

NATIONAL FUEL GAS CO

Form 10-Q

May 07, 2010

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended March 31, 2010

OR

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

**For the transition period from _____ to _____
Commission File Number 1-3880**

NATIONAL FUEL GAS COMPANY
(Exact name of registrant as specified in its charter)

New Jersey

13-1086010

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

**6363 Main Street
Williamsville, New York**

14221

(Address of principal executive offices)

(Zip Code)

(716) 857-7000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

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

Common stock, \$1 par value, outstanding at April 30, 2010: 81,920,814 shares.

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GLOSSARY OF TERMS

Frequently used abbreviations, acronyms, or terms used in this report:

National Fuel Gas Companies

Company	The Registrant, the Registrant and its subsidiaries or the Registrant's subsidiaries as appropriate in the context of the disclosure
Distribution Corporation	National Fuel Gas Distribution Corporation
Empire	Empire Pipeline, Inc.
ESNE	Energy Systems North East, LLC
Highland	Highland Forest Resources, Inc.
Horizon	Horizon Energy Development, Inc.
Horizon LFG	Horizon LFG, Inc.
Horizon Power	Horizon Power, Inc.
Midstream Corporation	National Fuel Gas Midstream Corporation
Model City	Model City Energy, LLC
National Fuel	National Fuel Gas Company
NFR	National Fuel Resources, Inc.
Registrant	National Fuel Gas Company
Seneca	Seneca Resources Corporation
Seneca Energy	Seneca Energy II, LLC
Supply Corporation	National Fuel Gas Supply Corporation

Regulatory Agencies

EPA	United States Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
NYDEC	New York State Department of Environmental Conservation
NYPSC	State of New York Public Service Commission

PaPUC	Pennsylvania Public Utility Commission
SEC	Securities and Exchange Commission
<i>Other</i>	
2009 Form 10-K	The Company's Annual Report on Form 10-K for the year ended September 30, 2009
Bbl	Barrel (of oil)
Bcf	Billion cubic feet (of natural gas)
Board foot	A measure of lumber and/or timber equal to 12 inches in length by 12 inches in width by one inch in thickness.
Btu	British thermal unit; the amount of heat needed to raise the temperature of one pound of water one degree Fahrenheit.
Capital expenditure	Represents additions to property, plant, and equipment, or the amount of money a company spends to buy capital assets or upgrade its existing capital assets.
Degree day	A measure of the coldness of the weather experienced, based on the extent to which the daily average temperature falls below a reference temperature, usually 65 degrees Fahrenheit.
Derivative	A financial instrument or other contract, the terms of which include an underlying variable (a price, interest rate, index rate, exchange rate, or other variable) and a notional amount (number of units, barrels, cubic feet, etc.). The terms also permit for the instrument or contract to be settled net and no initial net investment is required to enter into the financial instrument or contract. Examples include futures contracts, options, no cost collars and swaps.
Development costs	Costs incurred to obtain access to proved reserves and to provide facilities for extracting, treating, gathering and storing the oil and gas.
Dth	Decatherm; one Dth of natural gas has a heating value of 1,000,000 British thermal units, approximately equal to the heating value of 1 Mcf of natural gas.
Exchange Act	Securities Exchange Act of 1934, as amended

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GLOSSARY OF TERMS (Cont.)

Expenditures for long-lived assets	Includes capital expenditures, stock acquisitions and/or investments in partnerships.
Exploration costs	Costs incurred in identifying areas that may warrant examination, as well as costs incurred in examining specific areas, including drilling exploratory wells.
Firm transportation and/or storage	The transportation and/or storage service that a supplier of such service is obligated by contract to provide and for which the customer is obligated to pay whether or not the service is utilized.
GAAP	Accounting principles generally accepted in the United States of America
Goodwill	An intangible asset representing the difference between the fair value of a company and the price at which a company is purchased.
Hedging	A method of minimizing the impact of price, interest rate, and/or foreign currency exchange rate changes, often times through the use of derivative financial instruments.
Hub	Location where pipelines intersect enabling the trading, transportation, storage, exchange, lending and borrowing of natural gas.
Interruptible transportation and/or storage	The transportation and/or storage service that, in accordance with contractual arrangements, can be interrupted by the supplier of such service, and for which the customer does not pay unless utilized.
LIBOR	London Interbank Offered Rate
LIFO	Last-in, first-out
Mbbl	Thousand barrels (of oil)
Mcf	Thousand cubic feet (of natural gas)
MD&A	Management's Discussion and Analysis of Financial Condition and Results of Operations
MDth	Thousand decatherms (of natural gas)
MMBtu	Million British thermal units
MMcf	Million cubic feet (of natural gas)
NGA	The Natural Gas Act of 1938, as amended; the federal law regulating interstate natural gas pipeline and storage companies, among other things,

codified beginning at 15 U.S.C. Section 717.

NYMEX	New York Mercantile Exchange. An exchange which maintains a futures market for crude oil and natural gas.
Open Season	A bidding procedure used by pipelines to allocate firm transportation or storage capacity among prospective shippers, in which all bids submitted during a defined time period are evaluated as if they had been submitted simultaneously.
Precedent Agreement	An agreement between a pipeline company and a potential customer to sign a service agreement after specified events (called conditions precedent) happen, usually within a specified time.
Proved developed reserves	Reserves that can be expected to be recovered through existing wells with existing equipment and operating methods.
Proved undeveloped reserves	Reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required to make these reserves productive.
Reserves	The unproduced but recoverable oil and/or gas in place in a formation which has been proven by production.
Restructuring	Generally referring to partial deregulation of the pipeline and/or utility industry by statutory or regulatory process. Restructuring of federally regulated natural gas pipelines resulted in the separation (or unbundling) of gas commodity service from transportation service for wholesale and large-volume retail markets. State restructuring programs attempt to extend the same process to retail mass markets.
S&P	Standard & Poor's Rating Service
SAR	Stock appreciation right
Stock acquisitions	Investments in corporations.

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**GLOSSARY OF TERMS
(Concl.)**

Unbundled service	A service that has been separated from other services, with rates charged that reflect only the cost of the separated service.
VEBA	Voluntary Employees Beneficiary Association
WNC	Weather normalization clause; a clause in utility rates which adjusts customer rates to allow a utility to recover its normal operating costs calculated at normal temperatures. If temperatures during the measured period are warmer than normal, customer rates are adjusted upward in order to recover projected operating costs. If temperatures during the measured period are colder than normal, customer rates are adjusted downward so that only the projected operating costs will be recovered.

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The Company has nothing to report under this item.

Reference to the Company in this report means the Registrant or the Registrant and its subsidiaries collectively, as appropriate in the context of the disclosure. All references to a certain year in this report are to the Company's fiscal year ended September 30 of that year, unless otherwise noted.

This Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements should be read with the cautionary statements and important factors included in this Form 10-Q at Item 2 MD&A, under the heading Safe Harbor for Forward-Looking Statements. Forward-looking statements are all statements other than statements of historical fact, including, without limitation, statements regarding future prospects, plans, objectives, goals, projections, strategies, future events or performance and underlying assumptions, capital structure, anticipated capital expenditures, completion of construction and other projects, projections for pension and other post-retirement benefit obligations, impacts of the adoption of new accounting rules, and possible outcomes of litigation or regulatory proceedings, as well as statements that are identified by the use of the words anticipates, estimates, expects, forecasts, intends, plans, predicts, believes, seeks, will, may, and similar expressions.

Table of Contents**Part I. Financial Information****Item 1. Financial Statements**

National Fuel Gas Company
Consolidated Statements of Income and Earnings
Reinvested in the Business
(Unaudited)

(Thousands of Dollars, Except Per Common Share Amounts)	Three Months Ended March 31,	
	2010	2009
INCOME		
Operating Revenues	\$ 671,380	\$ 804,645
Operating Expenses		
Purchased Gas	334,430	485,468
Operation and Maintenance	117,019	118,928
Property, Franchise and Other Taxes	20,454	20,372
Depreciation, Depletion and Amortization	46,891	41,714
	518,794	666,482
Operating Income	152,586	138,163
Other Income (Expense):		
Income from Unconsolidated Subsidiaries	672	974
Interest Income	326	1,005
Other Income	1,266	947
Interest Expense on Long-Term Debt	(22,061)	(17,545)
Other Interest Expense	(2,006)	(2,849)
Income Before Income Taxes	130,783	120,695
Income Tax Expense	50,355	47,211
Net Income Available for Common Stock	80,428	73,484
EARNINGS REINVESTED IN THE BUSINESS		
Balance at December 31	985,663	884,476
	1,066,091	957,960
Dividends on Common Stock (2010 - \$0.335 per share; 2009 - \$0.325 per share)	(27,222)	(25,841)
Balance at March 31	\$ 1,038,869	\$ 932,119
Earnings Per Common Share:		
Basic:		

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Net Income Available for Common Stock	\$ 0.99	\$ 0.92
Diluted:		
Net Income Available for Common Stock	\$ 0.97	\$ 0.92
Weighted Average Common Shares Outstanding:		
Used in Basic Calculation	81,175,261	79,514,793
Used in Diluted Calculation	82,569,323	80,129,743

See Notes to Condensed Consolidated Financial Statements

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Table of Contents**Item 1. Financial Statements (Cont.)**

National Fuel Gas Company
Consolidated Statements of Income and Earnings
Reinvested in the Business
(Unaudited)

