RGC RESOURCES INC
Form 10-Q/A
April 21, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/A

Amendment No. 1

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended December 31, 2003

Commission File Number 000-26591

RGC Resources, Inc.

(Exact name of Registrant as Specified in its Charter)

VIRGINIA	**54-1909697**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
519 Kimball Ave., N.E., Roanoke, VA	**24016**
(Address of Principal Executive Offices)	**(Zip Code)**

(540) 777-4427

(Registrant s Telephone Number, Including Area Code)

None

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the close of the period covered by this report.

Class	Outstanding at December 31, 2003
Common Stock, $5 Par Value	2,014,576

EXPLANATORY NOTE

This Amendment No. 1 to the Quarterly Report on Form 10-Q of RGC Resources Inc. and Subsidiaries for the quarter ended December 31, 2003 is being filed for the purpose of amending and revising the Condensed Consolidated Balance Sheets Unaudited and Condensed Note 10 to the Condensed Consolidated Financial Statements Unaudited. In accordance with accounting guidance issued subsequent to the original 10-Q filing on February 13, 2004, the originally filed Quarterly Report on Form 10-Q is being amended to reflect the reclassification of amounts recorded for the cost of removal of utility plant, previously recognized within accumulated depreciation, as a separate liability and a regulatory liability for the periods ended December 31, 2003, and September 30, 2003. This amendment does not reflect events occurring after the original filing of the Form 10-Q or modify or update those disclosures except as stated in the preceding sentence.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

UNAUDITED

	December 31, 2003	September 30, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,412,945	$ 135,998
Accounts receivable - (less allowance for uncollectibles of $741,799 and $318,899, respectively)	18,902,360	6,183,162
Inventories	2,710,830	2,559,306
Prepaid gas service	10,995,800	14,782,752
Prepaid income taxes		1,079,802
Deferred income taxes	2,007,411	1,605,509
Under-recovery of gas costs	862,513	790,126
Unrealized gains on marked-to-market transactions	503,330	
Other	1,032,883	541,322
Total current assets	38,428,072	27,677,977
Property, Plant And Equipment:		
Utility plant in service	97,035,515	96,385,022
Accumulated depreciation and amortization	(33,788,153)	(33,136,643)
Utility plant in service, net	63,247,362	63,248,379
Construction work in progress	2,476,600	1,992,222
Utility Plant, Net	65,723,962	65,240,601
Nonutility property	21,019,094	20,793,278
Accumulated depreciation and amortization	(9,018,341)	(8,832,823)
Nonutility property, net	12,000,753	11,960,455
Total property, plant and equipment	77,724,715	77,201,056
Other Assets:		
Goodwill	298,314	298,314
Other assets	774,220	769,754
Total other assets	1,072,534	1,068,068
Total Assets	$ 117,225,321	$ 105,947,101

See notes to condensed consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

UNAUDITED

	December 31, 2003	September 30, 2003
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Current maturities of long-term debt	$ 32,959	$ 1,032,372
Borrowings under lines of credit	19,080,000	12,992,000
Dividends payable	574,562	571,458
Accounts payable	12,222,268	9,289,899
Income taxes payable	613,371	
Customer deposits	620,628	477,465
Accrued expenses	4,273,320	4,798,106
Refunds from suppliers due customers	44,776	42,320
Overrecovery of gas costs	2,611,624	1,172,585
Unrealized losses on marked to market transactions	189,381	319,264
Total current liabilities	40,262,889	30,695,469
Long-term Debt, Excluding Current Maturities	30,211,523	30,219,987
Deferred Credits:		
Asset retirement obligations	5,706,666	5,449,702
Deferred income taxes	5,584,358	5,457,991
Deferred investment tax credits	258,046	266,338
Total deferred credits	11,549,070	11,174,031
Stockholders Equity:		
Common stock, $5 par value; authorized, 10,000,000 shares; issued and outstanding 2,014,576 and 2,003,232 shares, respectively	10,072,880	10,016,160
Preferred stock, no par, authorized, 5,000,000 shares; no shares issued and outstanding		
Capital in excess of par value	12,179,869	11,977,084
Retained earnings	13,043,761	12,018,920
Accumulated other comprehensive loss	(94,671)	(154,550)
Total stockholders equity	35,201,839	33,857,614
Total Liabilities and Stockholders Equity	$ 117,225,321	$ 105,947,101

