

SAN JUAN BASIN ROYALTY TRUST

Form 10-Q

November 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Quarterly Period Ended September 30, 2006**

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 No. 1-8032**

**SAN JUAN BASIN ROYALTY TRUST**

(Exact name of registrant as specified in the  
Amended and Restated San Juan Basin Royalty Trust Indenture)

Texas  
(State or other jurisdiction  
of incorporation or organization)

75-6279898  
(I.R.S. Employer  
Identification No.)

Compass Bank, Trust Department  
2525 Ridgmar Boulevard, Suite 100  
Fort Worth, Texas 76116  
(Address of principal executive offices)

(Zip Code)  
(866) 809-4553

(Registrant's telephone number, including area code)

N/A

(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  No   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Act).

Large Accelerated Filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Number of Units of beneficial interest outstanding at November 7, 2006: 46,608,796

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Certification Required by Rule 13a-14(b) - Lee Ann Anderson

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**SAN JUAN BASIN ROYALTY TRUST  
PART 1  
FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The condensed financial statements included herein have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 47, released September 16, 1982, the financial statements of the San Juan Basin Royalty Trust (the Trust ) continue to be prepared in a manner that differs from accounting principles generally accepted in the United States of America ( GAAP ); this form of presentation is customary to other royalty trusts. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted pursuant to Rule 10-01 of Regulation S-X promulgated under the Securities Exchange Act of 1934, although Compass Bank, the Trustee of the Trust, believes that the disclosures are adequate to make the information presented not misleading. These condensed financial statements should be read in conjunction with the financial statements and the notes thereto included in the Trust s Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of the Trustee, all adjustments, consisting only of normal recurring adjustments, have been included that are necessary to present fairly the assets, liabilities and trust corpus of the San Juan Basin Royalty Trust at September 30, 2006, and the distributable income and changes in trust corpus for the three-month periods and nine-month periods ended September 30, 2006 and 2005. The distributable income for such interim periods is not necessarily indicative of the distributable income for the full year.

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CONDENSED STATEMENTS OF ASSETS, LIABILITIES AND TRUST CORPUS**

|                                                                                                                                                                                                    | <b>September<br/>30,<br/>2006<br/>(Unaudited)</b> | <b>December 31,<br/>2005</b> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------|------------------------------|
| <b>ASSETS</b>                                                                                                                                                                                      |                                                   |                              |
| Cash and short-term investments                                                                                                                                                                    | \$ 10,656,319                                     | \$ 19,173,162                |
| Net overriding royalty interest in producing oil and gas properties (net of accumulated amortization of \$110,981,666 and \$109,394,034 at September 30, 2006 and December 31, 2005, respectively) | 22,293,862                                        | 23,881,494                   |
|                                                                                                                                                                                                    | <b>\$ 32,950,181</b>                              | <b>\$ 43,054,656</b>         |
| <b>LIABILITIES AND TRUST CORPUS</b>                                                                                                                                                                |                                                   |                              |
| Distribution payable to Unit Holders                                                                                                                                                               | \$ 10,541,461                                     | \$ 19,058,304                |
| Cash reserves                                                                                                                                                                                      | 114,858                                           | 114,858                      |
| Trust corpus 46,608,796 Units of beneficial interest authorized and outstanding                                                                                                                    | 22,293,862                                        | 23,881,494                   |
|                                                                                                                                                                                                    | <b>\$ 32,950,181</b>                              | <b>\$ 43,054,656</b>         |

**CONDENSED STATEMENTS OF DISTRIBUTABLE INCOME (UNAUDITED)**

|                                                  | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |                |
|--------------------------------------------------|---------------------------------------------|---------------|--------------------------------------------|----------------|
|                                                  | <b>2006</b>                                 | <b>2005</b>   | <b>2006</b>                                | <b>2005</b>    |
| Royalty income                                   | \$ 30,779,508                               | \$ 32,832,885 | \$ 109,792,831                             | \$ 107,370,970 |
| Interest income                                  | 601,349                                     | 44,893        | 1,136,032                                  | 110,249        |
|                                                  | 31,380,857                                  | 32,877,778    | 110,928,863                                | 107,481,219    |
| General and administrative expenditures          | 293,291                                     | 585,828       | 1,418,453                                  | 1,933,994      |
| Distributable income                             | \$ 31,087,566                               | \$ 32,291,950 | \$ 109,510,410                             | \$ 105,547,225 |
| Distributable income per Unit (46,608,796 Units) | \$ .666989                                  | \$ .692829    | \$ 2.349564                                | \$ 2.264533    |

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

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CONDENSED STATEMENTS OF CHANGES IN TRUST CORPUS (UNAUDITED)**

|                                                 | <b>Three Months Ended</b> |               | <b>Nine Months Ended</b> |               |
|-------------------------------------------------|---------------------------|---------------|--------------------------|---------------|
|                                                 | <b>September 30,</b>      |               | <b>September 30,</b>     |               |
|                                                 | <b>2006</b>               | <b>2005</b>   | <b>2006</b>              | <b>2005</b>   |
| Trust corpus, beginning of period               | \$ 22,803,487             | \$ 25,197,903 | \$ 23,881,494            | \$ 26,674,821 |
| Amortization of net overriding royalty interest | (509,625)                 | (639,915)     | (1,587,632)              | (2,116,833)   |
| Distributable income                            | 31,087,566                | 32,291,950    | 109,510,410              | 105,547,225   |
| Distributions declared                          | (31,087,566)              | (32,291,950)  | (109,510,410)            | (105,547,225) |
| Trust corpus, end of period                     | \$ 22,293,862             | \$ 24,557,988 | \$ 22,293,862            | \$ 24,557,988 |

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

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**SAN JUAN BASIN ROYALTY TRUST  
NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)**