(Thousands of Dollars, Except Per Common Share Amounts)	Six Months Ended March 31,	
	2010	2009
INCOME		
Operating Revenues	\$ 1,128,392	\$ 1,411,808
Operating Expenses		
Purchased Gas	507,217	814,201
Operation and Maintenance	211,516	219,816
Property, Franchise and Other Taxes	39,113	39,134
Depreciation, Depletion and Amortization	91,846	84,056
Impairment of Oil and Gas Producing Properties		182,811
	849,692	1,340,018
Operating Income	278,700	71,790
Other Income (Expense):		
Income from Unconsolidated Subsidiaries	1,073	2,092
Impairment of Investment in Partnership		(1,804)
Interest Income	1,480	2,898
Other Income	1,622	5,827
Interest Expense on Long-Term Debt	(44,124)	(35,601)
Other Interest Expense	(3,390)	(2,474)
Income Before Income Taxes	235,361	42,728
Income Tax Expense	90,434	11,922
Net Income Available for Common Stock	144,927	30,806
EARNINGS REINVESTED IN THE BUSINESS		
Balance at October 1	948,293	953,799
	1,093,220	984,605
Adoption of Authoritative Guidance for Defined Benefit Pension and Other Post-Retirement Plans		(804)
Dividends on Common Stock (2010 - \$0.67 per share; 2009 - \$0.65 per share)	(54,351)	(51,682)
Balance at March 31	\$ 1,038,869	\$ 932,119
Earnings Per Common Share:		

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Basic:			
Net Income Available for Common Stock	\$	1.79	\$ 0.39
Diluted:			
Net Income Available for Common Stock	\$	1.76	\$ 0.38
Weighted Average Common Shares Outstanding:			
Used in Basic Calculation		80,866,311	79,400,660
Used in Diluted Calculation		82,347,254	80,156,407

See Notes to Condensed Consolidated Financial Statements

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Table of Contents**Item 1. Financial Statements (Cont.)**

National Fuel Gas Company
Consolidated Balance Sheets
(Unaudited)

(Thousands of Dollars)	March 31, 2010	September 30, 2009
ASSETS		
Property, Plant and Equipment	\$5,413,119	\$5,184,844
Less Accumulated Depreciation, Depletion and Amortization	2,118,594	2,051,482
	3,294,525	3,133,362
Current Assets		
Cash and Temporary Cash Investments	426,804	408,053
Cash Held in Escrow	2,000	2,000
Hedging Collateral Deposits	13,657	848
Receivables Net of Allowance for Uncollectible Accounts of \$50,993 and \$38,334, Respectively	226,566	144,466
Unbilled Utility Revenue	38,634	18,884
Gas Stored Underground	14,696	55,862
Materials and Supplies at average cost	27,754	24,520
Other Current Assets	50,593	68,474
Deferred Income Taxes	40,600	53,863
	841,304	776,970
Other Assets		
Recoverable Future Taxes	138,435	138,435
Unamortized Debt Expense	13,683	14,815
Other Regulatory Assets	521,917	530,913
Deferred Charges	4,876	2,737
Other Investments	79,219	78,503
Investments in Unconsolidated Subsidiaries	13,713	14,940
Goodwill	5,476	5,476
Intangible Assets	20,637	21,536
Fair Value of Derivative Financial Instruments	48,850	44,817
Other	3,153	6,625
	849,959	858,797
Total Assets	\$4,985,788	\$4,769,129

See Notes to Condensed Consolidated Financial Statements

Table of Contents**Item 1. Financial Statements (Cont.)**

National Fuel Gas Company
Consolidated Balance Sheets
(Unaudited)

(Thousands of Dollars)	March 31, 2010	September 30, 2009
CAPITALIZATION AND LIABILITIES		
Capitalization:		
Comprehensive Shareholders Equity		
Common Stock, \$1 Par Value Authorized - 200,000,000 Shares; Issued And Outstanding 81,258,186 Shares and 80,499,915 Shares, Respectively	\$ 81,258	\$ 80,500
Paid in Capital	627,871	602,839
Earnings Reinvested in the Business	1,038,869	948,293
Total Common Shareholder Equity Before Items of Other Comprehensive Loss	1,747,998	1,631,632
Accumulated Other Comprehensive Loss	(38,902)	(42,396)
Total Comprehensive Shareholders Equity	1,709,096	1,589,236
Long-Term Debt, Net of Current Portion	1,049,000	1,249,000
Total Capitalization	2,758,096	2,838,236
Current and Accrued Liabilities		
Notes Payable to Banks and Commercial Paper		
Current Portion of Long-Term Debt	200,000	
Accounts Payable	109,145	90,723
Amounts Payable to Customers	64,336	105,778
Dividends Payable	27,222	26,967
Interest Payable on Long-Term Debt	30,512	32,031
Customer Advances	2,715	24,555
Customer Security Deposits	19,426	17,430
Other Accruals and Current Liabilities	110,174	18,875
Fair Value of Derivative Financial Instruments	16,632	2,148
	580,162	318,507
Deferred Credits		
Deferred Income Taxes	720,584	663,876
Taxes Refundable to Customers	67,053	67,046
Unamortized Investment Tax Credit	3,638	3,989
Cost of Removal Regulatory Liability	121,954	105,546
Other Regulatory Liabilities	87,215	120,229
Pension and Other Post-Retirement Liabilities	414,479	415,888
Asset Retirement Obligations	92,461	91,373

Other Deferred Credits	140,146	144,439
	1,647,530	1,612,386
Commitments and Contingencies		
Total Capitalization and Liabilities	\$4,985,788	\$4,769,129

See Notes to Condensed Consolidated Financial Statements

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Table of Contents**Item 1. Financial Statements (Cont.)**

National Fuel Gas Company
Consolidated Statements of Cash Flows
(Unaudited)

(Thousands of Dollars)	Six Months Ended March 31,	
	2010	2009
OPERATING ACTIVITIES		
Net Income Available for Common Stock	\$ 144,927	\$ 30,806
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Impairment of Oil and Gas Producing Properties		182,811
Depreciation, Depletion and Amortization	91,846	84,056
Deferred Income Taxes	41,796	(80,857)
Income from Unconsolidated Subsidiaries, Net of Cash Distributions	1,228	808
Impairment of Investment in Partnership		1,804
Excess Tax Benefits Associated with Stock-Based Compensation Awards	(13,437)	(5,927)
Other	6,270	8,997
Change in:		
Hedging Collateral Deposits	(12,809)	(22,194)
Receivables and Unbilled Utility Revenue	(101,881)	(149,895)
Gas Stored Underground and Materials and Supplies	37,932	79,128
Unrecovered Purchased Gas Costs		34,782
Prepayments and Other Current Assets	31,318	16,954
Accounts Payable	12,179	(45,186)
Amounts Payable to Customers	(41,442)	18,897
Customer Advances	(21,840)	(31,189)
Customer Security Deposits	1,996	968
Other Accruals and Current Liabilities	90,498	215,281
Other Assets	11,285	2,399
Other Liabilities	(535)	(4,301)
Net Cash Provided by Operating Activities	279,331	338,142
INVESTING ACTIVITIES		
Capital Expenditures	(230,530)	(181,158)
Net Proceeds from Sale of Oil and Gas Producing Properties		60
Other	(115)	(595)
Net Cash Used in Investing Activities	(230,645)	(181,693)
FINANCING ACTIVITIES		
Excess Tax Benefits Associated with Stock-Based Compensation Awards	13,437	5,927
Reduction of Long-Term Debt		(100,000)
Dividends Paid on Common Stock	(54,096)	(51,556)

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Net Proceeds from Issuance of Common Stock	10,724	6,989
Net Cash Used in Financing Activities	(29,935)	(138,640)
Net Increase in Cash and Temporary Cash Investments	18,751	17,809
Cash and Temporary Cash Investments at October 1	408,053	68,239
Cash and Temporary Cash Investments at March 31	\$ 426,804	\$ 86,048

See Notes to Condensed Consolidated Financial Statements

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Table of Contents**Item 1. Financial Statements (Cont.)**

National Fuel Gas Company
Consolidated Statements of Comprehensive Income
(Unaudited)

(Thousands of Dollars)	Three Months Ended March 31,	
	2010	2009
Net Income Available for Common Stock	\$80,428	\$ 73,484
Other Comprehensive Income (Loss), Before Tax:		
Foreign Currency Translation Adjustment	47	34
Unrealized Gain (Loss) on Securities Available for Sale Arising During the Period	1,158	(2,945)
Unrealized Gain on Derivative Financial Instruments Arising During the Period	27,633	32,923
Reclassification Adjustment for Realized Gains on Derivative Financial Instruments in Net Income	(5,590)	(39,615)
Other Comprehensive Income (Loss), Before Tax	23,248	(9,603)
Income Tax Expense (Benefit) Related to Unrealized Gain (Loss) on Securities Available for Sale Arising During the Period	438	(1,113)
Income Tax Expense Related to Unrealized Gain on Derivative Financial Instruments Arising During the Period	11,310	13,399
Reclassification Adjustment for Income Tax Expense on Realized Gains from Derivative Financial Instruments In Net Income	(2,300)	(15,959)
Income Taxes Net	9,448	(3,673)
Other Comprehensive Income (Loss)	13,800	(5,930)
Comprehensive Income	\$94,228	\$ 67,554
(Thousands of Dollars)	Six Months Ended March 31,	
	2010	2009
Net Income Available for Common Stock	\$144,927	\$ 30,806
Other Comprehensive Income, Before Tax:		
Foreign Currency Translation Adjustment	64	42
Unrealized Gain (Loss) on Securities Available for Sale Arising During the Period	445	(12,977)
Unrealized Gain on Derivative Financial Instruments Arising During the Period	22,780	151,802
Reclassification Adjustment for Realized (Gains) Losses on Derivative Financial Instruments in Net Income	(17,643)	(68,407)

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Other Comprehensive Income, Before Tax	5,646	70,460
Income Tax Expense (Benefit) Related to Unrealized Gain (Loss) on Securities Available for Sale Arising During the Period	167	(4,904)
Income Tax Expense Related to Unrealized Gain on Derivative Financial Instruments Arising During the Period	9,247	61,526
Reclassification Adjustment for Income Tax (Expense) Benefit on Realized (Gains) Losses from Derivative Financial Instruments In Net Income	(7,262)	(27,370)
Income Taxes Net	2,152	29,252
Other Comprehensive Income	3,494	41,208
Comprehensive Income	\$148,421	\$ 72,014

See Notes to Condensed Consolidated Financial Statements

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Item 1. Financial Statements (Cont.)

