RGC RESOURCES INC
Form ARS
December 12, 2014

Table of Contents

Table of Contents

Table of Contents

Table of Contents

Table of Contents

Table of Contents

Table of Contents

Operationally, 2014 was a strong and busy year. The weather was 9% colder than the 30-year average and our total natural gas deliveries exceeded 10 million deka-therms. Industrial demand increased by 6% over last year and we anticipate this higher level of natural gas use to continue next year. We are also excited to provide natural gas service to a new packaging manufacturer, Ardagh Group, which opened a $93 million metal packaging plant with the capability of producing 1.7 billion cans a year.

We invested a record $14.7 million in capital improvements in 2014 and plan to invest approximately $13.5 million in fiscal 2015. We continue to aggressively modernize our distribution system. In 2014, we replaced 13.6 miles of cast iron and bare steel pipe with polyethylene pipe. In 1991, cast iron and bare steel pipe accounted for approximately 25% of our distribution system. At the end of fiscal 2014, it represents less than 2%. Based on the estimated replacement rate, we anticipate replacing all remaining bare steel and cast iron pipe by the end of 2016, further enhancing safety and system reliability. Once we complete the replacement of our bare steel and cast iron mains, our efforts will shift to replacing all pre-1973 plastic mains with current polyethylene pipe. This infrastructure replacement program is forecast to be completed in fiscal 2019. In 2014, we replaced and upgraded one of our primary gas transfer stations and are in the final stages of replacing a critical piece of equipment at our liquefied natural gas facility that is used for peak shaving during extremely cold periods.

INDUSTRIAL DEMAND INCREASED BY 6% OVER LAST YEAR AND WE ANTICIPATE THIS HIGHER LEVEL OF NATURAL GAS USE TO CONTINUE NEXT YEAR.

As the economy continues to gradually improve, we are experiencing improved customer growth. In 2014, new customer additions increased 43% over last year. The new construction segment increased 7%, the conversion segment where existing homes or businesses converted to natural gas from either propane, fuel oil or electric increased 17%, and the balance of the increase was derived from the conversion of an apartment complex to individual gas meters.

We had an active year from a regulatory prospective. The rate case filed in September 2013 was settled favorably with the Virginia State Corporation Commission (SCC) in May 2014, at $887,000 with an authorized return on equity of 9.75%. We filed an updated depreciation study with the SCC in June and received approval of the new depreciation rates in September, resulting in a slight decrease in annual depreciation expense. We filed and received approval on an amendment to a separate regulatory infrastructure replacement plan designed to recover the increased investment carrying costs and depreciation expense associated with future planned infrastructure replacements through calendar year 2018. This includes modernization of our distribution system, replacement of our gas transfer station on

Table of Contents

ON A NATIONAL LEVEL, NATURAL GAS INDUSTRY DATA INDICATES THAT WE HAVE A NATURAL GAS SUPPLY OF OVER 100 YEARS. THIS ABUNDANT AND INCREASINGLY ACCESSIBLE SUPPLY HAS CREATED LOW AND STABLE PRICES ON BOTH A NEAR AND INTERMEDIATE TERM BASIS.

the interstate pipeline, and replacement of a key component at our liquefied natural gas facility. Last, we filed and received approval from the SCC for refinancing our existing long-term debt, which will reduce our annual interest expense going forward.

On a national level, natural gas industry data indicates that we have a natural gas supply of over 100 years. This abundant and increasingly accessible supply has created low and stable prices on both a near and intermediate term basis. Production continues to increase in the various shale formations around the country as natural gas exploration and production companies continue to improve drilling and fracking technologies. As production has increased, so has the demand for new pipelines to move this increased supply to market. Interstate pipeline companies are investing billions of dollars constructing new pipelines and modifying existing pipelines to make them bi-directional so they can efficiently move gas as future demand increases.

In the Commonwealth of Virginia, two pipelines are proposed: Atlantic Coast Pipeline and the Mountain Valley Pipeline. Both are designed to move gas from the Marcellus and Utica shale formations to the Southeast.

The Mountain Valley Pipeline, if constructed, may provide future opportunities to expand our footprint in Virginia to areas that currently do not have access to natural gas.

We are excited to be part of the growing natural gas industry and the pursuit of potential growth opportunities it may bring to our Company. I look forward to reporting to you at the end of 2015 on what I anticipate to be another year of solid performance.

On behalf of our dedicated employees and the Board of Directors, I thank you for your continued interest in our operations and your continuing decision to invest in RGC Resources.