**1. BASIS OF ACCOUNTING**

The San Juan Basin Royalty Trust (the Trust ) was established as of November 1, 1980. The financial statements of the Trust are prepared on the following basis:

Royalty income recorded for a month is the amount computed and paid with respect to the Trust's 75% net overriding royalty interest (the Royalty ) in certain oil and gas leasehold and royalty interests (the Underlying Properties ) by Burlington Resources Oil & Gas Company LP ( BROG ), the present owner of the Underlying Properties, to the Trustee for the Trust. Royalty income consists of the proceeds received by BROG from the sale of production from the Underlying Properties less accrued production costs, development and drilling costs, applicable taxes, operating charges, and other costs and deductions, multiplied by 75%. The calculation of net proceeds by BROG for any month includes adjustments to proceeds and costs for prior months and impacts the Royalty income paid to the Trust and the distribution to Unit Holders for that month.

Trust expenses recorded are based on liabilities paid and cash reserves established from Royalty income for liabilities and contingencies.

Distributions to Unit Holders are recorded when declared by the Trustee.

The conveyance which transferred the Royalty to the Trust provides that any excess of development and production costs applicable to the Underlying Properties over gross proceeds from such properties must be recovered from future net proceeds before Royalty income is again paid to the Trust.

The financial statements of the Trust differ from financial statements prepared in accordance with United States generally accepted accounting principles ( GAAP ) because revenues are not accrued in the month of production; certain cash reserves may be established for contingencies which would not be accrued in financial statements prepared in accordance with GAAP; expenses are recorded when paid instead of when incurred; and amortization of the Royalty calculated on a unit-of-production basis is charged directly to trust corpus instead of an expense. The basis of accounting used by the Trust is widely used by royalty trusts for financial reporting purposes.

**2. FEDERAL INCOME TAXES**

For federal income tax purposes, the Trust constitutes a fixed investment trust which is taxed as a grantor trust. A grantor trust is not subject to tax at the trust level. The Unit Holders are considered to own the Trust's income and principal as though no trust were

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in existence. The income of the Trust is deemed to have been received or accrued by each Unit Holder at the time such income is received or accrued by the Trust rather than when distributed by the Trust.

The Royalty constitutes an economic interest in oil and gas properties for federal income tax purposes. Unit Holders must report their share of the revenues of the Trust as ordinary income from oil and gas royalties and are entitled to claim depletion with respect to such income. The Royalty is treated as a single property for depletion purposes. The Trust has on file technical advice memoranda confirming such tax treatment.

Sales of production from coal seam wells drilled prior to January 1, 1993, qualified for federal income tax credits through 2002 but not thereafter. Accordingly, under present law, the Trust's production of gas from coal seam wells does not qualify for tax credit under Section 45 (formerly Section 29) of the Internal Revenue Code of 1986, as amended (the Section 45 Tax Credit). Congress has at various times since 2002 considered energy legislation, including provisions to reinstate the Section 45 Tax Credit in various ways and to various extents but no legislation that would qualify the Trust's current production for such credit has been enacted. Most recently, for example, on August 8, 2005, new energy tax legislation was enacted which, among other things, modified the Section 45 Tax Credit in several respects, but did not extend the credit for production from coal seam wells. No prediction can be made as to what future tax legislation affecting Section 45 of the Internal Revenue Code of 1986, as amended, may be proposed or enacted or, if enacted, its impact, if any, on the Trust and the Unit Holders.

The classification of the Trust's income for purposes of the passive loss rules may be important to a Unit Holder. As a result of the Tax Reform Act of 1986, royalty income such as that derived through the Trust will generally be treated as portfolio income and will not reduce passive losses.

**3. CONTINGENCIES**

See Part II Item 1 Legal Proceedings concerning the status of litigation matters.

**4. SETTLEMENTS AND LITIGATION**

In 2005, as part of the ongoing negotiations between the Trust and BROG concerning a number of revenue and expense audit issues, an aggregate of \$2,405,486 was included in calculating net proceeds paid to the Trust in settlement of certain of those audit issues.

In February 2006, as part of the ongoing negotiations between the Trust and BROG, \$393,923 was included in BROG's distribution to the Trust in payment of interest due on late payment of gross proceeds.

On November 11, 2005, an Arbitration Award was issued in favor of the Trust in the aggregate amount of \$7,683,699 in arbitration styled *San Juan Basin Royalty Trust vs. Burlington Resources Oil & Gas Company LP*. The purpose of the arbitration was to



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resolve certain joint interest audit issues as between the parties to the arbitration. On November 21, 2005, BROG filed its Original Petition to Vacate or to Modify or Correct Arbitration Award in the case styled *Burlington Resources Oil & Gas Company LP vs. San Juan Basin Royalty Trust*, No. 2005-74370, in the District Court of Harris County, Texas, 281<sup>st</sup> Judicial District. In this litigation, BROG alleged that the award in favor of the Trust should be vacated or modified because one of the issues decided was beyond the scope of the matters agreed to be arbitrated, the award was issued in manifest disregard of applicable law, and a portion of the award is barred by limitations. BROG also sought to recover its attorneys' fees. The Trust filed an answer and counterclaim in the litigation filed by BROG denying those allegations and asking that the arbitrator's award be confirmed. At the conclusion of a hearing conducted on April 20, 2006, the Court entered an Order denying BROG's motion to vacate and granting the Trust's application to confirm the Arbitration Award and on June 6, 2006, rendered a final judgment in favor of the Trust. However, on May 22, 2006, BROG filed a Notice of Appeal indicating its desire to appeal from the Order and any final judgment confirming the Arbitration Award and on July 5, 2006, filed a Motion for New Trial in the District Court of Harris County urging substantially similar arguments made at the hearing. The Trust responded to the Motion for New Trial and served BROG with post-judgment discovery requests. BROG's Motion for New Trial was overruled on August 4, 2006. BROG's distribution to the Trust for July 2006 included \$1,534,182 representing a portion of the Arbitration Award, plus accrued interest. Of this amount, \$1,325,826 (the equivalent of \$994,370 grossed up to account for the Trust's 75% net overriding royalty interest) was included in calculating the net proceeds paid to the Trust, and the accrued interest thereon was \$539,812. The balance of the Arbitration Award is pending BROG's appeal, which has been assigned No. 01-06-00485-CV in the First Court of Appeals in Houston, Texas. On August 24, 2006, BROG filed its Supersedeas Bond to secure payment of the balance of the Arbitration Award, plus interest, if the appeal is dismissed or BROG does not perform the adverse judgment which becomes final on appeal. BROG's brief in the Court of Appeals is due November 29, 2006. It is anticipated that the Trust's brief will be due January 29, 2007 and BROG's reply brief will be due February 19, 2007.