National Fuel Gas Company
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1 Summary of Significant Accounting Policies

Principles of Consolidation. The Company consolidates its majority owned entities. The equity method is used to account for minority owned entities. All significant intercompany balances and transactions are eliminated.

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

Reclassification. Certain prior year amounts have been reclassified to conform with current year presentation.

Earnings for Interim Periods. The Company, in its opinion, has included all adjustments that are necessary for a fair statement of the results of operations for the reported periods. The consolidated financial statements and notes thereto, included herein, should be read in conjunction with the financial statements and notes for the years ended September 30, 2009, 2008 and 2007 that are included in the Company's 2009 Form 10-K. The consolidated financial statements for the year ended September 30, 2010 will be audited by the Company's independent registered public accounting firm after the end of the fiscal year.

The earnings for the six months ended March 31, 2010 should not be taken as a prediction of earnings for the entire fiscal year ending September 30, 2010. Most of the business of the Utility and Energy Marketing segments is seasonal in nature and is influenced by weather conditions. Due to the seasonal nature of the heating business in the Utility and Energy Marketing segments, earnings during the winter months normally represent a substantial part of the earnings that those segments are expected to achieve for the entire fiscal year. The Company's business segments are discussed more fully in Note 7 Business Segment Information.

Consolidated Statement of Cash Flows. For purposes of the Consolidated Statement of Cash Flows, the Company considers all highly liquid debt instruments purchased with a maturity of generally three months or less to be cash equivalents.

At March 31, 2010, the Company accrued \$15.3 million of capital expenditures in the Exploration and Production segment, the majority of which was in the Appalachian region. This amount was excluded from the Consolidated Statement of Cash Flows at March 31, 2010 since it represented a non-cash investing activity at that date.

At September 30, 2009, the Company accrued \$9.1 million of capital expenditures in the Exploration and Production segment, the majority of which was in the Appalachian region. The Company also accrued \$0.7 million of capital expenditures in the All Other category related to the construction of the Midstream Covington Gathering System. These amounts were excluded from the Consolidated Statement of Cash Flows at September 30, 2009 since they represented non-cash investing activities at that date. These capital expenditures were paid during the quarter ended December 31, 2009 and have been included in the Consolidated Statement of Cash Flows for the six months ended March 31, 2010.

At March 31, 2009, the Company accrued \$7.7 million of capital expenditures in the Exploration and Production segment, the majority of which was in the Appalachian region. The Company also accrued \$0.9 million of capital expenditures at March 31, 2009 related to the completion of the Empire Connector project. These amounts were excluded from the Consolidated Statement of Cash Flows at March 31, 2009 since they represent non-cash investing activities at that date.

Table of Contents**Item 1. Financial Statements (Cont.)**

At September 30, 2008, the Company accrued \$16.8 million of capital expenditures related to the construction of the Empire Connector project. This amount was excluded from the Consolidated Statement of Cash Flows at September 30, 2008 since it represented a non-cash investing activity at that date. These capital expenditures were paid during the quarter ended December 31, 2008 and have been included in the Consolidated Statement of Cash Flows for the six months ended March 31, 2009.

Hedging Collateral Deposits. This is an account title for cash held in margin accounts funded by the Company to serve as collateral for open hedging positions. At March 31, 2010, the Company had hedging collateral deposits of \$8.5 million related to its exchange-traded futures contracts and \$5.2 million related to its over-the-counter crude oil swap agreements. It is the Company's policy to not offset hedging collateral deposits paid or received against the derivative financial instruments liability or asset balances.

Cash Held in Escrow. On July 20, 2009, the Company's wholly-owned subsidiary in the Exploration and Production segment, Seneca, acquired Ivanhoe Energy's United States oil and gas operations for approximately \$39.2 million in cash (including cash acquired of \$4.3 million). The cash acquired at acquisition includes \$2 million held in escrow at March 31, 2010 and September 30, 2009. Seneca placed this amount in escrow as part of the purchase price, and in accordance with the purchase agreement, this amount will remain in escrow for one year from the closing of the transaction provided there are no pending disputes or actions regarding obligations and liabilities required to be satisfied or discharged by Ivanhoe Energy. If no disputes occur, this cash will be released to Ivanhoe Energy.

Gas Stored Underground Current. In the Utility segment, gas stored underground current is carried at lower of cost or market, on a LIFO method. Gas stored underground current normally declines during the first and second quarters of the year and is replenished during the third and fourth quarters. In the Utility segment, the current cost of replacing gas withdrawn from storage is recorded in the Consolidated Statements of Income and a reserve for gas replacement is recorded in the Consolidated Balance Sheets under the caption Other Accruals and Current Liabilities. Such reserve, which amounted to \$87.9 million at March 31, 2010, is reduced to zero by September 30 of each year as the inventory is replenished.

Property, Plant and Equipment. In the Company's Exploration and Production segment, oil and gas property acquisition, exploration and development costs are capitalized under the full cost method of accounting. Under this methodology, all costs associated with property acquisition, exploration and development activities are capitalized, including internal costs directly identified with acquisition, exploration and development activities. The internal costs that are capitalized do not include any costs related to production, general corporate overhead, or similar activities. The Company does not recognize any gain or loss on the sale or other disposition of oil and gas properties unless the gain or loss would significantly alter the relationship between capitalized costs and proved reserves of oil and gas attributable to a cost center.

Capitalized costs include costs related to unproved properties, which are excluded from amortization until proved reserves are found or it is determined that the unproved properties are impaired. Such costs amounted to \$135.1 million at March 31, 2010. All costs related to unproved properties are reviewed quarterly to determine if impairment has occurred. The amount of any impairment is transferred to the pool of capitalized costs being amortized.

Capitalized costs are subject to the SEC full cost ceiling test. The ceiling test, which is performed each quarter, determines a limit, or ceiling, on the amount of property acquisition, exploration and development costs that can be capitalized. The ceiling under this test represents (a) the present value of estimated future net cash flows, excluding future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, using a discount factor of 10%, which is computed by applying current market prices of oil and gas (as adjusted for hedging) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet, less estimated future expenditures, plus (b) the cost of unevaluated properties not being depleted, less (c) income tax effects related to the differences between the book and tax basis of the properties. If capitalized costs, net of accumulated depreciation, depletion and amortization and related deferred income taxes, exceed the ceiling at the end of any quarter, a permanent impairment is required to be charged to earnings in that quarter. The Company's

Table of Contents**Item 1. Financial Statements (Cont.)**

capitalized costs exceeded the full cost ceiling for the Company's oil and gas properties at December 31, 2008. As a result, the Company recognized a pre-tax impairment of \$182.8 million at December 31, 2008. Deferred income taxes of \$74.6 million were recorded associated with this impairment. At March 31, 2010, the Company's capitalized costs were below the full cost ceiling for the Company's oil and gas properties. As a result, an impairment charge was not required at March 31, 2010.

Accumulated Other Comprehensive Loss. The components of Accumulated Other Comprehensive Loss, net of related tax effect, are as follows (in thousands):

	At March 31, 2010	At September 30, 2009
Funded Status of the Pension and Other Post-Retirement Benefit Plans	\$ (63,802)	\$ (63,802)
Cumulative Foreign Currency Translation Adjustment	(40)	(104)
Net Unrealized Gain on Derivative Financial Instruments	21,643	18,491
Net Unrealized Gain on Securities Available for Sale	3,297	3,019
Accumulated Other Comprehensive Loss	\$ (38,902)	\$ (42,396)

Earnings Per Common Share. Basic earnings per common share is computed by dividing income available for common stock by the weighted average number of common shares outstanding for the period. Diluted earnings per common share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For purposes of determining earnings per common share, the only potentially dilutive securities the Company has outstanding are stock options and SARs. The diluted weighted average shares outstanding shown on the Consolidated Statements of Income reflects the potential dilution as a result of these stock options and SARs as determined using the Treasury Stock Method. Stock options and SARs that are antidilutive are excluded from the calculation of diluted earnings per common share. For both the quarter and six months ended March 31, 2010, there were no stock options excluded as being antidilutive. There were 145,450 and 84,058 SARs excluded as being antidilutive for the quarter and six months ended March 31, 2010, respectively. For both the quarter and six months ended March 31, 2009, there were 765,000 stock options excluded as being antidilutive. In addition, there were 402,858 and 365,000 SARs excluded as being antidilutive for the quarter and six months ended March 31, 2009, respectively.

Stock-Based Compensation. During the quarter and six months ended March 31, 2010, the Company granted 520,500 performance-based SARs having a weighted average exercise price of \$52.10 per share. The weighted average grant date fair value of these SARs was \$12.06 per share. These SARs may be settled in cash, in shares of common stock of the Company, or in a combination of cash and shares of common stock of the Company, as determined by the Company. These SARs are considered equity awards under the current authoritative guidance for stock-based compensation. The accounting for those SARs is the same as the accounting for stock options. The performance-based SARs granted during the quarter and six months ended March 31, 2010 vest and become exercisable annually in one-third increments, provided that a performance condition is met. The performance condition for each fiscal year, generally stated, is an increase over the prior fiscal year of at least five percent in certain oil and natural gas production of the Exploration and Production segment. The weighted average grant date fair value of these performance-based SARs granted during the quarter and six months ended March 31, 2010 was estimated on the date of grant using the same accounting treatment that is applied for stock options, and assumes that the performance conditions specified will be achieved. If such conditions are not met or it is not considered probable that such conditions will be met, no compensation expense is recognized and any previously recognized compensation expense is reversed.

