,322</u>
Assets available for sale	<u>\$ 12,825,344</u>
Liabilities:	
Accounts payable and customer credit balances	\$ 1,499,604
Accrued expenses	99,821
Other current liabilities	4,800,048
Non-current liabilities	<u>1,159,132</u>
Liabilities of assets available for sale	<u>\$ 7,558,605</u>

### 3. REGULATORY MATTERS

The SCC exercises regulatory authority over the natural gas operations of Roanoke Gas Company. Such regulation includes the approval of rates to be charged to customers for natural gas service.

On November 1, 2007, Roanoke Gas Company placed into effect new base rates to provide for approximately \$700,000 in additional annual revenues, subject to refund. The Company received the final order from the SCC on May 22, 2008 approving rates, which provided for approximately \$416,000 in additional annual revenues. In June 2008, the Company completed its refund of rates billed in excess of the amount authorized by the final order, including interest on the excess amount.

On September 16, 2008, the Company filed a request for an expedited rate increase with the SCC. The request was for an increase of approximately \$1,198,000 in annual non-gas revenues. Under an expedited rate request, the Company was able to place the increased rates into effect for service rendered on and after November 1, 2008, subject to refund pending a final order by the SCC. The hearing on the request for rate increase is scheduled for the end of March 2009, with a final order expected some time after that date.

### 4. BORROWINGS UNDER LINES-OF-CREDIT

The Company has available unsecured lines-of-credit with a bank which will expire March 31, 2009. The Company anticipates being able to extend or replace the lines-of-credit. The Company's available unsecured lines-of-credit vary during the year to accommodate its seasonal borrowing demands. Generally, the Company's borrowing needs are at their lowest in spring, increase during the summer and fall due to gas storage purchases and construction expenditures and reach their

maximum levels in winter. Available limits under these agreements for the remaining term are as follows:

<b>Effective</b>	<b>Available Lines of Credit</b>
September 30, 2008	\$ 27,000,000
November 16, 2008	29,000,000
February 16, 2009	16,000,000

A summary of the lines-of-credit follows:

	<u>2008</u>	<u>2007</u>
Lines-of-credit at year-end	\$ 27,000,000	\$ 17,000,000
Outstanding balance at year-end	13,960,000	4,808,000
Highest month-end balances outstanding	13,960,000	8,421,000
Average month-end balances	5,178,000	2,715,000
Average rates of interest during year	4.25%	5.83%
Average rates of interest on balances outstanding at year-end	4.43%	5.62%

## 5. LONG-TERM DEBT

Long-term debt consists of the following:

	<u>September 30</u>	
	<u>2008</u>	<u>2007</u>
First Mortgage notes payable, at 7.804%, due July 1, 2008	\$ -	\$ 5,000,000
Unsecured senior notes payable, at 7.66%, with provision for retirement of \$1,600,000 each year beginning December 1, 2014 through December 1, 2018	8,000,000	8,000,000
Unsecured note payable, with variable interest rate based on 30-day LIBOR (3.70% at September 30, 2008) plus 69 basis point spread, with provision for retirement on December 1, 2010	<u>15,000,000</u>	<u>15,000,000</u>
Total long-term debt	23,000,000	28,000,000
Less current maturities	<u>-</u>	<u>(5,000,000)</u>
Total long-term debt	<u>\$ 23,000,000</u>	<u>\$ 23,000,000</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, 2008 and 2007. At September 30, 2008, approximately \$14,900,000 of retained earnings was available for dividends.

The Company may request an extension of the maturity date of the unsecured variable rate note anytime subsequent to the first anniversary subject to approval by the Bank. The Company also has an interest rate swap related to the \$15,000,000 note. The swap essentially converted the variable rate note into fixed rate debt with a 5.74% interest rate.

The Company retired the \$5,000,000 first mortgage note on July 1, 2008. Prior to September 30, Roanoke Gas Company filed an application with the SCC requesting to refinance the \$5,000,000 with a long-term note. On October 17, 2008, the SCC approved Roanoke Gas' request to refinance the \$5,000,000 note. On October 31, 2008, the Company issued a \$5,000,000 variable rate note at LIBOR plus 125 basis points, and simultaneously entered into an interest rate swap to convert the variable rate note into a fixed rate debt with a 5.79% interest rate. The new note places a restriction on the payment of dividends that, if in place at September 30, 2008, would have limited retained earnings available for dividends to approximately \$11,400,000.

