

McDep Energy Income Producers

A Weekly Analysis of Royalty Trusts and Master Limited Partnerships

February 24, 2004

Tax Time

Summary and Recommendation

A U.S. taxable investor in the 35% bracket who purchased buy-recommended **San Juan Basin Royalty Trust (SJT)** as well as **Hugoton Royalty Trust (HGT)**, **Sabine Royalty Trust (SBR)** and **Cross Timbers Royalty Trust (CRT)** at the beginning of last year received cash distributions after tax of 13.5%, 12.4%, 12.2% and 10.0% respectively for 2003 (see Table on page 2). We calculate those results using final tax information just disclosed. Because of cost depletion, new purchasers of royalty trusts can defer most or all of what would otherwise be a current tax obligation. On stock prices today that are higher than at the beginning of 2003, futures prices imply 2004 cash returns of 9.6%, 9.5%, 9.6% and 8.5% respectively (see Table headed Rank by EV/Ebitda, page 5). The main variable is commodity price, a factor that we consider more of an opportunity than a risk in today's environment particularly for income investors who may be too dependent on fixed dollar commitments.

Endure Moderate Complexity to Defer Income Taxation

Royalty trusts are attractive investments on the basis of their concentration on long-life natural resources and current cash distributions, as we see it. We also believe that royalty trusts are suitable for tax-exempt investors such as endowments, pension funds and individual retirement accounts. In addition, taxable investors can defer current taxation by claiming cost depletion and filing a moderate amount of further detail on tax forms. We describe that process for those trusts that have disclosed final tax information for 2003.

For purposes of discussion we assume the purchase of \$100,000 of a royalty trust at the beginning of 2003. The amount chosen has enough zeroes so that we need not use many decimals in reflecting disclosures accurately. Aside from the name of the trust and the tax identification number, the first item to be reported by U.S. taxpayers is a gross income amount on Line 4 of Schedule E. The trustee furnishes the amount per unit. We have taken the amount for the full year while investors who bought or sold during the year would want to refer to further detail on the trusts' websites. Similarly tax payers report severance tax, a levy paid to the states in which production occurs, and administration expense. Interest income is reported separately on Schedule B.

Gross income minus severance tax, minus administration expense, plus interest may not match cash received during calendar 2003 because cash received in January represents

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income earned in December typically. As a result Form 1099 sent to taxpayers from brokers or fiduciaries will not likely match disclosures on Schedule E.

Royalty Trust Reporting for U.S. Income Tax

	<i>San Juan Basin Royalty Trust SJT</i>	<i>Hugoton Royalty Trust HGT</i>	<i>Sabine Royalty Trust SBR</i>	<i>Cross Timbers Royalty Trust CRT</i>
Sample Calculation Assuming \$100,000 Purchase 12/31/02				
Price 12/31/02 (\$/unit)	13.70	12.82	23.66	19.50
Units for \$100,000 invested 12/31/02	7,299	7,800	4,227	5,128
Gross income 2003 (\$)	15,976	17,115	12,384	12,943
Severance tax (\$)	1,569	1,380	906	1,879
Administration expense (\$)	264	67	831	222
Depletion (\$)	11,876	6,151	15,007	8,024
Royalty income taxable (\$)	2,268	9,517	(4,359)	2,817
Royalty income before depletion (\$)	14,144	15,668	10,648	10,841
Interest income (\$)	7	6	14	4
Cash income (\$)	14,151	15,673	10,662	10,845
	14.2%	15.7%	10.7%	10.8%
Depletion (\$)	11,876	6,151	15,007	8,024
Taxable income (\$)	2,275	9,523	(4,346)	2,821
Income tax at 35% (\$)	796	3,333	(1,521)	987
Nonconventional Fuel Source Credit (\$)	135	12	-	133
Cash income after tax (\$)	13,489	12,353	12,183	9,990
	13.5%	12.4%	12.2%	10.0%

Input for U.S. Income Tax Return

Form 1040, Schedule E:

Line 4	Gross income 2003 (\$/unit)	2.188780	2.194125	2.930078	2.523830
Line 16	Severance tax (\$/unit)	0.214966	0.176930	0.214244	0.366490
Line 18	Administration expense (\$/unit)	0.036116	0.008607	0.196541	0.043303
Line 20	Depletion factor	0.118758	0.061506	0.150073	0.080237
Schedule B:	Interest Income (\$/unit)	0.000941	0.000740	0.003272	0.000754
Form 1040:	Nonconventional Fuel Source Credit	0.018459	0.001600		0.025904

Short Reserve Life Best for Tax Purposes

The most important part of the tax process is the calculation of depletion. The presumption is that the amount of natural gas or oil resource is finite and that investors recover cost in proportion to the rate of resource depletion. The depletion factor for 2003 times the cost not yet recovered equals the dollar amount of depletion for 2003 that is not taxable as current income.