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

**Forward-Looking Information**

Certain information included in this Quarterly Report on Form 10-Q contains, and other materials filed or to be filed by the Trust with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Trust) may contain or include, forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, and Section 27A of the Securities Act of 1933. Such forward-looking statements may be or may concern, among other things, capital expenditures, drilling activity, development activities, production efforts and volumes, hydrocarbon prices, estimated future net revenues, estimates of reserves, the results of the Trust's activities, and regulatory matters. Such forward-looking statements generally are accompanied by words such as may, will, estimate, expect, predict, project, anticipate, goal, should, plan, intend, or other words that convey the uncertainty of future events or outcomes. Such statements reflect BROG's current view with respect to future events; are based on an assessment of, and are subject to, a variety of factors deemed relevant by Compass Bank, the Trustee of the Trust, and BROG and involve risks and uncertainties. These risks and uncertainties include volatility of oil and gas prices, product supply and demand, competition, regulation or government action, litigation and uncertainties about estimates of reserves. Should one or more of these risks or uncertainties occur, actual results may vary materially and adversely from those anticipated.

**Business Overview**

The Trust is an express trust created under the laws of the state of Texas by the San Juan Basin Royalty Trust Indenture (the Original Indenture) entered into on November 3, 1980, between Southland Royalty Company (Southland Royalty) and The Fort Worth National Bank. Effective as of September 30, 2002, the Original Indenture was amended and restated (the Original Indenture, as amended and restated, the Indenture). The Trustee of the Trust is Compass Bank (as a result of the merger discussed below).

On October 23, 1980, the stockholders of Southland Royalty approved and authorized that company's conveyance of a 75% net overriding royalty interest (equivalent to a net profits interest) to the Trust for the benefit of the stockholders of Southland Royalty of record at the close of business on the date of the conveyance (the Royalty) carved out of that company's oil and gas leasehold and royalty interests (the Underlying Properties) in properties located in the San Juan Basin of northwestern New Mexico. Pursuant to the Net Overriding Royalty Conveyance (the

Conveyance) the Royalty was transferred to the Trust on November 3, 1980, effective as to production from and after November 1, 1980 at 7:00 A.M.

On March 24, 2006 Compass Bancshares Inc., the parent company of Compass Bank, completed its acquisition of TexasBanc Holding Co., the parent company of TexasBank, the prior trustee of the Trust. On that same date, TexasBank merged with Compass Bank, and as a result, Compass Bank succeeded TexasBank as Trustee under the terms of the Indenture.

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The Royalty constitutes the principal asset of the Trust and the beneficial interests in the Trust are divided into that number of Units of Beneficial Interest (the Units) of the Trust equal to the number of shares of the common stock of Southland Royalty outstanding as of the close of business on November 3, 1980. Holders of Units are referred to herein as Unit Holders. Subsequent to the Conveyance of the Royalty, through a series of assignments and mergers, Southland Royalty's successor became BROG. On March 31, 2006, a subsidiary of ConocoPhillips completed its acquisition of Burlington Resources, Inc., BROG's parent. As a result, ConocoPhillips became the parent of Burlington Resources, Inc., which in turn, is the parent of BROG.

The function of the Trustee is to collect the income attributable to the Royalty, to pay all expenses and charges of the Trust, and then distribute the remaining available income to the Unit Holders. The Trust is not empowered to carry on any business activity and has no employees, all administrative functions being performed by the Trustee.

**Three Months Ended September 30, 2006 and 2005**

The Trust received Royalty income of \$30,779,508 and interest income of \$601,349 during the third quarter of 2006. There was no change in cash reserves. After deducting administrative expenses of \$293,291, distributable income for the quarter was \$31,087,566 (\$.666989 per Unit). In the third quarter of 2005, royalty income was \$32,832,885, interest income was \$44,893, there was no change in cash reserves, administrative expenses were \$585,828 and distributable income was \$32,291,950 (\$.692829 per Unit). Based on 46,608,796 Units outstanding, the per Unit distributions during the third quarter of 2006 were as follows:

|                   |               |
|-------------------|---------------|
| July              | \$.222023     |
| August            | .218797       |
| September         | .226169       |
| <br>Quarter Total | <br>\$.666989 |

The Royalty income distributed in the third quarter of 2006 was lower than that distributed in the third quarter of 2005. The average gas price decreased from \$5.85 per Mcf for the third quarter of 2005 to \$5.79 per Mcf for the third quarter of 2006, and gas production decreased in the quarter ended September 30, 2006 as compared to the quarter ended September 30, 2005. Production and development costs for the third quarter of 2006 were approximately \$3 million higher than production costs for the third quarter of 2005 primarily as a result of the implementation of projects included in the increased capital budget announced by BROG for 2006 and resulting increases in capital expenditures. Interest earnings for the quarter ended September 30, 2006, as compared to the quarter ended September 30, 2005, were higher, primarily due to additional interest received in July as part of the partial payment of the Arbitration Award described below in Part II Item 1 Legal Proceedings. Administrative expenses were higher in 2005 primarily as a result of differences in timing in the receipt and payment of these expenses and costs relating to obtaining the Arbitration Award.