The aggregate annual maturities of long-term debt for the next five years ending September 30 and thereafter are as follows:

<b>Years Ended September 30</b>	<b>Maturities</b>
2009	\$ -
2010	-
2011	15,000,000
2012	-
2013	-
Thereafter	<u>8,000,000</u>
Total	<u>\$ 23,000,000</u>

## 6. INCOME TAXES

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

	<u>Years Ended September 30</u>	
	<u>2008</u>	<u>2007</u>
Current income taxes:		
Federal	\$ 2,385,856	\$ 806,956
State	<u>508,082</u>	<u>113,461</u>
Total current income taxes	<u>2,893,938</u>	<u>920,417</u>
Deferred income taxes:		
Federal	(192,741)	1,100,072
State	<u>(89,288)</u>	<u>246,407</u>
Total deferred income taxes	<u>(282,029)</u>	<u>1,346,479</u>
Amortization of investment tax credits	<u>(30,167)</u>	<u>(30,488)</u>
Total income tax expense	<u>\$ 2,581,742</u>	<u>\$ 2,236,408</u>

Income tax expense for the years ended September 30, 2008 and 2007 differed from amounts computed by applying the U.S. Federal income tax rate of 34 percent to earnings before income taxes as a result of the following:

	<u>Years Ended September 30</u>	
	<u>2008</u>	<u>2007</u>
Income before income taxes	<u>\$ 6,839,566</u>	<u>\$ 6,002,077</u>
Income tax expense computed at the federal statutory rate	\$ 2,325,452	\$ 2,040,706
State income taxes, net of federal income tax benefit	276,404	237,513
Amortization of investment tax credits	(30,167)	(30,488)
Other, net	<u>10,053</u>	<u>(11,323)</u>
Total income tax expense	<u>\$ 2,581,742</u>	<u>\$ 2,236,408</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>	
	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Allowance for uncollectibles	\$ 24,215	\$ 18,838
Accrued pension and post-retirement medical benefits	1,888,963	1,454,905
Accrued vacation	195,733	187,173
Over-recovery of gas costs	-	215,346
Costs of gas held in storage	933,035	853,169
Accrued gas costs	676,389	-
Deferred compensation	417,224	338,891
Interest rate swap	317,967	32,655
Other	<u>184,318</u>	<u>169,515</u>
Total deferred tax assets	<u>4,637,844</u>	<u>3,270,492</u>
Deferred tax liabilities:		
Utility plant	7,551,517	7,054,425
Accrued gas costs	-	51,630
Sale of Bluefield Gas stock	-	605,838
Under-recovery of gas costs	<u>370,199</u>	<u>-</u>
Total deferred tax liabilities	<u>7,921,716</u>	<u>7,711,893</u>
Net deferred tax liability	<u>\$ 3,283,872</u>	<u>\$ 4,441,401</u>

FIN 48 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. The Company has evaluated its tax positions and accordingly has determined that an unrecognized tax benefit in the amount of \$23,276 existed as of October 1, 2007. The unrecognized tax benefit is associated with a timing difference and therefore would not impact the effective tax rate for the periods presented. Interest associated with uncertain tax positions is classified as interest expense in the financial statements. Penalties are classified under other income (expense).

The Company files federal income tax returns and state income tax returns in Virginia and West Virginia. An audit of the Company's federal income tax return was completed for the year ended September 30, 2006. The federal returns and the state returns for both Virginia and West Virginia for the tax years ended prior to September 30, 2005 are no longer subject to examination.

## **7. 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 and life insurance benefits to retired employees who meet specific age and service requirements.

On September 30, 2007, the Company adopted SFAS No. 158. This Standard retains the previous periodic expense calculation on an actuarial basis under the provisions of SFAS No. 87, *Employers' Accounting for Pensions* and SFAS No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*. In addition, this statement also requires an employer to recognize the overfunded or underfunded status of defined benefit pensions 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 established a regulatory asset for the portion of the obligation expected to be recovered in rates in future periods in accordance with SFAS No. 71. The portion of the obligation attributable to the unregulated operations of the holding company parent is recognized in comprehensive income. SFAS No. 158 also requires an employer to measure the funded status of each plan as of the Company's fiscal year end for fiscal years ending after December 31, 2008. The effect of the change in measurement date is reflected in footnote 1.