Sincerely,
John D Orazio
President & CEO

Table of Contents

Table of Contents

BOARD OF DIRECTORS

LEFT TO RIGHT: John B. Williamson, III; Nancy Howell Agee; George W. Logan; J. Allen Layman; Raymond D. Smoot, Jr.; Maryellen F. Goodlatte; S. Frank Smith; John S. D Orazio; (Abney S. Boxley, III not pictured)

Table of Contents

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Robert L. Wells, II
VICE PRESIDENT,
INFORMATION TECHNOLOGY
RGC Resources, Inc.

[1] *RGC Resources, Inc.*

[2] *Roanoke Gas Company*

[3] *Diversified Energy Company*

[4] *RGC Ventures of Virginia, Inc.*

DIRECTOR [3, 4] **DIRECTOR** [3, 4]

Table of Contents

SELECTED FINANCIAL DATA

YEAR ENDING SEPTEMBER 30	2014	2013	2012	2011	2010
Operating Revenues	**$ 75,016,134**	$ 63,205,666	$ 58,799,687	$ 70,798,871	$ 73,823,914
Gross Margin	**29,337,089**	27,602,891	26,933,097	27,269,566	26,440,273
Operating Income	**9,681,868**	8,795,055	8,786,535	9,313,046	8,982,181
Net Income	**4,708,440**	4,262,052	4,296,745	4,653,473	4,445,436
Basic Earnings Per Share	**$ 1.00**	$ 0.91	$ 0.92	$ 1.01	$ 0.98
Cash Dividends Declared Per Share	**$ 0.74**	$ 1.72	$ 0.70	$ 0.68	$ 0.66
Book Value Per Share	**$ 11.02**	$ 10.51	$ 10.85	$ 10.55	$ 10.18
Average Shares Outstanding	**4,715,478**	4,698,727	4,647,439	4,592,713	4,514,262
Total Assets	**$ 139,320,722**	$ 124,526,701	$ 129,756,338	$ 125,549,049	$ 120,683,316
Long-Term Debt (Less Current Portion)	**30,500,000**	13,000,000	13,000,000	13,000,000	28,000,000
Stockholders Equity	**52,020,847**	49,502,422	50,682,930	48,785,778	46,309,747
Shares Outstanding at Sept. 30	**4,720,378**	4,709,326	4,670,567	4,624,682	4,548,864

Table of Contents

Forward-looking Statements

This report contains forward-looking statements that relate to future transactions, events or expectations. RGC Resources, Inc. (Resources or the Company) may publish forward-looking statements relating to such matters as anticipated financial performance, business prospects, technological developments, new products, research and development activities and similar matters. These statements are based on management s current expectations and information available at the time of such statements and are believed to be reasonable and are made in good faith. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company s actual results and experience to differ materially from the anticipated results or expectations expressed in the Company s forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company s business include, but are not limited to those set forth in the following discussion and within Item 1A Risk Factors of this Annual Report

on Form 10-K. All of these factors are difficult to predict and many are beyond the Company s control. Accordingly, while the Company believes its forward-looking statements to be reasonable, there can be no assurance that they will approximate actual experience or that the expectations derived from them will be realized. When used in the Company s documents or news releases, the words anticipate, believe, intend, plan, estimate, expect, objective, projection, forecast, budget, assume, indicate or similar words or future or conditional verbs su would, should, can, could or may are intended to identify forward-looking statements.

Forward-looking statements reflect the Company s current expectations only as of the date they are made. The Company assumes no duty to update these statements should expectations change or actual results differ from current expectations except as required by applicable laws and regulations.

Table of Contents

MANAGEMENT S DISCUSSION & ANALYSIS

OVERVIEW

Resources is an energy services company primarily engaged in the regulated sale and distribution of natural gas to approximately 58,600 residential, commercial and industrial customers in Roanoke, Virginia and the surrounding localities, through its Roanoke Gas Company (Roanoke Gas) subsidiary. Resources also provides certain unregulated services through Roanoke Gas and utility consulting and information system services through RGC Ventures of Virginia, Inc., which operates as The Utility Consultants and Application Resources. The unregulated operations represent less than 3% of revenues and margins of Resources.

The utility operations of Roanoke Gas are regulated by the Virginia State Corporation Commission (SCC), which oversees the terms, conditions, and rates to be charged to customers for natural gas service, safety standards, extension of service, accounting and depreciation. The Company is also subject to federal regulation from the Department of Transportation in regard to the construction, operation, maintenance, safety and integrity of its transmission and distribution pipelines. The Federal Energy Regulatory Commission regulates prices for the transportation and delivery of natural gas to the Company s distribution system and underground storage services. The Company is also subject to other regulations which are not necessarily industry specific.