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More easily thought of as percentages, annual depletion rates range from 6% to 15%. The range of rates poses a dilemma. A higher rate is better for tax purposes because more depletion means less income immediately taxable.

After Tax Return Can Exceed Before Tax Return

Pursuing the tax calculations further it soon becomes apparent that depletion can offset most taxable income. SBR's after tax return of 12.2% exceeds the pre-tax return of 10.7%. Alas, such circumstances may not last. Reserves can be depleted only once and the annual dollar amount soon diminishes as the percentage is applied against a lower remaining undepleted base each succeeding year. When units are sold for more than the remaining undepleted amount, the difference up to the original cost is subject to a recapture tax.

Long Reserve Life Best for Investment Purposes

A lower depletion rate is better for investment valuation purposes because it implies that cash flow will last longer and should therefore be valued at a higher multiple. Because SJT is concentrated on a single area, the San Juan Basin, we feel that we can understand the fundamental outlook for production well enough to realize how the engineer's report understates investment potential (see *Stock Idea*, SJT, April 2, 2003 for a reconciliation of our work with that of the engineer).

In the case of CRT and HGT the longer reserve life implied by the reported reserves is more realistic for investment purposes. In the case of SBR, it is clear in hindsight that the engineer's report has influenced us to underestimate reserve life for investment analysis most of the time since the trust paid its first distribution in 1983.

Different standards for tax purposes and investment purposes ought to be reconcilable. Taxes imply immediate cash outlays and a conservative standard may be appropriate particularly in the current environment where government policy encourages risk taking.

Six-Year Natural Gas Price Holding

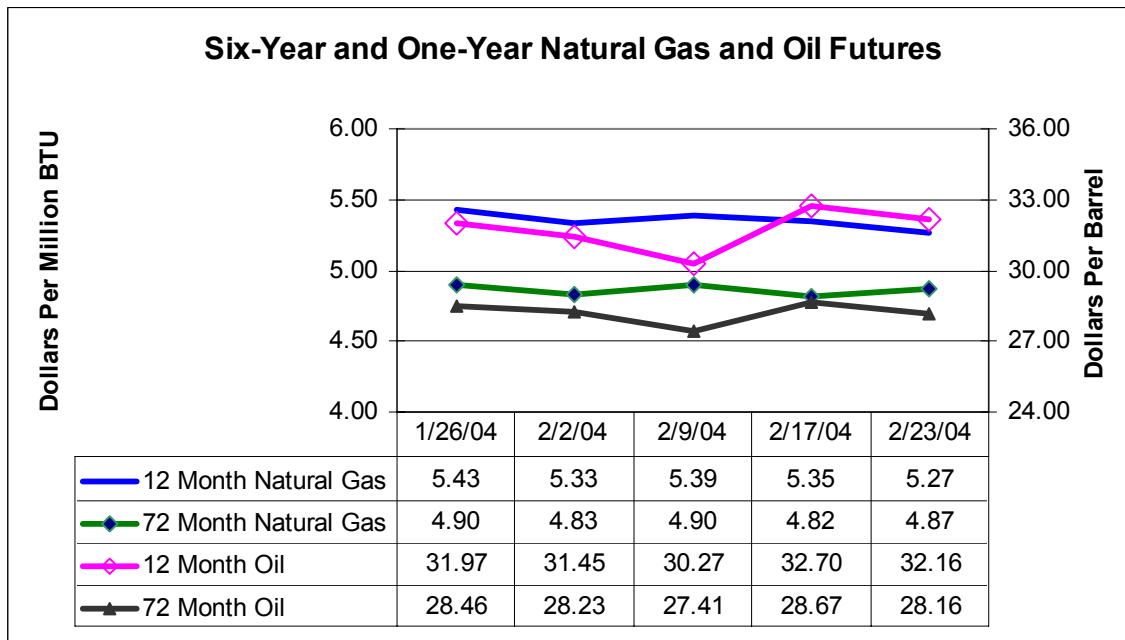
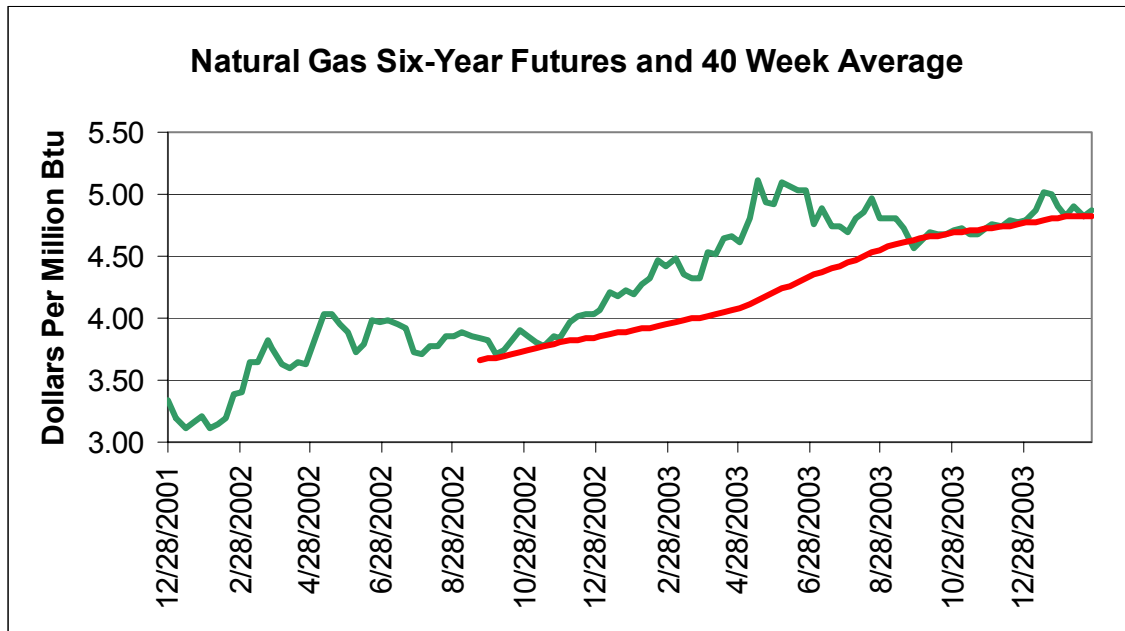
In contrast to the vigorous trend currently for six-year oil, six-year natural gas is only a few cents above the 40 week average (see Chart). We can always be surprised on the near term direction while the signs remain positive for longer term strength.