There were no stock options granted during the quarter or six months ended March 31, 2010. The Company granted 4,000 restricted share awards (non-vested stock as defined by the current accounting literature) during the

quarter and six months ended March 31, 2010. The weighted average fair value of such restricted shares was \$52.10 per share.

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New Authoritative Accounting and Financial Reporting Guidance. In September 2006, the FASB issued authoritative guidance for using fair value to measure assets and liabilities. This guidance serves to clarify the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect that fair-value measurements have on earnings. This guidance is to be applied whenever assets or liabilities are to be measured at fair value. On October 1, 2008, the Company adopted this guidance for financial assets and financial liabilities that are recognized or disclosed at fair value on a recurring basis. The FASB's authoritative guidance for using fair value to measure nonfinancial assets and nonfinancial liabilities on a nonrecurring basis became effective during the quarter ended December 31, 2009. The Company's nonfinancial assets and nonfinancial liabilities were not impacted by this guidance during the six months ended March 31, 2010. The Company has identified Goodwill as being the major nonfinancial asset that may be impacted by the adoption of this guidance. The impact of this guidance will be known when the Company performs its annual test for goodwill impairment at the end of the fiscal year; however, at this time, it is not expected to be material. The Company has identified Asset Retirement Obligations as a nonfinancial liability that may be impacted by the adoption of the guidance. The impact of this guidance will be known when the Company recognizes new asset retirement obligations. However, at this time, the Company believes the impact of the guidance will be immaterial. Additionally, in February 2010, the FASB issued updated guidance that includes additional requirements and disclosures regarding fair value measurements. The guidance now requires the gross presentation of activity within the Level 3 roll forward and requires disclosure of details on transfers in and out of Level 1 and 2 fair value measurements. It also provides further clarification on the level of disaggregation of fair value measurements and disclosures on inputs and valuation techniques. Effective with this March 31, 2010 Form 10-Q, the Company has updated its disclosures to reflect the new requirements in Note 2 Fair Value Measurements, except for the Level 3 roll forward gross presentation, which will be effective as of the Company's first quarter of fiscal 2012.

On December 31, 2008, the SEC issued a final rule on Modernization of Oil and Gas Reporting. The final rule modifies the SEC's reporting and disclosure rules for oil and gas reserves and aligns the full cost accounting rules with the revised disclosures. The most notable changes of the final rule include the replacement of the single day period-end pricing used to value oil and gas reserves with a 12-month average of the first day of the month price for each month within the reporting period. The final rule also permits voluntary disclosure of probable and possible reserves, a disclosure previously prohibited by SEC rules. Additionally, on January 6, 2010, the FASB amended the oil and gas accounting standards to conform to the SEC final rule on Modernization of Oil and Gas Reporting. The revised reporting and disclosure requirements will be effective for the Company's Form 10-K for the period ended September 30, 2010. Early adoption is not permitted. The Company is currently evaluating the impact that adoption of these rules will have on its consolidated financial statements and MD&A disclosures.

In March 2009, the FASB issued authoritative guidance that expands the disclosures required in an employer's financial statements about pension and other post-retirement benefit plan assets. The additional disclosures include more details on how investment allocation decisions are made, the plan's investment policies and strategies, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets, the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period, and disclosure regarding significant concentrations of risk within plan assets. The additional disclosure requirements are required for the Company's Form 10-K for the period ended September 30, 2010. The Company is currently evaluating the impact that adoption of this authoritative guidance will have on its consolidated financial statement disclosures.

In June 2009, the FASB issued amended authoritative guidance to improve and clarify financial reporting requirements by companies involved with variable interest entities. The new guidance requires a company to perform an analysis to determine whether the company's variable interest or interests give it a controlling financial interest in a variable interest entity. The analysis also assists in identifying the primary beneficiary of a variable interest entity. This authoritative guidance will be effective as of the Company's first quarter of fiscal 2011. The Company is currently evaluating the impact that adoption of this authoritative guidance will have on its consolidated financial statements.

Table of Contents**Item 1. Financial Statements (Cont.)****Note 2 Fair Value Measurements**

The FASB authoritative guidance regarding fair value measurements establishes a fair-value hierarchy and prioritizes the inputs used in valuation techniques that measure fair value. Those inputs are prioritized into three levels. Level 1 inputs are unadjusted quoted prices in active markets for assets or liabilities that the Company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly at the measurement date. Level 3 inputs are unobservable inputs for the asset or liability at the measurement date. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

The following table sets forth, by level within the fair value hierarchy, the Company's financial assets and liabilities (as applicable) that were accounted for at fair value on a recurring basis as of March 31, 2010 and September 30, 2009. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. In January 2010, the FASB issued amended authoritative guidance respecting disclosures related to fair value measurements. The amended guidance requires disclosure of financial instruments and liabilities by class of assets and liabilities (not major category of assets and liabilities). In addition, this amended guidance also requires enhanced disclosures about the valuation techniques and inputs used to measure fair value and disclosures of transfers in and out of Level 1 or 2. During the quarter ended March 31, 2010, the Company adopted this amended guidance.

Recurring Fair Value Measures (Thousands of Dollars)	At fair value as of March 31, 2010			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash Equivalents Money Market Mutual Funds	\$319,891	\$	\$	\$319,891
Derivative Financial Instruments:				
Commodity Futures Contracts Gas	1,013			1,013
Over the Counter Swaps Oil		(100)	(2,349)	(2,449)
Over the Counter Swaps Gas		50,286		50,286
Other Investments:				
Balanced Equity Mutual Fund	16,972			16,972
Common Stock Financial Services Industry	7,781			7,781
Other Common Stock	214			214
Hedging Collateral Deposits	13,657			13,657
Total	\$359,528	\$50,186	\$ (2,349)	\$407,365
Liabilities:				
Derivative Financial Instruments:				
Commodity Futures Contracts	\$ 4,816	\$	\$	\$ 4,816
Over the Counter Swaps Oil			11,751	11,751
Over the Counter Swaps Gas		65		65
Total	\$ 4,816	\$ 65	\$ 11,751	\$ 16,632
Total Net Assets/(Liabilities)	\$354,712	\$50,121	\$(14,100)	\$390,733

Table of Contents**Item 1. Financial Statements (Cont.)**

Recurring Fair Value Measures (Thousands of Dollars)	At fair value as of September 30, 2009			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash Equivalents	\$390,462	\$	\$	\$390,462
Derivative Financial Instruments	5,312	12,536	26,969	44,817
Other Investments	24,276			24,276
Hedging Collateral Deposits	848			848
Total	\$420,898	\$12,536	\$26,969	\$460,403
Liabilities:				
Derivative Financial Instruments	\$	\$ 2,148	\$	\$ 2,148
Total	\$	\$ 2,148	\$	\$ 2,148
Total Net Assets/(Liabilities)	\$420,898	\$10,388	\$26,969	\$458,255

Derivative Financial Instruments

At March 31, 2010, the derivative financial instruments reported in Level 1 consist of NYMEX futures contracts used in the Company's Energy Marketing and Pipeline and Storage segments (at September 30, 2009, the derivative financial instruments reported in Level 1 consist of NYMEX futures used in the Company's Energy Marketing segment). Hedging collateral deposits of \$8.5 million associated with these futures contracts have been reported in Level 1 as well. The derivative financial instruments reported in Level 2 consist of natural gas and some of the crude oil swap agreements used in the Company's Exploration and Production segment and natural gas swap agreements used in the Energy Marketing segment at March 31, 2010 (at September 30, 2009, the derivative financial instruments reported in Level 2 consist of natural gas swap agreements used in the Company's Exploration and Production and Energy Marketing segments). The fair value of these swap agreements is based on an internal, discounted cash flow model that uses observable inputs (i.e. LIBOR based discount rates and basis differential information, if applicable, at active natural gas/crude oil trading markets). At March 31, 2010, the derivative financial instruments reported in Level 3 consist of a majority of the Exploration and Production segment's crude oil swap agreements (at September 30, 2009, all of the Exploration and Production segment's crude oil swap agreements were reported as Level 3). Hedging collateral deposits of \$5.2 million associated with these oil swap agreements have been reported in Level 1. The fair value of the crude oil swap agreements is based on an internal, discounted cash flow model that uses both observable (i.e. LIBOR based discount rates) and unobservable inputs (i.e. basis differential information of inactive crude oil trading markets). Based on an assessment of the counterparties' credit risk, the fair market value of the price swap agreements reported as Level 2 and Level 3 assets have been reduced by \$1.2 million and \$0.9 million at March 31, 2010 and September 30, 2009, respectively. The fair market value of the price swap agreements reported as Level 2 and Level 3 liabilities at March 31, 2010 have been reduced by \$0.2 million and the price swap agreements reported as Level 2 liabilities at September 30, 2009 have been reduced by less than \$0.1 million based on an assessment of the Company's credit risk. These credit reserves were determined by applying default probabilities to the anticipated cash flows that the Company is either expecting from its counterparties or expecting to pay to its counterparties.