The following tables set forth the benefit obligation, fair value of plan assets, and the funded status of the Plans; amounts recognized in the Company's financial statements and the assumptions used:

	<u>Pension Benefits</u>		<u>Postretirement Benefits</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Accumulated benefit obligation	<u>\$10,437,064</u>	<u>\$ 9,364,621</u>	<u>\$ 8,304,632</u>	<u>\$ 8,427,326</u>
<b>Change in benefit obligation:</b>				
Benefit obligation at beginning of year	\$12,538,300	\$12,102,103	\$ 8,427,326	\$ 8,266,411
Service cost	429,461	404,909	140,327	147,693
Interest cost	769,517	740,918	511,387	501,838
Actuarial (gain) loss	429,383	(307,353)	(339,674)	(113,471)
Benefit payments, net of retiree contributions	<u>(411,240)</u>	<u>(402,277)</u>	<u>(434,734)</u>	<u>(375,145)</u>
Benefit obligation at end of year	<u>\$13,755,421</u>	<u>\$12,538,300</u>	<u>\$ 8,304,632</u>	<u>\$ 8,427,326</u>
<b>Change in plan assets:</b>				
Fair value of plan assets at beginning of year	\$10,984,155	\$ 9,248,810	\$ 5,202,179	\$ 4,212,556
Actual return on plan assets, net of taxes	27,412	1,312,622	(300,504)	594,768
Employer contributions	800,000	825,000	724,000	770,000
Benefit payments, net of retiree contributions	<u>(411,240)</u>	<u>(402,277)</u>	<u>(434,734)</u>	<u>(375,145)</u>
Fair value of plan assets at end of year	<u>\$11,400,327</u>	<u>\$10,984,155</u>	<u>\$ 5,190,941</u>	<u>\$ 5,202,179</u>
<b>Reconciliation of funded status:</b>				
Funded status	\$ (2,355,094)	\$ (1,554,145)	\$ (3,113,691)	\$ (3,225,147)
Contributions made between the measurement date and fiscal year-end	<u>-</u>	<u>200,000</u>	<u>700,000</u>	<u>724,000</u>
Net amount recognized in the balance sheet	<u>\$ (2,355,094)</u>	<u>\$ (1,354,145)</u>	<u>\$ (2,413,691)</u>	<u>\$ (2,501,147)</u>
<b>Amounts recognized in the balance sheets consist of:</b>				
Noncurrent liabilities	<u>\$ (2,355,094)</u>	<u>\$ (1,354,145)</u>	<u>\$ (2,413,691)</u>	<u>\$ (2,501,147)</u>
<b>Amounts recognized in accumulated other comprehensive loss:</b>				
Transition obligation, net of tax	\$ -	\$ -	\$ 146,393	\$ 175,671
Net actuarial loss, net of tax	<u>372,501</u>	<u>160,387</u>	<u>185,828</u>	<u>85,827</u>
Total amounts included in other comprehensive loss, net of tax	<u>\$ 372,501</u>	<u>\$ 160,387</u>	<u>\$ 332,221</u>	<u>\$ 261,498</u>
<b>Amounts deferred to a regulatory asset:</b>				
Transition obligation	\$ -	\$ -	\$ 708,345	\$ 850,014
Net actuarial loss	<u>1,607,687</u>	<u>726,454</u>	<u>415,642</u>	<u>329,600</u>
Amounts recognized as regulatory assets	<u>\$ 1,607,687</u>	<u>\$ 726,454</u>	<u>\$ 1,123,987</u>	<u>\$ 1,179,614</u>

The Company expects that approximately \$72,000, before tax, of accumulated other comprehensive loss will be recognized as a portion of net periodic benefit costs in fiscal 2009 and approximately \$187,000 of amounts deferred as regulatory assets will be amortized and recognized in net periodic benefit costs in fiscal 2009.

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 2008 and 2007.

	<u>Pension Benefits</u>		<u>Postretirement Benefits</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
<b>Assumptions related to benefit obligations:</b>				
Discount rate	6.25%	6.25%	6.25%	6.25%
Expected rate of compensation increase	5.00%	5.00%	N/A	N/A
<b>Assumptions related to benefit costs:</b>				
Discount rate	6.25%	6.25%	6.25%	6.25%
Expected long-term rate of return on plan assets	7.50%	7.50%	5.22%	5.39%
Expected rate of compensation increase	5.00%	5.00%	N/A	N/A

To develop the expected long-term rate of return on assets assumption, the Company 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.

