

SABINE ROYALTY TRUST

Form 10-Q

August 08, 2014

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x Quarterly Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2014

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: 1-8424

SABINE ROYALTY TRUST

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction
of incorporation or
organization)

75-6297143
(I.R.S. Employer
Identification No.)

Southwest Bank

Park Place

2911 Turtle Creek Blvd

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Suite 850

Dallas, Texas 75219

(Address of principal executive offices)

(Zip Code)

(855) 588-7839

(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 (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 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, a non-accelerated filer, or a smaller reporting company. See the 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 (Do not check if a smaller reporting company) 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

Number of units of beneficial interest outstanding at August 8, 2014: 14,579,345

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SABINE ROYALTY TRUST

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

The condensed financial statements included herein have been prepared by Southwest Bank, as Trustee (the Trustee) of Sabine Royalty Trust (the Trust), pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted pursuant to such rules and regulations, although the Trustee believes that the disclosures are adequate to make the information presented not misleading. The condensed financial statements of the Trust presented herein are unaudited. It is suggested that these condensed financial statements and notes thereto be read in conjunction with the financial statements and notes thereto included in the Trust 's latest annual report on Form 10-K. The December 31, 2013 condensed statement of assets, liabilities and trust corpus is derived from the audited statement of assets, liabilities and trust corpus as of that date. In the opinion of the Trustee, all adjustments necessary to present fairly the assets, liabilities and trust corpus of the Trust as of June 30, 2014, the distributable income for the three-month and six-month periods ended June 30, 2014 and 2013 and the changes in trust corpus for the six-month periods ended June 30, 2014 and 2013, have been included. The distributable income for such interim periods is not necessarily indicative of the distributable income for the full year.

The condensed financial statements as of June 30, 2014 and for the three-month and six-month periods ended June 30, 2014 and 2013, included herein, have been reviewed by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report appearing herein.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Unit Holders of Sabine Royalty Trust and

Southwest Bank, Trustee

Dallas, Texas

We have reviewed the accompanying condensed statement of assets, liabilities and trust corpus of Sabine Royalty Trust (the Trust) as of June 30, 2014, and the related condensed statements of distributable income for the three-month and six-month periods ended June 30, 2014 and 2013 and changes in trust corpus for the six-month periods ended June 30, 2014 and 2013. These interim financial statements are the responsibility of the Trustee.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

As described in Note 2 to the condensed interim financial statements, these condensed interim financial statements have been prepared on a modified cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed interim financial statements for them to be in conformity with the basis of accounting described in Note 2.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the statement of assets, liabilities, and trust corpus of Sabine Royalty Trust as of December 31, 2013, and the related statements of distributable income and changes in trust corpus for the year then ended (not presented herein); and in our report dated March 3, 2014, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed statement of assets, liabilities and trust corpus as of December 31, 2013 is fairly stated, in all material respects, in relation to the statement of assets, liabilities, and trust corpus from which it has been derived.

/s/ DELOITTE & TOUCHE LLP

Dallas, TX

August 8, 2014

Table of Contents**SABINE ROYALTY TRUST****CONDENSED STATEMENTS OF ASSETS, LIABILITIES, AND TRUST CORPUS (UNAUDITED)**

	Note	June 30, 2014	December 31, 2013
Assets			
Cash and short-term investments		\$ 4,460,707	\$ 6,547,635
Royalty interests in oil and gas properties (less accumulated amortization of \$22,016,346 and \$21,993,814 at June 30, 2014 and December 31, 2013)		378,839	401,371
TOTAL		\$ 4,839,546	\$ 6,949,006
Liabilities and Trust Corpus			
Trust expenses payable		\$ 235,577	\$ 112,760
Other payables	4	377,142	1,201,733
		612,719	1,314,493
Contingencies	6		
Trust corpus 14,579,345 units of beneficial interest authorized and outstanding		4,226,827	5,634,513
TOTAL		\$ 4,839,546	\$ 6,949,006

The accompanying notes are an integral part of these condensed financial statements.

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CONDENSED STATEMENTS OF DISTRIBUTABLE INCOME (UNAUDITED)

	Notes	Three Months Ended June 30,	
		2014	2013
Royalty Income		\$ 16,538,597	\$ 13,857,161
Interest Income		1,359	1,775
Total		16,539,956	13,858,936
General and administrative expenses		(813,394)	(721,856)
Distributable Income		\$ 15,726,562	\$ 13,137,080
Distributable Income per unit (14,579,345 units)	1,3,5	\$ 1.08	\$.90

The accompanying notes are an integral part of these condensed financial statements.