The tables listed below provide reconciliations of the beginning and ending net balances for assets and liabilities measured at fair value and classified as Level 3 for the quarter and six months ended March 31, 2010 and 2009,

respectively. For the quarter ended March 31, 2010, no transfers in or out of Level 1 or Level 2 occurred.

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Table of Contents**Item 1. Financial Statements (Cont.)**

Fair Value Measurements Using Unobservable Inputs (Level 3)

	January	Total Gains/Losses - Realized and Unrealized Included in Other	Transfer In/Out of Level	March 31,
(Thousands of Dollars)	1, 2010	Included in Earnings	3	2010
Derivative Financial Instruments ⁽²⁾	\$ (149)	\$ (1,662) ⁽¹⁾	\$	\$ (14,100)

(1) Amounts are reported in Operating Revenues in the Consolidated Statement of Income for the three months ended March 31, 2010.

(2) Derivative Financial Instruments are shown on a net basis.

Fair Value Measurements Using Unobservable Inputs (Level 3)

	October 1,	Total Gains/Losses - Realized and Unrealized Included in Other	Transfer In/Out of Level	March 31,
(Thousands of Dollars)	2009	Included in Earnings	3	2010
Derivative Financial Instruments ⁽²⁾	\$ 26,969	\$ (4,797) ⁽¹⁾	\$	(\$14,100)

(1) Amounts are reported in Operating Revenues in the Consolidated Statement of Income for the six months

ended
March 31, 2010.

- (2) Derivative
Financial
Instruments are
shown on a net
basis.

Fair Value Measurements Using Unobservable Inputs (Level 3)

	January 1,	Total Gains/Losses - Realized and Unrealized Included in	Other	Transfer In/Out of Level	March 31,
(Thousands of Dollars)	2009	Included in	Comprehensive	3	2009
Derivative Financial Instruments ⁽²⁾	\$83,030	Earnings \$(19,961) ⁽¹⁾	Income (Loss) \$ 16,090	\$	\$79,159

- (1) Amounts are
reported in
Operating
Revenues in the
Consolidated
Statement of
Income for the
three months
ended
March 31, 2009.

- (2) Derivative
Financial
Instruments are
shown on a net
basis.

Fair Value Measurements Using Unobservable Inputs (Level 3)

	October 1,	Total Gains/Losses - Realized and Unrealized Included in	Other	Transfer In/Out of Level	March 31,
(Thousands of Dollars)	2008	Included in	Comprehensive	3	2009
Derivative Financial Instruments ⁽²⁾	\$6,333	Earnings \$(35,781) ⁽¹⁾	Income (Loss) \$ 108,607	\$	\$79,159

- (1) Amounts are
reported in
Operating

Revenues in the
Consolidated
Statement of
Income for the
six months
ended
March 31, 2009.

- (2) Derivative
Financial
Instruments are
shown on a net
basis.

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Table of Contents**Item 1. Financial Statements (Cont.)****Note 3 Financial Instruments**

Long-Term Debt. The fair market value of the Company's debt, as presented in the table below, was determined using a discounted cash flow model, which incorporates the Company's credit risk in determining the yield, and subsequently, the fair market value of the debt. Based on these criteria, the fair market value of long-term debt, including current portion, was as follows:

	March 31, 2010		September 30, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-Term Debt	\$1,249,000	\$1,358,050	\$1,249,000	\$1,347,368

Other Investments. Investments in life insurance are stated at their cash surrender values or net present value as discussed below. Investments in an equity mutual fund and the stock of an insurance company (marketable equity securities), as discussed below, are stated at fair value based on quoted market prices.

Other investments include cash surrender values of insurance contracts (net present value in the case of split-dollar collateral assignment arrangements) and marketable equity securities. The values of the insurance contracts amounted to \$54.3 million at March 31, 2010 and \$54.2 million at September 30, 2009. The fair value of the equity mutual fund was \$17.0 million at March 31, 2010 and \$15.8 million at September 30, 2009. The gross unrealized loss on this equity mutual fund was \$0.1 million at March 31, 2010 and \$1.0 million at September 30, 2009. Management does not consider this investment to be other than temporarily impaired. The fair value of the stock of an insurance company was \$7.8 million at March 31, 2010 and \$8.3 million at September 30, 2009. The gross unrealized gain on this stock was \$5.4 million at March 31, 2010 and \$5.9 million at September 30, 2009. The insurance contracts and marketable equity securities are primarily informal funding mechanisms for various benefit obligations the Company has to certain employees.

Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is commodity price risk in the Exploration and Production, Energy Marketing and Pipeline and Storage segments. The Company enters into futures contracts and over-the-counter swap agreements for natural gas and crude oil to manage the price risk associated with forecasted sales of gas and oil. The Company also enters into futures contracts and swaps to manage the risk associated with forecasted gas purchases, storage of gas, and withdrawal of gas from storage to meet customer demand. The duration of the Company's hedges do not typically exceed 3 years.

The Company has presented its net derivative assets and liabilities on its Consolidated Balance Sheets at March 31, 2010 and September 30, 2009 as shown in the table below.

Table of Contents**Item 1. Financial Statements (Cont.)****Fair Values of Derivative Instruments
(Thousands of Dollars)**

Derivatives Designated as Hedging Instruments	Asset Derivatives		Liability Derivatives	
	Consolidated Balance Sheet Location	Fair Value	Consolidated Balance Sheet Location	Fair Value
Commodity Contracts				
at March 31, 2010	Fair Value of Derivative Financial Instruments	\$48,850	Fair Value of Derivative Financial Instruments	\$ 16,632
Commodity Contracts				
at September 30, 2009	Fair Value of Derivative Financial Instruments	\$44,817	Fair Value of Derivative Financial Instruments	\$ 2,148

The following table discloses the fair value of derivative contracts on a gross-contract basis as opposed to the net-contract basis presentation on the Consolidated Balance Sheets at March 31, 2010 and September 30, 2009.

	Derivatives Designated as Hedging Instruments	Fair Values of Derivative Instruments (Thousands of Dollars)	
		Gross Asset Derivatives Fair Value	Gross Liability Derivatives Fair Value
Commodity Contracts	at March 31, 2010	\$ 64,776	\$ 32,558
Commodity Contracts	at September 30, 2009	\$ 63,601	\$ 20,932

Cash flow hedges

For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income (loss) and reclassified into earnings in the period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

As of March 31, 2010, the Company's Exploration and Production segment had the following commodity derivative contracts (swaps) outstanding to hedge forecasted sales (where the Company uses short positions (i.e. positions that pay-off in the event of commodity price decline) to mitigate the risk of decreasing revenues and earnings):

Commodity	Units
Natural Gas	34.0 Bcf (all short positions)
Crude Oil	2,830,000 Bbls (all short positions)

Table of Contents**Item 1. Financial Statements (Cont.)**

As of March 31, 2010, the Company's Energy Marketing segment had the following commodity derivative contracts (futures contracts and swaps) outstanding to hedge forecasted sales (where the Company uses short positions to mitigate the risk associated with natural gas price decreases and its impact on decreasing revenues and earnings) and purchases (where the Company uses long positions (i.e. positions that pay-off in the event of commodity price increases) to mitigate the risk of increasing natural gas prices, which would lead to increased purchased gas expense and decreased earnings):

Commodity	Units
Natural Gas	2.2 Bcf (1.7 Bcf short positions (forecasted storage withdrawals) and 0.5 Bcf long positions (forecasted storage injections))

As of March 31, 2010, the Company's Pipeline and Storage segment has the following commodity derivative contracts (futures contracts) outstanding to hedge forecasted sales (where the Company uses short positions to mitigate the risk associated with natural gas price decreases and its impact on decreasing revenues and earnings):

Commodity	Units
Natural Gas	0.9 Bcf (all short positions)

As of March 31, 2010, the Company's Exploration and Production segment had \$35.1 million (\$20.6 million after tax) of gains included in the accumulated other comprehensive income (loss) balance. It is expected that \$24.7 million (\$14.5 million after tax) of those gains will be reclassified into the Consolidated Statement of Income within the next 12 months as the expected sales of the underlying commodities occur. See Note 1, under Accumulated Other Comprehensive Income (Loss), for the after-tax gain pertaining to derivative financial instruments (Net Unrealized Gain (Loss) on Derivative Financial Instruments in Note 1 includes the Exploration and Production, Energy Marketing and Pipeline and Storage segments).

As of March 31, 2010, the Company's Energy Marketing segment had \$1.1 million (\$0.7 million after tax) of gains included in the accumulated other comprehensive income (loss) balance. It is expected that \$0.2 million (\$0.1 million after tax) of these gains will be reclassified into the Consolidated Statement of Income within the next 12 months as the sales and purchases of the underlying commodities occur. See Note 1, under Accumulated Other Comprehensive Income (Loss), for the after-tax gain pertaining to derivative financial instruments (Net Unrealized Gain (Loss) on Derivative Financial Instruments in Note 1 includes the Exploration and Production, Energy Marketing and Pipeline and Storage segments).

As of March 31, 2010, the Company's Pipeline and Storage segment had \$0.5 million (\$0.3 million after tax) of gains included in the accumulated other comprehensive income (loss) balance. It is expected that the full amount will be reclassified into the Consolidated Statement of Income within the next 12 months as the expected sales of the underlying commodities occur. See Note 1, under Accumulated Other Comprehensive Income (Loss), for the after-tax gain pertaining to derivative financial instruments (Net Unrealized Gain (Loss) on Derivative Financial Instruments in Note 1 includes the Exploration and Production, Energy Marketing and Pipeline and Storage segments).