The capital costs attributable to the Underlying Properties for the third quarter of 2006 and deducted by BROG in calculating Royalty income were approximately \$8.6 million.

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BROG's capital expenditure budget for the Underlying Properties for 2006 is estimated at \$37.6 million of which approximately \$16.9 million had been spent as of September 30, 2006; however, BROG reports that based on its actual capital requirements, the pace of regulatory approvals, and the mix of projects and swings in the price of natural gas, the actual capital expenditures for 2006 could range from \$20 million to \$45 million. Capital expenditures were approximately \$5.7 million for the third quarter of 2005. In 2005, approximately \$19.1 million in capital expenditures were deducted in calculating Royalty income. In February 2006, BROG informed the Trustee that the 2006 budget for the Underlying Properties anticipates 451 projects, including the drilling of 103 new wells to be operated by BROG and 50 wells to be operated by third parties. Of the new BROG-operated wells, 52 are projected to be conventional wells completed in the Pictured Cliffs, Mesaverde and/or Dakota formations, and the remaining 51 are projected as coal seam wells completed in the Fruitland Coal formation. A total of 40 of the wells operated by third parties are projected to be conventional wells and the remaining ten are projected to be coal seam wells. BROG projects approximately \$33 million will be spent on the new wells, and \$4.6 million will be expended in working over existing wells and in the maintenance and improvement of production facilities. BROG has announced that the budget for 2006 reflects the continuation of a shift toward increased development of conventional gas.

BROG has informed the Trustee that lease operating expenses and property taxes were \$6,592,348 and \$208,050, respectively, for the third quarter of 2006, as compared to \$6,115,517 and \$184,056, respectively, for the third quarter of 2005.

BROG has reported to the Trustee that during the third quarter of 2006, 13 gross (3.23 net) coal seam wells, one gross (0.04 net) coal seam miscellaneous project, one gross (0.04 net) coal seam payadd, one gross (0.03 net) coal seam recompletion, 46 gross (5.64 net) conventional wells, two gross (1.74 net) recompletions, and one gross (0.82 net) restimulation were completed on the Underlying Properties.

Forty-six gross (20.56 net) coal seam wells, five gross (0.21 net) coal seam payadds, five gross (3.57 net) coal seam recompletions, two gross (0.004 net) coal seam restimulations, 135 gross (34.81 net) conventional wells, four gross (0.02 net) conventional miscellaneous projects, seven gross (3.49 net) recompletions, and six (4.02 net) restimulations were in progress at September 30, 2006.

There were seven gross (1.09 net) coal seam wells, one gross (0.88 net) coal seam recavitation, two gross (0.61 net) coal seam recompletions, and 17 gross (3.20 net) conventional wells completed on the Underlying Properties as of September 30, 2005. Sixty-five gross (7.28 net) coal seam wells, two gross (0.86 net) coal seam recompletions, 55 gross (9.71 net) conventional wells, 11 gross (1.74 net) payadds, three gross (0.92 net) recompletions, and five gross (3.11 net) restimulations were in progress at September 30, 2005.

Gross acres or wells, for purposes of this discussion, means the entire ownership interest of all parties in such properties, and BROG's interest therein is referred to as the net acres or wells. A payadd is the completion of an additional productive interval in an existing completed zone in a well.

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Royalty income for the quarter ended September 30, 2006 is associated with actual gas and oil production during May 2006 through July 2006 from the Underlying Properties. Gas and oil sales from the Underlying Properties for the three months ended September 30, 2006 and 2005 were as follows:

|                         | <b>Three Months Ended<br/>September 30,</b> |             |
|-------------------------|---------------------------------------------|-------------|
|                         | <b>2006</b>                                 | <b>2005</b> |
| Gas:                    |                                             |             |
| Total sales (Mcf)       | 10,314,842                                  | 10,466,804  |
| Mcf per day             | 112,118                                     | 113,770     |
| Average price (per Mcf) | \$ 5.79                                     | \$ 5.85     |
| Oil:                    |                                             |             |
| Total sales (Bbls)      | 20,635                                      | 17,020      |
| Bbls per day            | 224                                         | 185         |
| Average price (per Bbl) | \$ 66.65                                    | \$ 49.70    |

Gas and oil sales attributable to the Royalty for the quarters ended September 30, 2006 and 2005 were as follows:

|                  | <b>Three Months Ended<br/>September 30,</b> |             |
|------------------|---------------------------------------------|-------------|
|                  | <b>2006</b>                                 | <b>2005</b> |
| Gas sales (Mcf)  | 5,585,866                                   | 6,163,750   |
| Oil sales (Bbls) | 11,206                                      | 10,017      |

Sales volumes attributable to the Royalty are determined by dividing the net profits received by the Trust and attributable to oil and gas, respectively, by the prices received for sales volumes from the Underlying Properties, taking into consideration production taxes attributable to the Underlying Properties. Since the oil and gas sales attributable to the Royalty are based on an allocation formula that is dependent on such factors as price and cost, including capital expenditures, the aggregate production volumes from the Underlying Properties may not provide a meaningful comparison to volumes attributable to the Royalty.

During the third quarter of 2006, average gas prices were \$0.06 lower than the average prices reported during the third quarter of 2005. The average price per barrel of oil during the third quarter of 2006 was \$16.95 per barrel higher than that received for the third quarter of 2005 due to increases in oil prices in world markets generally, including the posted prices applicable to oil sales attributable to the Royalty.