	<u>Pension Benefits</u>		<u>Postretirement Benefits</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
<b>Components of net periodic pension cost:</b>				
Service cost	\$ 429,461	\$ 404,909	\$ 140,327	\$147,693
Interest cost	769,517	740,918	511,387	501,838
Expected return on plan assets	(821,381)	(691,262)	(286,504)	(238,896)
Amortization of unrecognized transition obligation	-	-	188,892	188,892
Recognized loss	-	72,225	-	9,887
Net periodic benefit cost	<u>\$ 377,597</u>	<u>\$ 526,790</u>	<u>\$ 554,102</u>	<u>\$609,414</u>

Actuarial estimates for the postretirement benefit plan assumed a weighted average annual rate increase in the per capital costs of covered health care benefits (medical trend rate) were 8% and 9% for 2008 and 2007, respectively. The rates were assumed to decrease gradually to 5% by the year 2011 and remain at that level thereafter. Assumed medical trend rates have a significant effect on the amounts reported. A 1% point change in assumed healthcare cost trend rates would have the following effects:

	<u>1% Increase</u>	<u>1% Decrease</u>
Effect on total service and interest cost components	\$ 90,401	\$ (73,738)
Effect on accumulated postretirement benefit obligation	1,013,001	(839,389)

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

	<u>Pension Plan</u>			<u>Postretirement Benefit Plan</u>		
	Target	2008	2007	Target	2008	2007
Asset category:						
Equity securities	50%-70%	56%	60%	35%-65%	49%	51%
Debt securities	30%-50%	30%	34%	35%-65%	45%	41%
Other	0%-20%	14%	6%	0%-20%	6%	8%

The primary objectives of the Company's investment policy is 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. The investment policy is periodically reviewed by the Company and a third-party fiduciary for investment matters.

The Company expects to contribute \$600,000 to its pension plan and \$600,000 to its postretirement benefit plan in fiscal 2009.

The following table reflects expected future benefit payments.

<b>Fiscal year ending September 30</b>	<b>Pension Plan</b>	<b>Postretirement Benefit</b>
2009	\$ 412,000	\$ 488,000
2010	433,000	486,000
2011	435,000	495,000
2012	466,000	496,000
2013	515,000	507,000
2014-2018	3,088,000	2,751,000

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. The Company makes matching contributions to the 401k plan with a 100% match on the

participants' first 3% of contributions and 50% on the next 3% of contributions. Company matching contributions were \$246,338 and \$240,946 for 2008 and 2007, respectively.

## 8. 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, 2008, the number of shares available for future grants under the KESOP is 2,000 shares.

SFAS No. 123R, *Share-Based Payment*, a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, eliminates the use of the intrinsic value method of accounting as 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 SFAS No. 123R 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. All awards granted and vested prior to the effective date remain under the provision of APB Opinion No. 25.

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

	<b>Number of Shares</b>	<b>Weighted- Average Exercise Price</b>	<b>Option Price Per Share</b>
Options outstanding, September 30, 2006	44,000	\$ 19.485	\$16.875-\$20.875
Options exercised	(12,500)	\$ 19.425	
Options expired	-		
Options outstanding, September 30, 2007	31,500	\$ 19.508	\$18.100-\$20.875
Options exercised	(2,000)	\$ 20.875	
Options expired	-		
Options outstanding, September 30, 2008	<u>29,500</u>	\$ 19.416	\$18.100-\$20.875

The intrinsic value of the options exercised during fiscal 2008 and 2007 were \$14,251 and \$86,439, respectively.

<b>Options Outstanding and Exercisable</b>			
	<b>Remaining</b>		
<b>Shares</b>	<b>Life (Years)</b>	<b>Exercise Price</b>	<b>Intrinsic Value</b>
7,000	1.2	\$ 20.875	
7,000	2.2	19.250	
9,000	3.2	19.360	
<u>6,500</u>	<u>4.2</u>	<u>18.100</u>	
Weighted average	<u>29,500</u>	<u>2.7</u>	<u>\$ 19.416</u>
			<u>\$ 311,940</u>

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, 2008 and 2007. No options were granted in 2008 and 2007. The Company received \$41,750 from the exercise of options in 2008.

## 9. 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 16,715 and 28,490 shares in 2008 and 2007, respectively. As of September 30, 2008, the Company had 270,686 shares available for issuance.