The Company is committed to the safe and reliable delivery of natural gas to its customers. Since 1991, the Company has placed an emphasis on the modernization of its distribution system through the renewal and replacement of its cast iron and bare steel natural gas distribution pipelines. With recent regulatory actions placing a greater emphasis on pipeline safety, the Company continues to focus its efforts on completing its renewal and replacement program. Management anticipates replacing all remaining cast iron and bare steel pipe within the next three years.

The Company is also dedicated to the safeguarding of its information technology systems. These systems contain confidential customer, vendor and employee information as well as important financial data. There is risk associated with the unauthorized access of this

information with a malicious intent to corrupt data, cause operational disruptions, or compromise information. Management believes it has taken reasonable security measures to protect these systems from cyber security attacks and other types of breaches; however, there can be no guarantee that a breach will not occur. In the event of a breach, the Company will execute its Security Incident Response Plan to assist with managing the incident. The Company also maintains cyber-insurance coverage to mitigate financial implications resulting from a breach of confidential information.

Over 97% of the Company s revenues are derived through the regulated operations of Roanoke Gas primarily associated with the sale and delivery of natural gas to its customers. The SCC authorizes the rates and fees that the Company charges its customers for these services. These rates are designed to provide the Company with the opportunity to recover its gas and non-gas expenses and to earn a reasonable rate of return for shareholders based on normal weather. Normal weather refers to the average number of heating degree days (an industry measure by which the average daily temperature falls below 65 degrees Fahrenheit) over the previous 30-year period.

The Company s business is seasonal in nature and weather sensitive as a majority of natural gas sales are for space heating during the winter season. Volatility in winter weather and the commodity price of natural gas, can impact the effectiveness of the Company s rates in recovering its costs and providing a reasonable return for its shareholders. In order to mitigate the effect of weather variations, the Company has certain approved rate mechanisms that help provide stability in earnings. These mechanisms include a weather normalization adjustment factor, inventory carrying cost revenue and a SAVE adjustment rider.

The weather normalization adjustment mechanism (WNA) reduces the volatility in earnings due to the variability in temperatures during the heating season. The WNA is based on a weather measurement band around the most recent 30-year temperature average. The WNA provides the Company with a level of earnings protection

Table of Contents

when weather is warmer than normal and provides its customers with price protection when the weather is colder than normal. Through March 31, 2014, the WNA provided for a weather band of 3% above and below the 30-year average, whereby the Company would bill its customers for the lost margin (excluding gas costs) for the impact of weather that was more than 3% warmer than normal or refund customers the excess margin earned for weather that was more than 3% colder than normal. The annual WNA period extends from April to March. For the WNA periods ending March 31, 2014, 2013 and 2012, the number of heating degree days were 10% colder than normal, less than 3% warmer than normal and 22% warmer than normal, respectively. As a result, the Company refunded customers approximately $707,000 in excess margin in fiscal 2014 and billed customers approximately $1,747,000 in additional margin in fiscal 2012. No billing or refunds were required in fiscal 2013 as the number of heating degree days fell within the 3% band. Effective with the new WNA period beginning April 1, 2014, the 3% weather band was eliminated and the WNA is now based strictly on the variations from normal. At September 30, 2014, the number of heating degree days for the six month period was less than the 30-year average and the Company accrued approximately $144,000 in additional margin. Additional information on the WNA is provided under the Regulatory Affairs section.

The Company also has an approved rate structure in place that mitigates the impact of financing costs of its natural gas inventory. Under this rate structure, Roanoke Gas recognizes revenue for the financing costs, or carrying costs , of its investment in natural gas inventory. The carrying cost revenue (ICC) factor applied to inventory is based on the Company s weighted-average cost of capital including interest rates on short-term and long-term debt and the Company s authorized return on equity.

During times of rising gas costs and rising inventory levels, the Company recognizes revenues to offset higher financing costs associated with higher inventory balances. Conversely, during times of decreasing gas costs and declining inventory balances, the Company recognizes less carrying cost revenue as financing costs are lower. Although the total cost of natural gas in storage, as well as the cost per decatherm, at September 30, 2014 was higher than the cost in storage at September 30, 2013, the average balance during the year was down by more than 4% due to greater level of storage withdrawals during a much colder 2013-2014 winter season. In addition, the ICC factor declined by 2%, resulting in a reduction in ICC revenues of $58,000. Fiscal 2013 reflected a $299,000 reduction in ICC revenues due to a 14% lower average balance of natural gas in storage as compared to fiscal 2012.