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BROG previously entered into two contracts for the sale of all volumes of gas produced from the Underlying Properties. These contracts provided for (i) the sale of such gas to Duke Energy and Marketing, L.L.C. and PNM Gas Services, respectively, (ii) the delivery of such gas at various delivery points through March 31, 2005, and from year-to-year thereafter until terminated by either party on twelve months' notice, and (iii) the sale of such gas at prices which fluctuate in accordance with published indices for gas sold in the San Juan Basin of New Mexico. Effective January 1, 2004, the rights and obligations of Duke Energy and Marketing L.L.C. were assumed by ConocoPhillips pursuant to an Assignment and Novation Agreement. By correspondence dated March 25, 2004, BROG notified ConocoPhillips of BROG's election to terminate such contract as of March 31, 2005. BROG then prepared a form of request for proposal and circulated it to a number of potential purchasers, including ConocoPhillips, inviting them to bid for the purchase of the gas currently sold under the contract expiring March 31, 2005. Effective as of April 1, 2005, BROG entered into two new contracts for the sale of all volumes of gas produced from the Underlying Properties and formerly sold to ConocoPhillips. These new contracts provide for (i) the sale of such gas to ChevronTexaco Natural Gas, a division of Chevron U.S.A. Inc. (ChevronTexaco), and Coral Energy Resources, L.P. (Coral), respectively, (ii) the delivery of such gas at various delivery points through March 31, 2007, and from year-to-year thereafter until terminated by either party on twelve months' notice, and (iii) the sale of such gas at prices which fluctuate in accordance with the published indices for gas sold in the San Juan Basin of New Mexico. With respect to BROG's contract with PNM Gas Services, BROG and PNM Gas Services entered into a letter agreement dated January 31, 2005, pursuant to which the parties waived the right to terminate the underlying contract as of March 31, 2006, so that the term of that contract will continue until at least March 31, 2007, and from year-to-year thereafter until terminated by either party upon twelve months' notice to the other. Neither BROG nor any of ChevronTexaco, Coral nor PNM gave notice to terminate the three contracts described above for the sale of all volumes of gas produced from the Underlying Properties and, accordingly, the terms of those contracts have been extended through March 31, 2008.

Confidentiality agreements with purchasers of gas produced from the Underlying Properties prohibit public disclosure of certain terms and conditions of gas sales contracts with those entities, including specific pricing terms and gas receipt points. Such disclosure could compromise the ability to compete effectively in the marketplace for the sale of gas produced from the Underlying Properties.

**Nine Months Ended September 30, 2006 and 2005**

For the nine months ended September 30, 2006, the Trust received Royalty income of \$109,792,831 and interest income of \$1,136,032. There was no change in cash reserves. After deducting administrative expenses of \$1,418,453, distributable income was \$109,510,410 (\$2.349564 per Unit) for the nine months ended September 30, 2006. For the nine months ended September 30, 2005, the Trust received Royalty income of \$107,370,970 and interest income of \$110,249. There was no change in cash reserves. After deducting administrative expenses of \$1,933,994, distributable income was \$105,547,225 (\$2.264533 per Unit) for the nine months ended September 30, 2005.

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The increase in distributable income from 2005 to 2006 resulted primarily from higher gas prices during the first half of 2006. Interest earnings for the nine months ended September 30, 2006, as compared to the nine months ended September 30, 2005 were higher primarily due to interest paid to the Trust in February 2006 in settlement of audit issues relating to the late payment of gross proceeds, to accrued interest paid to the Trust in July 2006 as a portion of the Arbitration Award, and also due to an increase in funds available for investment pending distribution as well as an increase in interest rates. General and administrative expenses were higher for the nine months ended September 30, 2005, as compared to the same period in 2006 primarily as a result of differences in timing in the receipt and payment of these expenses, but also as a result of expenses incurred in 2005 in the resolution of certain revenue and expense audit issues.

Capital expenditures incurred by BROG, attributable to the Underlying Properties, for the first nine months of 2006 amounted to approximately \$30.8 million. Capital expenditures were approximately \$14.4 million for the first nine months of 2005. Lease operating expenses and property taxes totaled \$17,209,468 and \$605,934, respectively, for the first nine months of 2006 as compared to \$15,809,068 and \$499,498, respectively, for the first nine months of 2005.

BROG has reported to the Trustee that during the nine months ended September 30, 2006, 25 gross (5.90 net) coal seam wells, two gross (0.08 net) coal seam miscellaneous projects, three gross (0.12 net) coal seam payadds, two gross (0.48 net) coal seam recompletions, 91 gross (13.61 net) conventional wells, two gross (0.003 net) payadds, two gross (1.74 net) recompletions, and three gross (2.50 net) restimulations were completed on the Underlying Properties.

There were 28 gross (0.41 net) conventional wells, two gross (0.004 net) payadds, 12 gross (2.50 net) coal seam wells, one gross (0.88 net) coal seam recavitation, two gross (0.61 net) coal seam recompletions, and five gross (0.20 net) miscellaneous coal seam capital projects completed on the Underlying Properties during the nine months ended September 30, 2005.