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Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating		Price (\$/sh) 23-Feb 2004	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Master Limited Partnerships and Canadian Royalty Trusts								
Kinder Morgan Energy Partners, L.P.	KMP	S	44.99	140.1	6,300	14.00	0.48	2.15
Kinder Morgan Management, LLC	KMR	S	41.85	48.6	2,030	14.00	0.48	2.03
Pengrowth Energy Trust	PGH		14.05	120.0	1,690	12.00	0.14	1.15
Enerplus Resources Fund	ERF		28.74	88.5	2,540	25.00	0.14	1.13
Dorchester Minerals, L.P.	DMLP		17.66	27.0	480	17.00	-	1.04
Provident Energy Trust	PVX		7.89	70.6	560	7.50	0.25	1.04
Canadian Oil Sands Trust (US\$)	COSWF	B	37.99	86.9	3,300	50.00	0.23	0.81
	<i>Total or Median</i>				16,900		0.23	1.13
U.S. Royalty Trusts								
Sabine Royalty Trust	SBR		29.39	14.6	430	26.00	-	1.13
Permian Basin RT (41%)	PBT		8.40	19.1	160	7.50	-	1.12
Cross Timbers Royalty Trust	CRT		27.17	6.0	163	25.00	-	1.09
Hugoton RoyaltyTrust (46%)	HGT		19.66	18.4	360	20.00	-	0.98
San Juan Basin Royalty Trust	SJT	B	19.40	46.6	900	22.00	-	0.88
	<i>Total or Median</i>				2,000		-	1.09

Buy/Sell rating after symbol: B - Buy, S - Sell

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating		Price (\$/sh) 23-Feb 2004	EV/ Sales NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)	PV/ Ebitda NTM
Master Limited Partnerships and Canadian Royalty Trusts								
Kinder Morgan Energy Partners, L.P.	KMP	S	44.99	3.2	19.2	23	6.0	8.9
Kinder Morgan Management, LLC	KMR	S	41.85	3.1	18.1	21	6.5	8.9
Dorchester Minerals, L.P.	DMLP		17.66	9.1	10.0	25	10.0	9.6
Canadian Oil Sands Trust (US\$)	COSWF	B	37.99	4.8	9.2	15	4.0	11.3
Enerplus Resources Fund	ERF		28.74	5.3	7.2	12	11.2	6.4
Pengrowth Energy Trust	PGH		14.05	4.8	6.8	12	13.7	5.9
Provident Energy Trust	PVX		7.89	3.7	5.6	30	13.9	5.4
	<i>Median</i>			4.8	9.2	21	10.0	8.9
U.S. Royalty Trusts								
Cross Timbers Royalty Trust	CRT		27.17	8.2	11.6	12	8.5	10.7
Sabine Royalty Trust	SBR		29.39	10.1	10.5	10	9.6	9.3
Permian Basin RT (41%)	PBT		8.40	7.0	9.8	11	8.9	8.7
Hugoton RoyaltyTrust (46%)	HGT		19.66	6.5	8.6	11	9.5	8.8
San Juan Basin Royalty Trust	SJT	B	19.40	6.8	8.4	10	9.6	9.5
	<i>Median</i>			7.0	9.8	11	9.5	9.3

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended December 31, 2004; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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