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE-MONTH PERIODS ENDED DECEMBER 31, 2003 AND 2002

UNAUDITED

	Three Months Ended December 31,	
	2003	**2002**
Operating Revenues:		
Gas utilities	$ 25,232,488	$ 21,093,267
Propane operations	4,367,615	4,449,776
Energy marketing	4,493,413	2,716,562
Other	207,256	196,522
Total operating revenues	34,300,772	28,456,127
Cost of Sales:		
Gas utilities	18,632,493	14,931,493
Propane operations	2,385,019	2,104,523
Energy marketing	4,436,987	2,643,631
Other	88,700	110,683
Total cost of sales	25,543,199	19,790,330
Operating Margin	8,757,573	8,665,797
Other Operating Expenses:		
Operations	3,431,849	3,410,902
Maintenance	354,071	360,906
General taxes	470,463	459,076
Depreciation and amortization	1,369,518	1,335,529
Total other operating expenses	5,625,901	5,566,413
Operating Income	3,131,672	3,099,384
Other Expenses, net	(881)	39,309
Interest Expense	544,966	554,576
Income Before Income Taxes	2,587,587	2,505,499
Income Tax Expense	988,184	967,362
Net Income	$ 1,599,403	$ 1,538,137

Basic Earnings Per Common Share	$ 0.80	$ 0.78
Diluted Earnings Per Common Share	$ 0.79	$ 0.78

See notes to condensed consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE THREE-MONTH PERIODS ENDED DECEMBER 31, 2003 AND 2002

UNAUDITED

	Three Months Ended December 31,	
	2003	**2002**
Net Income	$ 1,599,403	$ 1,538,137
Reclassification of loss (gain) transferred to net income	19,650	(73,772)
Unrealized gain (loss) on cash flow hedges	40,229	(83,038)
Other comprehensive income (loss), net of tax	59,879	(156,810)
Comprehensive Income	$ 1,659,282	$ 1,381,327

See notes to condensed consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE-MONTH PERIODS ENDED DECEMBER 31, 2003 AND 2002

UNAUDITED

	Three Months Ended December 31, 2003	Three Months Ended December 31, 2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,599,403	$ 1,538,137
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,428,757	1,391,516
Gain on asset disposition	(14,853)	(3,467)
Deferred taxes and investment tax credits	(283,827)	350,236
Changes in assets and liabilities which provided (used) cash, exclusive of changes and noncash transactions shown separately	(4,540,104)	(7,627,352)
Net cash used in operating activities	(1,810,624)	(4,350,930)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to utility plant and nonutility property	(1,712,366)	(1,891,849)
Cost of removal of utility plant, net	(26,239)	1,415
Proceeds from sales of assets	58,006	10,861
Net cash used in investing activities	(1,680,599)	(1,879,573)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt	2,000,000	8,000,000
Retirement of long-term debt and capital leases	(2,132,876)	(32,330)
Net borrowings (repayments) under lines of credit	5,213,000	(1,396,000)
Cash dividends paid	(571,459)	(559,070)
Proceeds from issuance of stock	259,505	215,070
Net cash provided by financing activities	4,768,170	6,227,670
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,276,947	(2,833)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	135,998	288,030
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,412,945	$ 285,197
SUPPLEMENTAL INFORMATION:		
Interest paid	$ 718,438	$ 922,940
Income taxes refunded, net	(383,928)	(825,067)

Noncash transactions:

The Company executed a $2,000,000 intermediate term note in October 2003, which resulted in the reclassification of $1,125,000 from current maturities of long-term debt and $875,000 from borrowings under lines of credit to long-term debt on the September 30, 2003 balance sheet as the Company met the requirements for making the reclassification.

See notes to condensed consolidated financial statements.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

1. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary to present fairly RGC Resources, Inc. s financial position as of December 31, 2003 and the results of its operations and its cash flows for the three months ended December 31, 2003 and 2002. Because of seasonal and other factors, the results of operations for the three months ended December 31, 2003 are not indicative of the results to be expected for the fiscal year ending September 30, 2004. Quarterly earnings are affected by the highly seasonal nature of the business as variations in weather conditions generally result in greater earnings during the winter months.

2. The condensed consolidated financial statements and condensed notes are presented as permitted by Form 10-Q and do not contain certain information included in the Company s annual consolidated financial statements and notes thereto. The condensed consolidated financial statements and condensed notes should be read in conjunction with the financial statements and notes contained in the Company s Form 10-K.