### **Restricted Stock Plan**

The Board of Directors of the Company implemented the Restricted Stock Plan for Outside Directors 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 reelection 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, the right to receive cash or stock dividends, 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 Company issued a total of 4,232 shares of Restricted Stock in fiscal 2008 to its outside directors, representing \$89,980 in compensation and \$30,707 in dividends reinvested. The directors also received a total of 4,091 shares of Restricted Stock in fiscal 2007, representing \$84,550 in compensation and \$25,013 in dividends reinvested. As of September 30, 2008, the Company had 15,894 shares available for issuance under this Plan.

### **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. Under the Stock Bonus Plan, the Company issued 781 and 2,462 shares valued at \$22,163 and \$68,573, respectively, in 2008 and 2007. As of September 30, 2008, the Company had 22,998 shares available for issuance under this Plan.

## **10. ENVIRONMENTAL MATTER**

Both Roanoke Gas Company and Bluefield Gas Company operated manufactured gas plants (MGPs) as a source of fuel for lighting and heating until the late 1940s or 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, 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 rate recovery 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.

## **11. COMMITMENTS**

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 supply.

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 into 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.

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, 2008. 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, 2008 for each of the next five years and thereafter.

Fiscal Year Ending September 30,	Fixed Price Contracts	Market Price Contracts
	Pipeline and Storage Capacity	Natural Gas Contracts (Decatherms)
2009	\$ 9,892,482	1,907,195
2010	9,892,482	2,225,059
2011	9,892,482	317,864
2012	9,892,482	-
2013	9,259,717	-
Thereafter	17,398,732	-

The Company purchased approximately \$71,838,000 and \$60,121,000 in gas under the asset management contracts in fiscal year 2008 and 2007, respectively.

The Company has historically entered into derivative financial contracts for the purpose of hedging the price of natural gas. As of September 30, 2008, the Company has contracted to hedge, through derivative collar arrangements, a set amount of decatherms of natural gas for each month in the winter period, totaling 370,000 decatherms. All decatherm amounts have a ceiling price of \$12.00 per decatherm and floor prices ranging from \$6.33 to \$8.30 per decatherm; see *Derivative and Hedging Activities* in footnote 1 for more information.

## 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying value of cash and cash equivalents, temporary cash investments, accounts receivable, accounts payable and borrowings under lines of credit are a reasonable estimate of fair value due to the short-term nature of these financial instruments.

The fair value of long-term debt is estimated by discounting the future cash flows of each issuance at rates currently offered to the Company for similar debt instruments of comparable maturities. The carrying amounts and approximate values for the years ended September 30, 2008 and 2007 are as follows:

	2008		2007	
	Carrying Amounts	Approximate Fair Value	Carrying Amounts	Approximate Fair Value
Long-term debt	\$23,000,000	\$23,925,711	\$28,000,000	\$28,934,541

The Company has an interest rate swap related to the \$15,000,000 variable rate note. The swap essentially converted the variable rate note into fixed rate debt with a 5.74% interest rate. The fair value of the interest rate swap included as a liability in the consolidated balance sheets was \$837,637 and \$86,025 as of September 30, 2008 and 2007, respectively. See Other Comprehensive Income in footnote 1 for more information.

Judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates determined as of September 30, 2008 and 2007 are not necessarily indicative of the amounts the Company could have realized in current market exchanges.

### **13. ASSET RETIREMENT OBLIGATIONS**

The Company adopted FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47"), as of September 30, 2006. FIN 47 requires that a liability be recognized for an asset retirement obligation which is conditional based on the occurrence of a future event even if the timing or method of settlement is uncertain. SFAS No. 143 and FIN 47 require entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. 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. Under the provisions of FIN 47, 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 estimated cost of retirement of its utility plant through depreciation expense and creates a corresponding regulatory liability in accordance with the provisions of SFAS No. 71. The costs of retirement considered in the development of the depreciation component include those costs associated with the legal liability as defined under SFAS No. 143 and FIN 47. Therefore, at the time of adoption of FIN 47, 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 would 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>Asset Retirement Obligation</u>
September 30, 2006	<u>\$ 2,404,839</u>
Accretion	115,810
Additions	21,217
Retirements	<u>(42,521)</u>
September 30, 2007	<u>2,499,345</u>
Accretion	121,982
Additions	27,766
Retirements	<u>(40,098)</u>
September 30, 2008	<u><u>\$ 2,608,995</u></u>

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