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CONDENSED STATEMENTS OF DISTRIBUTABLE INCOME (UNAUDITED)

	Notes	Six Months Ended June 30,	
		2014	2013
Royalty Income		\$ 30,313,918	\$ 29,359,283
Interest Income		2,587	3,184
Total		30,316,505	29,362,467
General and administrative expenses		(1,422,690)	(1,217,550)
Distributable Income		\$ 28,893,815	\$ 28,144,917
Distributable Income per unit (14,579,345 units)	1,3,5	\$ 1.98	\$ 1.93

The accompanying notes are an integral part of these condensed financial statements.

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CONDENSED STATEMENTS OF CHANGES IN TRUST CORPUS (UNAUDITED)

	Note	Six Months Ended June 30,	
		2014	2013
Trust corpus, beginning of period		\$ 5,634,513	\$ 4,067,313
Amortization of royalty interests		(22,532)	(25,449)
Distributable income		28,893,815	28,144,917
Distributions	3	(30,278,969)	(27,363,099)
Trust corpus, end of period		\$ 4,226,827	\$ 4,823,682
Distributions per unit (14,579,345 units)	3	\$ 2.08	\$ 1.88

The accompanying notes are an integral part of these condensed financial statements.

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SABINE ROYALTY TRUST

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

1. TRUST ORGANIZATION AND PROVISIONS

Sabine Royalty Trust (the Trust) was established by the Sabine Corporation Royalty Trust Agreement (the Trust Agreement), made and entered into effective as of December 31, 1982, to receive a distribution from Sabine Corporation (Sabine) of royalty and mineral interests, including landowner's royalties, overriding royalty interests, minerals (other than executive rights, bonuses and delay rentals), production payments and any other similar, nonparticipatory interests, in certain producing and proved undeveloped oil and gas properties located in Florida, Louisiana, Mississippi, New Mexico, Oklahoma and Texas (the Royalties).

Certificates evidencing units of beneficial interest (the Units) in the Trust were mailed on December 31, 1982 to Sabine's shareholders of record on December 23, 1982, on the basis of one Unit for each share of Sabine's outstanding common stock. In May 1988, Sabine was acquired by Pacific Enterprises (Pacific), a California corporation. Through a series of mergers, Sabine was merged into Pacific Enterprises Oil Company (USA) (Pacific (USA)), a California corporation and a wholly owned subsidiary of Pacific, effective January 1, 1990. This acquisition and the subsequent mergers had no effect on the Units. Pacific (USA), as successor to Sabine, has assumed by operation of law all of Sabine's rights and obligations with respect to the Trust. The Units are listed and traded on the New York Stock Exchange.

In connection with the transfer of the Royalties to the Trust upon its formation, Sabine had reserved to itself all executive rights, including rights to execute leases and to receive bonuses and delay rentals. In January 1993, Pacific (USA) completed the sale of substantially all its producing oil and gas assets to a third party. The sale did not include executive rights relating to the Royalties, and Pacific (USA)'s ownership of such rights was not affected by the sale.

Southwest Bank (the Trustee), acts as trustee of the Trust. Southwest Bank became the Trustee effective May 30, 2014, upon the resignation of Bank of America, N.A., the prior trustee. The terms of the Trust Agreement provide, among other things, that:

The Trust shall not engage in any business or commercial activity of any kind or acquire assets other than those initially transferred to the Trust.

The Trustee may not sell all or any part of its assets unless approved by the holders of a majority of the outstanding Units in which case the sale must be for cash and the proceeds, after satisfying all existing liabilities, promptly distributed to Unit holders.

The Trustee may establish a cash reserve for the payment of any liability that is contingent or uncertain in amount or that otherwise is not currently due or payable.

The Trustee will use reasonable efforts to cause the Trust and the Unit holders to recognize income and expenses on monthly record dates.

The Trustee is authorized to borrow funds to pay liabilities of the Trust provided that such borrowings are repaid in full before any further distributions are made to Unit holders.

The Trustee will make monthly cash distributions to Unit holders of record on the monthly record date (see Note 3).

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Because of the passive nature of the Trust and the restrictions and limitations on the powers and activities of the Trustee contained in the Trust Agreement, the Trustee does not consider any of the officers and employees of the Trustee to be officers or executive officers of the Trust as such terms are defined under applicable rules and regulations adopted under the Securities Exchange Act of 1934.