3. On October 1, 2003, Bluefield Gas Company executed a $2,000,000 unsecured 26 month note to refinance a portion of it s maturing long-term debt and a portion of it s outstanding line-of-credit balance. The note has a variable interest rate based on 30-day LIBOR plus 113 basis point spread. The note maturity was structured to correspond with maturity periods of other debt instruments of RGC Resources, Inc. to allow for a more comprehensive debt offering in the future. Because the Company had both the intent and ability to execute the note at the end of its fiscal year, the Company reclassified the $2,000,000 from current maturities of long-term debt and lines-of-credit to long-term debt on its September 30, 2003 Balance Sheet.

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

The Company has historically entered into futures, swaps and caps for the purpose of hedging the price of propane in order to provide price stability during the winter months. During 2003, the Company had entered into propane price cap arrangements due to the uncertainty of energy prices during the current heating season. The price caps provide protection against increasing prices and allow the Company to benefit from reductions in energy prices. The price caps qualify as cash flow hedges; therefore, changes in the fair value are reported in other comprehensive income. No portion of the hedges were ineffective during the three months ended December 31, 2003 and 2002.

In addition, the Company has historically entered into futures, swaps and caps for the purpose of hedging the price of natural gas in order to provide price stability during the winter months. During 2003, the Company had entered into both price caps and swap

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

arrangements for the purchase of natural gas. The fair value of these instruments is recorded in the balance sheet with the offsetting entry to over-recovery or under-recovery of gas costs. Net income and other comprehensive income are not affected by the change in market value as any cost incurred or benefit received from these instruments is recoverable or refunded through the regulated natural gas purchased gas adjustment (PGA) mechanism. Both the Virginia State Corporation Commission (SCC) and the West Virginia Public Service Commission (PSC) currently allow for full recovery of prudent costs associated with natural gas purchases, and any additional costs or benefits associated with the settlement of these instruments will be passed through to customers when realized.

The Company also entered into an interest rate swap related to the $8,000,000 note issued in November 2002. The swap essentially converted the three-year floating rate note into fixed rate debt with a 4.18 percent interest rate. The swap qualifies as a cash flow hedge with changes in fair value reported in other comprehensive income.

A summary of the derivative activity is provided below:

	Propane Derivatives	Interest Rate Swap	Natural Gas Derivative	Total
Three Months Ended December 31, 2003				
Unrealized gains/(losses) on derivatives	$ 47,082	$ 18,513	$	$ 65,595
Income tax (expense)/benefit	(18,338)	(7,028)		(25,366)
Net unrealized gains/(losses)	28,744	11,485		40,229
Transfer of realized losses/(gains) to income	(9,702)	41,220		31,518
Income tax (benefit)/expense	3,779	(15,647)		(11,868)
Net transfer of realized losses/(gains) to income	(5,923)	25,573		19,650
Net other comprehensive income/(loss)	$ 22,821	$ 37,058	$	$ 59,879
Unrealized gain/(loss) on marked to market transactions	$ 37,380	$ (189,381)	465,950	$ 313,949
Accumulated comprehensive income/(loss)	22,821	$ (117,492)		$ (94,671)

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

	Propane Derivatives	Interest Rate Swap	Natural Gas Derivative	Total
Three Months Ended December 31, 2002				
Unrealized gains/(losses) on derivatives	$ 80,498	$ (213,059)	$	$ (132,561)
Income tax (expense)/benefit	(31,354)	80,877		49,523
Net unrealized gains/(losses)	49,144	(132,182)		(83,038)
Transfer of realized losses/(gains) to income	(120,839)			(120,839)
Income tax benefit/expense	47,067			47,067
Net transfer of realized losses/(gains) to income	(73,772)			(73,772)
Net other comprehensive income/(loss)	$ (24,628)	$ (132,182)	$	$ (156,810)
Unrealized gain/(loss) on marked to market transactions	$ 179,550	$ (213,059)	1,351,500	$ 1,317,991
Accumulated comprehensive income/(loss)	109,615	$ (132,182)		$ (22,567)

5. Basic earnings per common share are based on the weighted average number of shares outstanding during each period. The weighted average number of shares outstanding for the three-month period ended December 31, 2003 was 2,010,247 compared to 1,967,635 for the same period last year. The weighted average number of shares outstanding assuming dilution was 2,021,897 for the three-month period ended December 31, 2003 compared to 1,968,735 for the same period last year. The difference between the weighted average number of shares for the calculation of basic and diluted earnings per share relates to the dilutive effect associated with the assumed issuance of stock options as calculated using the Treasury Stock method.