Table of Contents**Item 1. Financial Statements (Cont.)****The Effect of Derivative Financial Instruments on the Statement of Financial Performance for the Three Months Ended March 31, 2010 and 2009 (Thousands of Dollars)**

	Amount of Derivative Gain or (Loss) Recognized in Other Comprehensive Income (Loss) on the Consolidated Statement		Location of Derivative Gain or (Loss) Recognized from Accumulated Other Comprehensive Income (Loss) on the Consolidated Sheet	Amount of Derivative Gain or (Loss)		Location of Derivative Gain or (Loss) Recognized in the Consolidated Statement of Income (Ineffective Portion and Amount Excluded from Effectiveness Testing) for the Three Months Ended	Derivative Gain or (Loss) Recognized in the Consolidated Statement of Income (Ineffective Portion and Amount Excluded from Effectiveness Testing) for the Three Months Ended	
				Reclassified from Accumulated Other Comprehensive Income (Loss) on the Consolidated Balance Sheet into the Consolidated Statement of Income (Effective Portion) for Three Months Ended			March 31, 2010 2009	
Derivatives in Cash Flow Hedging Relationships	2010	2009		2010	2009	Testing)	2010	2009
Commodity Contracts Exploration & Production segment	\$ 24,375	\$ 30,874	Operating Revenue	\$ 5,538	\$ 28,407	Operating Revenue	\$	\$ (9)
Commodity Contracts Energy Marketing segment	\$ 2,278	\$ 2,049	Purchased Gas	\$ (470)	\$ 11,208	Operating Revenue	\$	\$
Commodity Contracts Pipeline & Storage segment	\$ 980	\$	Operating Revenue	\$ 522	\$	Operating Revenue	\$	\$
Total	\$ 27,633	\$ 32,923		\$ 5,590	\$ 39,615		\$	\$ (9)

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Item 1. Financial Statements (Cont.)

	195	124
Net cash provided by financing activities		
	205	176
Decrease (increase) in cash and cash equivalents	(1,666)	1,556
Beginning cash and cash equivalents		3,074
Ending cash and cash equivalents		1,518
	\$1,408	\$3,074
Supplementary disclosure of cash flow information:		
Cash paid for income taxes		\$2
Cash paid for interest		\$4
\$4	\$21	

See Accompanying Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Summary of Significant Accounting Policies

The Company The accompanying consolidated financial statements include the accounts of Giga-tronics Incorporated (“Giga-tronics”) and its wholly-owned subsidiary, Microsource Incorporated (“Microsource”), collectively the “Company”. The Company’s corporate office and manufacturing facilities are located in Northern California. Giga-tronics and its subsidiary company design, manufacture and market a broad line of test and measurement equipment used in the development, test, and maintenance of wireless communications products and systems, flight navigational equipment, electronic defense systems, and automatic testing systems. The Company also manufactures and markets a line of test, measurement, and handling equipment used in the manufacturing of semiconductor devices. The Company’s products are sold worldwide to customers in the test and measurement and semiconductor industries. The Company currently has no foreign-based operations or material amounts of identifiable assets in foreign countries. Its gross margins on foreign and domestic sales are similar, and all non-U.S. sales are made in U.S. dollars.

Principles of Consolidation The consolidated financial statements include the accounts of Giga-tronics and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

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

Fiscal Year The Company’s financial reporting year consists of either a 52 week or 53 week period ending on the last Saturday of the month of March. Both fiscal year 2011 and 2010 contained 52 weeks. All references to years in the consolidated financial statements relate to fiscal years rather than calendar years.

Reclassifications Certain reclassifications, none of which affected net income, have been made to prior year balances in order to conform to the current year presentation.

Revenue Recognition The Company records revenue when there is persuasive evidence of an arrangement, delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. This occurs when products are shipped or the customer accepts title transfer. If the arrangement involves acceptance terms, the Company defers revenue until product acceptance is received. On certain large development contracts, revenue is recognized upon achievement of substantive milestones. Determining whether a milestone is substantive is a matter of judgment and that assessment is performed only at the inception of the arrangement. The consideration earned from the achievement of a milestone must meet all of the following for the milestone to be considered substantive:

- a. It is commensurate with either of the following:
 1. The Company’s performance to achieve the milestone
 2. The enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the Company’s performance to achieve the milestone.
- b. It relates solely to past performance.
- c. It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

Milestones for revenue recognition are agreed upon with the customer prior to the start of the contract and some milestones will be tied to product shipping while others will be tied to design review.

The Company has estimated an allowance for uncollectable accounts based on analysis of specifically identified accounts, outstanding receivables, consideration of the age of those receivables and the Company's historical collection experience. The activity in the reserve account is as follows:

Allowance For Uncollectable Accounts	March 26, 2011	March 27, 2010
(Dollars in thousands)		
Beginning balance	\$95	\$102
Provision for doubtful accounts	154	7
Write-off of doubtful accounts	(1)	(14)
Ending balance	\$248	\$95

Accrued Warranty The Company's warranty policy generally provides one to three years of coverage depending on the product. The Company records a liability for estimated warranty obligations at the date products are sold. The estimated cost of warranty coverage is based on the Company's actual historical experience with its current products or similar products. For new products, the required reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Adjustments are made as new information becomes available.

Inventories Inventories are stated at the lower of cost or market. Cost is determined on a first-in, first-out basis.

Property and Equipment Property and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets, which range from three to ten years for machinery and equipment and office fixtures. Leasehold improvements and assets acquired under capital leases are amortized using the straight-line method over the shorter of the estimated useful lives of the respective assets or the lease term.

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such review indicates that the carrying amount of an asset exceeds the sum of its expected future cash flows on an undiscounted basis, the asset's carrying amount would be written down to fair value. Additionally, the Company reports long-lived assets to be disposed of at the lower of carrying amount or fair value less cost to sell. As of March 26, 2011 and March 27, 2010, management believes there has been no impairment of the Company's long-lived assets.

Deferred Rent Rent expense is recognized in an amount equal to the minimum guaranteed base rent plus future rental increases amortized on the straight-line basis over the terms of the leases, including free rent periods.

Income Taxes Income taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Future tax benefits are subject to a valuation allowance when management is unable to conclude that its deferred tax assets will more likely than not be realized. The ultimate realization of deferred tax assets is dependent upon generation of future taxable income during the periods in which those temporary differences become deductible. Management considers both positive and negative evidence and tax planning strategies in making this assessment.

The Company considers all tax positions recognized in its financial statements for the likelihood of realization. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the positions taken or the amounts of the positions that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if any, would be reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company recognizes accrued interest and penalties, if any, related to unrecognized tax benefits as a component of the provision for income taxes in the consolidated statements of income.

Product Development Costs The Company incurs pre-production costs on certain long-term supply arrangements. The costs, which represent non-recurring engineering and tooling costs, are capitalized as other assets and amortized over their useful life when reimbursable by the customer. All other product development costs are charged to operations as incurred. There were no capitalized pre-production costs included in other assets as of March 26, 2011 and March 27, 2010.

Software Development Costs Development costs included in the research and development of new products and enhancements to existing products are expensed as incurred, until technological feasibility in the form of a working model has been established. To date, completion of software development has been concurrent with the establishment of technological feasibility, and accordingly, no costs have been capitalized.

Share-based Compensation The Company has established the 2000 Stock Option Plan and the 2005 Equity Incentive Plan, which provide for the granting of options for up to 1,400,000 shares of Common Stock. The Company records share-based compensation expense for the fair value of all stock options and restricted stock that are ultimately expected to vest as the requisite service is rendered.

The cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) are classified as a cash flows from financing in the statements of cash flows. These excess tax benefits were not significant for the Company for the fiscal year ended March 26, 2011. There were no excess tax benefits for the fiscal year ended March 27, 2010.

In calculating compensation related to stock option grants, the fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option-pricing model and the following weighted-average assumptions:

Years Ended	March 26, 2011	March 27, 2010
Dividend yield	Zero	Zero
Expected volatility	101	% 96
Risk-free interest rate	1.13	% 1.49
Expected term (years)	3.17	3.75

The computation of expected volatility used in the Black-Scholes-Merton option-pricing model is based on the historical volatility of Giga-tronics' share price. The expected term is estimated based on a review of historical employee exercise behavior with respect to option grants.

The fair value of restricted stock awards is based on the fair value of the underlying shares at the date of the grant. Management makes estimates regarding pre-vesting forfeitures that will impact timing of compensation expense recognized for stock option and restricted stock awards.

Earnings Per Share Basic earnings per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share incorporate the incremental shares issuable upon the assumed exercise of stock options using the treasury stock method. Antidilutive options are not included in the computation of diluted earnings per share.

Comprehensive Income (Loss) There are no items of comprehensive income other than net income.

Financial Instruments and Concentration of Credit Risk Financial instruments that potentially subject the Company to credit risk consist of cash, cash equivalents and trade accounts receivable. The Company's cash equivalents consist of overnight deposits with federally insured financial institutions. Under Section 343 of the Dodd-Frank Wall Street

Reform and Consumer Protection Act, those funds on deposit are covered by unlimited deposit insurance until December 31, 2012. Concentration of credit risk in trade accounts receivable results primarily from sales to major customers. The Company individually evaluates the creditworthiness of its customers and generally does not require collateral or other security. At March 26, 2011, one customer comprised 64% of consolidated gross accounts receivable primarily due to the timing of the receivable. At March 27, 2010, two customers comprised 14% and 27%, respectively, of consolidated gross accounts receivable.

Fair Value of Financial Instruments The carrying amount for the Company's cash-equivalents, trade accounts receivable and accounts payable approximates fair market value because of the short maturity of these financial instruments.