The proceeds of production from the Royalties are receivable from hundreds of separate payors. In order to facilitate creation of the Trust and to avoid the administrative expense and inconvenience of daily reporting to Unit holders, the conveyances by Sabine of the Royalties located in five of the six states provided for the execution of an escrow agreement by Sabine and the initial trustee of the Trust, in its capacities as trustee of the Trust and as escrow agent. The conveyances by Sabine of the Royalties located in Louisiana provided for the execution of a substantially identical escrow agreement by Sabine and a Louisiana bank in the capacities of escrow agent and of trustee under the name of Sabine Louisiana Royalty Trust. Sabine Louisiana Royalty Trust, the sole beneficiary of which is the Trust, was established in order to avoid uncertainty under Louisiana law as to the legality of the Trustee's holding record title to the Royalties located in Louisiana. The Trust now only has one escrow agent, which is the Trustee, and a single escrow agreement.

Pursuant to the terms of the escrow agreement and the conveyances of the properties by Sabine, the proceeds of production from the Royalties for each calendar month, and interest thereon, are collected by the Trustee, as escrow agent, and are paid to and received by the Trust only on the next monthly record date. The Trustee, as escrow agent, has agreed to endeavor to assure that it incurs and pays expenses and fees for each calendar month only on the next monthly record date. The Trust Agreement also provides that the Trustee is to endeavor to assure that income of the Trust will be accrued and received and expenses of the Trust will be incurred and paid only on each monthly record date. Assuming that the escrow agreement is recognized for federal income tax purposes and that the Trustee is able to control the timing of income and expenses, as stated above, cash and accrual basis Unit holders should be treated as realizing income only on each monthly record date. The Trustee is treating the escrow agreement as effective for federal income tax purposes. However, for financial reporting purposes, royalty and interest income are recorded in the calendar month in which the amounts are received by either the escrow agent or the Trust.

Distributable income as determined for financial reporting purposes for a given quarter will not usually equal the sum of distributions made during that quarter. Distributable income for a given quarter will approximate the sum of the distributions made during the last two months of such quarter and the first month of the next quarter.

U.S. Trust, Bank of America Private Wealth Management, a division of Bank of America, N.A., as trustee of the Sabine Royalty Trust, announced that at the special meeting of the Trust's Unit holders held on May 22, 2014, the Unit holders of the Trust voted to approve the proposal to appoint Southwest Bank as successor trustee of the Trust effective May 30, 2014. References to the Trustee prior to May 30, 2014 shall mean Bank of America, N.A., and references to the Trustee on and after May 30, 2014 shall mean Southwest Bank.

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2. ACCOUNTING POLICIES

Basis of Accounting

The financial statements of the Trust are prepared on the following basis and are not intended to present financial position and results of operations in conformity with accounting principles generally accepted in the United States of America (GAAP):

Royalty income, net of severance and ad valorem tax, and interest income are recognized in the month in which amounts are received by the Trust (see Note 1).

Trust expenses, consisting principally of routine general and administrative costs, include payments made during the accounting period. Expenses are accrued to the extent of amounts that become payable on the next monthly record date following the end of an accounting period. Reserves for liabilities that are contingent or uncertain in amount may also be established if considered necessary.

Royalties that are producing properties are amortized using the unit-of-production method. This amortization is shown as a reduction of Trust corpus.

Distributions to Unit holders are recognized when declared by the Trustee (see Note 3).
The financial statements of the Trust differ from financial statements prepared in conformity with accounting principles generally accepted in the United States of America because of the following:

Royalty income is recognized in the month received rather than in the month of production.

Expenses other than those expected to be paid on the following monthly record date are not accrued.

Amortization of the Royalties is shown as a reduction to Trust corpus and not as a charge to operating results.

Reserves may be established for contingencies that would not be recorded under accounting principles generally accepted in the United States of America.

This comprehensive basis of accounting other than GAAP corresponds to the accounting permitted for royalty trusts by the U.S. Securities and Exchange Commission, as specified by Staff Accounting Bulletin Topic 12:E, *Financial Statements of Royalty Trusts*.

Use of Estimates

The preparation of financial statements in conformity with the basis of accounting described above requires the Trustee to make estimates and assumptions that affect reported amounts of certain assets, liabilities, revenues and expenses as of and for the reporting periods. Actual results may differ from such estimates.