6. RGC Resources, Inc. s reportable segments are included in the following table. The segments are comprised of natural gas, propane, energy marketing and other. Other is composed of appliance services, information system services and certain corporate eliminations.

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

	Natural Gas	Propane	Energy Marketing	Other	Total
For the Three Months Ended December 31, 2003					
Operating revenues	25,232,488	4,367,615	4,493,413	207,256	34,300,772
Operating margin	6,599,995	1,982,596	56,426	118,556	8,757,573
Income before income taxes	1,951,938	473,747	45,419	116,483	2,587,587
As of December 31, 2003:					
Total assets	93,227,592	14,208,989	3,648,444	433,630	111,518,655
Gross additions to long-lived assets	1,262,905	449,334		127	1,712,366
For the Three Months Ended December 31, 2002					
Operating revenues	21,093,267	4,449,776	2,716,562	196,522	28,456,127
Operating margin	6,161,774	2,345,253	72,931	85,839	8,665,797
Income before income taxes	1,582,514	775,282	63,033	84,670	2,505,499
As of December 31, 2002:					
Total assets	81,776,129	15,645,906	1,579,741	622,832	99,624,608
Gross additions to long-lived assets	1,100,466	791,383			1,891,849

7. The Company has a Key Employee Stock Option Plan (the Plan), which is intended to provide the Company s executive officers with long-term (ten-year) incentives and rewards tied to the price of the Company s common stock. The Company applies the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for this Plan. No stock-based employee compensation expense is reflected in net income as all options granted under the Plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to the options granted under the Plan.

	3 Months Ended December 31	
	2003	**2002**
Net income, as reported	$ 1,599,403	$ 1,538,137
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of tax		(3,291)
Pro forma net income	$ 1,599,403	$ 1,534,846
Earnings per share:		
Basic - as reported	$ 0.80	$ 0.78
Basic - pro forma	$ 0.80	$ 0.78
Diluted - as reported	$ 0.79	$ 0.78
Diluted - pro forma	$ 0.79	$ 0.78

Weighted Average Shares	2,010,247	1,967,635
Diluted Average Shares	2,021,897	1,968,735

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

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

	Three Months Ended December 31	
	2003	**2002**
Components of net periodic pension cost:		
Service cost	$ 95,397	$ 75,217
Interest cost	153,347	150,569
Expected return on plan assets	(127,100)	(127,535)
Amortization of unrecognized transition obligation		283
Recognized (gain) loss	30,888	5,856
Net periodic pension cost	$ 152,532	$ 104,390

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

	Three Months Ended December 31	
	2003	**2002**
Components of net periodic postretirement benefit cost:		
Service cost	$ 50,414	$ 42,877
Interest cost	136,776	138,855
Expected return on plan assets	(33,630)	(30,410)
Amortization of unrecognized transition obligation	59,325	59,325
Recognized (gain) loss	28,225	14,977
Net periodic benefit cost	$ 241,110	$ 225,624

Total expected employer funding contributions during the fiscal year ended September 30, 2004 are $700,000 for the pension plan and $750,000 for the post retirement plan.

9. Both Roanoke Gas Company and Bluefield Gas Company, subsidiaries of RGC Resources, Inc., operated manufactured gas plants (MGPs) as a source of fuel for lighting and heating until the early 1950 s. A by-product of operating MGPs was coal tar, and the potential exists for on-site tar waste contaminants at the former plant sites. The extent of contaminants at these sites, if any, is unknown at this time. An analysis at the Bluefield Gas Company site indicates some soil contamination. The Company, with concurrence of legal counsel, does not believe any events have occurred requiring regulatory reporting. Further, the Company has not received any notices of violation or liabilities associated with environmental regulations related to the MGP sites and is not aware of any off-site contamination or pollution as a result of prior operations. Therefore, the Company has no plans for subsurface remediation at the MGP sites. Should the Company eventually be required to remediate either site, the Company will pursue all prudent and reasonable means to recover any related costs, including insurance claims and regulatory approval for rate case recognition of expenses associated with any work required. A stipulated rate case agreement between the Company and the West Virginia Public Service Commission recognized the Company s right to defer MGP clean-up costs, should any be incurred, and to seek rate relief for such costs. If the Company eventually incurs costs associated with a required clean-up of either MGP site, the Company anticipates recording a regulatory asset for such clean-up costs to be recovered in future rates. Based on anticipated regulatory actions and current practices, management believes that any costs incurred related to this matter will not have a material effect on the Company s financial condition or results of operations.