Generally, as investment in natural gas inventory increases so does the level of borrowing under the Company s line-of-credit. However, as the carrying cost factor used in determining carrying cost revenues is based on the Company s weighted-average cost of capital, carrying cost revenues do not directly correspond with incremental short-term financing costs. Therefore, when inventory balances decline due to a reduction in commodity prices, net income will decline as carrying cost revenues decrease by a greater amount than short-term financing costs decrease. The inverse occurs when inventory costs increase.

The Company s non-gas rates provide for the recovery of non-gas related expenses and a reasonable return to shareholders. These rates are determined based on the filing of a formal rate application with the SCC utilizing historical information including investment in natural gas facilities. Generally, investments related to extending service to new customers are recovered through the non-gas rates currently in place. The investment in replacing and upgrading existing infrastructure is not recoverable until a formal rate application is made to

include the additional investment and new non-gas rates are approved. The SAVE (Steps to Advance Virginia s Energy) Plan and Rider provides the Company with the ability to recover costs related to these investments on a prospective basis rather than on a historical basis. Additional information regarding the SAVE Rider is provided under the Regulatory Affairs section.

The economic environment has a direct correlation with business and industrial production, customer growth and natural gas utilization. The local economy continues to show signs of improvement from the economic downturn that began in 2008, as industrial production activities and the related interruptible and transportation sales to support those activities have returned to pre-2008 levels. Although there are signs of improvement, residential construction and housing starts continue to remain below historical levels. If economic stagnation were to return, industrial activity and new customer growth could be negatively impacted. In addition to economic considerations, natural gas consumption continues to be affected by technological and efficiency improvements in heating equipment.

Table of Contents

RESULTS OF OPERATIONS

Fiscal Year 2014 Compared with Fiscal Year 2013

The table below reflects operating revenues, volume activity and heating degree-days.

OPERATING REVENUES

YEAR ENDING SEPTEMBER 30	2014	2013	Increase / (Decrease)	Percentage
Gas Utilities	**$ 73,865,487**	$ 62,024,174	$ 11,841,313	19%
Other	**1,150,647**	1,181,492	(30,845)	-3%
Total Operating Revenues	**$ 75,016,134**	$ 63,205,666	$ 11,810,468	19%

DELIVERED VOLUMES

YEAR ENDING SEPTEMBER 30	2014	2013	Increase	Percentage
Regulated Natural Gas (DTH)				
Residential and Commercial	**7,005,920**	6,498,783	507,137	8%
Transportation and Interruptible	**3,081,731**	2,910,111	171,620	6%
Total Delivered Volumes	**10,087,651**	9,408,894	678,757	7%
Heating Degree Days (Unofficial)	**4,351**	4,001	350	9%

Total gas utility operating revenues for the year ended September 30, 2014 increased by 19% from the year ended September 30, 2013. The increase in gas revenues was primarily attributable to a combination of a 7% increase in total delivered natural gas volumes, a 30% per decatherm increase in the average commodity price of natural gas, implementation of a non-gas rate increase and higher SAVE Plan revenues. The increase in delivered volumes was driven by the colder winter heating season

where total heating degree days increased by 9% over fiscal 2013 and were above the 30-year average by the same percentage. Transportation and interruptible volumes, which are primarily driven by production activities rather than weather, increased by 6%. Other revenues decreased by 3% due to the completion of a one-time project during the prior year more than offsetting increases in the level of certain other contract services during the current year.

Table of Contents

GROSS MARGIN

YEAR ENDING SEPTEMBER 30	2014	2013	Increase	Percentage
Gas Utility	**$ 28,774,213**	$ 27,108,112	$ 1,666,101	6%
Other	**562,876**	494,779	68,097	14%
Total Gross Margin	**$ 29,337,089**	$ 27,602,891	$ 1,734,198	6%

Regulated natural gas margins from utility operations increased by 6% from fiscal 2013, primarily as a result of higher residential and commercial sales volumes, the implementation of a non-gas rate increase and the addition of the SAVE Plan rider. Residential and commercial volumes (which are strongly correlated to the weather) increased due to the much colder winter season. The higher margins generated by the increased residential and commercial volume were mostly offset by a net WNA refund of $563,000 recognized in fiscal 2014. The Company also implemented a non-gas rate increase effective November 1, 2013 and an increased SAVE Plan Rider beginning January 1, 2014. The non-gas rate increase was designed to provide approximately $887,000 in additional annual non-gas revenues. The implementation of the increased non-gas rates in November accounted for approximately $422,000 of the increase in customer base charges, a flat monthly fee billed to each natural gas customer, and $474,000 of the additional volumetric revenue. The SAVE Plan Rider, as discussed in more detail in the Regulatory Affairs section below, provided an additional $123,000 in margin. ICC revenues continued to decline with a $58,000 reduction in fiscal 2014 compared to fiscal 2013 due to the larger storage withdrawals and lower ICC factor.