Impairment

The Trustee routinely reviews the Trust's royalty interests in oil and gas properties for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. If an impairment event occurs and it is determined that the carrying value of the Trust's royalty interests may not be recoverable, an impairment will be recognized as measured by the amount by which the carrying amount of the royalty interests exceeds the fair value of these assets, which would likely be measured by discounting projected cash flows. As of June 30, 2014, no impairment is required.

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Distributable Income per Unit

Basic distributable income per Unit is computed by dividing distributable income by the weighted average Units outstanding. Distributable income per Unit assuming dilution is computed by dividing distributable income by the weighted average number of Units and equivalent Units outstanding. The Trust had no equivalent Units outstanding for any period presented. Therefore, basic distributable income per Unit and distributable income per Unit assuming dilution are the same.

New Accounting Pronouncements

There are no new pronouncements that are expected to have a significant impact on the Trust's financial statements.

Federal Tax Considerations

The Internal Revenue Service has ruled that the Trust is classified as a grantor trust for federal income tax purposes and therefore is not subject to taxation at the trust level. The Unit holders are considered, for federal income tax purposes, to own the Trust's income and principal as though no trust were in existence. Accordingly, no provision for federal income tax expense has been made in these financial statements. The income of the Trust will be deemed to have been received or accrued by each Unit holder at the time such income is received or accrued by the Trust (on the applicable monthly record date) if the escrow arrangement discussed in Note 1 to these financial statements is respected by the Internal Revenue Service. In the absence of the escrow arrangement, Unit holders would be deemed to receive or accrue income from production from the royalty properties (and interest income) on a daily basis, in accordance with their method of accounting, as the proceeds from production and interest thereon were received or accrued by the Trust. The Trustee is treating the escrow arrangement as effective for federal income tax purposes and furnishes tax information to Unit holders on that basis.

The Royalties constitute economic interests in oil and gas properties for federal income tax purposes. Unit holders must report their share of the revenues from the Royalties as ordinary income from oil and gas royalties and are entitled to claim depletion with respect to such income. During the first six months of 2014, the Trust also incurred administration expenses and earned interest income on funds held for distribution and for the cash reserve maintained for the payment of contingent and future obligations of the Trust.

The classification of the Trust's income for purposes of the passive loss rules may be important to a Unit holder. Royalty income generally is treated as portfolio income and does not offset passive losses.

Some Trust Units are held by middlemen, as such term is broadly defined in U.S. Treasury Regulations (and includes custodians, nominees, certain joint owners, and brokers holding an interest for a customer in street name, referred to herein collectively as "middlemen"). Therefore, the Trustee considers the Trust to be a non-mortgage widely held fixed investment trust (WHFIT) for U.S. federal income tax purposes. Southwest Bank, 2911 Turtle Creek Boulevard, Suite 850, Dallas, Texas, 75219, telephone number 972-919-1350, email address trustee@sbr-sabineroyalty.com, is the representative of the Trust that will provide tax information in accordance with applicable U.S. Treasury Regulations governing the information reporting requirements of the Trust as a WHFIT. Tax information is also posted by the Trustee at www.sbr-sabineroyalty.com. Notwithstanding the foregoing, the middlemen holding Trust Units on behalf of Unit holders, and not the Trustee of the Trust, are solely responsible for complying with the information reporting requirements under the U.S. Treasury Regulations with respect to such Trust Units, including the issuance of IRS Forms 1099 and certain written tax statements. Unit holders whose Trust Units are held by middlemen should consult with such middlemen regarding the information that will be reported to them by the middlemen with respect to the Trust Units.

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Pursuant to the Foreign Account Tax Compliance Act (commonly referred to as FATCA), distributions from the Trust to foreign financial institutions and certain other non-financial foreign entities may be subject to U.S. withholding taxes. Specifically, certain withholdable payments (including certain royalties, interest and other gains or income from U.S. sources) made to a foreign financial institution or non-financial foreign entity will generally be subject to the withholding tax unless the foreign financial institution or non-financial foreign entity complies with certain information reporting, withholding, identification, certification and related requirements imposed by FATCA. Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA may be subject to different rules.

The Treasury Department recently issued guidance providing that the FATCA withholding rules described above generally will apply to qualifying payments made after June 30, 2014. Foreign Unit holders are encouraged to consult their own tax advisors regarding the possible implications of these withholding provisions on their investment in Trust Units.