Royalty income for the nine months ended September 30, 2006 is associated with actual gas and oil production during November 2005 through July 2006 from the Underlying Properties. Gas and oil sales from the Underlying Properties for the nine months ended September 30, 2006 and 2005 were as follows:

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|                         | <b>Nine Months Ended<br/>September 30,</b> |             |
|-------------------------|--------------------------------------------|-------------|
|                         | <b>2006</b>                                | <b>2005</b> |
| Gas:                    |                                            |             |
| Total sales (Mcf)       | 31,118,008                                 | 32,618,591  |
| Mcf per day             | 113,985                                    | 119,482     |
| Average price (per Mcf) | \$ 6.77                                    | \$ 5.77     |
| Oil:                    |                                            |             |
| Total Sales (Bbls)      | 59,446                                     | 53,081      |
| Bbls per day            | 218                                        | 194         |
| Average price (per Bbl) | \$ 61.42                                   | \$ 46.68    |

Gas and oil sales attributable to the Royalty for the nine months ended September 30, 2006 and 2005 were as follows:

|                  | <b>Nine Months Ended<br/>September 30,</b> |             |
|------------------|--------------------------------------------|-------------|
|                  | <b>2006</b>                                | <b>2005</b> |
| Gas sales (Mcf)  | 17,318,681                                 | 20,084,548  |
| Oil sales (Bbls) | 32,908                                     | 32,713      |

During the first nine months of 2006, average gas and oil prices were higher than during the first nine months of 2005. Since the oil and gas sales attributable to the Royalty are based on an allocation formula that is dependant on such factors as price and cost, including capital expenditures, the aggregate sales amounts from the Underlying Properties may not provide a meaningful comparison to sales attributable to the Royalty.



**Table of Contents****Calculation of Royalty Income**

Royalty income received by the Trust for the three months and nine months ended September 30, 2006 and 2005, respectively, was computed as shown in the following table:

|                                                           | <b>Three Months Ended<br/>September 30,</b> |                      | <b>Nine Months Ended<br/>September 30,</b> |                       |
|-----------------------------------------------------------|---------------------------------------------|----------------------|--------------------------------------------|-----------------------|
|                                                           | <b>2006</b>                                 | <b>2005</b>          | <b>2006</b>                                | <b>2005</b>           |
| Gross proceeds of sales from the Underlying Properties:   |                                             |                      |                                            |                       |
| Gas proceeds                                              | \$ 59,729,249                               | \$ 61,276,528        | \$ 210,729,922                             | \$ 188,240,413        |
| Oil proceeds                                              | 1,375,288                                   | 845,878              | 3,651,097                                  | 2,478,003             |
| Other                                                     | 1,325,826(1)                                |                      | 1,325,826(1)                               | 2,405,486(2)(3)       |
| <b>Total</b>                                              | <b>62,430,363</b>                           | <b>62,122,406</b>    | <b>215,706,845</b>                         | <b>193,123,902</b>    |
| Less production costs:                                    |                                             |                      |                                            |                       |
| Severance tax gas                                         | 5,803,814                                   | 6,296,781            | 20,333,258                                 | 18,964,311            |
| Severance tax oil                                         | 139,490                                     | 87,509               | 366,035                                    | 254,395               |
| Lease operating expense and property tax                  | 6,800,398                                   | 6,299,573            | 17,815,402                                 | 16,308,566(2)(3)      |
| Other                                                     |                                             |                      | 42,968                                     | 42,505                |
| Capital expenditures                                      | 8,647,317                                   | 5,661,363            | 30,758,741                                 | 14,392,832            |
| <b>Total</b>                                              | <b>21,391,019</b>                           | <b>18,345,226</b>    | <b>69,316,404</b>                          | <b>49,962,609</b>     |
| Less excess production costs and interest from prior year |                                             |                      |                                            |                       |
| Net profits                                               | 41,039,344                                  | 43,777,180           | 146,390,441                                | 143,161,293           |
| Net overriding royalty interest                           | 75%                                         | 75%                  | 75%                                        | 75%                   |
| <b>Royalty income</b>                                     | <b>\$ 30,779,508</b>                        | <b>\$ 32,832,885</b> | <b>\$ 109,792,831</b>                      | <b>\$ 107,370,970</b> |

(1) BROG's distribution to the Trust for July 2006 included \$1,534,182 representing a portion of the Arbitration

Award referred to in Note 4 of the Notes to Condensed Financial Statements, plus accrued interest. Of this amount, \$1,325,826 (the equivalent of \$994,370 grossed up to account for the Trust's 75% net overriding royalty interest) was included in calculating the net proceeds paid to the Trust, and the accrued interest thereon was \$539,812.

- (2) In March 2005, as part of the ongoing negotiations between the Trust and BROG concerning a number of revenue and expense audit issues, \$833,851 was included in calculating net proceeds paid to the Trust by BROG in settlement of claims for interest on late payments of net proceeds and in settlement of certain other audit issues. Of that amount,

\$822,077 was included in settlement of claims for additional revenue and \$11,774 was included in settlement of claims concerning disputed lease operating expenses.

- (3) In May 2005, as part of the ongoing negotiations between the Trust and BROG concerning a number of revenue and expense audit issues, \$988,392 was included in calculating net proceeds

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paid to the Trust by BROG in settlement of certain of those audit issues. Of that amount, \$982,038 was included in net proceeds paid to the Trust by BROG in settlement of claims for additional revenue and \$6,354 was included in net proceeds in settlement of claims concerning disputed lease operating expenses.

**Contractual Obligations**

Under the Indenture governing the Trust, the Trustee is entitled to an administrative fee for its administrative services and the preparation of quarterly and annual statements of: (i) 1/20 of 1% of the first \$100 million of the annual gross revenue of the Trust, and 1/30 of 1% of the annual gross revenue of the Trust in excess of \$100 million and (ii) the Trustee's standard hourly rates for time in excess of 300 hours annually. As of January 1, 2003, the administrative fee due under items (i) and (ii) above will not be less than \$36,000 per year (as adjusted annually to reflect the increase (if any) in the Producers Price Index as published by the U.S. Department of Labor, Bureau of Labor Statistics).