Recently Issued Financial Accounting Standards In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2009-13, Multiple-Deliverable Revenue Arrangements. The objective of this Update is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Vendors often provide multiple products or services to their customers. Those deliverables often are provided at different points in time or over different time periods. Subtopic 605-25, Revenue Recognition—Multiple-Element Arrangements, establishes the accounting and reporting guidance for arrangements under which the vendor will perform multiple revenue-generating activities. Specifically, this Subtopic addresses how to separate deliverables and how to measure and allocate arrangement consideration to one or more units of accounting. The amendments in this Update are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted this standard on March 27, 2011 and management does not expect adoption will have a significant impact on the Company's financial condition, operations or cash flows.

In April 2010, the FASB issued Accounting Standards Update No. 2010-17, Revenue Recognition-Milestone Method. The objective of this Update is to provide guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon milestone events such as successful completion of phases or achieving a specific result from the research or development efforts. An entity often recognizes these milestone payments as revenue in their entirety upon achieving the related milestone, commonly referred to as the milestone method. The amendments in this Update will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted this standard on March 27, 2011 and management does not expect adoption will have a significant impact on the Company's financial condition, operations or cash flows.

2 Cash and Cash-Equivalents

Cash and cash-equivalents of \$1,408,000 and \$3,074,000 at March 26, 2011 and March 27, 2010, respectively, consist of overnight deposits.

3 Inventories

Inventories, net of reserves, consist of the following:

(Dollars in thousands)	March 26, 2011	March 27, 2010
Raw materials	\$3,518	\$3,337
Work-in-progress	1,349	1,930
Finished goods	134	128
Demonstration inventory	385	408
Total	\$5,386	\$5,803

4 Selling Expenses

Selling expenses consist primarily of commissions paid to various marketing agencies. Commission expense totaled \$565,000 and \$735,000 for fiscal 2011 and 2010, respectively. Advertising costs, which are expensed as incurred, totaled \$98,000 and \$95,000 for fiscal 2011 and 2010, respectively.

5 Significant Customers and Industry Segment Information

The Company has two reportable segments: Giga-tronics Division and Microsource. Giga-tronics Division produces a broad line of test and measurement equipment used in the development, test and maintenance of wireless communications products and systems, flight navigational equipment, electronic defense systems and automatic testing systems and designs, manufactures, and markets a line of switching devices that link together many specific purpose instruments that comprise automatic test systems. Microsource develops and manufactures a broad line of Yttrium, Iron and Garnet (YIG) tuned oscillators, filters and microwave synthesizers, which are used in a wide variety of microwave instruments or devices.

The accounting policies for the segments are the same as those described in the "Summary of Significant Accounting Policies". The Company evaluates the performance of its segments and allocates resources to them based on earnings before income taxes. Segment net sales include sales to external customers. Inter-segment activities are eliminated in consolidation. Assets include accounts receivable, inventories, equipment, cash, deferred income taxes, prepaid expenses and other long-term assets. The Company accounts for inter-segment sales and transfers at terms that allow a reasonable profit to the seller. During the periods reported there were no significant inter-segment sales or transfers.

The Company's reportable operating segments are strategic business units that offer different products and services. They are managed separately because each business utilizes different technology and requires different accounting systems. The Company's chief operating decision maker is considered to be the Company's Chief Executive Officer ("CEO"). The CEO reviews financial information presented on a consolidated basis accompanied by disaggregated information about revenues and pre-tax income by operating segment. The tables below present information for the fiscal years ended in 2011 and 2010.

March 26, 2011 (Dollars in thousands)	Giga-tronics		Total
	Division	Microsource	
Revenue	\$ 13,946	\$ 7,083	\$ 21,029
Interest income, net	--	4	4
Depreciation and amortization	127	22	149
Income (loss) before income taxes	980	(133)	847
Assets	23,228	3,420	26,648

March 27, 2010 (Dollars in thousands)	Giga-tronics		Total
	Division	Microsource	
Revenue	\$ 12,001	\$ 7,056	\$ 19,057
Interest (expense) income, net	(18)	2	(16)
Depreciation and amortization	117	29	146
(Loss) income before income taxes	(30)	1,332	1,302
Assets	7,083	6,836	13,919

The Company's Giga-tronics Division and Microsource segments sell to agencies of the U.S. government and U.S. defense-related customers. In fiscal 2011 and 2010, U.S. government and U.S. defense-related customers accounted for 44% and 62% of sales, respectively. During fiscal 2011, one customer other than U.S. government agencies and their defense contractors accounted for 10% or more of the Company's consolidated revenues at March 26, 2011. During fiscal 2010, no customer other than U.S. government agencies and their defense contractors accounted for 10% of the Company's consolidated revenues at March 27, 2010.

Export sales accounted for 40% and 21% of the Company's sales in fiscal 2011 and 2010, respectively. Export sales by geographical area are shown below:

(Dollars in thousands)	March 26, 2011	March 27, 2010
Americas	\$ 1,603	\$ 23
Europe	1,148	2,251
Asia	5,477	989
Rest of world	254	702
Total	\$ 8,482	\$ 3,965

6 Earnings per Share

Net income and shares used in per share computations for the years ended March 26, 2011 and March 27, 2010 are as follows:

(In thousands except per-share data)	March 26, 2011	March 27, 2010
Net income	\$ 14,072	\$ 1,300
Weighted average:		
Common shares outstanding	4,935	4,846
Potential common shares	105	61
Common shares assuming dilution	5,040	4,907
Net earnings per share of common stock	\$2.85	\$0.27
Net earnings per share of common stock assuming dilution	\$2.79	\$0.26
Stock options not included in computation that could potentially dilute basic EPS in the future	636	568
Restricted stock awards not included in computation that could potentially dilute basic EPS in the future	90	-

The number of stock options not included in the computation of diluted earnings per share (EPS) for the periods ended March 26, 2011 and March 27, 2010 reflect stock options where the exercise prices were greater than the average market price of the common shares and are, therefore, antidilutive.

7 Income Taxes

Following are the components of the provision for income taxes:

Years Ended (In thousands)	March 26, 2011	March 27, 2010
Current		
Federal	\$29	\$---
State	2	2
Total current	31	2
Deferred		
Federal	2,283	442
State	41	72
Total deferred	2,324	514
Change in liability for uncertain tax positions	714	(70)
Change in valuation allowance	(16,294)	(444)
Provision for income taxes	\$(13,225)	\$2)

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

Year Ended (In thousands)	March 26, 2011	March 27, 2010
Net operating loss carryforwards	\$9,410	\$12,059
Income tax credits	1,426	2,202
Inventory reserves and additional capitalized costs	1,785	1,688
Fixed asset depreciation	100	122
Accrued vacation	117	114
Accrued warranty	79	55
Deferred rent	179	---
Other accrued liabilities	---	---
Allowance for doubtful accounts	100	38
Non-qualified stock options	60	14
State taxes benefit	---	2
Total deferred tax assets	13,256	16,294
Valuation allowance	---	(16,294)
Net deferred tax assets	\$13,256	---

Years Ended (In thousands except percentages)	March 26, 2011			March 27, 2010		
Statutory federal income tax (benefit)	\$288	34.0 %		\$443	34.0 %	
Valuation allowance	(16,294)	(1,923.7)		(444)	(30.2)	
State income tax, net of federal benefit	49	5.8		76	5.8	
Net operating loss expiration	2,023	238.8		-	-	
Non tax-deductible expenses	72	8.5		52	4.0	
Tax credits	(85)	(10.0)		(54)	(4.1)	
Liability for uncertain tax positions	714	84.3		(70)	(9.2)	
Other	8	0.9		(1)	1.5	
Effective income tax	\$(13,225)	(1,561.4)%		\$2	0.7 %	

The decrease in valuation allowance from March 27, 2010 to March 26, 2011 was \$16,294,000.

As of March 26, 2011, the Company had pre-tax federal net operating loss carryforwards of \$24,204,000 and state net operating loss carryforwards of \$20,239,000 available to reduce future taxable income. The federal and state net operating loss carryforwards begin to expire from fiscal 2016 through 2029 and from 2014 through 2020, respectively. \$1,275,000 of federal net operating loss carryforwards are subject to an annual IRC § 382 limitation of approximately \$100,000. At March 26, 2011, the accumulated IRC § 382 losses available for use are approximately \$1,098,000. Utilization of net operating loss carryforwards may be subject to annual limitations due to certain ownership change limitations as required by Internal Revenue Code Section 382. The federal income tax credits begin to expire from 2020 through 2029 and state income tax credit carryforwards are carried forward indefinitely.

The Company has recorded a valuation allowance to reflect the estimated amount of deferred tax assets, which may not be realized. The ultimate realization of deferred tax assets is dependent upon generation of future taxable income during the periods in which those temporary differences become deductible. Management considers both positive and

negative evidence and tax planning strategies in making this assessment.

The Company has demonstrated consistent pre-tax book income and does not have cumulative losses over the past three years. The Company's FY 2011 Budget and Strategic Plans for FY 2012 and FY 2013 are all forecasted to be profitable. The Company continues to maintain a two year backlog of orders for its YIG (Yttrium, Iron, Garnet) filters and projects continued orders. Its legacy Model 8003 precision scalar analyzer continues to receive orders from the U.S. Navy one of which was booked for \$1.1 million in the first quarter. The Company is now serving a new market in the consumer wireless handheld telecommunication market with its high volume production automation switch for which it received several small orders in the first quarter which is expected to lead to much larger orders in the future. The Company has entered the semiconductor market with its new integrated switch product for testing thin-film memory storage components.

The Test and Measurement market is forecasted to grow at the rate of 4% per year, per industry forecasting experts. The Company has no known contingencies or unsettled circumstances. Based on historical income and projections for future taxable income over the periods in which the deferred tax assets become deductible, management believes the Company is more likely than not to realize benefits of these deductible differences. Management has, therefore, reversed the valuation allowance against its deferred tax assets, resulting in an income tax benefit of \$13,569,000 for the three month period ended June 26, 2010. At year end, the deferred tax asset balance was \$13,256,000.