Each Unit holder should consult his tax advisor regarding Trust tax compliance matters.

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State Tax Considerations

The Trust holds properties located in Florida, Louisiana, Mississippi, New Mexico, Oklahoma, and Texas. Unit holders should consult the Trust's latest annual report on Form 10-K for a summary of tax matters.

Florida does not have a personal income tax. Florida imposes an income tax on resident and nonresident corporations (except for S corporations not subject to the built-in-gains tax or passive investment income tax), which will be applicable to royalty income allocable to a corporate Unit holder from properties located within Florida.

Louisiana, Mississippi, New Mexico and Oklahoma each impose taxes applicable to both resident and nonresident individuals and/or corporations (subject to certain exceptions for S corporations and limited liability companies, depending on their treatment for federal tax purposes), which will be applicable to royalty income allocable to a Unit holder from properties located within those states. New Mexico and Oklahoma impose a withholding tax on payments of oil and gas proceeds derived from royalty interests. To reduce the administrative burden imposed by these rules, the Trustee has opted to allow the payors of oil and gas proceeds to withhold on royalty payments made to the Trust. The Trust files New Mexico and Oklahoma tax returns, obtains a refund, and distributes that refund to Unit holders. Unit holders who transfer their Units before either the New Mexico or Oklahoma tax refunds are received by the Trust or after the refunds are received but before the next Monthly Record Date will not receive any portion of the refund. As a result, such Unit holders may incur a double tax—first through the reduced distribution received from the Trust as withholding at the Trust level reduces the amount of cash available for distribution and second by the tax payment made directly to New Mexico or Oklahoma with the filing of their New Mexico or Oklahoma income tax returns.

Texas imposes a franchise tax at a rate of 1% on gross revenues less certain deductions, as specifically set forth in the Texas franchise tax statutes. Entities subject to tax generally include trusts and most other types of entities that provide limited liability protection, unless otherwise exempt. Trusts that receive at least 90% of their federal gross income from designated passive sources, including royalties from mineral properties and other non-operated mineral interest income, and do not receive more than 10% of their income from operating an active trade or business generally are exempt from the Texas franchise tax as passive entities. The Trust has been and expects to continue to be exempt from Texas franchise tax as a passive entity. Because the Trust should be exempt from Texas franchise tax at the Trust level as a passive entity, each Unit holder that is considered a taxable entity under the Texas franchise tax will generally be required to include its portion of Trust revenues in its own Texas franchise tax computation. This revenue is sourced to Texas under provisions of the Texas Administrative Code sourcing such income according to the principal place of business of the Trust, which is Texas.

Each Unit holder should consult his or her tax advisor regarding state tax requirements, if any, applicable to such person's ownership of trust units.

3. DISTRIBUTION TO UNIT HOLDERS

The amount to be distributed to Unit holders (Monthly Income Amount) is determined on a monthly basis. The Monthly Income Amount is an amount equal to the sum of cash received by the Trust during a monthly period (the period commencing on the day after a monthly record date and continuing through and including the next succeeding monthly record date) attributable to the Royalties, any reduction in cash reserves and any other cash receipts of the Trust, including interest, reduced by the sum of liabilities paid and any increase in cash reserves. Unit holders of record as of the monthly record date (the 15th day of each calendar month except in limited circumstances) are entitled to have distributed to them the calculated Monthly Income Amount for such month on or before 10 business days after the monthly record date. The Monthly Income Amount per Unit is declared by the Trust no later than 10 days prior to the monthly record date.

The cash received by the Trust from purchasers of the Trust's oil and gas production consists of gross sales of production less applicable severance taxes.

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Other payables consist primarily of royalty receipts suspended pending verification of ownership interest or title.

The Trustee believes that these other payables represent an ordinary operating condition of the Trust and that such payables will be paid or released in the normal course of business.

5. SUBSEQUENT EVENTS

Subsequent to June 30, 2014, the Trust declared the following distributions:

Notification	Monthly Record	Payment	Distribution
Date	Date	Date	per Unit
July 3, 2014	July 15, 2014	July 29, 2014	\$.25364
August 5, 2014	August 15, 2014	August 29, 2014	\$.38632

6. CONTINGENCIES

Contingencies related to the royalty properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders. The Trustee is not aware of any such items as of June 30, 2014.