**Effects of Securities Regulation**

As a publicly-traded trust listed on the New York Stock Exchange (the "NYSE"), the Trust is and will continue to be subject to extensive regulation under, among others, the Securities Act of 1933, the Securities Exchange Act of 1934 (which contains many of the provisions of the Sarbanes-Oxley Act of 2002) and the rules and regulations of the NYSE. Issuers failing to comply with such authorities risk serious consequences, including criminal as well as civil and administrative penalties. In most instances, these laws, rules and regulations do not specifically address their applicability to publicly-traded trusts, such as the Trust. In particular, the Sarbanes-Oxley Act of 2002 provides for the adoption by the Securities and Exchange Commission (the "Commission") and NYSE of certain rules and regulations that may be impossible for the Trust to literally satisfy because of its nature as a pass-through trust. It is the Trustee's intention to follow the Commission's and NYSE's rulemaking closely, attempt to comply with such rules and regulations and, where appropriate, request relief from these rules and regulations. However, if the Trust is unable to comply with such rules and regulations or to obtain appropriate relief, the Trust may be required to expend as yet unknown but potentially material costs to amend the Indenture that governs the Trust to allow for compliance with such rules and regulations. To date, the rules implementing the Sarbanes-Oxley Act of 2002 have generally made appropriate accommodation for passive entities such as the Trust.

**Critical Accounting Policies**

In accordance with the Commission's staff accounting bulletins and consistent with other royalty trusts, the financial statements of the Trust are prepared on the following basis:

Royalty income recorded for a month is the amount computed and paid pursuant to the Conveyance by BROG to the Trustee for the Trust. Royalty income consists of the proceeds received by BROG from the sale of production from the Underlying Properties less accrued production costs, development and drilling costs, applicable taxes, operating charges, and other costs and deductions, multiplied by 75%. The calculation of net proceeds by BROG for any month includes adjustments to proceeds and costs for prior months and impacts the

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Royalty income paid to the Trust and the distribution to Unit Holders for that month.

Trust expenses recorded are based on liabilities paid and cash reserves established from royalty income for liabilities and contingencies.

Distributions to Unit Holders are recorded when declared by the Trustee.

The Conveyance which transferred the Royalty to the Trust provides that any excess of development and production costs applicable to the Underlying Properties over gross proceeds from such properties must be recovered from future net proceeds before Royalty income is again paid to the Trust.

The financial statements of the Trust differ from financial statements prepared in accordance with GAAP because revenues are not accrued in the month of production; certain cash reserves may be established for contingencies which would not be accrued in financial statements prepared in accordance with GAAP; expenses are recorded when paid instead of when incurred; and amortization of the Royalty calculated on a unit-of-production basis is charged directly to trust corpus instead of an expense.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

The Trust invests in no derivative financial instruments, and has no foreign operations or long-term debt instruments. The Trust is a passive entity and is prohibited from engaging in business transactions, other than the Trust's ability to borrow money periodically as necessary to pay expenses, liabilities and obligations of the Trust that cannot be paid out of cash held by the Trust. The amount of any such borrowings is unlikely to be material to the Trust. The Trust is also permitted to hold short-term investments acquired with funds held by the Trust pending distribution to Unit Holders and funds held in reserve for the payment of Trust expenses and liabilities. Because of the short-term nature of these borrowings and investments and certain limitations upon the types of such investments which may be held by the Trust, the Trustee believes that the Trust is not subject to any material interest rate risk. The Trust is not permitted to engage in transactions in foreign currencies which could expose the Trust or Unit Holders to any foreign currency related market risk. The Trust is not permitted to market the gas, oil and/or natural gas liquids from the Underlying Properties. BROG is responsible for such marketing.

**Item 4. Controls and Procedures.**

The Trust maintains a system of disclosure controls and procedures that is designed to ensure that information required to be disclosed in the Trust's filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Trust is accumulated and communicated by BROG to the Trustee and its employees who participate in the preparation of the Trust's periodic reports to allow timely decisions regarding disclosure. Due to the pass-through nature of the Trust, BROG provides much of the information disclosed in this Form 10-Q and the other periodic reports filed by the Trust with the Commission.

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The Indenture does not require BROG to update or provide information to the Trust. Under the Conveyance transferring the Royalty to the Trust, BROG is obligated to provide the Trust with certain information concerning calculations of net proceeds owed to the Trust, among other information. Pursuant to the settlement of litigation in 1996 between the Trust and BROG, BROG agreed to new, more formal financial reporting and audit procedures as compared to those provided in the Conveyance.

The Trustee receives periodic updates from BROG regarding activities related to the Trust. Accordingly, the Trust's ability to timely report certain information required to be disclosed in the Trust's periodic reports is dependent on BROG's timely delivery of such information to the Trust. In order to help ensure the accuracy and completeness of the information required to be disclosed in the Trust's periodic reports, the Trust employs independent public accountants, joint interest auditors, marketing consultants, attorneys and petroleum engineers. These outside professionals advise the Trustee in its review and compilation of this information for inclusion in this Form 10-Q and the other periodic reports provided by the Trust to the Commission.

The Trustee has evaluated the Trust's disclosure controls and procedures as of September 30, 2006, and has concluded that such disclosure controls and procedures are effective at the reasonable assurance level to ensure that material information related to the Trust is gathered on a timely basis to be included in the Trust's periodic reports. In reaching its conclusion, the Trustee considered the Trust's dependence on BROG to deliver timely and accurate information to the Trust. The Trustee has not reviewed the Trust's disclosure controls and procedures in concert with management, a board of directors or an independent audit committee. The Trust does not have, nor does the Indenture provide for, officers, a board of directors or an independent audit committee.

During the quarter ended September 30, 2006 there were no changes in the Trust's internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) that materially affected, or are reasonably likely to materially affect, the Trust's internal control over financial reporting. The Trustee has not evaluated the Trust's internal control over financial reporting in concert with management, a board of directors or an independent audit committee. The Trust does not have, nor does the Indenture provide for, officers, a board of directors or an independent audit committee.