10. The Company adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*, on October 1, 2002. SFAS No. 143 requires the reporting at fair value of a legal obligation associated with the retirement of tangible long-lived assets that result from acquisition,

RGC RESOURCES, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

construction or development. Management has determined that the Company has no material legal obligations for the retirement of its assets. However, the Company provides a provision, as part of its depreciation expense, for the ultimate cost of asset retirements and removal. Removal costs are not a legal obligation as defined by SFAS No. 143 but rather the result of cost-based regulation and therefore accounted for under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. Upon adoption of SFAS No. 143, the Company classified removal costs that do not have an associated legal retirement obligation as a regulatory liability, in accordance with regulatory treatment.

In accordance with guidance that became available subsequent to the Company s filing of its Quarterly Report on Form 10-Q on February 13, 2004, the Company has reclassified the estimated costs of removal of utility plant previously recognized in accumulated depreciation as a separate liability for the periods ended December 31, 2003 and September 30, 2003. As a result of the adoption of SFAS No. 143, these liabilities are reported as regulatory liabilities.

The following table shows how consolidated utility plant, net and deferred credits and other liabilities on the balance sheet have been revised.

	December 31, 2003	**September 30, 2003**
Utility plant, net - as reported	$ 60,017,296	$ 59,790,899
Utility plant, net reclassification	5,706,666	5,449,702
Utility plant, net - as revised	$ 65,723,962	$ 65,240,601
Total deferred credits and other Liabilities - as reported	$ 5,842,404	$ 5,724,329
Total deferred credits and other Liabilities reclassification	5,706,666	5,449,702
Total deferred credits and other Liabilities - as revised	$ 11,549,070	$ 11,174,031

The Company also adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* on October 1, 2002. The adoption of the standard had no material impact on the Company s financial position or results of operations.

RGC RESOURCES, INC. AND SUBSIDIARIES

ITEM 2- MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

RGC Resources, Inc. is an energy services company primarily engaged in the regulated sale and distribution of natural gas to approximately 59,300 residential, commercial and industrial customers in Roanoke, Virginia and Bluefield, Virginia and West Virginia and the surrounding areas through its Roanoke Gas Company and Bluefield Gas Company subsidiaries. Natural gas service is provided at rates and for the terms and conditions set forth by the State Corporation Commission (SCC) in Virginia and the Public Service Commission (PSC) in West Virginia.

RGC Resources, Inc. also provides unregulated energy products through Diversified Energy Company, which operates as Highland Propane Company and Highland Energy Company. Highland Propane sells and distributes propane to approximately 18,500 customers in western Virginia and southern West Virginia. Highland Energy brokers natural gas to several industrial transportation customers of Roanoke Gas Company and Bluefield Gas Company. Propane sales have become a more significant portion of the consolidated operation with an annual growth rate that far exceeds the growth in natural gas customers.

RGC Resources, Inc. also provides information system services to software providers in the utility industry through RGC Ventures, Inc. of Virginia, which operates as Application Resources.

Management views warm winter weather; energy conservation, fuel switching and bad debts due to high energy prices; and competition from alternative fuels each as factors that could have a significant impact on the Company s earnings.

For the quarter ended December 31, 2003, rising energy prices continued to be a primary concern for management as higher prices could result in customer retention issues, higher customer account delinquencies and reduced usage through conservation and fuel switching. In addition, the warmer weather has led to reduced deliveries of both natural gas and propane as compared to the same period last year.

Results of Operations

Consolidated net income for the three-month period ended December 31, 2003 was $1,599,403 compared to $1,538,137 for the same period last year.