* * * * *

*Item 2. Trustee's Discussion and Analysis of Financial Condition and Results of Operations.***Liquidity and Capital Resources**

The Trust makes monthly distributions to the holders of Units of the excess of the preceding month's revenues received over expenses incurred. Upon receipt, royalty income is invested in short-term investments until its subsequent distribution. In accordance with the Trust Agreement, the Trust's only long-term assets consist of royalty interests in producing and proved undeveloped oil and gas properties. Although the Trust is permitted to borrow funds if necessary to continue its operations, borrowings are not anticipated in the foreseeable future.

Results of Operations

Distributable income consists of royalty income plus interest income plus any decrease in cash reserves established by the Trustee less general and administrative expenses of the Trust less any increase in cash reserves established by the Trustee. Distributable income for the three months ended June 30, 2014 was \$15,726,562, or \$1.08 per unit. Royalty income for the three months ended June 30, 2014 amounted to \$16,538,597 while interest income was \$1,359. General and administrative expenses totaled \$813,394 for the three months ended June 30, 2014.

Distributions during the period were \$.42267, \$.39808, and \$.42298 per Unit payable to Unit holders of record on April 15, May 15, and June 16, 2014, respectively.

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Royalty income for the quarter ended June 30, 2014 increased approximately \$2,681,000 or 19% compared with the second quarter of 2013. This increase was primarily caused by increases in the pricing of both natural gas and oil (\$2.7 million) along with an increase in the production of oil (\$1.7 million). These increases were offset somewhat by a decrease in the production of natural gas (\$1.3 million) along with a decrease in net proceeds payable to the Trust due to a delay in the timing of the receipt of a refund of previously withheld state income taxes received (\$0.4 million).

Compared to the preceding quarter ended March 31, 2014, royalty income increased approximately \$2,763,000 or 20%, due mainly to increases in the pricing of both natural gas and oil (\$2.5 million) along with an increase in the production of both natural gas and oil (\$0.3 million).

Royalty income for the six months ended June 30, 2014 increased \$955,000 or 3% compared with the same time period in 2013. This increase was due mainly to an increase in the pricing of both natural gas and oil (\$3.8 million) and an increase in the production of oil (\$2.0 million) and a decrease in operating expenses (\$0.2 million). These increases were offset somewhat by a decrease in the production of natural gas (\$4.5 million) along with an increase in state income taxes withheld on payments to the Trust (\$0.6 million).

The following tables illustrate average prices received for the periods discussed above and the related oil and gas production volume:

	June 30, 2014	Quarter Ended June 30, 2013	March 31, 2014
Production			
Oil (Bbls)	122,226	103,589	120,819
Gas (Mcf)	1,388,575	1,642,953	1,362,625
Average Price			
Oil (per Bbl)	\$ 89.34	\$ 85.89	\$ 80.43
Gas (per Mcf)	\$ 4.96	\$ 3.55	\$ 3.92

	June 30, 2014	Six-Months Ended June 30, 2013
Production		
Oil (Bbls)	243,045	219,774
Gas (Mcf)	2,751,200	3,769,113
Average Price		
Oil (per Bbl)	\$ 84.91	\$ 83.46
Gas (per Mcf)	\$ 4.44	\$ 3.51

Gas revenues received for the three months ended June 30, 2014, related primarily to production for January through March 2014. The average price of gas as reported by the Henry Hub for the same time period was \$4.66 per Mcf. The average price of gas for the Henry Hub was \$4.40 per Mcf for January through June 2014. Oil revenues for the three months ended June 30, 2014 related primarily to production for February through April 2014. The average price of oil

as reported by NYMEX for that time period was \$101.09 per barrel. The average price of oil was \$100.84 per barrel for January through June 2014. As of July 21, 2014, the average price of gas for the Henry Hub was \$3.48 per Mcf and the average price of oil reported by NYMEX was \$104.59 per barrel. It is difficult to accurately estimate future prices of oil and gas, and any assumptions concerning future prices may prove to be incorrect.

Interest income for the quarter ended June 30, 2014 decreased approximately \$400 compared with the second quarter of 2013. Compared to the preceding quarter ended March 31, 2014, interest income increased approximately \$100. Interest income for the six months ended June 30, 2014 decreased approximately \$600 compared to the same time period in 2013. Changes in interest income are the result of changes in interest rates and funds available for investment.