**PART II  
OTHER INFORMATION**

**Item 1. Legal Proceedings.**

As discussed above under Part I Item 4 Controls and Procedures, due to the pass-through nature of the Trust, BROG provides much of the information disclosed in this Form 10-Q and the other periodic reports filed by the Trust with the Commission. Although the Trustee receives periodic updates from BROG regarding activities which may relate to the Trust, the Trust's ability to timely report certain information required to be disclosed in the Trust's periodic reports is dependent on BROG's timely delivery of the information to the Trust.

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On November 11, 2005, an Arbitration Award was issued in favor of the Trust in the aggregate amount of \$7,683,699 in arbitration styled *San Juan Basin Royalty Trust vs. Burlington Resources Oil & Gas Company LP*. The purpose of the arbitration was to resolve certain joint interest audit issues as between the parties to the arbitration. On November 21, 2005, BROG filed its Original Petition to Vacate or to Modify or Correct Arbitration Award in the case styled *Burlington Resources Oil & Gas Company LP vs. San Juan Basin Royalty Trust*, No. 2005-74370, in the District Court of Harris County, Texas, 281<sup>st</sup> Judicial District. In this litigation, BROG alleged that the award in favor of the Trust should be vacated or modified because one of the issues decided was beyond the scope of the matters agreed to be arbitrated, the award was issued in manifest disregard of applicable law, and a portion of the award is barred by limitations. BROG also sought to recover its attorneys' fees. The Trust filed an answer and counterclaim in the litigation filed by BROG denying those allegations and asking that the arbitrator's award be confirmed. At the conclusion of a hearing conducted on April 20, 2006, the Court entered an Order denying BROG's motion to vacate and granting the Trust's application to confirm the Arbitration Award and on June 6, 2006, rendered a final judgment in favor of the Trust. However, on May 22, 2006, BROG filed a Notice of Appeal indicating its desire to appeal from the Order and any final judgment confirming the Arbitration Award and on July 5, 2006, filed a Motion for New Trial in the District Court of Harris County urging substantially similar arguments made at the hearing. The Trust responded to the Motion for New Trial and served BROG with post-judgment discovery requests. BROG's Motion for New Trial was overruled on August 4, 2006. BROG's distribution to the Trust for July 2006 included \$1,534,182 representing a portion of the Arbitration Award, plus accrued interest. Of this amount, \$1,325,826 (the equivalent of \$994,370 grossed up to account for the Trust's 75% net overriding royalty interest) was included in calculating the net proceeds paid to the Trust, and the accrued interest thereon was \$539,812. The balance of the Arbitration Award is pending BROG's appeal, which has been assigned No. 01-06-00485-CV in the First Court of Appeals in Houston, Texas. On August 24, 2006, BROG filed its Supersedeas Bond to secure payment of the balance of the Arbitration Award, plus interest, if the appeal is dismissed or BROG does not perform the adverse judgment which becomes final on appeal. BROG's brief in the Court of Appeals is due November 29, 2006. It is anticipated that the Trust's brief will be due January 29, 2007 and BROG's reply brief will be due February 19, 2007.

In addition to the litigation described above, BROG is involved in various legal proceedings, the outcome of which may impact the Trust. Should certain legal proceedings to which BROG is a party be decided in a manner adverse to BROG, the amount of Royalty income received by the Trust could materially decrease. The Trust has not received from BROG any estimate of the amount of any potential loss in such proceedings, or the portion of any such potential loss that might be allocated to the Royalty.

**Item 6. Exhibits.**

- 4(a) Amended and Restated Royalty Trust Indenture, dated September 30, 2002 (the original Royalty Trust Indenture, dated November 1, 1980 having been entered into between Southland Royalty Company and The Fort Worth National Bank, as Trustee), heretofore filed as Exhibit 99.2 to the Trust's Current Report on Form 8-K filed with the Commission on October 1, 2002, is incorporated herein by reference.\*



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- 4(b) Net Overriding Royalty Conveyance from Southland Royalty Company to the Fort Worth National Bank, as Trustee, dated November 3, 1980 (without Schedules), heretofore filed as Exhibit 4(b) to the Trust's Annual Report on Form 10-K filed with the Commission for the fiscal year ended December 31, 1980, is incorporated herein by reference.\*
- 4(c) Assignment of Net Overriding Interest (San Juan Basin Royalty Trust), dated September 30, 2002, between Bank One, N.A. and TexasBank, heretofore filed as Exhibit 4(c) to the Trust's Quarterly Report on Form 10-Q filed with the Commission for the quarter ended September 30, 2002, is incorporated herein by reference.\*
- 31 Certification required by Rule 13a-14(a), dated November 8, 2006, by Lee Ann Anderson, Vice President and Senior Trust Officer of Compass Bank, the Trustee of the Trust.\*\*
- 32 Certification required by Rule 13a-14(b), dated November 8, 2006, by Lee Ann Anderson, Vice President and Senior Trust Officer of Compass Bank, on behalf of Compass Bank, the Trustee of the Trust.\*\*\*

\* A copy of this exhibit is available to any Unit Holder (free of charge) upon written request to the Trustee, Compass Bank, 2525 Ridgmar Boulevard, Suite 100, Fort Worth, Texas 76116.

\*\* Filed herewith.

\*\*\* Furnished herewith.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COMPASS BANK, AS TRUSTEE FOR  
THE SAN JUAN BASIN ROYALTY  
TRUST

By: /s/ Lee Ann Anderson  
Lee Ann Anderson  
Vice President and Senior Trust Officer

Date: November 8, 2006

(The Trust has no directors or executive officers.)

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**INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                            |
|---------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
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