Other margins, consisting of non-utility related services, increased by $68,097 due to an increased level of activity under one of the contracted services. The service contracts that comprise most of the non-utility related activities are subject to annual or semi-annual renewal provisions and the potential exists that these contracts may not be renewed or extended by the customer. In addition, the level of activity under these contracts will fluctuate based on customer requirements.

The changes in the components of the gas utility margin are summarized below:

NET UTILITY MARGIN INCREASE

Customer Base Charge	$ 659,671
Volumetric	1,493,353
SAVE Plan	123,199
WNA	(563,187)
Carrying Cost	(58,303)
Other	11,368
Total	$ 1,666,101

Table of Contents

OPERATIONS AND MAINTENANCE EXPENSE Operations and maintenance expenses increased by $529,789, or 4%, in fiscal 2014 compared with fiscal 2013 primarily due to higher labor costs, contracted services, bad debt expense and corporate insurance expense more than offsetting significant reductions in employee benefit costs and greater capitalization of Company overheads on construction projects and LNG (liquefied natural gas) production. Labor costs and contracted services increased by $1,128,000 primarily due to a full year of increased operations staffing, timing of pipeline right-of-way clearing, a full year of costs related to an SCC mandated meter installation inspection and remediation program, expenses related to updating the Company s corrosion control processes, benefit consulting services and network services support and training. Bad debt expense increased by approximately $64,000 related to much higher customer billings due to a colder winter heating season. Corporate property and liability insurance increased by $93,000 due to a combination of higher premiums and increased general liability coverage limits. Insurance premiums are expected to increase in fiscal 2015 as well but at a lesser amount. These higher costs were partially offset by a $605,000 reduction in employee benefit expenses, specifically in the defined benefit pension plan (pension plan) and the postretirement medical and life insurance plan (postretirement plan). These actuarially determined expenses declined in fiscal 2014 due to a combination of a higher discount rate for valuing both plans liabilities at September 30, 2013 and strong investment performance of both plans assets. More information on these plans and the impact on the financial statements are provided under the Pension and Postretirement Benefits section of the Critical Accounting Policies and Estimates below and in Note 6 of the financial statements. In addition, $339,000 of additional overheads was capitalized due to a significantly higher level of construction expenditures related to the Company s renewal program and other projects. Total capital expenditures rose by more than $4.7 million over the prior year. The remaining increase of $188,000 relates to a variety of areas including additional facility and equipment maintenance and support costs, higher utility expenses and increased administrative costs related to the Company s operations.

GENERAL TAXES General taxes increased $79,640, or 5%, primarily due to higher property taxes associated with increases in utility property and greater payroll taxes related to increased operations staffing.

DEPRECIATION Depreciation expense increased by $237,956, or 5%, corresponding to the increase in utility plant investment partially offset by lower depreciation rates.

OTHER EXPENSE Other expense, net, increased by $146,770 primarily due to the absence of interest income related to the ANGD note which was paid off in fiscal 2013 combined with a greater level of corporate charitable giving and increased SCC pipeline assessments.

INTEREST EXPENSE Total interest expense remained virtually unchanged from last year as the Company benefited in September from lower interest expense due to its debt refinancing which offset the increased interest incurred under the line- of-credit.

INCOME TAXES Income tax expense increased by $294,753 on higher pre-tax earnings. The effective tax rate for fiscal 2014 was 38.4% compared to 38.3% for 2013.

NET INCOME AND DIVIDENDS Net income for fiscal 2014 was $4,708,440 compared to $4,262,052 for fiscal 2013. Basic and diluted earnings per share were $1.00 in fiscal 2014 compared to $0.91 in fiscal 2013. Dividends declared per share of common stock were $0.74 in fiscal 2014 compared to $1.72 in fiscal 2013, which included the one-time special dividend of $1.00.

Table of Contents

Fiscal Year 2013 Compared with Fiscal Year 2012

The table below reflects operating revenues, volume activity and heating degree-days.

OPERATING REVENUES

YEAR ENDING SEPTEMBER 30	2013	2012	Increase	Percentage
Gas Utilities				