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General and administrative expenses for the quarter ended June 30, 2014 increased by approximately \$91,500 compared to the same quarter of 2013 primarily due to increases in revenue processing fees of approximately \$68,900; printing and unitholder information services of approximately \$46,900 and legal and other professional fees of approximately \$22,500. These increases were offset somewhat by decreases in engineering services of approximately \$25,500 and decreases in escrow agent/trustee fees of approximately \$22,700.

Compared to the previous quarter ended March 31, 2014, general and administrative expenses increased \$204,100 due mainly to printing and unitholder information services of approximately \$159,200; timing of payment of engineering services of approximately \$129,500 and revenue processing fees of approximately \$57,500. These increases were offset somewhat by decreases in legal and other professional fees of approximately \$48,700; timing of payment of the New York Stock Exchange annual listing fee of \$42,000 in the first quarter; decrease in engineering fees of approximately \$33,000 and a decrease in the escrow agent/trustee fees of approximately \$18,100.

Administrative expenses increased \$205,100 for the six months ended June 30, 2014 compared to the same time period in 2013 due primarily to increases in legal and other professional fees of approximately \$88,200; revenue processing fees of approximately \$79,600; printing and unitholder information services of approximately \$63,200 and an increase in audit fees of approximately \$32,500. These increases were tempered somewhat by a decrease in escrow agent/trustee fees of approximately \$33,700 as well as a decrease in engineering fees of approximately \$25,500.

The financial statements of the Trust differ from financial statements prepared in conformity with accounting principles generally accepted in the United States of America because of the following:

Royalty income is recognized in the month received rather than in the month of production.

Expenses other than those expected to be paid on the following monthly record date are not accrued.

Amortization of the Royalties is shown as a reduction to Trust corpus and not as a charge to operating results.

Reserves may be established for contingencies that would not be recorded under accounting principles generally accepted in the United States of America.

This comprehensive basis of accounting other than GAAP corresponds to the accounting permitted for royalty trusts by the U.S. Securities and Exchange Commission, as specified by Staff Accounting Bulletin Topic 12:E, *Financial Statements of Royalty Trusts*.

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Critical Accounting Policies and Estimates

The Trust's financial statements reflect the selection and application of accounting policies that require the Trust to make significant estimates and assumptions. The following are some of the more critical judgement areas in the application of accounting policies that currently affect the Trust's financial condition and results of operations.

Basis of Accounting

The financial statements of the Trust are prepared on the following basis and are not intended to present financial position and results of operations in conformity with accounting principles generally accepted in the United States of America:

Royalty income, net of severance and ad valorem taxes, and interest income are recognized in the month in which amounts are received by the Trust.

Trust expenses, consisting principally of routine general and administrative costs, include payments made during the accounting period. Expenses are accrued to the extent of amounts that become payable on the next monthly record date following the end of the accounting period. Reserves for liabilities that are contingent or uncertain in amount may also be established if considered necessary.

Royalties that are producing properties are amortized using the unit-of-production method. This amortization is shown as a reduction of Trust corpus.

Distributions to Unit holders are recognized when declared by the Trustee.

Revenue Recognition

Revenues from royalty interests are recognized in the period in which amounts are received by the Trust. Royalty income received by the Trust in a given calendar year will generally reflect the proceeds, on an entitlements basis, from natural gas produced for the twelve-month period ended September 30th in that calendar year and from oil produced for the twelve-month period ended October 31st in the same calendar year.

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Reserve Disclosure

The SEC and the Financial Accounting Standards Board requires supplemental disclosures for oil and gas producers based on a standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities. Under this disclosure, future cash inflows are computed by applying the average prices during the 12-month period prior to the fiscal year-end, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions. Future price changes are only considered to the extent provided by contractual arrangements in existence at year end. The standardized measure of discounted future net cash flows is achieved by using a discount rate of 10% a year to reflect the timing of future cash flows relating to proved oil and gas reserves. Numerous uncertainties are inherent in estimating volumes and the value of proved reserves and in projecting future production rates and the timing of development of nonproducing reserves. Such reserve estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production may be substantially different from the reserve estimates. Other than those filed with the SEC, our estimated reserves have not been filed with or included in any reports to any federal agency.

Contingencies

Contingencies related to the royalty properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders. The Trustee is not aware of any such items as of June 30, 2014.

Use of Estimates

The preparation of financial statements in conformity with the basis of accounting described above requires management to make estimates and assumptions that affect reported amounts of certain assets, liabilities, revenues and expenses as of and for the reporting periods. Actual results may differ from such estimates.

Impairment

The Trustee routinely rev