As of March 26, 2011, the Company recorded unrecognized tax benefits of \$834,000 related to uncertain tax positions. The unrecognized tax benefit is netted against the non-current deferred tax asset on the Consolidated Balance Sheet. The Company has not recorded a liability for any penalties or interest related to the unrecognized tax benefits.

The Company files U.S federal and California state tax returns. The Company is generally no longer subject to tax examinations for years prior to the fiscal year 2008 for federal purposes and fiscal year 2007 for California purposes, except in certain limited circumstances. The Company does not have any tax audits pending.

A reconciliation of the beginning and ending amount of the liability for uncertain tax positions, excluding potential interest and penalties, is as follows:

	Fiscal Year 2011	Fiscal Year 2010
Balance as of beginning of year	120,000	\$ 190,000
Additions based on current year tax positions	34,000	100,000
Reductions for prior year tax positions and lapses of applicable statute	(72,000)	(170,000)
Additions based on prior year tax positions	752,000	---
Balance as of end of year	\$ 834,000	\$ 120,000

The total amount of interest and penalties related to unrecognized tax benefits at March 26, 2011 and March 27, 2010 is not material. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within next twelve months.

8 Share-based Compensation and Employee Benefit Plans

Share-based Compensation The Company established the 2000 Stock Option Plan and the 2005 Equity Incentive Plan, each of which provide for the granting of options and restricted stock for up to 1,400,000 shares of common stock at 100% of fair market value at the date of grant, with each grant requiring approval by the Board of Directors of the Company. Options granted vest in one or more installments through 2014 and must be exercised while the grantee is employed by the Company or within a certain period after termination of employment. Options granted to employees shall not have terms in excess of 10 years from the grant date. Holders of options may be granted stock appreciation rights (SAR), which entitle them to surrender outstanding options for a cash distribution under certain changes in ownership of the Company, as defined in the stock option plan. As of March 26, 2011, no SAR's have been granted under the option plan. As of March 26, 2011, the total number of shares of common stock available for issuance is 155,725 under the 2000 and 2005 stock option plans. All outstanding options have a term of five years.

A summary of the changes in stock options outstanding for the years ended March 26, 2011 and March 27, 2010 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Terms (Years)	Aggregate Intrinsic Value
Outstanding at March 28, 2009	747,900	\$ 1.91	2.7	\$ 2,795
Granted	320,500	2.07		
Exercised	67,373	1.85		
Forfeited / Expired	133,000	2.46		
Outstanding at March 27, 2010	868,027	\$ 1.89	3.0	\$ 332,127
Granted	140,000	2.41		
Exercised	102,763	1.90		
Forfeited / Expired	20,250	2.18		
Outstanding at March 26, 2011	885,014	\$ 1.96	2.5	\$ 459,708
Exercisable at March 26, 2011	468,514	\$ 1.90	1.5	\$ 276,708
Expected to vest at March 26, 2011	324,068	\$ 2.03	3.5	\$ 142,388

As of March 26, 2011, there was \$345,934 of total unrecognized compensation cost related to nonvested options granted under the plans. That cost is expected to be recognized over a weighted average period of 1.12 years. There were 252,224 and 147,349 options vested during the years ended March 26, 2011 and March 27, 2010 respectively. The total fair value of options vested during the years ended March 26, 2011 and March 27, 2010 was \$314,017 and \$167,954, respectively. Cash received from stock option exercises for the years ended March 26, 2011 and March 27, 2010 was \$195,000 and \$124,000, respectively.

There were 90,000 restricted stock awards granted during the year ended March 26, 2011 and no restricted stock awards granted during the year ended March 27, 2010. The restricted stock awards are considered fixed awards as the number of shares and fair value are known at the grant date and the fair value at the grant date is amortized over the requisite service period net of estimated forfeitures. The restricted stock awards are performance-based and one-third will vest annually each year through 2013 only if certain sales and profit goals are achieved by the Company. The weighted average grant date fair value of awards granted during the year ended March 26, 2011 was \$2.34. No compensation cost was recognized for restricted stock awards because management believes it is not more likely than not that the performance criteria will be met.

Employee Stock Purchase Plan This plan expired in September 2006 and is no longer available.

401(k) Plans The Company has established 401(k) plans which cover substantially all employees. Participants may make voluntary contributions to the plans for up to 100% of their defined compensation. The Company matches a percentage of the participant's contributions in accordance with the plan. Participants vest ratably in Company contributions over a four-year period. Company contributions to the plans for fiscal 2011 and 2010 were approximately \$24,000 and \$15,000, respectively.

The Company leases a 47,300 square foot facility located in San Ramon, California, under a twelve-year lease that commenced in April 1994, which was amended on April 1, 2010 and now expires December 31, 2016. The amendment resulted in a reduction of monthly lease costs. The Company leases a 33,400 square foot facility located in Santa Rosa, California, under a twenty-year lease that commenced in July 1993 and was amended in April 2003, to now expire May 31, 2013.

These facilities accommodate all of the Company's present operations. The Company also leases other equipment under operating leases.

Total future minimum lease payments under these leases amount to approximately \$4,528,000.

Fiscal year (Dollars in thousands)	
2012	\$978
2013	1,000
2014	696
2015	654
2016	677
Thereafter	523
Total	\$4,528

The aggregate rental expense was \$1,025,000 and \$968,000 in fiscal 2011 and 2010, respectively.

The Company leases equipment under capital leases that expire through October 2011. The future minimum lease payments under these leases amount to approximately \$108,000.

The Company is committed to purchase certain inventory under non-cancelable purchase orders. As of March 26, 2011, total non-cancelable purchase orders were approximately \$1,248,000 through fiscal 2012 and \$90,000 beyond fiscal 2012 and were scheduled to be delivered to the Company at various dates through December 2012.

10 Warranty Obligations

The Company records a liability in cost of sales for estimated warranty obligations at the date products are sold. Adjustments are made as new information becomes available. The following provides a reconciliation of changes in the Company's warranty reserve. The Company provides no other guarantees.

(Dollars in thousands)	March 26, 2011	March 27, 2010
Balance at beginning of period	\$ 139	\$ 177
Provision, net	237	84
Warranty costs incurred	(176)	(122)
Balance at end of period	\$200	\$ 139

11 Line of Credit

The Company has a secured revolving line of credit with a financial institution for a total borrowing capacity of \$1,500,000. The maximum amount that can be borrowed is limited to 80% of trade receivables. Interest is payable at prime plus 1%. The Company is required to comply with certain financial covenants under the arrangement. The Company has re-negotiated a new line of credit effective June 15, 2010, which expires on June 15, 2011. At March 26, 2011, the Company is in compliance with the covenants relating to the line of credit. At March 26, 2011 and March 27, 2010, there was no balance outstanding on the line of credit.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Giga-tronics Incorporated

We have audited the accompanying consolidated balance sheets of Giga-tronics Incorporated (the “Company”) as of March 26, 2011 and March 27, 2010 and the related consolidated statements of income, shareholders’ equity and cash flows for the years then ended. These consolidated 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 audits.

We conducted our audits 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Giga-tronics Incorporated as of March 26, 2011 and March 27, 2010, 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.

/s/ Perry-Smith LLP

San Francisco, California
May 19, 2011

SIGNATURES

In accordance with the requirements of Section 13 or 15(d) of the Securities Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

GIGA-TRONICS INCORPORATED

Dated: 6/20/2011

/s/ JOHN R. REGAZZI
Chief Executive Officer

Dated: 6/20/2011

/s/ PATRICK J. LAWLOR
VP Finance/Chief Financial Officer & Secretary

The following exhibits are filed by reference or herewith as a part of this report:

Index To Exhibits

- | | |
|------|--|
| 3.1 | Articles of Incorporation of the Registrant, as amended, previously filed as Exhibit 3.1 to Form 10-KSB for the fiscal year ended March 27, 1999 and incorporated herein by reference. |
| 3.2 | Amended and Restated Bylaws of Giga-tronics Incorporated, as amended on March 7, 2008, previously filed as Exhibit 3.2 to Form 10-K for the fiscal year ended March 29, 2008, and incorporated herein by reference. |
| 10.1 | Standard form Indemnification Agreement for Directors and Officers, previously filed as Exhibit 10.1 to Form 10-K for the fiscal year ended March 27, 2010, and incorporated herein by reference. |
| 10.2 | First Amendment to Office Lease Agreement between Giga-tronics Incorporated and VIF/ZKS Norris Tech Center, LLC, for 4650 Norris Canyon Road, San Ramon, CA, dated March 29, 2010, previously filed as Exhibit 10.2 to Form 10-K for the fiscal year ended March 27, 2010, and incorporated herein by reference. |
| 10.3 | 2000 Stock Option Plan and form of Incentive Stock Option Agreement, previously filed on September 8, 2000 as Exhibit 99.1 to Form S-8 (33-45476) and incorporated herein by reference. * |
| 10.4 | 2005 Equity Incentive Plan incorporated herein by reference to Attachment A of the Registrant's Proxy Statement filed July 21, 2005. * |
| 21 | Significant Subsidiaries, previously filed on May 19, 2011 and incorporated herein by reference. |
| 23.1 | Consent of Independent Registered Public Accounting Firm, Perry-Smith LLP. |
| 31.1 | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002, amended June 20, 2011. |
| 31.2 | Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002, amended June 20, 2011. |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, amended June 20, 2011. |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the |

* Management contract or compensatory plan or arrangement.