

U.S. Natural Gas Royalty Trusts

A Weekly Analysis

October 29, 2004

Founding Fathers

Summary and Recommendation

We pay tribute to the founders of the royalty trusts that are still providing welcome income to holders 25 years after the oldest was formed. Mr. Jon Brumley fathered **San Juan Basin Royalty Trust (SJT)** and **Permian Basin Royalty Trust (PBT)** in 1980 and **Cross Timbers Royalty Trust (CRT)** in 1992. Mr. Brumley also founded the predecessor of **XTO Energy (XTO)** whose successor chief executive, Mr. Bob Simpson, fathered **Hugoton Royalty Trust (HGT)** in 1998. Mr. Boone Pickens founded the oldest of the trusts in our coverage, **Mesa Royalty Trust (MTR)**, in 1979. Mr. Preston Peak founded **Dorchester Hugoton, Ltd.**, predecessor of **Dorchester Master Limited Partnership (DMLP)**, in 1982. Finally, the late Ashley Priddy formed **Sabine Royalty Trust (SBR)** also in 1982.

Mr. Pickens Restarts a Movement with MTR

Marine Petroleum Trust (MARPS) may have been a model for MTR. MARPS has traded since about 1956 as a holder of interests in properties originally owned by Gulf Oil, now part of Chevron. We give Mr. Pickens credit for picking up on a good idea and taking it to a higher level by catalyzing the formation of each of the trusts and partnerships discussed here and more. MTR was formed with interests in the Hugoton field held by Mesa Petroleum. Mesa later reacquired about 90% of Mesa Royalty Trust leaving the untendered shares as the smaller Mesa Royalty Trust that trades today.

In an ironic turn of events, Gulf, the grantor of rights to MARPS, became the target of a proposal by Mr. Pickens that Gulf Oil turn the whole company into a royalty trust. Management that rejected the proposal were soon rejected themselves. The values in Gulf were unlocked by a sale of the company to Chevron. Rather than leave a legacy as a royalty trust, the Seven Sister oil giant disappeared into one of the remaining Six Sisters at the time. A veteran oil analyst may have had that historic example in mind when he brought up the royalty trust idea in a question on the analyst call with Burlington Resources on October 21, 2004.

Mr. Brumley Expands on a Good Idea

Recall that 1979 and 1980 were the days of most powerful commodity price and stock price advances for oil and gas. For companies that wanted to transfer real value to shareholders, the tax-free spinoff of an entity that then avoided double taxation seemed attractive. Thinking that if one royalty trust was good, two should be better, Mr. Brumley

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had his company, Southland Royalty, distribute natural gas properties in SJT and oil properties in PBT.

The wisdom of Mr. Brumley's move was proven within a few years when Burlington Resources acquired Southland Royalty in an unfriendly transaction. Missing most of the original Southland assets, the acquirer later purchased half of PBT in a tender offer intended to snare all of PBT. The holders of SJT and PBT have done better by being able to keep their interests as opposed to being bought out by BR and reinvesting the proceeds in BR or another typical operating company.

SBR Sets a New Standard

While the name is royalty trust, not all the properties are true royalties. What we also call natural royalty is a net revenue interest in underlying production with no obligation to pay for development or to bear any of the costs of production other than state taxes. Buying true royalties is just what Mr. Priddy of Sabine Royalty Company did for years. Those interests in properties operated by others were spun off in the Sabine Royalty Trust. From the beginning we underestimated the potential of SBR. We may not have appreciated the lower risk characteristic of the natural royalty. Nor did we realize how greatly understated was the official estimate of remaining production from the many scattered properties in SBR.

Mr. Peak Takes the Long View

Mr. Peak formed Dorchester Hugoton with natural gas properties owned by Dorchester Gas that had little near-term value to the potential acquirers of the parent. Indeed we initially rejected doing research on Dorchester Hugoton because it was too small. We knew that Dorchester Hugoton had a lot of gas, but we also knew the gas was sold for practically nothing. We soon changed our mind and were willing to anticipate that the day was coming when even the most rigidly regulated natural gas supplies would be freed from price controls. Today's spot price of natural gas, \$8 a million btu's is 50 times the price that Dorchester Hugoton received when it was formed.

Mr. Peak found his successor in Casey McManemin the general partner of Dorchester Minerals, successor to Dorchester Hugoton. Mr. McManemin appears to have inherited Ashley Priddy's interest in royalty properties. The DMLP GP is the only person we have met who seems to have a thorough understanding of all the properties in SBR. The properties Mr. McManemin contributed to DMLP are mineral interests accumulated patiently over a period of years on behalf of pension funds and endowments. That accumulation continues on behalf of DMLP unitholders with a recently announced acquisition.

Unlike U.S. royalty trusts, master limited partnerships can buy and sell properties, sell stock and take on debt. Those advantages are often abused. DMLP is a master limited

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partnership in a class by itself without debt and exploding general partner compensation. It has royalty trust quality. Like royalty trusts it can be held in tax deferred accounts like Individual Retirement Accounts.

CRT Combines Characteristics of SJT, PBT and SBR

After more than a decade of seeing royalty trusts perform, Mr. Brumley combined the characteristics he liked into a single new entity. Combining the resource emphasis of SJT and PBT, he put both San Juan Basin natural gas and long-life oil production in CRT. Replicated SBR strength, most of the CRT assets are in the form of natural royalties.

HGT Picks a Magic Name

When XTO Energy formed HGT, we said, "With a name like Hugoton, how can we not be interested?" Of course the trust has the quality properties connoted. The newest of trusts in our coverage is still held in part by XTO. If experience with CRT is any indication, we can look to XTO to distribute units of HGT to its shareholders over the next few years.

Kurt H. Wulff, CFA

U.S. Natural Gas and Oil Royalty Trusts

The Account

	<i>Symbol</i>	<i>Price (\$/un) 28-Oct 2004</i>	<i>Units</i>	<i>Market Value (\$)</i>	<i>Next Twelve Months Distrib. (\$/un)</i>	<i>Distrib. Yield (%/yr)</i>
Cross Timbers Royalty Trust	CRT	35.39	400	14,156	3.34	9.4
Dorchester Minerals, L.P.	DMLP	23.00	700	16,100	2.35	10.2
Hugoton Royalty Trust	HGT	27.73	500	13,865	2.97	10.7
Mesa Royalty Trust	MTR	68.08	200	13,616	6.58	9.7
Permian Basin Royalty Trust	PBT	12.89	1,200	15,468	1.19	9.2
Sabine Royalty Trust	SBR	37.25	400	14,900	3.72	10.0
San Juan Basin Royalty Trust	SJT	30.66	500	15,330	3.19	10.4
	<i>Total</i>			<i>103,435</i>		<i>9.9</i>
Futures Strip						
12 Month - Oil (\$/bbl)		48.67				
12 Month - Natural Gas (\$/mmbtu)		7.85				
72 Month - Oil (\$/bbl)		42.16				
72 Month - Natural Gas (\$/mmbtu)		6.44				

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