Total operating revenues for the three months ended December 31, 2003 increased by $5,844,645, or 21 percent, compared to the same period last year, primarily due to increasing gas costs and implementation of base rate increases. The average cost of natural gas and propane increased by 35 percent and 24 percent, respectively. Sales volumes declined for both the natural gas and propane activity with total regulated natural gas deliveries decreasing by more than 3 percent, while propane deliveries declined by nearly 9 percent. The total number of heating-degree days (an industry measure by which the average daily temperature falls below 65

RGC RESOURCES, INC. AND SUBSIDIARIES

ITEM 2 - MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

degrees Fahrenheit) declined by 11 percent from the same period last year. Energy marketing volumes, on the other hand, increased by 27 percent due in part to the recovering economy and to the return of a few customers who had purchased natural gas from other sources. Other revenues increased by 5 percent due to a higher level of service billing work.

	Quarter Ended 12/31/03	**Quarter Ended 12/31/02**	**Increase/ (Decrease)**	**Percentage**
Operating Revenues				
Gas Utilities	25,232,488	21,093,267	4,139,221	20%
Propane Operations	4,367,615	4,449,776	(82,161)	-2%
Energy Marketing	4,493,413	2,716,562	1,776,851	65%
Other	207,256	196,522	10,734	5%
Total Operating Revenues	34,300,772	28,456,127	5,844,645	21%

Total operating margin increased by $91,776, or 1 percent, for the quarter ended December 31, 2003 over the same period last year. Regulated natural gas margins increased by $438,221, or 7 percent, even though total delivered volume (tariff and transporting) decreased by 126,025 dekatherms, or 3 percent. Tariff sales, primarily consisting of residential and commercial usage, declined 8 percent due to the 11 percent decline in heating degree-days from the same period last year. Transporting volumes, which correlate more with economic conditions rather than weather, provided a strong increase of 14 percent, reflecting improvement in the economy and increased industrial production. The Company was able to realize an increase in the regulated natural gas margins due to a non gas cost rate increase effective October 16, 2003 for Roanoke Gas Company and the implementation of a new billing rate structure in April 2003 which allowed Roanoke Gas Company to recover the specific costs associated with financing its investment in gas inventory and prepaid gas service. Both Roanoke Gas Company and Bluefield Gas Company placed increased rates into effect during the quarter ended December 31, 2003. Roanoke Gas Company s rates were placed into effect subject to refund pending a final order from the Virginia SCC. Bluefield Gas Company s rates were placed into effect in accordance with a final rate order issued by the West Virginia PSC. As a result of the rate increases, the Company realized approximately $196,000 in additional customer base charges, which is a flat monthly fee billed to each natural gas customer, and approximately $270,000 associated with increase in the volumetric price of natural gas. More information regarding the rate increase may be found under the Regulatory Affairs section below.

Furthermore, prior to April 2003, billing rates for Roanoke Gas Company customers included a component to recover the financing costs of natural gas inventory and prepaid gas service based upon historical inventory levels and historical interest rates and the allowed rate of return on equity. Therefore, when costs increased, the Company had to absorb the higher financing costs without rate relief. The new rate structure provides for a different recovery mechanism, which

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also results in different timing of revenue recognition. The Company is able to recover higher financing costs related to increased inventory and prepaid gas balances arising from higher gas costs; conversely, the Company will pass along savings to customers if financing costs decrease due to lower inventory and prepaid gas balances resulting from reductions in gas costs. The new rate structure resulted in the recognition of additional revenue related to the recovery of these financing costs during fiscal 2003. Under the new rate structure, the revenue associated with the calculated carrying cost is accrued based upon gas inventory and prepaid gas levels, primarily during the summer and fall as gas is being injected into storage. Under the previous rate structure, the majority of the revenue was recorded in winter and early spring when customers were billed for higher levels of gas consumption. As a result of the new rate structure, the Company recorded approximately $170,000 in additional revenues and margin related to the carrying costs during the current quarter. Of the $170,000, approximately $61,000 was associated with recovery of financing costs on higher cost inventory and prepaid gas balances, while the remaining balance represents a timing issue on revenue recognition. Consequently, for comparative purposes, revenues will be lower in the second quarter of fiscal 2004 when inventory levels and the related carrying cost accruals are lower. If the impact of any weather differential between periods is ignored, management anticipates most of the reduction in revenues in the second quarter will be offset by the rate increase implemented in October 2003.

	Quarter Ended 12/31/03	**Quarter Ended 12/31/02**	**Increase/ (Decrease)**	**Percentage**
Operating Margin				
Gas Utilities	6,599,995	6,161,774	438,221	7%
Propane Operations	1,982,596	2,345,253	(362,657)	-15%
Energy Marketing	56,426	72,931	(16,505)	-23%
Other	118,556	85,839	32,717	38%